

Negative Gearing & CGT

AUSTRALIAN DEMOCRATS ACTION PLAN
NEGATIVE GEARING & CGT
TAXATION, FINANCE & CORPORATE AFFAIRS

The Australian Democrats oppose the use of negative gearing to reduce salary income tax, and propose quarantining the use of investment losses for offsetting investment income only. By allowing investment property losses to offset salary income, the Government is effectively subsidising wealthier investors to make speculative gains in the property market. Negative gearing has a significant public cost in the form of income tax revenue foregone, currently estimated at \$2.4 billion annually. The 50% concession on Capital Gains Tax for properties held longer than one year has cost the revenue nearly \$5 billion a year.

“It is not at all obvious to me why capital gains should be taxed at a lower rate than income from wages and salaries, other than that this is also the case in some other countries. There's certainly no evidence that it has lifted the level of saving”

Saul Eslake speaking at the University of Tasmania September 2005.

Our Action Plan

The Australian Democrats propose

- limiting negative geared losses so that they can only be used to offset profits from investment assets, not from salary income;
- reviewing capital gains tax concessions.

Issue one: housing price bubble?

The increase in Australian house prices has been phenomenal:

- In the last 20 years house prices in Australia have more than quadrupled
- In real terms after taking inflation into account, houses are now 80% more expensive than 10 years ago
- In some capital cities, such as Perth and Brisbane, the increase has been even more dramatic

This asset inflation has been welcomed by many home-owners but has created plenty of problems for those without homes.

The Commonwealth HIA Index of Housing Affordability is at its lowest level since the index was established in 1984, meaning that despite our overall economic prosperity, owning a home is harder than ever for many Australians.

Despite lower interest rates and higher overall national disposable income, housing affordability has deteriorated dramatically with the ratio of an average house price to annual household disposable income increasing from 2.5 times in 1986 to 5.4 times in 2006.



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Negative Gearing

Whilst fluctuations in housing prices can be cyclical and market driven, the federal government has played an important role through its policies, including taxation policy. They have encouraged people to take advantage of tax concessions – the combined effect of negative gearing and capital gains tax concessions have helped promote speculative investment and reduced housing affordability.

Such property investment strategies take advantage of 'beneficial' tax concessions. This is the combined effect of negative gearing and capital gains tax concessions – two policy initiatives that have exacerbated housing affordability.

Issue two: negatively geared investment property

Negative gearing is a form of financial leverage for investments. It occurs when

- the amount of allowable tax deductions in connection with an investment exceeds the level of assessable income derived from that investment, resulting in a net loss by the tax payer on the specific activity concerned;
- this net loss is offset against income from other sources to reduce the income tax that must be paid.

Negative gearing is different from standard business practice. The principal motivation is not to earn regular business income from an investment but to make a capital gain on an asset when it is finally sold. Negative gearing enables the minimisation of the annual holding costs by setting annual operating losses against other income for a tax benefit. Business investors in rental property seek to make an annual profit, and therefore seek a commercial return, which means the rent must be affordable to the class of renter targeted. Negative gearing in contrast encourages speculative investors to focus on asset inflation not annual profit.

Recent Australian Tax Office data reveals that taxpayers declared a total of \$17.65 billion in rental income but claimed \$21.75 billion in rental deductions. Interest deductions alone accounted for \$12.13 billion. About 1 in 6 taxpayers are involved.

Such property investments are speculative since a negative gearing strategy relies upon asset price inflation greater than the shortfall between income generated and interest expense incurred. This implies that a rapidly rising property market is an essential trend upon which negative gearing investment strategies are dependent. Is negative gearing as an investment strategy perpetuating the sustained increase in property prices, or merely reliant upon it?

Considering all of the factors it is apparent that in a period of rapidly rising house prices, growing disposable incomes and rising interest rates negative gearing is an attractive investment strategy but with a significant public cost in the form of income tax revenue foregone, currently estimated at \$2.4 billion annually.

The Democrats oppose the use of negative gearing to reduce tax on salary income as is currently the case. Negative gearing encourages tax-levered debt and tax schemes solely designed to minimise tax. It is the foundation of all the 'taxman buys your investment property' schemes, and enables investors to purchase one or more

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investment properties at increasingly higher prices and lower rental yields. This new 'equilibrium position' has been funded through the public purse.

The majority of overseas countries – including the USA, the UK, and Canada - do not allow negative gearing. The United States, for example, allows negative gearing losses from investment to be claimed against income from that (and other investments), but not against salary income.

Negative gearing attacks the integrity of the tax system, significantly reduces the tax revenue available for other government services, and distorts the rental market.

Issue three: capital gains tax exemptions

Despite the great national benefits of the previous Labor government's compulsory superannuation – now over \$1 trillion in savings – Australia's tax system has had less incentives for saving, and has rather encouraged the accumulation of wealth through borrowing to buy assets that are expected to appreciate at a rate faster than inflation.

A key stimulus for the most recent housing boom and consequential crisis in housing affordability was the 1999 decision by the Liberal/National Government to implement a 50% concession on Capital Gains Tax for properties held longer than one year. The appeal of negative gearing was greatly enhanced by this decision. This change to tax law in 2000 was supported by Labor, but opposed by the Democrats.

The doubling in Australia's capital cities house prices has occurred since that decision. In addition, this CGT concession has cost the revenue nearly \$5 billion a year. Imagine that spent on affordable housing initiatives instead. The investment surge was fuelled by borrowings, largely funded by increased bank borrowings offshore, in turn helping raise Australia's foreign liabilities to record heights.

This CGT exemption, combined with negative gearing was a tremendous boost for investors who, logically, 'priced in' the value of this tax concession, thereby explaining in part, the dramatic upward shift in house prices.

The Democrats opposed the 50% capital gains tax exemption on the basis that it enables and subsidises an investor's speculative gain on investment assets, including real estate property through the public purse. Moreover, such distortions in tax policy effectively encourage investment in property, merely for the value of the tax break, artificially inflating house prices at the expense of first or low income home owners.

This halving of the CGT allows tax to be deferred and reduced. At the top tax rate (where two-thirds of CGT payers are to be found), interest on borrowings is deductible in the current year at 46.5 cents in the dollar, but the capital gain tax to be paid in a later year will be paid at the rate of 23.25 cents in the dollar.

The Democrats support the concept of a stepped CGT rate to encourage productive investment. A stepped rate commencing after just one year is far too short a holding period for assets such as property.



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