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Submission to Standing Committee on Economics inquiry into Tax Deductibility

John Daley and Danielle Wood

1 Summary

We welcome the Standing Committee on Economics inquiry into tax deductibility.

Personal and company income tax deductions can erode the efficiency and integrity of the tax system and reduce the amount of revenue raised. Therefore tax deductions should only exist where they are well targeted to a particular policy objective.

This submission focuses on one widely used tax deduction that we consider is not delivering desirable policy outcomes in its current form: the full deductibility of investment losses, mainly rental losses (so called **negative gearing**).

In March this year, Grattan Institute will release a report, *Negative gearing and the capital gains tax*, which looks at the potential for reforms to capital gains tax and negative gearing to increase tax collections, reduce distortions in investment decisions and improve fairness. In this submission we set out some of the arguments for limiting the tax deductibility of investment losses.

First, if investors can write off their losses in full each year while they are only taxed on half their gains (because of the capital gains tax discount) then people can reduce and defer the taxes on their labour income. This is a popular tax minimisation strategy that ultimately comes at a cost to the budget bottom line. By international standards, Australia is unusually generous in the tax treatment of rental losses.

Second, along with the capital gains tax discount, unlimited negative gearing creates an incentive for investors to favour assets that pay more via capital gains and less via steady income. It also encourages investors to borrow as much as possible to finance investments. Ultimately, these tax benefits divert capital from more productive investments and increase volatility in housing markets.

Third, like most other tax deductions or concessions, the benefits of negative gearing accrue largely to those on higher incomes. The top 20 per cent of income earners before rental loss deductions receive around 70 per cent of the tax benefits from negative gearing. And while there are some nurses, teachers and cleaners that negatively gear property, it is much more common amongst lawyers and doctors and they generate much larger average tax benefits from doing so.

Finally, there is no basis for the claims from the property industry that negative gearing serves a broader social purpose in moderating house prices and rents. As we show in this submission, negative gearing puts *upward* pressure on house prices and plays very little role in moderating rents.

In our forthcoming report, we examine two options for reforming negative gearing:

- Quarantining losses so they can only be written off against other investment income (operating profits and capital gains) could raise around **$3 billion a year** in the short-term. This would decline to around **$2 billion** over time as those losses are offset against investment income.

- **Aligning the tax rates for capital gains and losses**. For example, the capital gains discount could be reduced so that investors pay tax on 75 per cent of their capital gains, and can deduct only 75 per cent of any investment losses. Treating capital gains and recurrent losses consistently would reduce tax incentives to borrow to invest. It would contribute around **$3.7 billion** a year to the bottom line.

Other proposals such as only allowing full deductibility of losses for new properties are somewhat less economically desirable but would still be a large improvement on current arrangements.

The best way to introduce the new arrangements would be to phase them in over a number of years. Such a phase-in will help smooth reductions in asset prices and reduce resistance to reform. Grandfathering is generally undesirable, because it introduces complexity and treats older and younger generations inconsistently. However, grandfathering tax concessions for properties that are already negatively geared may be a reasonable compromise because properties tend to become positively geared over time as rents increase and the loan principal is repaid.

2 Negative gearing provides a (widely used) tax shelter on wages

2.1 Negative gearing is an attractive tax strategy

Negative gearing allows taxpayers to subtract the losses they make on investments (after costs including mortgage interest payments) from their taxable income including wages.

The ability to deduct expenses incurred in generating assessable income is part of the normal operation of the Australian tax system, and applies to a wide range of investments and business activities. If losses were not deductible but gains were taxed, the asymmetry would make high-risk (high expected return) assets a less attractive investment. Deductibility of interest payments in theory maintains tax neutrality for investors choosing between debt and equity financing.[1]

But there is no theoretical basis for allowing losses on investment to be deducted against entirely unrelated income such as wages.

In contrast, taxes on capital gains are discounted by 50 per cent and only paid when the asset is sold.[2] Allowing full deductibility of investment losses against wages each year when capital gains are taxed concessionally and only on realisation leads investors to favour debt-financed investments that generate more of their returns via capital gains (Section 3).

With the right investment strategy, an investor can use this asymmetry in the tax treatment of gains and losses to pay less tax in total and later despite receiving additional investment income (Box 1).

Tax deductions from wage income may also generate "psychic payoff" for some investors – the pleasure of denying the Tax Office its due. As an investment strategy, negative gearing only makes sense if the expected capital gain exceeds the rental losses over the life of the investment.[3] But for some investors, reducing taxes on their wages has become one of the primary goals. Investment advisors have warned against investors placing too much emphasis on tax breaks and not enough on the financial returns to the investment.[4]

The attractiveness of using investment losses to reduce taxes on wage income is evident in the age profile of those negatively gearing property. Investing in loss making properties is popular amongst those of working age, but far less prevalent amongst over 60s who are unlikely to benefit from the tax write-offs. Over 70 per cent of those under 60 with investment properties make

[1] Fane and Richardson (2004)

[2] Under the current rules, net capital gains are included as part of assessable income. For individuals and small businesses, **50 per cent of their capital gains** are excluded from income if they hold the asset for more than one year.

[3] And this is more than the returns that could have been generated through other investments.

[4] See for example: Brown (2012). There is some evidence from the US of taxpayers placing disproportionate weight on tax deductions for investments . For example, taxpayers are far more likely to contribute to a tax deductible retirement saving account if they owe money to the Internal Revenue Service in excess of taxes withheld. Hubbard and Skinner (1996), p.76.

rental losses compared to less than 35 per cent over 60 (see Figure 1).

Box 1 Using negative gearing to reduce taxes on wage income

High-income investors can maximise the tax shelter on their wage income by borrowing to invest in assets that generate less in recurrent income and more through capital gains.

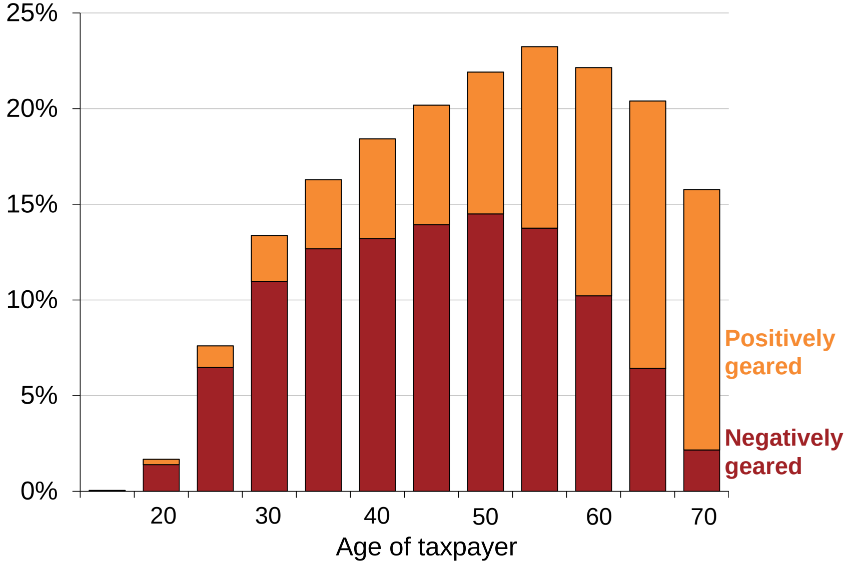
Suppose Dan, a lawyer earning $250,000 a year, borrows $750,000 to purchase an investment property. Interest on the loan is 6 per cent a year and the property generates a rental return of 2.5 per cent each year. Most of the return is via capital appreciation of 7 per cent each year.

In the first year, Dan makes a loss of $26,000 on the property and reduces the tax he pays on his $250,000 salary by $12,000. His rental losses decline over time as the property appreciates. After five years, Dan has reduced taxes on his wage income by a total of $55,000. If he sells the property after five years he will realise a capital gain of $233,000 and pay tax on the gain of just under $55,000.

Because of the asymmetry of tax treatment of gains and losses, Dan pays $294 less tax in total over five years than he if he had not purchased the house. So despite his profit of more than $115,000 on the investment, in effect he pays no tax on this profit, actually receiving a small tax reduction.

Figure 1: More people negatively gear property investments in their peak earning years

Percentage of 2012-13 taxpayers



Source: ATO (2015c); Grattan analysis.

The tax advantages are also evident in the greater propensity of those with negatively geared properties to “churn” their investments. Properties do not stay negatively geared forever. Rents tend to rise over time with increases in wages, while interest payments only vary with the interest rate, as the loan value is unchanged.[5] So if investors want to stay negatively geared they need to turnover their investments.

We see evidence of higher property turnover amongst negatively geared investors. Wood and Ong (2010) showed that 40 per cent of investors with rental properties retained their properties at the end of a 5 year period.[6] Amongst the investors that were negatively geared, however, only 20 per cent retained ownership. And the proportion of landlords that purchased another property after selling was slightly higher for negatively geared investors than other investors.[7]

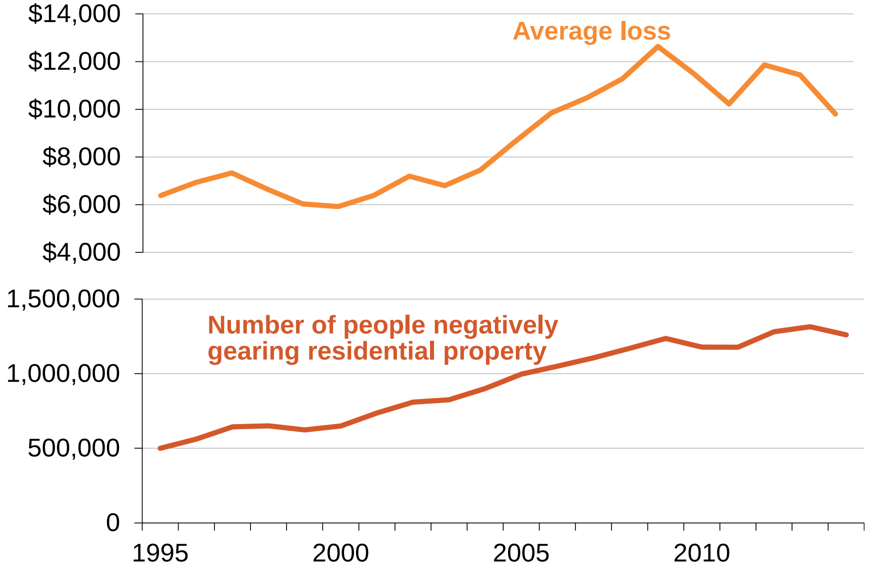
2.2 Investors have responded to the tax incentives

There has been a boom in negatively geared residential property investments over the last two decades. Other than a temporary dip following the global financial crisis, the number of taxpayers making losses on residential property has increased steadily. Average losses for those negative gearing have grown to more than $9,000 per year (Figure 2).

Australian landlords have moved from being collectively profitable, to accruing billions in net rental losses each year. This switch coincided with the introduction of the capital gains tax discount in 1999.

Figure 2: More people are negatively gearing and have higher losses

Number of people negative gearing residential property and average net rental losses ($ 2013-14)



Source: Grattan analysis based on ATO (2015c)

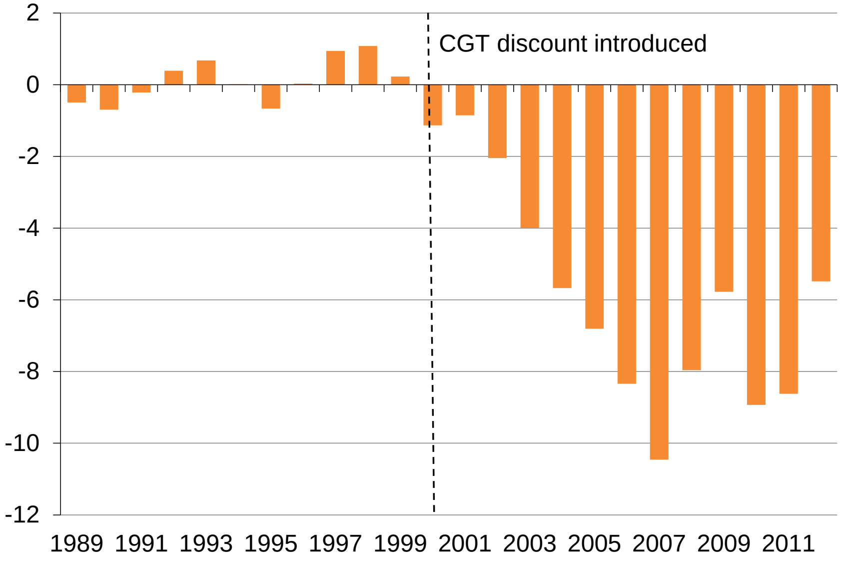
In the year before the introduction of the discount, Australia's 1.3 million landlords made an aggregate taxable *profit* of $700 million in real terms. By 2012-13, the 2 million landlords reported collective *losses* of $5.5 billion (Figure 3).[8]

5 This assumes an investor uses an interest only loan. If the investor also repays some principal the investment will flip to being positively geared even faster.
6 Wood and Ong (2010), p. 28.
7 13.1 per cent of negatively geared investors have repeat spells versus 11.2 per cent for positively geared investors. Ibid., p. 28.

8 Eslake (2013); ATO (2015c)

Figure 3: Since the introduction of the capital gain tax discount, rental losses have been large

Total net rent $2013-14bn



Notes: Net rent as marked by taxpayer upon lodgement of tax return.
Sources: ATO (multiple years)

And the average level of gearing for property investors is increasing. Even though interest rates are falling, interest deductions as a proportion of rents increased from 45.6 per cent of gross rental payments in 1997-98 to 84.2 per cent in 2007-08 and 61.6 per cent in 2012-13.[9]

This increase in geared investment activity is crowding out purchases by owner-occupiers. Investors now account for more than 50 per cent of new loans for housing, up from 29 per cent two decades ago.[10]

Negative gearing is used much less for investments outside of housing. Even at the height of the share market boom, only about 10 per cent of investments outside of superannuation were funded by borrowing – and many of them were positively geared;[11] since then margin lending has reduced by around 70 per cent from its peak in 2007.[12]

2.3 Australia's tax treatment is generous by international standards

Most other advanced economies provide a less generous treatment for rental losses. The United States and some European countries only allow losses to be written off against other forms of investment income.[13] The UK only allows losses to be written off against rental income. Others such as the Netherlands do not allow deductibility of losses for investment housing (Table 1).[14]

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[9] Treasury (2015), p. 65

[10] ABS (2015b), Table 8.
[11] Daley (2007)
[12] RBA (2015b)
[13] Passive income is defined as income from rental properties or businesses in which the taxpayer does not materially participate. It is distinct from active income (wage, salary and income from business in which the person is actively involved) and portfolio income (income from interest, dividends etc). See: IRS (2015).
[14] Summaries of international regimes can be found in RBA (2014), p. 43; Productivity Commission (2004), p. 86; O'Donnell (2005), pp. 92-95.

Table 1: Tax treatment of interest and losses for investment properties internationally

Country	Interest deductibility?	Negative gearing?
Australia	**Yes**	**Yes** – Rental losses can be written off against any other income
Canada	**Yes**	**Limited** - Only cash expenses, not depreciation can be written off. Subject to a 'reasonable expectations of profits test' based on whether investor expects to make a profit on the rental income (not capital gains)
New Zealand	**Yes**	**Yes** – Rental losses can be written off against any other income
Switzerland	**Yes**	**Limited**
United Kingdom	**Limited** - From 2017, the value of tax deductions for interest expenses related to investment properties to be limited, only deductible up to the basic level of income taxation (20%)	**Limited** – Rental losses can only be offset against other rental income, but losses can be carried forward and deducted from future rental income.
United States	**Limited** - Usually deductible, but limited to the amount of investment income generated; interest expenses over this amount can be carried forward to future years.	**Limited** – Rental property expenses cannot be deducted against unrelated labour income, only from other 'passive' income (unless gross income is below $150,000, in which case a capped amount can be claimed). Excess loss can be carried forward.
Netherlands	N/A	**No**. Taxation of investments based on an assumed yield of 4%.
Sweden	**Yes**	**Limited** – Dual income tax system. Only deductible against capital income, not against salary and wage income.

Sources: Treasury (2016), p.7; Cheung (2011), pp.38-39; O'Donnell (2005), pp. 92-95; Productivity Commission (2004), p. 86; RBA (2003), p. 43.

3 Negative gearing distorts investment choices

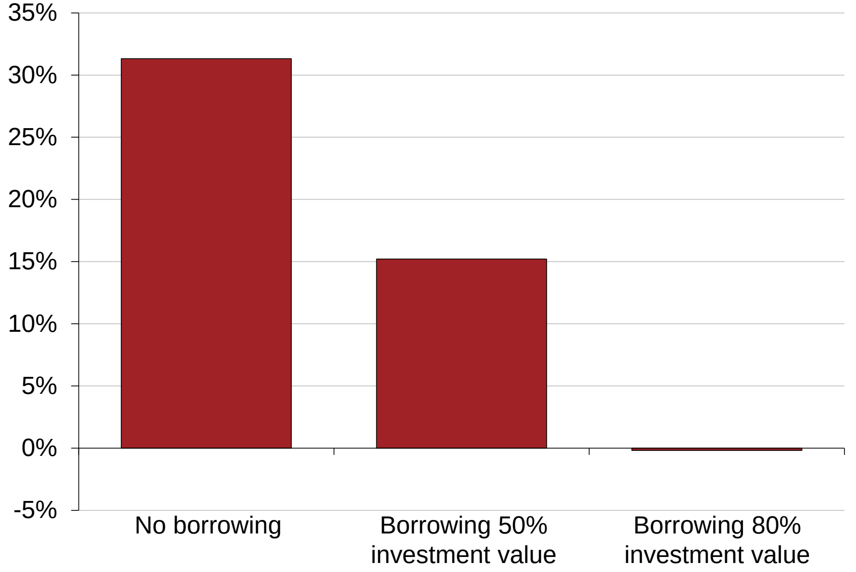
The tax advantages conferred by the interaction of negative gearing and capital gains tax biases the choice of investments. For a given overall return, an investor will prefer an asset that pays less in the way of recurrent income and more in the way of capital gain. As the RBA notes: [15]

> *"…in most countries the earning of rental income is seen as the most important reason for investing in rental properties…This seems to stand in contrast to the situation in Australia where properties are commonly marketed on the presumption that they do not earn positive taxable income for a considerable period."*

Seelig *et al.* (2009)[16] echo the RBA view, finding that the majority of property investors saw capital gains as more important that rental income in motivating them to invest in property.[17]

The asymmetry between the tax treatment of gains and losses also makes debt-financing of investment more attractive. For a high-income taxpayer investing in a rental property, real effective marginal tax rates are substantially lower for a property financed through borrowing. The higher the gearing, the lower the effective marginal tax rate (Figure 4).

Figure 4: Effective tax rates depend on amount of borrowing
Real effective marginal tax rate



Notes: Assumes a 6 per cent nominal return, 2.5 per cent inflation. 50 per cent of the return in attributed to capital gain and 50 per cent to rental income. All investment income is taxed at the top 45c tax rate. The property is held for seven years and then sold.
Source: Grattan analysis.

The Henry Tax Review described the asymmetry between gains and losses as "among the greatest tax induced biases to the savings choices of households".[18] This runs counter to the

[15] RBA (2014), p. 42.
[16] The study explored the motivations of rental property investors through in-depth interviews with 30-40 investors in each of the study states of NSW, Victoria and Queensland.
[17] A clear majority considered capital gains as more important than rental income over a five and ten year time horizon. Seelig, *et al.* (2009), p. 63.

[18] Treasury (2010a), p. 69.

rationale for allowing the deductibility of losses – to maintain tax neutrality of debt and equity financing.

Indeed, the distortions created are so large that even investments with *negative* pre-tax returns can provide a positive profit to investors once the tax benefits are taken into account.[19] Seelig *et al.* (2009) suggest that around half of investors would not have invested in property if negative gearing had not been available.[20]

While these distortions exist for all investments, the tax advantages are greatest for property because bank lending rules allow greater leverage than for other assets such as shares that also produce capital gains.[21]

[19] Burman (1999), p. 78.
[20] Seelig, *et al.* (2009), p.63.
[21] RBA (2015c), p. 23.

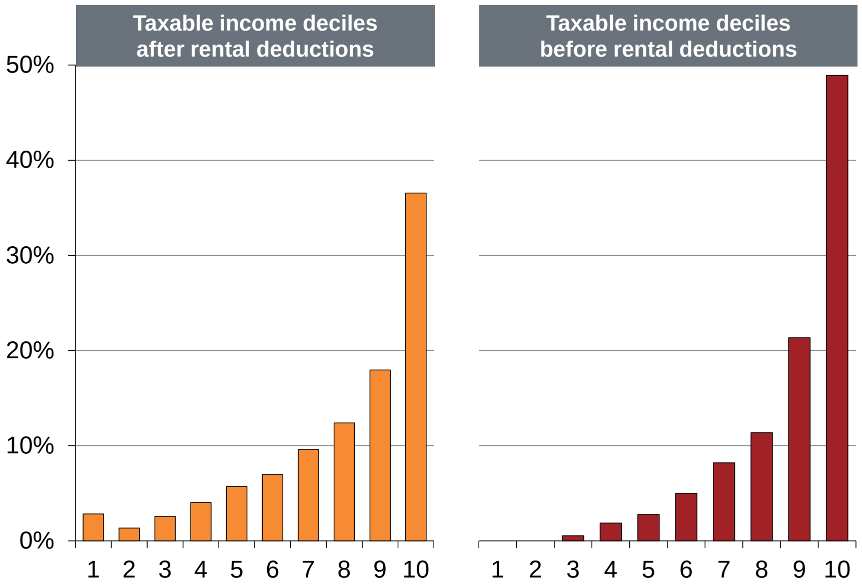
4 Negative gearing mainly benefits those on higher incomes

Like most tax concessions on investment, tax benefits from negative gearing are biased to the wealthy. The increase in after-tax return as a result of the current negative gearing/capital gains interaction is larger for individuals on higher marginal tax rates, all else being equal.[22]

Among individual taxpayers, the top 10 per cent by taxable income receive more than one third of the benefits from rental deductions. But taxable incomes are assessed after rental losses. In other words, people who are negatively gearing will have lower taxable incomes *because* they are negatively gearing. Correcting for this by assessing income *before* rental loss deductions shows that the top 10 per cent of income earners receive almost 50 per cent of the tax benefits of negative gearing. [23]

And despite the claims from the Property Council that lower paid workers – such as nurses, teachers and clerical staff – are the "primary beneficiaries" of negative gearing,[24] our analysis of ATO data suggests that a greater proportion of workers in high-wage occupations use negative gearing and, furthermore, receive larger average tax benefits from doing so (Figure 6 and Figure 7).

Figure 5: Negative gearing mainly benefits those on high incomes
Percentage of the total tax benefits from rental losses by income decile

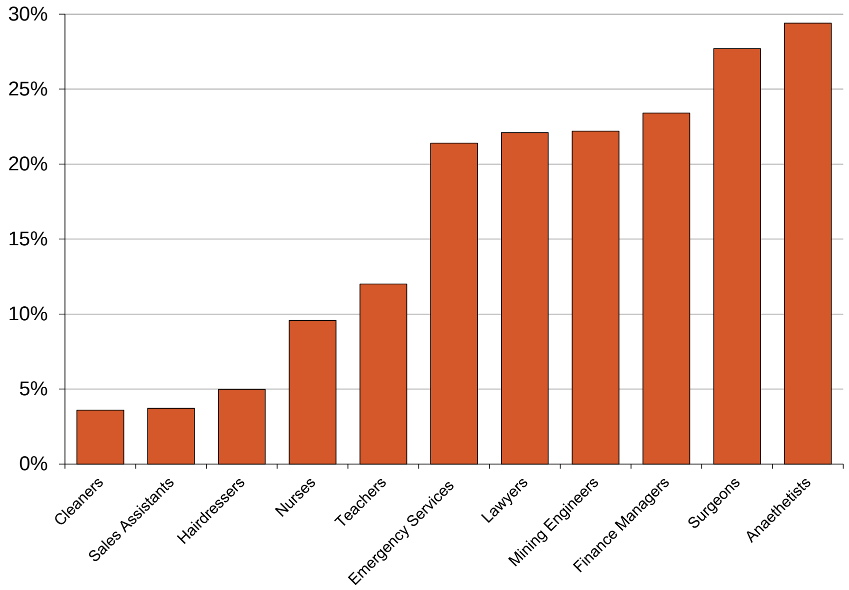


Notes: Tax benefits are the reduction in taxable income from rental losses. Income tax includes the Medicare levy, Medicare thresholds but not tax benefits such as the Seniors and Pensioners Tax Offset.
Source: ATO (2015a)

[22] Financial Systems Inquiry (2015)
[23] The RBA (2015a) analysis of HILDA (2015) also suggests that higher income earners are more likely to negatively gear property. It shows that the top 20 per cent of income earners are almost ten times more likely to have a debt-financed investment property than those in the bottom 20 per cent of earners.
[24] Property Council of Australia (2015)

Figure 6: A higher proportion of doctors and lawyers negatively gear properties than teachers and nurses

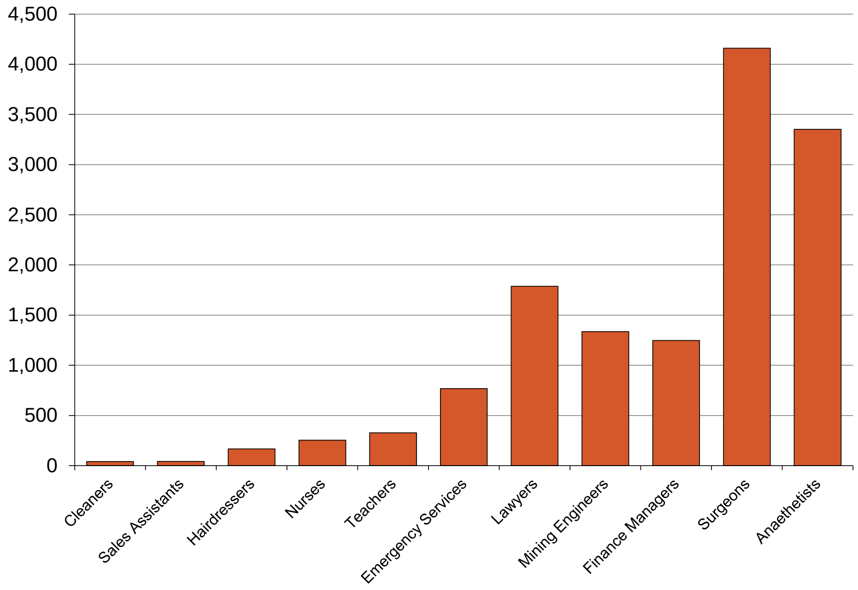
Percentage of each occupation with negatively geared property, 2012-13



Source: ATO, Taxation Statistics 2012-13.

Figure 7: Average tax benefits from negatively geared properties are higher amongst high income professions

Average tax benefit from negative gearing by occupation, $2012-13



Note: Average tax benefits are calculated by deducting rental losses at the tax rate associated with average taxable income for that occupation.
Source: ATO, Taxation Statistics 2012-13.

5 Negative gearing increases housing prices and has little impact on rents

Unlimited tax write-offs for loss-making investments contributes to higher house prices but puts very limited downward pressure on rents.

5.1 Impact of negative gearing on house prices

The favourable tax treatment drives up house prices because it increases the after-tax returns to housing investors.[25] This helps existing home-owners but reduces rates of home ownership among younger age groups.[26]

These tax incentives also contribute to volatility in housing markets. Negative gearing is most attractive as a tax minimisation strategy when asset prices are rising strongly. So in boom times it further increases investor demand for housing. The opposite is true when prices are stable or falling. The Reserve Bank, Productivity Commission, Henry Tax Review and Murray Inquiry have all suggested that the tax-based distortions contribute to volatility in the housing market.[27]

One concern with limiting negative gearing is that downward pressure on house prices could leave some highly geared investors with negative equity. But given expected one-off price impacts of less than 10 per cent (Box 2)[28], the risk of negative equity from the tax changes is limited. Only around 10 per cent of new property loans go to investors with loan value ratios in excess of 90 per cent.[29] And ratios for existing loans are falling as property prices continue to grow. For the small proportion of investors that remain highly leveraged, higher interest rates pose a far greater risk than changes to the tax treatment of rental losses.

[25] For example, Productivity Commission (2004) found that these tax settings had added to the housing price boom by encouraging investors to reduce current income in favour of longer term gains.
[26] See: Daley, *et al.* (2014), pp. 14-15.
[27] RBA (2014), p. 45; Productivity Commission (2004), p. 75, 131; Treasury (2010a); p. 70, 418; Financial Systems Inquiry (2015), p. 278.
[28] Sources: ATO (2015a); ABS (2016); Grattan analysis.
[29] APRA (2015)

Box 2 Impact of negative gearing on house prices

Limiting negative gearing will reduce the post-tax investment returns for negatively geared property investors. There will be a one-off decrease in house prices as investors reduce their willingness to pay. Of course, house prices may not fall if market dynamics continue to push prices upwards. But prices will be lower than they would have been in the absence of the changes.

The impact on prices depends on investor expectations of the size of the lost tax benefit. Average annual rental losses over the last decade were $12 billion, generating annual tax write-offs on average of $4.7 billion. If investor expectations are guided by history, then the expected present value of future tax benefits from negative gearing would be around $110 billion.

If the lost tax benefit were fully capitalised in the value of residential property – currently worth $5400 billion– prices would fall, but only in the order of 2 per cent. The price impacts would be smaller if some of the tax benefits are retained. For example, if investment losses are quarantined so they can't be written off against wage and salary income, the present value of tax benefits lost might be $50 billion with a maximum impact on property prices of around 1 per cent.

But in particular segments of the housing market (e.g., inner city apartments) price effects could be larger. To take an extreme example, if $280 billion of housing owned by investors were an entirely separate market, quarantining negative gearing might reduce prices in this market by as much as 18 per cent. In reality, some owner-occupiers compete for these same houses, so percentage price reductions are much more likely to be single digits.

5.2 Limiting negative gearing will not change rents much

Of all the effects that negative gearing has on housing markets, its effect on rental prices is by far the most contentious.

Concerns persist that limiting negative gearing will reduce the supply of rental properties and push up rents. These arguments typically rest on two pillars: one, that rental prices rose in the 1980s when negative gearing for property was restricted and two, that investors will abandon the market without present tax advantages.

The first argument is easily refuted. In 1985, the Hawke Government restricted negative gearing so that rental losses could not be used to reduce tax payable on other income streams.[30] Two years later, the policy was abolished out of concern for increasing rental prices.

But these concerns were ill-founded. Rents did rise rapidly in Perth and rose somewhat in Sydney. Yet inflation-adjusted rents were stable in Melbourne and actually fell in Adelaide and Brisbane (Figure 8). In Sydney and Perth it was population growth and insufficient residential construction – due to high borrowing rates and competition from the stock market for funds – not the policy change that led to the rent rises.[31]

The absence of a detectable rental response is also consistent with overseas empirical studies of the relationship between rents and the tax treatment of investment housing. These studies find

[30] McKell Institute (2015), p. 20. The measures only applied to real estate purchased after 17 July 1985.
[31] Badcock and Browett (1991), p. 186. Daley, *et al.* (2013), pp.47-48.

that rent increases in response to tax changes are modest[32] and very slow to take effect, with most impacts not seen for more than a decade.[33]

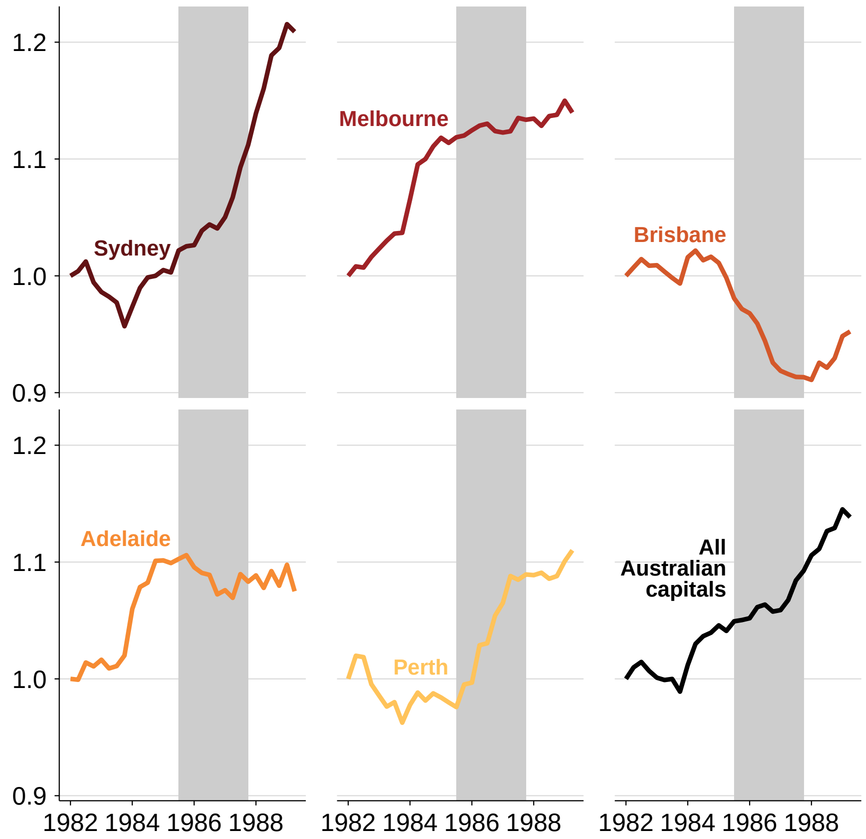
Beyond these historical lessons, economic theory predicts that limiting negative gearing should not change rents much.

Limiting or abolishing negative gearing will reduce the post-tax investment returns for negatively geared property investors. There will be a one-off decrease in house prices as investors reduce their willingness to pay. As house prices fall, rental yields – rents after tax as a proportion of prices – will rise to restore the attractiveness of property investment vis-à-vis other investments.

Existing negatively geared investors will have larger post-tax losses to service. Some may want to increase rents to maintain their returns. But rents are determined by dynamics of demand and supply, not by the returns that owners are seeking. In property markets – just like other markets – returns determine asset prices, not the other way around. Rents do not increase just to ensure that buyers of assets get their money back.

Figure 8: Rents did not rise when negative gearing was removed in Melbourne, Adelaide or Brisbane

Average rent prices (real compared with overall CPI), 1982 = 1. Grey band indicates the dates when negative gearing was not permitted



Source: ABS (Various years)

[32] DiPasquale and Wheaton (1992);
[33] Blackley and Follain (1996)

Existing negatively geared investors compete to supply rental properties against other property investors with no imperative to increase rents. Rental incomes for the one-third of landlords making positive rental profits would be unaffected by the tax changes. And new investors would purchase properties at lower prices that factor in the less generous tax treatment of rental losses. Tenants can beat rent rises by threatening to move to properties owned by these other investors.

Some negatively geared investors may sell their properties if tax concessions are less generous. But in the short term this has no impact on rents. Every time an investor sells a property to a renter, there is one less rental property, and one less renter. There is no change to the balance between supply and demand of rental properties. Others may sell to another investor, but one that doesn't rely on negative gearing to make the investment profitable. Again there is no shortage of rental properties.

Limiting negative gearing could have an impact on rents over the longer term if lower property prices reduce investment in new rental housing. But the effect is unlikely to be large. Currently 93 per cent of all investment property lending is for existing dwellings.[34] And one-off price impacts of less than 4 per cent (Box 5) are unlikely to substantially slow new construction.[35] The main constraint on new housing is land release and zoning restrictions – especially in established suburbs with good access to jobs and transport – rather than the profitability of developments.[36]

General tax breaks like negative gearing are a poorly targeted and inefficient way of supporting the rental market.[37]

[34] ABS (2015a)
[35] And the price transmission is somewhat muted by the fact that the market for new housing, typically at the edge of cities, is somewhat detached from the market for established housing typically closer to the centre (see: Kelly, *et al.* (2011).
[36] Kelly, *et al.* (2013); Kelly and Donegan (2015), pp. 84-90
[37] Treasury (2010b), p. 74.

6 Options for reform

In our forthcoming report, *Negative gearing and the Capital Gains Tax Discount*, we examine two options for reforming negative gearing:

- **Quarantining losses** so they can only be written off against other investment income (operating profits and capital gains) could raise around **$3 billion a year** in the short-term. This would decline to around **$2 billion** over time as those losses are offset against investment income. We propose in our report that this be done alongside reducing the capital gains tax discount to 25 per cent.

- **Aligning the tax rates for capital gains and losses**. For example, the capital gains discount could be reduced so that investors pay tax on 75 per cent of their capital gains, but can deduct only 75 per cent of any investment losses. Treating capital gains and recurrent losses consistently would reduce tax incentives to borrow to invest. It would contribute around **$3.7 billion** a year to the bottom line.

We do not provide further discussion of the reasons for our proposed changes to capital gains tax here as it is beyond the scope of this inquiry. Nonetheless, we would be happy to elaborate further if this would be off assistance to the Committee. A discussion of the proposed changes will be set out in detail in our forthcoming report.

6.1 Limiting negative gearing

There is also a strong case for **limiting the tax deductibility of losses**. Quarantining losses so they cannot be written off against wage and salary income would limit the current distortions.

While the deductibility of investment expenses including interest expenses, has a strong grounding, there is no reason that these expenses should be deducted against wage and salary income. Indeed, allowing these deductions provides significant tax advantages to investors, driving up house prices at the expense of would-be home buyers.

Governments already limit the scope for people to reduce their taxable income through investment losses to qualify for income support payments. Income tests for Family Tax Benefit Part A and Part B, Child Care Benefit are based on "adjusted taxable income" which adds back investment losses.[38]

There are different degrees of quarantining. The most generous approach is to allow losses to be written off against all non-wage and salary income.[39] This would include all forms of investment income, including interest and rental income. An alternative would be to restrict deductions to investment income from the same asset class – for example, property or shares. The most restrictive option would only allow deductions to be written off against the capital gain from the same asset.

The latter is preferred from an economic perspective because it aligns the timing of tax for gains and losses, minimising the tax driven preference to favour capital gains over recurrent investment income. But adopting more stringent rules may encourage switching to investment vehicles that allow more

[38] DHS (2015)
[39] Wage and salary income should include other forms of employee remuneration such as fringe benefits, allowances, and employee termination payments.

generous treatment of losses. For example, investors might hold assets in a company or trust so they can write off losses against other forms of investment income.[40]

A more generous treatment that simply quarantines losses to all non-wage and salary income would be less likely to promote switching to companies or trusts because losses from these vehicles cannot be written off against wage income.[41] This is also consistent with the approach taken in many other jurisdictions (Table 1).

Quarantining loss deductions would raise additional tax revenue in the short term, although the estimates are sensitive to changes in the housing market and the holding periods for assets. Separating investment income and income from income obtained through wages and salaries, and allowing rental deductions only the investment component would increase income tax collections by **$3 billion a year** in the short term.

Over the medium term, accrued rental losses – losses not offset against recurrent investment income – will be written off against income from capital gains. Assuming no change in investor behaviour, the additional tax revenue would stabilise at approximately **$2 billion a year**.

Applying one of the more restrictive standards – limiting loss write-offs to the same asset or asset class – would raise more over the medium term because investors will need to wait longer on average until they can realise their losses.

These estimates do not take into account behavioural shifts from the policy change but some behavioural change is likely. Investments that make income losses are less attractive when the tax benefits are more restricted. Much of the appeal of negative gearing lies in the scope to reduce annual taxes on wage income (section 1.3). Removing the tax incentive for leveraged investment should result in investors shifting toward income-producing assets and could therefore further increase income tax collections. On the other hand, if some investment properties are replaced by owner-occupied properties, less revenue should be expected because of the tax-privileged status of the family home.

Limiting negative gearing only to new properties

It would also be possible to quarantine wage and salary income generally but allow rental losses to be deducted against all income for new properties.

Proponents argue that this will maintain the incentives for the provision of new housing.[42] Certainly the policy will increase investor demand for new developments relative to existing property. But as noted in section 1.3, supply restrictions rather

[40] Tax losses from investments held in companies and trusts are carried forward and written off against future income generated within that company or trust. These loss write-off are not restricted to any particular investment. ATO (2015b). Of course, investors restructuring their affairs would have to weigh up the benefits against the disadvantages of these alternative structures, including the fact that assets held within a company would not be entitled to the capital gains tax discount.

[41] Tax losses from trusts and companies are quarantined within the structure and cannot be distributed to the beneficiaries or owners to write off against their other income. See: ibid..
Losses must be quarantined in a trust to be carried forward by the trust indefinitely until offset against future net income.

[42] McKell Institute (2015), p. 28.

than insufficient demand is the main constraint on new construction activity.

Restricting tax benefits to a subset of investments, such as new housing, creates additional complexity and distorts investment choices.[43] But while an across the board change to the negative gearing would be preferable, maintaining existing arrangements for new properties may not be too distorting. The supply of new properties will always be small relative to the stock of existing properties at any point in time,[44] so the costs to the budget and the economy of from such a policy should not be large.

6.2 Symmetrical tax treatment of losses and capital gains

An alternative proposal put forward in the Henry review was to **discount rental losses by the same amount as the capital gains tax discount**.[45] So if the capital gains discount were reduced to 25 per cent so that 75 per cent of gains were taxable, investors would only be able to write off 75 per cent of their losses against their taxable income (including wage and salary income).

This proposal could also raise an additional **$3.7 billion** each year for the budget.[46] By restoring the symmetry in the treatment of gains and losses, investors would have less incentive to 'chase' capital gains rather than recurrent income.[47]

This was part of a broader proposal in the Henry tax review to align the tax treatment of different savings vehicles. The review recommended that bank account interest and positive rental income receive the same discount as capital gains. Although theoretically appealing – the proposal would remove some of the largest tax based distortions in investment choices, most notably the tax penalty on bank interest – it seems unlikely given current fiscal constraints that the government will accept the need to reduce taxes on other forms of investment income.

[43] Complexity may be less of a problem if other government support schemes targeting new property investments – first home buyer's grants and stamp duty concessions – mean that some of the more tricky definitional issues around "new properties" have been addressed.

[44] New dwellings add less than 2 per cent to the stock of residential dwellings in year. See: ACIL Allen Consulting (2015), p. 47.

[45] Treasury (2010a), pp. 70, 72.
Henry specifically proposed that rental losses be discounted by 40 per cent in line with their proposed reduction in the capital gains tax discount to 40 per cents. Because we consider the CGT discount should be reduced to 25 per cent we have estimated that rental losses also be discounted by 25 per cent.

[46] This figure is obtained by applying a 25 per cent discount to the rental and investment losses component of taxable income and then comparing the income tax payable by the original income tax, using the most recent sample file for individual taxpayers.

[47] Treasury (2010a) p. 418.

7 Transition arrangements

Transition arrangements for changes in the tax treatment of investments could help minimise price shocks in asset markets and make reforms more politically palatable.

Changes to negative gearing could be introduced gradually. But grandfathering arrangements for existing investors may be the more politically attractive alternative.

7.1 Phase-in

Immediate reform to negative gearing regime might encourage some investors to sell before the new legislation came into force. This could be moderated by phasing in the changes over a number of years. For example, taxpayers might be allowed to claim only 90 per cent of their losses against wage and salary income in the first year (the remainder capitalised against any future capital gain), and the 10 percentage points less each year until no losses are claimed against wage and salary income.

A phase-in would provide investors with time to reorganise their affairs to adjust to the new regime.

7.2 Grandfathering existing arrangements

Another option would be to grandfather existing arrangements. Those who purchased assets before the changes to negative gearing could still claim investment losses until the asset was sold.

The most powerful argument for grandfathering is political economy: those who benefit from the current arrangements are likely to be the most vociferous opponents of reform.

In general, there are a number of drawbacks to grandfathering tax changes for investments: it can add to complexity, reduce liquidity, and treats new investors – particularly younger investors – unfairly. But for changes to negative gearing, grandfathering these issues are less of a concern. Properties inevitably become positively geared over time, often within 5-7 years. This provides a 'natural sunset' to any grandfathering arrangements. In other words, any issues around the complexity or unfairness of dual arrangements will be short-lived.

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