



EXECUTIVE SUMMARY

The income tax treatment of housing assets: an assessment of proposed reform arrangements

Inquiry into pathways to housing tax reform

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Inquiry into pathways to housing tax reform

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Karen Doran	ACT Treasury
Saul Eslake	University of Tasmania
Glen Hepburn	Department of Treasury and Finance, Victorian Government
Brian Howe AO	University of Melbourne
Caryn Kakas	Department of Family and Community Services, NSW Government
Paul McBride	Department of Social Services, Australian Government
Greg Smith	University of Melbourne Law School
Peter White	Department of Health and Human Services, Tasmanian Government

Executive summary

- This report models several potential transitional arrangements that may ease the distribution pressures arising from reforms to negative gearing and capital gains tax (CGT) reform, and help smooth a reform pathway that is more politically acceptable.
 - Negative gearing and CGT discount benefits are currently heavily skewed towards those who are more affluent, raising concerns around the extent to which such policies exacerbate income and wealth inequality among the Australian population.
 - We model a progressive rental deduction reform whereby ‘mum and dad’ investors receive greater access to generous tax concessions than ‘sophisticated’ investors on higher income and wealth levels.
 - The progressive rental deduction reform cushions ‘mum and dad’ investors from significant drops in tax savings and will moderate adverse impacts on their economic wellbeing in comparison to a blunt cap on rental deductions.
 - A progressive rental deduction reform has the potential to reduce inequities in the current negative gearing system by reducing tax savings by proportionately greater amounts for those with higher income or property asset levels.
 - However, progressive rental deduction reforms are likely be administratively more complex to implement than a rental deduction cap. The former may also blunt incentives to work by investors.
 - A reduction in CGT discount will also have the potential to reduce inequities within the current system that favour higher income earners compared to lower income earners.
 - A gradual reduction in the CGT discount would ‘soften’ the impact of the CGT reform by providing a transition pathway that raises the after-tax economic cost of holding rental investment housing incrementally.
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Key findings

How do existing elements of the Federal income tax system (in particular the availability of deductions and CGT provisions) potentially impact on housing ownership and affordability?

Currently, the Australian tax system offers preferential income tax treatment to both owner-occupied and own-to-invest properties. Owner-occupied properties are exempt from many taxes, including CGT. There is no imputed rent applied to claw back the exemption. In respect of own-to-invest properties, the report’s policy audit has shown that the income tax treatment of investment property provides an annual tax deduction to the owners of negatively geared property that subsidises the holding cost of property. This deduction is made up of a combination of cash outgoings, of which the most significant is loan interest, and capital

allowances that are non-cash expenses. In contrast, when the property is sold the gain is included on the capital account. The amount is included on realisation and is subject to a CGT discount of 50 per cent when derived by an individual or a trustee, or 33 per cent when derived by a superannuation fund.

Hence, the policy audit identified two key sources of asymmetric (or unbalanced) treatment of rental income and capital gains in the investment property market. First, there is a mismatch in the timing of the deduction and the capital gain, with the deductions predating the capital gain. Second, the amount of the rental deduction is not discounted, whereas the capital gain is discounted. This combination of factors provides an incentive for the owners of investment properties to borrow a larger proportion of the acquisition price. The incentive arises because the interest deduction is allowed in full whereas only 50 per cent of the capital gain is included. A leveraged investment will result in a higher capital gain where the growth in property prices exceeds the interest rate.

Which investor groups, household types and housing market segments benefit or are disadvantaged by current negative gearing and CGT provisions?

Negatively geared investors who receive the highest tax savings are typically middle-aged full-time employed males. On the other hand, the ones who benefit the least are females and older investors aged 55+ years who are not in the labour force. 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 can own a property portfolio worth over \$730,000. Home-owner investors' average tax assessable income is \$82,000 compared to \$31,000 among renters who do not own any properties.

What are the revenue and distributional impacts of different negative gearing reform scenarios and transitional arrangements on housing investors and the Federal budget?

A complete abolition of negative gearing reforms has often been criticised by policy-makers for its potentially adverse impacts on the financial wellbeing of 'mum and dad' investors. Hence, in our first set of policy simulations, we distinguish between 'mum and dad' investors and 'sophisticated' investors who own higher levels of income or wealth, and we apply more generous concessions to the former. We differentiate between these investor groups in two ways—by applying income and property-based criteria.

Under the proposed reforms, 'mum and dad' investors in the bottom half of the income and property value distributions continue to receive a 100 per cent rental deduction and therefore experience no reduction in tax savings. At the other extreme, those in the upper quartile 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. Those in the 50th to 75th percentiles receive an intermediate 50 per cent rental deduction. 'Mum and dad' investors in this group lose around half of their rental deductions and are therefore cushioned from a complete loss of their rental deductions. Hence, 'mum and dad' investors are less likely to make a behavioural decision to exit the rental market than if they were subject to a full quarantining of negative gearing, holding other factors constant. Such a measure therefore represents a potential transitional arrangement that could ease the pathway towards a complete negative gearing quarantine for all rental investors over time.

If a rental deduction cap is applied across all income levels, the average tax savings that negative-geared rental investors receive reduce only very slightly by \$25 under a generous \$40,000 cap to a \$921 decline if the cap is further reduced to \$5,000. Reducing the cap levels will result in increasingly lower levels of rental deductions across the income distribution.

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

What are the revenue and distributional impacts of different CGT reform scenarios and transitional arrangements on housing investors and the Federal budget?

It is possible to estimate the impact of a reduction in CGT discount rate on rental investors' economic outcomes in two ways. The first approach is to estimate the impact of the CGT reform on rental investors' after-tax or net incomes at the point of sale. The second is to estimate the impact of the reform on a rental investor's after-tax economic costs of holding rental property (per dollar of the capital value of their rental property) by amortising the investor's CGT liability across the investor's property holding period.

A reduction in CGT discount rate reduces the net incomes of rental investors. However, the extent of this reduction will depend on interactions across various factors, including the discount rate reduction, the investor's income and the investor's capital gains on the rental property at the time of sale. The greater the reduction in CGT discount rate and the higher the capital gains upon sale, the greater the reduction in net income. Holding other factors constant, a higher income investor will also experience a greater dollar reduction in net income at each reformed CGT discount rate than a lower income investor. However, in proportionate terms, the high-income investor experiences a smaller percentage reduction in net income.

A reduction in the CGT discount rate will impact on the after-tax economic costs of rental investors on higher incomes to a greater degree than investors on lower incomes. So for instance, among those in the 0.1–15 per cent MITR band in 2010, a reduction in CGT discount rate from 50 per cent to 0 per cent would raise their average user cost of capital from 7.3 per cent to 8.1 per cent, a rise of 0.8 percentage points. However, among investors in the highest MITR tax bracket, average user cost of capital would rise by 1.2 per cent—from 7.4 per cent to 8.6 per cent.

A gradual reduction in the discount would 'soften' the impact of the CGT reform. It provides a transition pathway that raises the after-tax economic costs of holding rental investment housing by 0.1 percentage point for every 10 percentage point reduction in the CGT discount rate. Assuming a rental investment property value of \$350,000, a 0.1 percentage point increase in user cost amounts to \$350 per year.

Policy development options

Negative gearing and CGT discount benefits are currently heavily skewed towards those who are more affluent, potentially exacerbating income and wealth inequality among the Australian population. In 2013–14, negatively-gearred rental investors made a loss of around \$8,800 on average while positively geared investors made a profit of around \$16,000. However, negatively-gearred investors have noticeably higher tax assessable incomes than positively-gearred investors. The former reported an average tax assessable income of \$91,000 in 2013–14 compared to \$78,500 among positively-gearred investors. Among negatively-gearred investors, those who receive the greatest tax savings also have the highest incomes and rental property values, and greatest net rental losses.

Similarly, 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 owned a property portfolio worth over \$730,000 in 2013–14. Home-owner investors' average tax assessable income was \$82,000 compared to \$31,000 among renters who did not own any

properties. Hence, 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.

Negative gearing reform scenarios

A key policy concern is that a tightening of negative gearing parameters will impact ‘mum and dad’ investors’ economic wellbeing negatively and result in their mass withdrawal from the rental housing market. Hence, a progressive rental deduction that cushions ‘mum and dad’ investors from significant drops in tax savings will likely 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 in turn be lower under a progressive rental deduction, holding other factors constant.

Moreover, an income (property value)-based deduction has the potential to reduce inequities inherent within the current systems. It does so by reducing tax savings by proportionately greater amounts for those who have relatively high income (property asset) levels than rental deduction caps.

However, progressive rental deduction reforms might be administratively more complex to implement than a cap. A more practical approach may be to differentiate between ‘mum and dad’ investors and ‘sophisticated’ investors by income or property value bands rather than percentile ranges.

Regardless of the income measure used to differentiate between the two types of investors, the nature of progressive rental deduction reforms may blunt incentives to work by investors looking to reduce their incomes so they fall into a band or percentile that allows them to be classified as ‘mum and dad’ investors.

Capital gains tax discount scenarios

A reduction in CGT discount rate would reduce the net incomes of rental investors. Holding other factors constant, a higher income investor will also experience a greater *dollar* reduction in net income at each reformed CGT discount rate than a lower income investor with the same capital gains rate. However, in *proportionate* terms, the high-income investor experiences a smaller percentage reduction in net income. Clearly, there is a 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 income.

A reduction in CGT discount 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. This finding supports a case for a transitional approach in CGT reform. However, it is worth noting the pros and cons of adopting an approach of amortising CGT liabilities. While it represents a convenient and logical approach in the absence of necessary data on sales transactions and capital gains, it does not reflect the reality that the CGT is actually a lump sum liability rather than a recurrent expenditure.

The study

This study develops and models pathways to reform the income tax treatment of housing assets. It focuses on key tax arrangements that have featured prominently in national policy debates as having the potential to exacerbate distortions in property markets, including negative gearing arrangements and CGT provisions. The study is part of a wide AHURI Inquiry entitled *Pathways to Housing Tax Reform*.

The existing literature has highlighted concerns around the potentially distortionary effects of the present Federal income tax treatment of housing assets on housing market stability and housing affordability. Personal income tax concessions distort investment decisions, with adverse implications for the distribution of housing assets and outcomes in the housing market. First, the presence of debt-financed housing investors on a large scale is a potential source of instability in the housing market. Second, it would appear that property investors are increasingly crowding out first home buyers from the property market. Third, the asymmetric tax treatment of rental income and capital gains favour high tax bracket investors at the expense of low tax bracket investors. Fourth, the main residence exemption, under which a primary residence is exempt from capital gains tax, can reduce mobility of labour supply. In short, personal income tax concessions distort investment decisions, with adverse implications for the distribution of housing assets and outcomes in the housing market. Despite periodic national reviews of the tax system such as the 2010 *Australia's Future Tax System Review* ('Henry Review'), meaningful action aimed at implementing reform to the negative gearing and CGT provisions continue to be fraught with political obstacles to change. These policy concerns form the primary motivators behind this report.

The analysis is conducted in three related research phases. First, we present a detailed policy audit of Federal income taxes as they relate to property investment and ownership. Second, we analyse and validate the distribution of housing tax expenditures associated with existing income tax provisions on key housing groups across multiple nationally representative datasets—namely, the *Survey of Income and Housing* (SIH), *Household, Income and Labour Dynamics in Australia* (HILDA) Survey, and the Australian Taxation Office (ATO) sample file. Third, we simulate a range of alternative negative gearing and CGT discount scenarios to enable comparisons of the distributional and budgetary impacts of reformed and transitional arrangements.

For the policy simulations, we draw on two key pieces of microsimulation modelling infrastructure that have complementarities in capability—the Evaluation Model for Incomes and Taxes in Australia (EVITA) and the Australian Housing and Urban Research Institute Housing Market Microsimulation Model (AHURI-3M). EVITA and AHURI-3M are particularly well-suited to simulate the impacts of negative gearing and CGT reforms respectively, including transitional arrangements. The former is operationalised on the 2013–14 SIH and the latter on the 2010 HILDA Survey.

This report confirms an existing body of knowledge about the distortionary impacts of negative gearing and CGT discount arrangement, and the potential of policy reforms to alleviate these distortions, with potential benefits for stability and reduction in inequity in the treatment of different lower income subgroups versus higher income subgroups in the housing market. However, it also offers new findings that are both novel and which add to the policy evidence base.

First, a sample validation exercise conducted across three nationally representative datasets—the ABS SIH, HILDA Survey and ATO sample file—shows that there is a significant underestimation of the number of negatively geared rental investors and net rental losses in survey data. As part of this report's analysis, we have undertaken an intricate benchmarking exercise to redistribute net rental losses across rental investors in SIH, so that the distribution of net rental losses in the SIH are better aligned with the ATO data.

Second, this report has modelled several potential transitional arrangements that may ease the distribution pressures arising from reforms to negative gearing and CGT reform, and help smooth a reform pathway that is more politically acceptable. Importantly, a complete abolition of negative gearing reforms has often been criticised by policy-makers for its potentially adverse impacts on the financial wellbeing of 'mum and dad' investors. In a series of simulations, we distinguish between 'mum and dad' and 'sophisticated' investors and apply more generous

concessions to the former so that they are less likely to exit the rental market in response to a negative gearing reform that results in a reduction in rental deductions. Such a measure is therefore also a potential transitional arrangement that could ease the pathway towards a complete negative gearing quarantine for all rental investors over time.

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AHURI undertakes evidence-based policy development on a range of priority policy topics that are of interest to our audience groups, including housing and labour markets, urban growth and renewal, planning and infrastructure development, housing supply and affordability, homelessness, economic productivity, and social cohesion and wellbeing.

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Parts of this report's analysis draws from AHURI-3M, a housing market microsimulation model operationalised using the HILDA Survey. The model was originally developed by Gavin Wood (RMIT University), Rachel Ong (Curtin University) and Melek Cigdem-Bayram (RMIT University) under AHURI research funding.

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