POLICY EVIDENCE SUMMARY

March 2018

Modelling negative gearing and capital gains tax reforms

Based on AHURI Final Report No. 295:
The income tax treatment of housing assets:
an assessment of proposed reform arrangements

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What this research is about

This report models several potential transitional arrangements that may ease the distribution pressures arising from reforms to negative gearing and capital gains tax (CGT), and lays out a politically acceptable reform pathway.

The context of this research

Previous research has highlighted the potentially distortionary effects of the present Federal income tax treatment of housing assets, such as through negative gearing and CGT discount benefits. These effects include:

- the increase in the share of investment property loans in total debt has tripled from one-tenth to three-tenths in approximately two decades. Such a large number of debt-financed housing investors is a potential source of instability in the housing market
- investors take up an increasingly greater share of the value of new loans compared to owner occupiers and, it would appear, are increasingly crowding out first home buyers from the property market
- owner occupiers are exempt from paying CGT on the sale of their principal residence, which can encourage over investment in housing assets
- tax arrangements may deter institutional investment in affordable rental housing as they make it more difficult for companies, property funds and financial institutions to obtain satisfactory returns on residential housing portfolios
- negative gearing and CGT discount benefits are currently heavily skewed towards those who are more affluent.

Despite reviews of the tax system, reform of negative gearing and CGT provisions face political opposition. A complete abolition of negative gearing has often been criticised by policy makers for its potentially adverse impacts on the financial wellbeing of 'mum and dad' investors.

The key findings

Current situation for Australian rental investors: negative gearing

In 2013–14 the ABS Survey of Income and Housing (SIH), HILDA (Household, Income and Labour Dynamics in Australia) Survey and Australian Tax Office (ATO) all indicated there were around 2 million rental investors. The ATO reported that nearly 61 per cent of rental investors recorded a net rental loss, while much lower proportions have negatively geared status in SIH and HILDA.

The typical negatively-geared investor is male; aged in his mid-to-late forties; employed full-time; and has a tax assessable income, or income before deductions, of $91,000. After deductions are taken into account, the average taxable income for negatively-geared investors is $80,000.

Negatively-geared investors who currently receive the greatest tax savings are those who have the highest incomes and rental property values, and greatest annual net rental losses.

"The two modelled reforms that will result in the greatest amount of budgetary savings are either a rental deduction cap of $5,000 or progressive rental deductions based on an income criteria. Both reform models cost $1.3 billion, resulting in savings of over $1.7 billion each..."

Positively-geared investors tend to be evenly split between males and females, and are more likely to be older and retired. Positively-geared investors have tax assessable incomes of $78,500 on average, and this only reduces slightly to $77,500 of taxable income after deductions.

Both types of investors have similar residential rental property values of around $300,000 on average. However, negatively-geared investors make a loss of around $8,800 on average while positively-geared investors make a profit of around $16,000 on average.

Rental investments that start off being negatively geared are more likely to be terminated after five years than those that start as positively geared.

The HILDA Survey shows that negatively-geared investors may be more likely to terminate rental leases as market conditions change. Negatively-geared investors make operating losses and hence their rental investment decisions are more sensitive to changes in economic conditions than positively-geared investors.

Current situation for Australian rental investors: CGT

Home-owner investors who own both a family home and at least one rental investment property received the greatest CGT discount benefits, while renters who do not own properties do not receive any CGT discount.

CGT discount benefits are heavily weighted towards those who are more affluent in terms of both income and property wealth; on average, a home-owner investor's property portfolio is worth over $730,000. Home-owner investors' average tax assessable income is $82,000 compared to $31,000 for renters who do not own any properties.

Modelling proposed changes to negative gearing and CGT provisions

1 Capping rental deductions model

This model puts a cap on the total value of rental deductions a landlord may claim. If a $40,000 cap is imposed, the average tax saving for a negative-geared rental investor is reduced by only $25. If a $5,000 cap is imposed, the average tax saving for a negative-geared rental investor is reduced by $921.

2 Progressive rental deduction model

In this model, 'mum and dad' investors in the bottom half of either the income or property value distributions continue to enjoy all rental deductions, and therefore experience no reduction in tax savings. At the other extreme, those in the top 25 per cent are subject to a full quarantine of negative gearing and therefore receive zero rental deductions, resulting in a complete loss of their tax savings from negative gearing.

— **Identifying 'mum and dad' landlords**

To differentiate between 'mum and dad' and 'sophisticated' (wealthy) landlords, the modelling considered two segregating options: landlords with high incomes or landlords with high value rental properties.

Income-based: The research differentiates low, middle and high-income rental investors. The assumption is that 'mum and dad' investors are more likely to have low to moderate incomes, while sophisticated investors are more likely to be concentrated in higher income ranges. It models a reform whereby rental investors in the bottom 50 per cent of the income distribution continue to receive a 100 per cent rental deduction, those in the 51st–75th percentiles receive a lower 50 per cent rental deduction, and those in the 76th–100th percentiles (representing 'sophisticated' investors) receive zero rental deductions.

Revenue impacts of capping negative gearing deductions, 2013–14

		Budgetary cost	Mean reduction in budgetary cost	
		billion $	billion $	%
Actual		3.04		
Progressive rental deduction	Income-based	1.30	1.74	57.3%
	Property-based	1.57	1.47	48.3%
Rental deduction cap	$40,000	2.99	0.05	1.6%
	$30,000	2.87	0.17	5.5%
	$20,000	2.57	0.46	15.3%
	$10,000	1.98	1.06	34.8%
	$5,000	1.30	1.73	57.0%

Notes: Estimates are population weighted on a person basis.
Source: Authors' own calculations from the 2013 SIH.

Mean tax savings of progressive rental deduction reforms on negatively-geared investors, 2013–14

	Percentile					
	Income-based criteria			Property based criteria		
	<=50%	50th–75th	75th–100th	<=50%	50th–75th	75th–100th
Actual: Mean tax savings (annual $)	$742	$2,362	$3,149	$1,336	$1,567	$2,156
Reform: Mean tax savings (annual $)	$742	$1,203	$0	$1,336	$752	$0
Mean reduction in tax savings						
Annual $	$0	$1,159	$3,149	$0	$815	$2,156
Per cent	0.0%	-49.1%	-100.0%	0.0%	-52.0%	-100.0%

Source: Authors' own calculations from the 2013 SIH.
Notes: Estimates are population weighted on a person basis.

Property-based: Second, the research differentiates between 'mum and dad' and 'sophisticated' investors based on the value and number of properties owned. The model simulates a reform whereby rental investors in the bottom 50 per cent of the rental property value distribution continue to receive a 100 per cent rental deduction, those in the 51st–75th percentiles receive a lower 50 per cent rental deduction, and those in the 76th–100th percentiles receive zero rental deductions.

A comparison of these reforms shows that the greatest savings to the Budget are made when the income-based criteria is applied ($1.74 billion saving) rather than the property-based criteria ($1.47 billion saving).

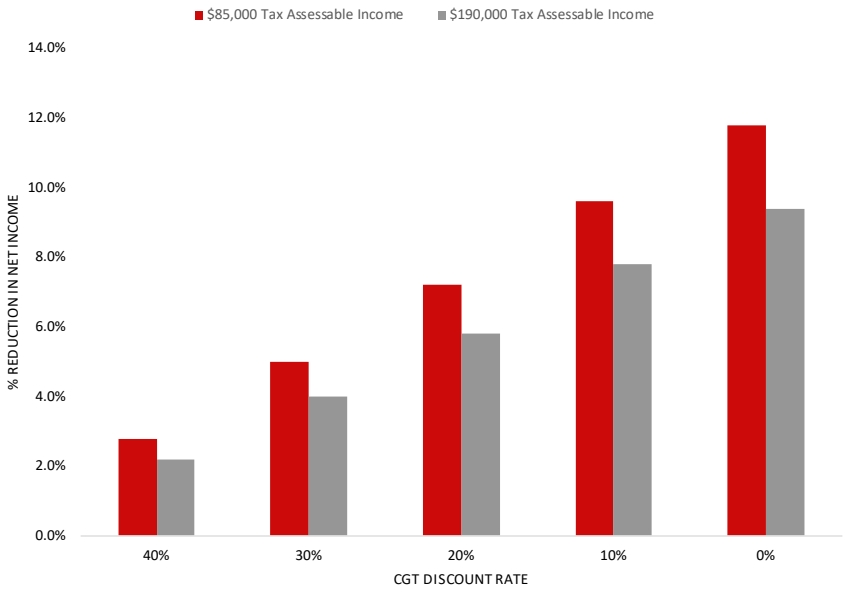
Reducing CGT discounts

Based on the 2013 SIH, a typical rental investor is male, aged 50, is employed full-time, owns a rental property that is valued on average $350,000 and his gross annual income is $85,000 per year, which attracts a tax rate of 37 per cent.

The research modelling shows that if this investor sold the house at $350,000, which included a 10 per cent capital gain (i.e. $35,000 capital gain plus the $315,000 cost of initially buying the house), under the current 50 per cent CGT exemption the investor's annual take home income (after paying tax on their salary and the house capital gains) would be $92,591 (assuming no other deductions etc.). If the CGT exemption is reduced to 40 per cent the investor would pay an extra $1,348 in tax, and if there was no CGT exemption they would pay an extra $6,738 in tax.

The modelling shows that the greater the reduction in the CGT discount rate and the higher the capital gains upon sale, the greater the reduction in net income for investors. For example, if there was no CGT exemption and the investor made a 10 per cent capital gain, they would pay 7.3 per cent more tax than they do currently. With no CGT exemption, if the investor made a 50 per cent capital gain, they would pay 19.5 per cent more tax than they do currently.

Figure: Impact of a reduction in CGT discount on the net income of a typical rental investor with gross annual income of $85,000 and $190,000, assuming capital gains of $70,000, 2013, percentage reduction



When the modelling is repeated for a second investor who earns twice as much from other income (i.e. $190,000 p.a.), and therefore pays a higher rate of tax (at 45% rate), it shows the high-income investor experiences a greater dollar reduction in net income at each reformed CGT discount rate. However, in proportionate terms, the high income investor experiences a smaller percentage reduction in net income than the lower income investor.

What this research means for policy makers

Any reforms to negative gearing or CGT ought to ensure that it reduces inequities inherent within the current systems by reducing tax savings by proportionately greater amounts for those who have relatively high income or asset levels.

Changes to negative gearing

The two modelled reforms that will result in the greatest amount of budgetary savings are either a rental deduction cap of $5,000 or progressive rental deductions based on an income criteria. Both reform models cost $1.3 billion, resulting in savings of over $1.7 billion each, and are progressive in nature, reducing tax savings from negative gearing by greater margins as tax assessable income increases.

If the policy concern is that a tightening of negative gearing parameters will impact negatively on 'mum and dad' investors' economic wellbeing, resulting in such investors withdrawing from the rental housing market, then it is likely that a progressive rental deduction that cushions 'mum and dad' investors from significant drops in tax savings will be a more appropriate policy option than a more blunt $5,000 cap on rental deductions. The potential for significant housing supply contraction in the rental market may therefore be lower under a progressive rental deduction, holding all other factors constant.

Reducing capital gains tax exemption

A reduction in the CGT discount rate will impact on rental investors on higher incomes to a greater degree (in actual dollars) than investors on lower incomes. This will narrow the gap in user cost burdens that lower income and higher income rental investors have to bear, reducing inequities within the current system.

Because of this discrepancy between percentage and dollar value impacts, any CGT policy reform proposals would need to be carefully communicated to avoid a misconception that the impact of the CGT reform is likely to be regressive in terms of its proportionate impact on rental investors' net incomes.

Methodology

This research draws on two key pieces of microsimulation modelling infrastructure that have complementary capabilities: EVITA (Evaluation Model for Incomes and Taxes in Australia) is particularly well-suited to modelling the impacts of negative gearing and AHURI-3M models the impacts of CGT reform, including transitional arrangements.

EVITA is a detailed income tax and transfer microsimulation model, developed by the Bankwest Curtin Economics Centre. EVITA provides a unique capacity to model both distributional and behavioural impacts of reforms to the full Australian tax and transfer system.

Further information

NOT FOR CITATION. TO CITE THE AHURI RESEARCH, PLEASE REFER TO:

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