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Tax reform: Informing the debate

What are the implications of changing housing tax benefits?

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Key points

- *Investors have access to two significant tax benefits – negative gearing and the CGT discount.*
- *While these measures apply to all investments types, their application to residential property is often associated with housing affordability and home ownership rates. Due to concerns regarding these potential effects, there have been calls to abolish both negative gearing and the CGT discount.*
- *Removing negative gearing would increase Commonwealth revenues by just over $5 billion in 2018-19, while removing the CGT discount on investment properties would raise just over $2 billion in the same year. If the CGT discount on all asset types was removed this would raise just over $6 billion in 2018-19.*
- *While abolishing negative gearing would improve government revenues in the short term, subject to how investment losses are treated, this revenue gain may fall over time as investors seek to apply these losses to future capital gains and reduce any CGT payable when they sell investments.*
- *Abolishing negative gearing and the CGT discount is also expected to affect:*
  - *decisions regarding the use of debt financing for housing investment, and the returns from investing in property relative to other investment mechanisms such as savings*
  - *retirement incomes, where individuals had made investment decisions based on current tax arrangements*
  - *future housing accessibility and affordability, including rents.*

Investors in housing have access to two significant forms of tax benefits:

- **Negative gearing:** This provision allows individuals who incur a net loss associated with their investment to deduct this, once adjusted by the investor's marginal tax rate, from their personal income tax liability. This effectively reduces their overall annual tax liability.
- **CGT discount:** This concession allows individual investors to pay tax on only 50 per cent of any capital gain that is realised when an investment is sold (where they hold this investment for more than one year). This gain is taxed at the individual's marginal tax rate.

Both tax benefits apply to all investment types, but their application to housing tends to draw significant attention given their perceived effect on housing demand and prices. As affordability of housing worsens and home ownership rates for low income households fall, there have been calls to wind back both measures.[1]

[1] See for instance, Eslake, S, 2013, '50 years of housing failure', Address to the 122nd Annual Henry George Commemorative Dinner, Melbourne, Available at: http://www.prosper.org.au/2013/09/03/saul-eslake-50-years-of-housing-failure/. [Accessed on 1 October 2014].

This publication assesses two scenarios

- Abolishing negative gearing: this scenario assesses the impact associated with removing individuals' ability to offset their residential property investment losses against their salary and wage income. The revenue analysis does not consider the effects related to removing negative gearing for other non-residential property investment types (such as shares).

- Abolishing the CGT discount: this scenario assesses the effect of removing the 50 per cent discount applied to capital gains on investment real estate.

While this assessment has focused on the treatment of negative gearing and the CGT discount with respect to investment housing, consideration could be given to applying the change across all asset classes, as similar effects in terms of equity and efficiency apply and it would ensure the consistent treatment of different asset classes.

Modelling assumptions

The analysis provided below is based on the following assumptions:

- *Tax changes are introduced from 1 July 2018, which is the first year after the forward estimates and no allowance for a transition phase is made. The 2018-19 revenue estimates are in nominal terms.*

- *The revenue gain from changes to negative gearing or the CGT discount are based on first round effects. While these changes may alter behaviours and effect economic growth, any secondary (or flow-on) impacts have not been captured in revenue estimates.*

- *Estimates of revenue foregone due to negative gearing rely on Tax Statistics published by the ATO. Our analysis has focused on negative gearing on residential properties on the basis that the majority of losses (just over 90 per cent) relate to net rental property loss.*[2]

- *Estimates of revenue foregone due to the capital gains tax discount also rely on Tax Statistics published by ATO. This assessment includes capital gains associated with residential property and other assets (including shares and collectables).*

- *Removing both the capital gains tax discount and negative gearing provisions for investors are expected to change behaviours. For instance, reducing the capital gains tax discount on investment properties might initially increase tax revenues associated with capital gains but might also prompt investors to buy fewer properties. The impact of this policy change on tax revenues is difficult to predict. The revenue estimates provided seek to demonstrate the likely magnitude of any change to government revenues and are indicative only. There may also be second round impacts (such as changes to land tax and stamp duty revenues), however, any interaction between these tax benefits and other taxes, such as land tax or stamp duty are not modelled.*

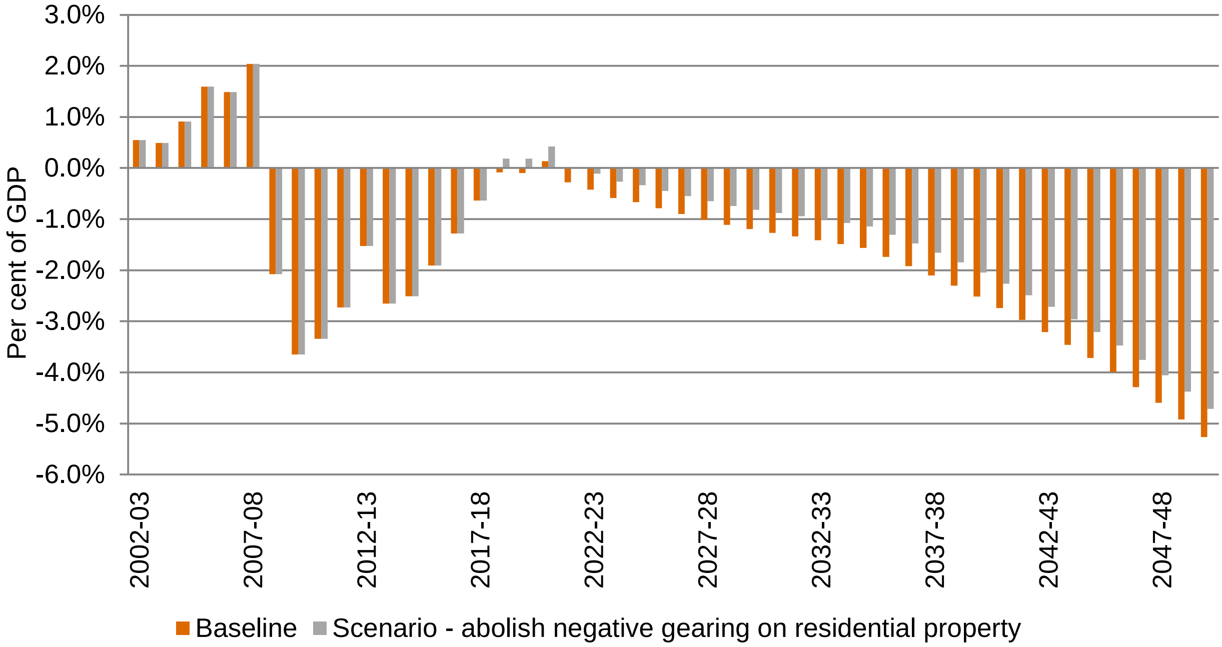
- *Both revenue measures are also affected by asset price appreciation and interest rates. These variables are inherently uncertain.*

[2] Australian Taxation Office. Taxation Statistics 2011-12. Available at: https://www.ato.gov.au/About-ATO/Research-and-statistics/In-detail/Tax-statistics/Taxation-statistics-2011-12/. [Accessed on 28 October 2014].

Abolishing housing tax concessions would improve budgets in the short term

Abolishing negative gearing on investment in residential properties would raise just over $5 billion for the Commonwealth Government in 2018-19, and slightly improve the operating balance (by around 0.3 per cent of GDP) (Figure 1).

Figure 1 Removing negative gearing, operating balance, Commonwealth Government, % of GDP

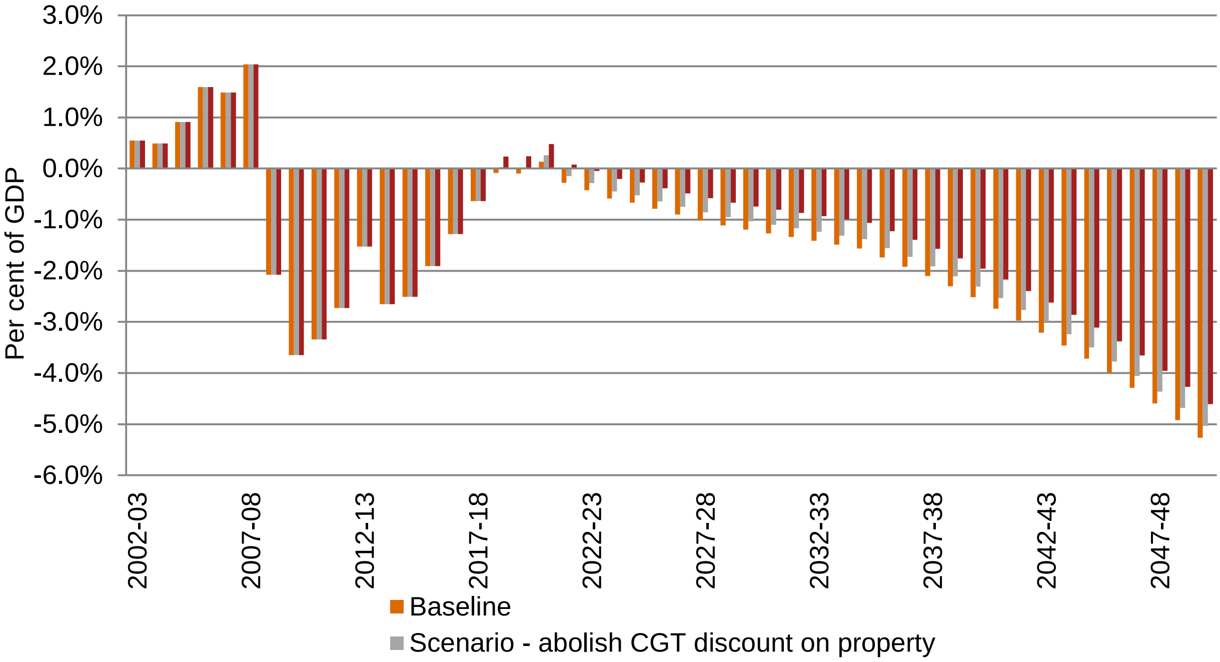


Source: PwC Analysis

By comparison, the revenue gain from removing the CGT discount on residential and non-residential properties would be slightly lower, raising Commonwealth revenues by more than $2 billion in 2018-19 and improving the operating balance of the Commonwealth by around 0.1 per cent of GDP per annum (Figure 2, grey line).

However, removing the CGT discount for all investment types, including shares and other investments, would raise just over $6 billion in revenue in 2018-19 and improve the operating balance of the Commonwealth by around 0.3 per cent of GDP per annum (Figure 2, burgundy line).

Figure 2: Removing CGT discount, operatingbalance, Commonwealth Government, % of GDP



Source: PwC Analysis

These revenue estimates do not consider any interaction between changes to negative gearing and the CGT discount (such as whether net rental losses would be able to be quarantined and used to offset future capital gains when investment properties were sold). However, if net rental losses were able to be used for this purpose, this would gradually erode some of the revenue gain associated with abolishing the CGT discount. While it is difficult to estimate how much CGT revenues would fall[3], since rental losses are generally larger than the CGT liability, it is likely that investors forced to defer their negative gearing benefit will end up paying no capital gains tax when they sell investments[4].

Any decision to grandfather either arrangement would also reduce revenue gains to government.

Negative gearing and the CGT discount can affect investment decisions

Does negative gearing distort housing availability and prices?

Negative gearing enables individuals to take on debt for investment purposes and reduce their personal income tax. This leads to differences in the effective tax rates faced by investors depending on whether the asset is financed through debt or equity; potentially giving rise to greater use of debt financing for investments.

Negative gearing is often justified on the basis that it encourages investment in new rental property stock, thereby reducing the growth in rents and supporting housing availability. However, evidence to support such a view is mixed.[5]

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3 This is because this would depend on future house price appreciation and the level of gearing of each individual investor.

4 Daley, J, McGannon, C, Savage, J, and Hunter, A, 2013, Balancing budgets: tough choices we need. Grattan Institute, 'Available at: http://grattan.edu.au/wp-content/uploads/2014/03/801_Balancing_Budgets.pdf. Accessed on 30 September 2014].'

5 Kelly, J, 2013, Renovating housing policy. Grattan Institute, Melbourne.

For instance, Australia's vacancy rates remain historically low, which is indicative of a shortage of rental properties.[6] Research also suggests that only 5 per cent of the money loaned for investment in housing is used for the construction of new dwellings,[7] indicating that negative gearing may contribute upward pressure on the price of established homes and diminish housing affordability for would-be home buyers.[8]

However, while investors may purchase existing properties, rather than stimulate the construction of new housing stock (and hence contribute to higher prices for establishing homes), this would add to the pool of rental properties and could contribute downward pressure on rents.

It is suggested that abolishing negative gearing will increase rents, with landlords selling their properties and reducing the supply of rental housing.[9] It is not clear if this would be the outcome, as arguably the sale of properties by landlords may lead to downward pressure on the prices of residential properties and enable more people to purchase housing; thereby reducing demand for rental property and limiting any effects on rents.[10]

On the other hand, if landlords chose to keep their investments (despite changes to negative gearing), this may see an increase in rents if landlords seek to maintain their after-tax return on investment. Though in a competitive market with no change to demand or supply, the ability of landlords to raise rents may be limited.

The net impact of changes to negative gearing is difficult to ascertain and will depend on the extent this policy change would influence an investor's decision to purchase property over other assets, or continue to hold existing assets.

Would abolishing the CGT discount improve the consistency of investment taxation?

Exempting capital gains from tax may introduce distortions which encourage investment in housing (or other assets), such that they appear more favourable, in terms of risk, than other investment mechanisms, such as savings.[11] While the CGT discount is often justified on the basis that it encourages greater risk taking and entrepreneurialism, where this occurs it may result in the misallocation of the nation's savings and have adverse effects on overall economic efficiency, capital market stability, and the distribution of risk between individuals.[12]

The CGT discount is also often rationalised on the basis that it compensates investors for the impact of inflation on capital gains, the double taxation of savings, and the reduction of potential lock-in effects[13] created by the tax.[14] Earnings on savings are subject to similar effects and receive no discount.[15] Taxes on earnings from savings are also payable each year, while investors can defer paying tax on their capital gains until the investment is sold, which provides a further discount.[16]

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[6] Kearns, J, 2012, 'The outlook for dwelling investment', Address to the Australian Business Economist lunchtime briefing. Available at: http://www.rba.gov.au/speeches/2012/sp-so-131112.html. [Accessed on 1 November 2014].

[7] ABS, 2013, Lending Finance (Cat 5671.0), August 2013.

[8] Eslake, S, 2013. '50 years of housing failure', Address to the 122nd Annual Henry George Commemorative Dinner, Melbourne. Available at: http://www.prosper.org.au/2013/09/03/saul-eslake-50-years-of-housing-failure/. [Accessed on 1 October 2014].

[9] This view is often based on the spike in rental prices following the Hawke Government's decision to quarantine negative gearing in 1986. However, only two cities experienced strong growth in rental prices (Sydney and Perth), with rents in other cities remaining largely unchanged or even lower. Moreover, the growth in Sydney and Perth was attributed to the unusually low vacancy rates in these cities prior to the policy change.

[10] Kelly, J, 2013, Renovating housing policy. Grattan Institute, Melbourne.

[11] OECD, 2006, *Taxation of capital gains of individuals: Policy considerations and approaches,* OECD Tax Policy Studies, No. 14, OECD.

[12] Commonwealth of Australia, 2009, *Australia's Future Tax System, Report to the Treasurer (Part 1 Overview)*, Canberra. Available at: http://taxreview.treasury.gov.au/content/downloads/final_report_part_1/00_AFTS_final_report_consolidated.pdf. [Accessed on 10 October 2014].

[13] The lock-in effect is the incentive to hold onto underperforming assets to avoid paying capital gains.

[14] Burman, L, 2009, 'Taxing capital gains in Australia: Assessment and recommendations', *Australian Business Tax Reform in Retrospect and Prospect*, C Evans and R, Krever eds, Thomson Reuters, Sydney.

[15] In particular, savings earnings are also reduced due to inflation and double taxation.

[16] Capital gains are taxed at the sale of an asset, rather than by estimating the increase in value and paying tax each year. It is generally acknowledged that the annual payment of capital gains would be impractical.

Removing the CGT discount would mean that income from investment and working would be taxed at the same marginal rates. This is expected to result in a more productive allocation of savings as distortions would be reduced and household investment choices would better represent individual circumstances and risk-preferences.

These changes would have broader impacts. For instance:

- As the return on invested capital is reduced, investors may defer selling assets (and realising any capital gains (or losses)), although international evidence suggests these lock-in effects are not significant.[17]
- Investor demand for housing may fall. In an already constrained rental market, this could place further pressure on the availability of affordable housing in the short term.[18] However, if the CGT discount was removed from all investment types, it is not clear how significant these effects would be over the medium to long term.
- The equitable tax treatment of investment is expected to reduce the dead-weight costs of structuring transactions artificially to classify gains as capital rather than income.[19]

Removing the CGT discount could create pressure for the government to re-introduce some form of inflation indexation of capital gains. This would erode some of the revenue gains associated with abolishing the CGT discount.

What are the distributional impacts of housing tax benefits?

Research by the Reserve Bank of Australia shows that investor households with incomes in the top 20 per cent of the income distribution own the bulk of the investor housing debt and over a quarter of total housing debt outstanding (around 60 per cent).[20] It is therefore not surprising that these households disproportionately benefit from negative gearing and the CGT discount. Table 7 presents the distributional impacts based on 2013-14 values.

In 2011-12, around 1 million Australians owned a negatively geared property, and over 65 per cent of these (700,000) had a taxable income of less than $80,000.[21] Negative gearing is estimated to represent between 0.4 per cent of taxable income for income earners in the lowest quintile, and 0.7 per cent for income earners in the highest income quintile.[22] In absolute terms, however, around 50 per cent of the estimated revenue gain associated with abolishing negative gearing will come from income earners in the highest quintile. These individuals are estimated to receive around $1,083 per person, per annum, in tax savings associated with this tax benefit.

By comparison, the CGT discount represents around 0.2 per cent of taxable income for income earners in the lowest quintile, and 1.1 per cent of taxable income for income earners highest quintile. In absolute terms, around 80 per cent of the estimated revenue gain from abolishing the CGT discount (for all assets types, including properties) is expected to come from income earners in the highest quintile. These individuals currently receive on average between $735 and $1,728 per person, per annum, in tax savings associated with this tax benefit.

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[17] Burman, L, 2009, 'Taxing capital gains in Australia: Assessment and recommendations', *Australian Business Tax Reform in Retrospect and Prospect*, C Evans and R, Krever eds, Thomson Reuters, Sydney.

[18] Commonwealth of Australia, 2009, *Australia's Future Tax System, Report to the Treasurer (Part 2 Detailed Analysis, Volume 2 of 2)*, Canberra. Available at: http://taxreview.treasury.gov.au/content/downloads/final_report_part_2/AFTS_Final_Report_Part_2_Vol_2_Consolidated.pdf. [Accessed on 10 October 2014].

[19] Daley, J, McGannon, C, Savage, J and Hunter, A, 2013, *Balancing budgets: tough choices we need. Grattan Institute*, Available at: http://grattan.edu.au/wp-content/uploads/2014/03/801_Balancing_Budgets.pdf. Accessed on 30 September 2014].

[20] Reserve Bank of Australia, 2014, 'Box C: Households' investment property exposures: evidence from tax and survey data' *Financial Sustainability Review*, September 2014. Available at: http://www.rba.gov.au/publications/fsr/2014/sep/html/contents.html. [Accessed on 2 November 2014]

[21] Australian Taxation Office. *Taxation Statistics 2011-12*. Available at: https://www.ato.gov.au/About-ATO/Research-and-statistics/In-detail/Tax-statistics/Taxation-statistics-2011-12/. [Accessed on 28 October 2014].

[22] PwC Analysis

This distributional analysis is based on ATO statistics on taxable income, which reflects the impact of negative gearing and other tax offset measures. Some individuals captured in these lower quintiles may include high income individuals who have reduced their taxable income, or retirees whose annual taxable income is low but who have access to non-taxable sources of income (such as pension streams or drawdowns from superannuation funds).[23]

Finally, abolishing these tax benefits may impact retirement decisions. An individual that is not planning to sell their investment property and draw down on the equity, may have their retirement incomes adversely effected should the removal of negative gearing reduce their returns. Similarly, removing the CGT discount may also impact an individual's retirement decision if any capital gains associated with the sale of the property were intended to fund their retirement. To this extent, grandfathering or transitional arrangements would need to be considered.

Table 1: Value of housing tax concessions, by quintile, 2013-14

	Lowest	Second	Third	Fourth	Highest	Average
Abolish negative gearing						
Revenue raised by abolishing negative gearing ($ million)	204	377	607	872	2,113	835
Revenue gain ($ per employed person, per year)	105	193	311	447	1,083	428
Abolish CGT discount						
Revenue raised by abolishing the CGT discount on property ($ million)	34	67	95	61	1,433	338
Revenue gain (property only) ($ per employed person, per year)	18	34	49	83	735	184
Revenue raised by abolishing the CGT discount on all assets ($ million)	81	157	223	379	3,370	842
Revenue gain (all assets) ($ per employed person, per year)	41	80	115	194	1,728	432

Source: PwC Analysis

23 Reserve Bank of Australia, 2014, 'Box C: Households' investment property exposures: evidence from tax and survey data' *Financial Sustainability Review*, September 2014. Available at: http://www.rba.gov.au/publications/fsr/2014/sep/html/contents.html. [Accessed on 2 November 2014]

Contacts

Paul Abbey

Partner

PwC

+61 (3) 8603 6733
paul.abbey@au.pwc.com

Jeremy Thorpe

Partner

PwC

+61 (2) 8266 4611
jeremy.thorpe@au.pwc.com

Tom Seymour

Partner

PwC

+61 (7) 3257 8623
tom.seymour@au.pwc.com

www.pwc.com.au