Are changes to negative gearing in Australia imminent?

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Negative gearing on levered investments is one of Australia’s most prevalent tax shelters and has been the focal point of an ongoing and heated debate. While negative gearing is most commonly used in property, there is no limit on deductions from investments across a range of asset classes, such as bonds, managed funds, agriculture, real property or shares. This article will consider negative gearing concessions for investment in residential property, the arguments in favour of the abolition of negative gearing centered at the heart of the negative gearing debate, possible reform options and barriers to achieving reform.

The strategy — what is negative gearing?

Typically, negative gearing arises where an investor purchases property with the assistance of borrowed funds and the total expenses associated with holding that property, such as interest repayments, repairs or depreciation, exceed the gross income derived from a levered investment, creating a net loss position. The loss can be deducted against the taxpayer’s other assessable income and any unclaimed losses from negative gearing can be used to offset future assessable income or capital gains.

There are no specific legislative provisions governing negative gearing, instead the current tax regime in Australia allows investors to negatively gear their investment and claim the loss as a general deduction against other assessable income provided that the “loss...is incurred in gaining or producing [the taxpayer’s] assessable income”. The controversy surrounding negative gearing concerns the deductibility of interest expenses on the borrowing. An interest expense is deductible if it has a “sufficient nexus” to gaining or producing assessable income. This is dependent upon the “essential character” of the interest repayment, which is usually determined by ascertaining whether the borrowed funds are being used for an income producing purpose.

The High Court of Australia established precedent for negative gearing on residential property investments in FCT v Janmor Nominees Pty Ltd. In Janmor Nominees, a family trust used borrowed funds to purchase an investment property, which was then rented to a beneficiary of the trust at a commercial rate. The High Court held the trust’s expenses, including interest repayments, were deductible as the trustee’s motive for investment had been informed by sound business considerations at arm’s length.

Negative gearing will operate as an effective investment strategy if the property is expected to appreciate and the expected capital gain from that property is greater than the short-term losses. The negative gearing concession can be used in conjunction with the capital gains discount. In that regard, generally only 50% of the capital gain will be subject to tax at the time of disposal of the property. Accordingly, when coupled with the ability to offset unlimited and un-quarantined investment losses against assessable income outside the investment, the discount offers a second “advantage” to taxpayers who use negative gearing. Further, both mechanisms allow for some element of deferral of the loss which could be manipulated to the taxpayer’s advantage.

Historical background

In 1985, the Hawke government introduced a measure to “quarantine” losses arising from negatively geared investments, limiting their deductibility to income derived from the same source for properties acquired after 17 July 1985. The decision was met with considerable opposition which caused the Hawke government to repeal the measure in 1987. Supporters of negative gearing look back to the steep increase in rents observed in Sydney and Perth following the 1980s abolition of negative gearing as justification for maintaining negative gearing in its current form. Their argument is that if the tax incentives associated with negative gearing are abolished or reduced, this would potentially force landlords to increase rents to avoid losses previously deductible under negative gearing concessions, disadvantaging tenants. Coupled with this, there is a risk of reduced rental supply due to a lesser incentive for investors to enter the market. However, it is necessary to factor in the other market drivers present in the 1980s, such as record high interest rates, low vacancy rates and a booming stock market which are in stark contrast to the
current market conditions before making predictions about the impact of any reform to negative gearing today.  

The drivers of reform

Despite its popularity with investors, there have been numerous criticisms of negative gearing focused particularly upon the inequities that it creates, concerns in relation to its distortionary impact upon the economy and the impact on the revenue. These criticisms are discussed below and provide an impetus for reform.

Equitability concerns

The most common criticism of the current position on negative gearing is that it infringes upon the concept of “vertical equity”, as high income earners have the capacity to leverage more than lower income earners and higher income earners attract a higher marginal tax rate, which means that the benefits of negative gearing can reduce their tax liability significantly more than lower income earners who attract lower marginal tax rates. In that regard, negative gearing can be used by higher income earners to effectively circumvent the marginal tax rates applicable to their income. Further, high-wealth taxpayers are more likely to have strong enough cash flows in the form of salary and wages or income on positively held investments to enable them absorb the losses from negative gearing without a significant impact on their disposable income. While the Australian Taxation Office (ATO) statistics indicate that over half (66.5%) of the taxpayers claiming deductions for their investment property have a taxable income of $80,000 or less, these statistics are potentially misleading as a proportion of these taxpayers are only classified as “middle income” because significant deductions (including those attributable to negative gearing) have already been deducted. When gross income (rather than taxable income) is used as the measure, statistics show that over half of all negatively geared rental property investors earn over $100,000 and 30% earn over $500,000. The vertical inequity would be partially alleviated if low and middle-income earners benefit indirectly from the concessions through greater housing affordability. However, this is not the case, almost 93% of investment loans are directed towards the purchase of existing dwellings. This means that the concessions overwhelmingly support investments that do not contribute to expanding the housing supply which is exacerbating current issues surrounding housing affordability. The housing affordability problem has been one of the catalysts driving the debate on the appropriateness of the concessions, as home ownership has long been regarded as a fundamental right of an average hard-working Australian. A comparable effect cannot be observed for other types of negatively geared investment assets which support the differential tax treatment of residential property.

Economic concerns

Economic concerns have also been raised regarding negative gearing, with the Murray Financial Inquiry warning that over-encouragement of leveraged and speculative investment is a source of systematic risk for the financial system. There is a risk that negative gearing concessions have induced investors to become over-levered, inflating a perceived real estate bubble and increasing the detrimental impact of a potential collapse. The potential economic problems resulting from an over-levered nation or a housing crisis would be borne by all Australians. Reforms to negative gearing would presumably include a transition period for currently held residential investment properties that would seek to overcome these unsustainable debt levels by ensuring leveraging slowly decreases by reducing incentives to borrow, while still protecting existing levered investors from rising rates or forcing simultaneous sales from over-levered investors.

A further economic concern is that negative gearing concessions (when combined with the capital gains tax (CGT) discount) encourage investment in passive, appreciating assets, rather than investment in areas that would stimulate and grow the economy. Reform to negative gearing is likely to encourage investment in new and existing businesses through equity markets, better stimulating economic growth by allocating funds toward employment and productivity and into more productive areas such as plant and equipment, human capital, and research and development.

Fiscal adequacy concerns

The negative gearing concessions from investments in residential property result in a “loss” of government revenue in the range of $2–$4 billion per year. In the face of increasing budgetary pressures, this loss in government revenue from the concession may not be sustainable. Reforms to negative gearing may assist to alleviate some of the budgetary stress. However, a cautious approach should be taken to estimating the fiscal benefit of any proposed reform, as investors will inevitably make investment choices in response to a policy change which will have a distortionary effect, reducing the fiscal benefit.

The reform proposals

Reforming negative gearing is highly controversial, and there is very little consensus within the Australian community, politically or among tax reform experts, on
the best way forward or even whether reform is necessary at all. There are a number of reform options available, most of which are targeted at addressing the problems with the residential property market.

There is considerable flexibility toward negative gearing in Australia that is not present in jurisdictions outside of Australia. One common recommendation is to implement a policy similar to that in the United Kingdom, which quarantines gains and losses flowing from negatively geared investments. Quarantining could be implemented in various ways, such as limiting the deductibility of losses to income derived from the specific asset making the loss, or by only allowing losses to be deductible against assets within the same class. While the CGT discount is likely to remain under this reform, as future capital gains cannot be predicted, the advantage of the CGT discount may not be enough to encourage successful implementation of this reform proposal.

Another reform proposal is to disallow negative gearing for future purchases of established residential properties, but to continue to allow negative gearing for newly constructed dwellings. Under this suggested reform, individuals, not otherwise carrying on a business, will be denied deductions for interest payments and other expenses to the extent that they exceed assessable income from the property. Net losses can be “quarantined”, and carried forward and offset against future assessable profits and capital gains from the property. Negative gearing concessions will continue to be available for newly constructed dwellings only which will include construction on newly released land, and construction on existing land that increases the number of people accommodated. The policy behind this exception is that by maintaining an incentive to construct new residential properties, the housing stock will increase, which will make housing more affordable.

Transitional arrangements will need to be implemented in relation to currently negatively geared properties as it would be unfair for taxpayers who have factored a negative gearing strategy involving residential property into their long-term financial strategies. The transition period needs to be long enough to allow investors of currently negatively geared properties time to reconsider their medium to long-term investment strategies but not too long so as to distort the housing market by encouraging investors to retain their investment properties and enjoy an unfair advantage over other taxpayers. One suggestion is to phase out negative gearing for current investors over a period of 5 years which will allow property investors a reasonable amount of time to make any changes to their investment decisions, while avoiding property market instability. One criticism of this reform measure is that it infringes upon “horizontal equity” as current residential property investors continue to receive the tax benefit, while those without residential property investments receive no benefit. However, this inequity may not result as current investors may have purchased real estate in an inflated market, fueled by high investor demand which is likely to decrease as a result of the introduction of the reform, deflating property prices. Arguably, this will reduce current investors’ eventual capital gain, partially offsetting the benefits that they would have received had the reform not been introduced. Further, the issues in relation to vertical inequity in the current system of negative gearing discussed above will remain in relation to investment for newly constructed dwellings; however, this will be counteracted by the increase in housing supply which will make housing more affordable.

**Barriers to implementation**

At the forefront, any reform proposal for negative gearing faces steep political barriers. Negative gearing has arguably attained the status of a “sacred cow” in Australia and any political move involving the abolition or reform of negative gearing is likely to be very unpopular. The intense backlash felt by the Hawke government following the abolition of negative gearing in 1985 serves as a stark reminder to any government entertaining the idea of reform and not surprisingly, both sides of politics have previously sought to distance themselves from reform of negative gearing.

Edmonds J when speaking at the Australasian Tax Teacher Association’s conference earlier this year mentioned that conflicting political interests pose perhaps the most significant barrier toward any reform. Australian taxpayers enjoy the benefits of the negative gearing concessions and therefore have a vested economic interest in maintaining the status quo. Even with reasonable transitional arrangements, these taxpayers are likely to oppose the abolition of negative gearing, as it means they would not receive the tax concessions associated with negative gearing for any future property investments they make. Since most of these taxpayers are voters, their opposition invariably contributes to the political barriers to reform. It is relevant to note that the use of negative gearing concessions is most strongly associated with the baby boomer generation which occupies a significant, but declining, percentage of the voting population in Australia. Also of interest is that the biggest beneficiaries of negative gearing are located in electorates represented by senior government ministers, including the Prime Minister. Representative bodies such as the Property Council of Australia and the Housing Industry Association oppose reforming negative gearing. These housing industry bodies are highly effective at lobbying government and...
persuading the political view. For example, these housing industry lobbyists played an instrumental role in reversing the abolition of negative gearing in the 1980s, within the space of only 2 years. These groups are likely to focus on the previous policy change which was an “unmitigated disaster” as well as use a number of other scare tactics in campaigning against any reform proposals.

Reform of negative gearing may be more politically viable under a Labor government. Bill Shorten’s Opposition has suggested that it may consider reforming negative gearing, but is unlikely to reform it entirely. Measures abolishing or restricting negative gearing are likely to be supported by the Australian Greens Party, which has announced its policy package to abolish negative gearing.

Australia’s current economic conditions may suggest that any reform proposal is not appropriate in the short-term. The mining and resources sector as well as the banking sector were driving Australia’s economy and are now more vulnerable and potentially sensitive to collapse. Further, it is unclear just how sensitive the inflated real estate market is, but the government will be wary that any shock could be the catalyst to a crash. With record low interest rates, the Reserve Bank of Australia has very limited influence on economic conditions and would have no way of counteracting an economic downfall resulting from the reform of negative gearing.

Simplicity is one of the key strengths of the current policy regarding negative gearing concessions. The system is both simple to understand, it is well understood by practitioners and it is easy to administer, as property investors do not need to consider any additional criteria when claiming deductions. The Tax Institute has emphasised that any changes to negative gearing should be thoroughly assessed for their implications on complexity. History also cautions that simplicity should be a high priority, given that the short-lived 1985 legislative amendments were overly complex and unwieldy.

Conclusion

While negative gearing has remained relatively untouched in the Australian tax system since the late 1980s, the numerous criticisms of negative gearing focused particularly upon the inequities that it creates, concerns in relation to its distortionary impact upon the economy and its impact to the revenue provide an impetus for reform. There have been a number of proposed reform measures which may have merit and are worthy of further discussion. However, as discussed, there are significant political barriers to any reform being implemented which are likely to derail any meaningful discussion about policy. Coupled with the current fragile economic environment, any short to medium term changes to negative gearing in Australia are unlikely.

This paper has been subject to an independent review.

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Footnotes
1. Greg McKenna “Australia’s obsession with negative gearing and property investment is costing the economy” Business Insider Australia 10 November 2014; Richard Edmonds “Structural tax reform: what should be brought to the table?” (2015) 30 Australian Tax Forum 393 at 405.
3. Above n 3.
7. Above n 2, at 21.
10. ITAA 97, s 8–1.
12. ITAA 97, s 8–1.
17. Above n 15.
19. ITAA 97, Div 115.
20. ITAA 97, Subdiv 115–A.
25. Above n 24, at 204.
28. Above n 27.
31. Reserve Bank of Australia Financial Stability review — Box C(September 2014) p 51.
33. Saul Eslake, Submission No 2 to the Senate Economics References Committee, Australian Housing Policy: 50 Years Of Failure, December 2013, p 10–11.
35. Above n 33.
36. Above n 33, p 15.
37. Above n 5, at 63 and 83.
38. Above n 2.
41. Richard Edmonds, above n 1, at 393 and 405.
42. Above n 5.
43. Anthony Ting “Why negative gearing is not a fair tax policy” The Conversation 17 July 2015 p 1.
44. Above n 40; Matt Grudnoff Top Gears: How negative gearing and the capital gains tax discount benefit the top 10% and drive up house prices (April 2015); Jim O’Donnell, above n 5, 63; Rami Hanegbi, “Negative Gearing: Future Direction” (2002) 7(2) Deskin Law Review 349.
47. Matt Grudnoff, above n 44, p 11.
48. Above n 47.
49. Above n 47.
50. Above n 33, p 15.
51. Above n 33.
52. Above n 21, p 3.
53. Above n 5.
54. Above n 33, p 13.
57. Above n 5, 79.
61. Above n 60.
64. Australian Greens Party, Greens announce reforms to end negative gearing and boost affordable housing supply, 7 June 2015, greens.org.au.