Pegasus Economics

International Comparison of Taxation Arrangements for Individual Residential Property Investors

Alistair Davey

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Pegasus Economics • www.pegasus-economics.com.au • PO Box 449 Jamison Centre, Macquarie ACT 2614

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The views and opinions expressed in this report are those of the author.

For information on this report please contact:

Name: Dr Alistair Davey

Telephone: + 61 2 6100 4090

Mobile: 0422 211 110

Email: adavey@pegasus-economics.com.au

Front cover photograph shows houses in Tura Beach in New South Wales.

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Under the current tax rules in Australia, investment property losses are not "quarantined" (Wright, 2016). That is, the losses on an investment property are not only tax-deductible against the income from the investment property but also against other forms of taxable income. Not quarantining losses from residential property investments is a major point of difference between Australia compared to most other countries.

Australia's system of allowing net rental losses to be set against non-rental income is often thought to be extraordinary, if not unique (Martin, et al., 2018, p. 41). However, this is definitely not the case. The following nations also allow negative gearing in a manner similar to Australia:

- Germany
- Japan.

Several other countries allow for the deductibility of interest payments on residential property investments and in some cases a more limited application of negative gearing, including:

- Canada
- France
- Finland
- Ireland
- Norway
- Spain
- Sweden
- The United States.

There are two countries that have decided to phase out interest deductions for residential property investments:

- New Zealand
- United Kingdom (UK).

All countries considered make provision for deductions or else provide other offsets for residential property investors for non-interest expenses incurred. It is more often the case than not that interest expenses incurred on residential investment properties are deductible to some extent across the OECD.[1] It is also the case that most OECD countries offer some type of discount or concession for capital gains (Daley & Wood, 2016, p. 18). Even in those countries that are phasing out the deductibility on interest repayment, there are other tax benefits provided for residential property investors. It is therefore misleading and overly simplistic to focus simply on a few aspects of the tax system – the treatment of passive losses, deductibility of loan interest repayment or even negative gearing – without also taking into consideration the broader features of another country's tax system.

While overall Australia is a comparatively low taxing country by international standards as measured by our tax-to-GDP ratio, Australia raises more revenue from personal income tax than any other country other than Denmark across the 38 members states of the Organisation for Economic Co-operation and Development (OECD) (OECD, 2022a).

[1] See OECD (2022, pp. 138-140).

Australia's top personal tax rate of 47% hits workers at a lower income threshold than other economies in the Anglosphere of New Zealand, Canada, the United Kingdom and United States (Kehoe, 2022).

It has been observed that while Australia and Germany share several similar settings in relation to tax on investment housing – such as permitting negative gearing and providing generous discounts on the taxation of capital gains – this has resulted in quite different market outcomes: speculative inflation in Australia; versus relatively steady housing prices in Germany (Martin, et al., 2018). One of the reasons for the different outcomes may be due to the top marginal tax rate setting in at a relatively much lower level of income in Australia than compared to Germany.

1. Introduction

Pegasus Economics (Pegasus) has been commissioned by the Housing Industry Association to examine the taxation of individual investors in residential property in Australia and how it compares with taxation arrangements in overseas jurisdictions.

Pegasus identifies rental deductions including the practice of negative gearing, along with the application of the capital gains tax and personal income tax as the primary taxation arrangements for consideration in relation to individual investors in residential property and this will be the main focus of this report.

The views and opinions expressed in this report are entirely those of the author. The author of this report declares that so far he has never owned an interest in a residential investment property nor has he negatively geared any investment asset held.

2. Interest Rate Deductibility and Capital Gains Taxes

Under the current tax rules in Australia, investment property losses are not "quarantined" (Wright, 2016). That is, the losses on an investment property are not only tax-deductible against the income from the investment property but also against other forms of taxable income. Not quarantining losses from residential property investments is a major point of difference between Australia compared to most other countries. According to the Australian Council of Social Services (ACOSS) (Australian Council of Social Service, 2015, p. 5):

> *Australia has unusually generous tax treatment for investment in rental property. Unlike most wealthy countries, including the US and UK, our income tax system places no limit on deductions that can be claimed for investment expenses relating to rental properties and other investments producing capital gains such as shares and agriculture.*

2.1 Countries that Allow Negative Gearing

Australia's system of allowing net rental losses to be set against non-rental income is often thought to be extraordinary, if not unique (Martin, et al., 2018, p. 41). However, this is definitely not the case. The following nations also allow negative gearing in a manner similar to Australia:

- Germany
- Japan.

In **Germany** you can deduct any expenses resulting from rental income against your taxable rental income (New Zealand Treasury, 2021). This includes mortgage expenses, as well as costs for maintenance, improvements and repairs. Capital gains derived from private sales are taxed if the assets were held no more than 10 years, otherwise they are tax exempt (German Probate Lawyer, 2023; Martin, et al., 2018, p. 20). If an investment property is held for less than 10 years, then the capital gains on the sale of property are taxed at the rate of 25%, generally along with the application of a solidarity surcharge of 5.5% (German Tax Consultants, n.d.).

In **Japan**, some of the expenses incurred by residential property investors that can be deducted from gross rental income include:

- various real estate taxes
- insurance fees
- depreciation expense
- repair expenses
- interest rate on borrowings

- management fee to a property management company (Plaza Homes, 2018).

To the extent a taxpayer has a net rental loss excluding loss generated from offshore real estate, this loss can be used to offset other types of income (Kamachi, 2023). In Japan capital gains arising from the sale of real property are taxed at a total rate of up to 39.63% (30.63% for national tax purposes and 9% local tax) depending on various factors (Takashima, 2022).

2.2 Countries with Restrictions on Deductibility of Interest Payments

Several other countries allow for the deductibility of interest payments on residential property investments and in some cases a more limited application of negative gearing, including:

- Canada
- France
- Finland
- Ireland
- Norway
- Spain
- Sweden
- The United States.

In **Canada**, residential property investors can deduct any reasonable expenses that incur in earning rental income, including:

- advertising
- insurance
- interest and bank charges
- management and administration fees
- repairs and maintenance
- property taxes
- utilities (Canada Revenue Agency, 2022).

Interest deductibility is subject to 'reasonable expectation of profit' test (Martin, et al., 2018, p. 40). On the other hand, landlords cannot claim the expenses for renting part of a property if they have no reasonable expectation of making a profit (Canada Revenue Agency, 2023). Historically, this test has required the taxpayer to be able to demonstrate that the rental property will produce a profit within a reasonable number of years (Reserve Bank of Australia, 2003, p. 43). Like Australia, Canada offers a 50% reduction on tax for capital gains from the sale of investor residential property (Martin, et al., 2018, p. 20).

In arriving at net rental income in France, deductions can include repairs, maintenance and improvements, local taxes, employee costs, interest expenses, management fees and insurance costs (New Zealand Treasury, 2021).

In **France**, the method of taxation is complex and varies depending on the status of the leased property. If the property leased is unfurnished, as in without any furniture or appliances, rent (less any allowable deductions) is taxed in the "property revenue" category (Vaneau, n.d.). It is then added to the any other taxable revenue and taxed at the tax rate applicable to the owner. If the gross annual rent (excluding charges) is less than €15,000, the owner automatically benefits from the "microfoncier" scheme with a notable 30% lump sum rebate. On the other hand, the owner will not be able to deduct any eventual expenses incurred during the year.

Should the gross annual rent exceed the €15,000 threshold or if the owner has important expenditures (renovations for example) and wishes to opt for this, the rent revenue will be taxed on the “real” amount (Vaneau, n.d.). In this case, a large part of the charges and expenses (including the interest from a loan) are deductible from the property revenue: which will reduce the taxable amount. In the year of expenditure, the eventual balance may be deducted from the global revenue of the owner up to €10,700. Should there remain a deficit, it may be reattributed onto the rent over the next ten years.

If the rental property is furnished, even if it is only occasionally let out (such as a chalet rented for a couple of weeks in the winter) the rent is systematically taxed in the category of commercial and industrial revenue and is subject to the progressive tax scale (Vaneau, n.d.). Should the gross annual rent (excluding charges) be less than €70,000, the owner automatically benefits from the “micro-BIC” scheme with a notable 50% lump sum allowance. In return, the owner will not be able to deduct any eventual expenses incurred during the year.

Should the gross annual rent exceed the €70,000 threshold or should the owner have important expenditures (renovations for example) and wishes to opt for this, the rent revenue will be taxed on the “real” amount (Vaneau, n.d.). In this case, a majority of the charges and expenses are deductible from the property rent. The building (excluding land) and the furniture may be amortized (the building over 30-40 years and the furniture over 7-10 years). If the charges are more than the rent, the deficit may be deducted from the other taxable commercial and industrial revenue of the year and if the deficit remains, it may be reattributed over the next 10 years. Should the owner have opted for the Professional furnished landlord status, the deficit may be reattributed onto the global revenue of the year or on the following six years.

The standard capital gains tax rate in France when selling property is 19% (Blevin Franks, 2022). However, progressive surcharges from 2% to 6% are added to gains over €50,000, calculated after the application of the holding deduction. There are also exemptions for those who receive a state pension or whose wealth and income are below a certain level, in these cases property is free from the application of the capital gains tax. Likewise, if you invest the proceeds into a primary residence and did not own one in the previous four years. In any case, a taper relief system reduces capital gains tax the longer you have held the property, starting from the sixth year of ownership. After 22 years, no capital gains tax is due at all. Gains made on the sale of property are additionally liable to social charges at 17.2%. Again, a taper relief system reduces the charges by 1.65% from year six and by 9% from year 23, with total exemption after 30 years.

Expenses that are tax deductible from rental income in **Finland** include agent commissions, interest expenses on residential investment properties, maintenance fees, repair work needed to maintain the property, repair and renewal of household equipment, and Finnish Landlord Association membership fees (Vuokraturva, n.d.). The rental income left after the deductions is taxed as capital income. If there is no income after the deductions, no tax is paid. If the deductions are greater than the income, you have a deficit in capital income. The deficit can be credited against your income tax or confirmed as a loss in capital income, in which case you can deduct the amount from capital income within the next ten years.

In Finland various expenses related to rental operations can only be deducted for the apartments, flats, houses, other properties that are rented out for the purpose of receiving income (Vero Skatt, 2020). This means that you must charge rent at market value. To offer property for rent at market value refers to charging reasonable rent, in line with the rent rates charged for similar properties, in the same neighbourhood, town, district, etc. To rent out residential and other property below market is not considered to constitute a rental operation that aims for the production of income. In such cases, not all related expenses can be deducted. No deductions can be made for interest on mortgages, and mortgage fees, when buying residential property that is then rented out at below-market rent.

In Finland capital gains are basically fully taxable and included in the taxable capital income subject to 30% tax rate up to taxable capital income of €30,000 and 34% tax rate on the excess (Hirvonen, 2023). Capital gains that do not exceed €1,000 are exempt from capital gains tax (Taxation Researcher, 2023).

In **Ireland** residential property investors can claim certain expenses against their rental income to reduce the amount of tax they have to pay (Revenue, 2022). Allowable expenses include:

- rates to the local authority
- insurance premiums
- maintenance costs such as cleaning, painting and decorating
- property management fees
- certain utility expenses not paid by the tenant
- capital allowances
- repairs
- the cost of registering with the Residential Tenancies Board (RTB).

In Ireland, rental property owners can claim mortgage interest relief against their rental income (Revenue, 2022). The interest must be from a mortgage used directly to buy, improve or repair a rental property. In Ireland you can claim Mortgage Interest Relief if you are registered with the RTB:

- while your property is rented out
- in between renting out the property as long as you do not live in it during that time.

Mortgage Interest Relief in Ireland is restricted to a percentage of the interest as provided in Table 2 below.

Table 1: Mortgage Interest Relief in Ireland is restricted to a percentage as follows

	Percentage
interest accrued on or after 7 April 2009 to 31 December 2016	75%
interest accrued from 1 January 2017 to 31 December 2017	80%
interest accrued from 1 January 2018 to 31 December 2018	85%
interest accrued from 1 January 2019	100%

Source: Revenue (2022).

In Ireland capital gains are generally taxed at the rate of 33% (Revenue, 2021).

In **Norway** residential property investors can deduct expenses from rental income where a property is rented for at least 30 days (The Norwegian Tax Administration, n.d.). Deductions can include:

- maintenance
- municipal taxes
- insurance policies
- property management fees
- properties taxes
- utility charges
- furniture and home contents

As a general rule, interest expenses are deductible in Norway irrespective of whether the debt has any connection with the earning of income or not (PwC Norway, 2023). In turn, interest expenses are deductible irrespective of what the loan has been contracted for and irrespective of whether the loan is secured by mortgage or not. In general, capital gains/losses on the sale of real estate (asset deal) are taxable/deductible regardless of the seller's tax residence (KPMG Law, 2021, p. 8). The gain is taxed at 22%.

In **Spain**, landlords have a number of deductions that can be used to offset against their gross income earned from rent (Salazar, 2023). Applicable deductions include maintenance costs, annual depreciation, mortgage interest, community charges, municipal property taxes, refuse collection and similar outgoings. When a property is rented to tenants for use as their primary residence, landlords are permitted to reduce net profits (income earned minus costs) by 60%. In Spain sellers pay capital gains tax on profits from the sale of an investment property (Houses in Spain, n.d.). According to Spanish tax laws, if you're a resident, a scale of between 19% and 23% is applied.

In **Sweden** landlords are permitted to make a general deduction from their rental income (Skatteverket, 2023). The deduction is 40,000 Swedish Krona per property for the 2022 income year, regardless of how many owners there are. For rentals of houses, you may also deduct 20% of rental income in addition to the flat-rate deduction of 40 000 Swedish Krona per year (Be Resident Sweden, n.d.).However, the deductions may not exceed the income (Skatteverket, 2023). The surplus on the rental income minus deductions is taxed as capital gains, which in the current situation is 30% (Be Resident Sweden, n.d.). Capital gains on the sale of a residential investment property are in general taxable at 22% (RSM, 2023).

In the **United States**, in most cases the expenses of renting out a property, such as maintenance, insurance, taxes, and interest, can be deducted from your rental income (Internal Revenue Service, 2023, p. 3). Landlords are permitted to deduct mortgage interest they pay on their rental property (Internal Revenue Service, 2023, p. 4). In most cases, all rental real estate activities (except those of certain real estate professionals) are considered passive activities (Internal Revenue Service, 2023, p. 13). Deductions or losses from passive activities are limited. You are thus generally not permitted to offset income, other than passive income, with losses from passive activities. Nor can you offset taxes on income, other than passive income, with credits resulting from passive activities. Any excess loss or credit is carried forward to the next tax year.

In the United States, the tax rate on most net capital gain is no higher than 15% for most individuals (Internal Revenue Service, 2023a). Some or all net capital gain may be taxed at 0% if your taxable income is less than or equal to US$41,675 for single and married filing separately, US$83,350 for married filing jointly or qualifying surviving spouse or US$55,800 for head of household. A capital gain rate of 15% applies if your taxable income is more than US$41,675 but less than or equal to US$459,750 for single; more than US$83,350 but less than or equal to US$517,200 for married filing jointly or qualifying surviving spouse; more than US$55,800 but less than or equal to US$488,500 for head of household or more than US$41,675 but less than or equal to US$258,600 for married filing separately. However, a net capital gain tax rate of 20% applies to the extent that your taxable income exceeds the thresholds set for the 15% capital gain rate.

2,3 Countries Phasing Out Deductibility of Interest Payments

There are two countries that have decided to phase out interest deductions for residential property investments:

- New Zealand
- United Kingdom (UK).

The following expenses can be deducted from rental income by residential property investors in **New Zealand**:

- insurance costs
- property rates
- property management fees
- repair and maintenance costs
- fees for arranging a mortgage to finance the rental property
- depreciation on capital expenses (Inland Revenue, 2021).

New Zealand previously allowed interest deductions for loans on rental properties, including negative gearing, but the New Zealand Government announced changes in March 2021 to phase out interest deductions. From 1 October 2021 new rules limited the amount of interest deductions that could be claimed on rental properties in New Zealand (Inland Revenue, 2021). For residential rental property acquired on or after 27 March 2021 interest is not deductible (unless an exclusion or exemption applies). For residential rental property acquired before 27 March 2021 the ability to deduct interest is being phased-out over 4 income years. Interest on any new loans drawn down on or after 27 March 2021 cannot be claimed from 1 October 2021 onwards.

New Zealand Treasury officials justified the phasing out of negative gearing because there is no capital gains tax applied in New Zealand:

> *… a general principle of income tax is that expenses should only be deductible to the extent that they relate to taxable income. As property investors invest in housing, at least in part, in order to earn untaxed capital gains, it would follow that some of the expenses they experience in earning this untaxed income should be denied. By denying these deductions, it is possible that investment in property reduces in a way that improves the efficient allocation of resources. (van der Scheer & Beaglehole, 2020, p. 20)*

In the **UK**, residential property investors are permitted to deduct allowable expenses from their rental income as long as they are wholly and exclusively for the purposes of renting out the property (UK Government, 2015). Allowable expenses include:

- general maintenance and repairs to the property
- utilities
- insurance
- property management fees.

From 6 April 2017 the UK Government restricted relief for finance costs on residential properties (UK Government, 2017). Finance costs included mortgage interest, interest on loans to buy furnishings and fees incurred when taking out or repaying mortgages or loans. Landlords are no longer able to deduct all of their finance costs from their property income to arrive at their property profits. The phasing out of deducting finance costs was implemented over 4 years. UK landlords now instead receive a basic rate reduction from their income tax liability for their finance costs. In the UK, the basic rate refers to the lowest marginal tax rate that sets in after receiving personal income of £12,570 in a tax year that is the UK equivalent of the Australian tax-free threshold (referred to as the personal allowance in the UK). In the Australian context, the practical implication of the policy change is to essentially increases the tax-free threshold for UK residential property investors. The policy objective of the measure was to ensure that landlords with higher incomes no longer received the most generous tax treatment.

The UK also offers concessional tax treatment of capital gains. If you are in the lowest marginal tax rate (basic rate), you only pay 18% tax on the capital gain from the sale of a residential investment property (Low Incomes Tax Reform Group, 2023). If you are in the higher marginal tax rates, then you pay 28% tax on the capital gain from the sale of a residential investment property.

2.4 Conclusions on Interest Rate Deductibility and Capital Gains Taxes

All countries considered make provision for deductions or else provide other offsets for residential property investors for non-interest expenses incurred. It is more often the case than not that interest expenses incurred on residential investment properties are deductible to some extent across the OECD.[2] It is also the case that most OECD countries offer some type of discount or concession for capital gains (Daley & Wood, 2016, p. 18). Even in those countries that are phasing out the deductibility on interest repayment, there are other tax benefits provided for residential property investors. It is therefore misleading and overly simplistic to focus simply on a few aspects of the tax system – the treatment of passive losses, deductibility of loan interest repayment or even negative gearing – without also taking into consideration the broader features of another country's tax system.

3. Comparison of Marginal Tax Rates

While overall Australia is a comparatively low taxing country by international standards as measured by our tax-to-GDP ratio, Australia raises more revenue from personal income tax than any other country other than Denmark across the 38 members states of the Organisation for Economic Co-operation and Development (OECD) (OECD, 2022a).

Australia's top personal tax rate of 47% hits workers at a lower income threshold than other economies in the Anglosphere of New Zealand, Canada, the United Kingdom and United States (Kehoe, 2022). The top 47% marginal rate, which includes a 2 per cent Medicare levy, cuts in at taxable incomes above $180,000 and has been stuck at this level since 2008-09. The income threshold at which the top tax rate is imposed is less generous here than in Canada ($250,000), the UK ($260,000) and US ($830,000) in currency-adjusted, Australian-dollar terms.

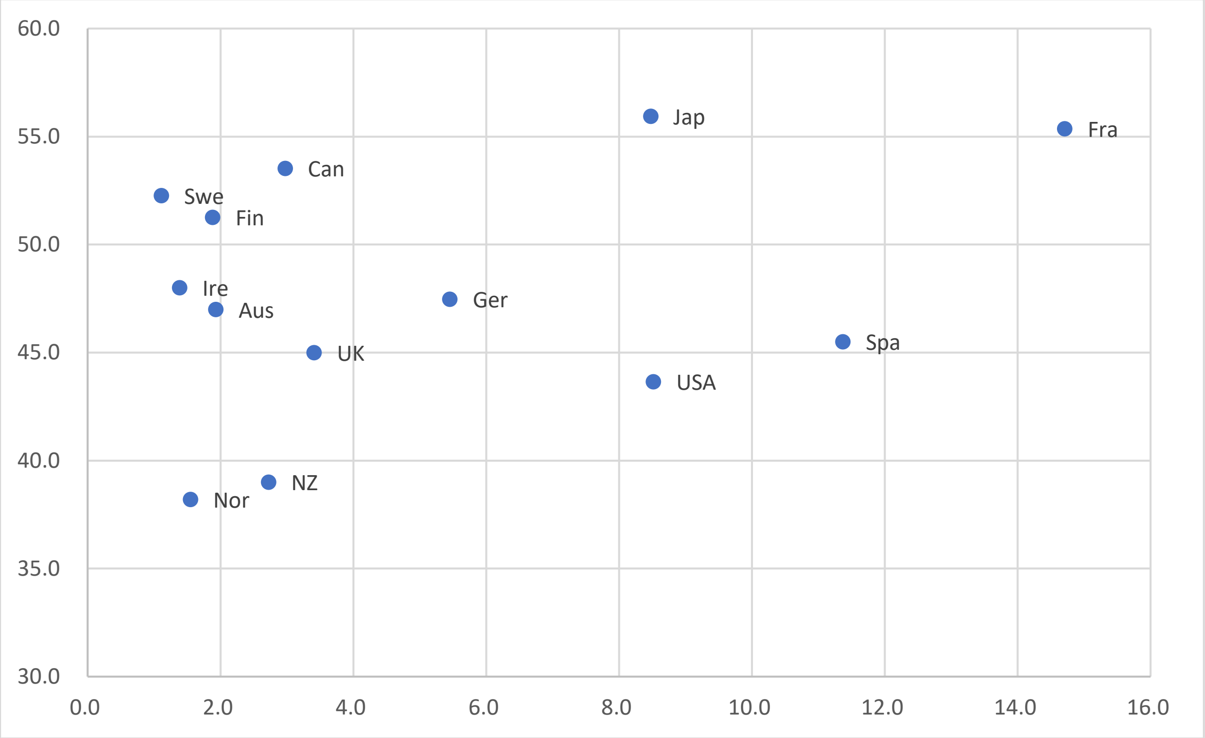
While New Zealand's top threshold is $160,000 in Australian dollar terms ($NZ180,000), the maximum rate is only 39% (Kehoe, 2022). Australia's maximum 47% rate is 8 percentage points higher than New Zealand (39 per cent), about 5 percentage points above the US (a figure which includes an estimated average state income tax) and 2 percentage points higher than the UK. Canada's maximum rate is about 48%, which includes Canada's top federal rate of 33 per cent and an average of about 15% applied by its major provincial governments.

It has been observed that while Australia and Germany share several similar settings in relation to tax on investment housing – such as permitting negative gearing and providing discounts on the taxation of capital gains – this has resulted in quite different market outcomes: speculative inflation in Australia; versus relatively steady housing prices in Germany (Martin, et al., 2018). One of the reasons for the different outcomes may be due to the top marginal tax rate setting in at a relatively much lower level of income in Australia than compared to Germany.

While Australia and Germany have similar top marginal tax rates (47% as compared to 47.5%), the top marginal tax rate in Australia sets in at 1.9 times the average wage as compared to 5.5 times the average wage in Germany even though the average wage is only around 14.5% higher in Germany (OECD, 2022b, p. 11). Figure 6 below shows where the top marginal tax rate sets in as a multiple of the average wage amongst the countries considered in this report.

[2] See OECD (2022, pp. 138-140).

Figure 1: Top Marginal Tax Rate versus Threshold against which it applies (as a multiple of average wage) for Australia, Canada, Finland, France, Germany, Ireland, Japan, New Zealand, Norway, Spain, Sweden, United Kingdom, United States of America – 2021



Threshold at which the top personal income tax rate applies (as a multiple of the average wage)

Source: OECD (2022b, p. 11).

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