Taxation Issues with Residential Property Investment

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Pegasus Economics is a boutique economics and public policy consultancy firm that specialises in strategy and policy advice, economic analysis, trade practices, competition policy, regulatory instruments, accounting, financial management and organisation development.

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

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Executive Summary

Rental Deductions and Negative Gearing

An asset is negatively geared when its interest payments on borrowings used to finance the asset exceed the income it generates, net of other expenses (Henry, Harmer, Piggott, Ridout, & Smith, 2009b, p. 741). Negative gearing commonly refers to the ability to deduct such a loss against another source of income, such as wages. It applies to all investments and not just to residential property (Hulse, Burke, Ralston, & Stone, 2012, p. 17).

Contrary to popular perception, negative gearing is not a specific tax concession for taxpayers with investment properties (The Australian Government the Treasury, 2015, p. 63) and there is no specific law enabling a deduction for a loss in relation to a rental property (Montani, 2017, p. 432).

In addition to interest payments on a loan used to finance the property, residential property investors are also able to deduct other rental expenses including, among others, depreciation, repairs and maintenance, utility bills, rates, insurance and management fees (Tunny, 2018, p. 8).

Since 1967 the Australian Taxation Office has determined that interest charges incurred by residential property investors are deductible where the amount payable exceeded the expected income (Duncan, Hodgson, Minas, Ong, & Seymour, 2018, p. 18). Apart from a brief hiatus in 1985-87, negative gearing has been an ongoing feature of the Australian tax system (Fane & Richardson, 2004, p. 211).

The extent of negative gearing can be measured by the amount of losses recorded on net rent by individual taxpayers.

There was a significant uptick in the number of individual taxpayers claiming a net loss on rental properties after 1998-99 that lasted until 2007-08 as compared to the number of individual taxpayers who were either neutral or made a net profit on rental properties. The ratio of individuals claiming a net loss on rental properties as compared to those who were either neutral or making a net profit went from 1.02 in 1998-99, to peak at 2.28 in 2007-08, and has been in trend decline since then.

This upward trend in negatively-geared rental properties up until 2007-08 may have been driven by:

a) changes to capital gains tax in 1999-2000 when a 50% discount on capital gains for taxation was adopted, replacing the previous inflation-adjustment of the cost-base method
b) greater availability of finance for investors, including interest-only loans
c) an increase in mortgage interest rates of around 2 percentage points from 1998-99 to 2007-08 (Tunny, 2018, p. 9).

After strong increases over the 2000s in the number of negatively-geared landlords and net rental losses, there appears to have been a levelling off in negatively-geared landlords and substantial reductions in rental losses in recent years (Tunny, 2018, p. 9).

Capital Gains Tax

Prior to 1985, Australia had no general tax on capital gains, with most capital gains excluded from the income tax base (Reinhardt & Steel, 2006, p. 11).

The capital gains tax arrangements introduced in 1985 applied to realised gains and losses on assets acquired after 19 September 1985 (Reinhardt & Steel, 2006, p. 11). Certain classes of assets are exempt from the capital gains tax, such as owner-occupied dwellings. From 1985 to 1999, an indexation system applied, so that only real, and not nominal, gains were taxed (Reinhardt & Steel, 2006, pp. 11-12).

The 1999 Review of Business Taxation chaired by John Ralph AO (Ralph Review) (Ralph, Allet, & Joss, 1999, p. 42) recommended that the indexation system be replaced by a new arrangement whereby

individuals only had to include 50% of the nominal capital gain realised on an asset held for at least 12 months.

Personal Income Tax

Australia's personal income tax system is relatively progressive (Henry, Harmer, Piggott, Ridout, & Smith, 2009a, p. 23).

Australia's personal income tax policy framework is based on nominal marginal tax rates and thresholds that are not indexed over time. This means that growth in taxable income will result in a higher tax incidence across the entire taxpaying population (Davis, Akroyd, Pearl, & Sainsbury, 2019, p. 10). In recent decades policy changes by successive Australian governments, taken together, have had the effect of redistributing personal tax incidence away from lower income earners and towards higher income earners. In doing so this has increased the progressivity of Australia's personal income tax system.

Taxation Issues with Residential Property Investment

Concerns about the impact of negative gearing grew during the 2000s in line with an increase in the number of landlords in general—which grew at more than twice the rate of population growth—and negatively-geared landlords in particular (Tunny, 2018, p. 9).

Any tax advantage received by individuals investing in residential property does not come from borrowing (The Australian Government the Treasury, 2015, p. 66).

According to the Organisation for Economic Co-operation and Development (OECD) (2022, p. 103)

> *There is a strong case for allowing taxpayers to deduct the costs they incur to earn taxable income.*

Negative gearing does not, in itself, cause a tax distortion, but it does allow more people to enter the market than those who might have had the equity alone to do so (The Australian Government the Treasury, 2015, p. 63).

On the other hand, negative gearing has also been criticised from various angles – including that it leads to greater inequality (particularly intergenerational inequality) and it encourages speculation in unproductive assets rather than investment in productive assets and privileges certain investments over others (Blunden, 2016, p. 346).

When judged against some 'standard' tax efficiency benchmarks, the Productivity Commission (2004, p. 117) has declared that it is far from clear that there is a fundamental problem with negative gearing. According to the Productivity Commission (2004, p. 117):

- Negative gearing facilitates risk-spreading among investments. In principle it would seemingly be both inefficient and inequitable to tax the returns from an investment in the year of gain, but not allow deductions that reduce an individual's income in the year of loss. Negative gearing also provides neutrality between investors who borrow and those who use their own equity.
- Were negative gearing more confined in its application, tax arrangements would then favour investment in income-producing assets at the expense of riskier growth assets without the income yield to cover immediate expenses.

The interaction of negative gearing and the CGT discount provides some investors with a sizeable tax advantage (Daley & Wood, 2016, p. 20). Taxes on capital gains are discounted by 50% and only paid when the asset is sold. But negative gearing arrangements allow investors to deduct losses from wages and salary income that would otherwise be taxed at the full marginal rate.

According to former Secretary of the Commonwealth Treasury, the late Ted Evans (2004, p. 41) when it comes to the tax treatment of rental properties, the policy weakness lies in the concessional treatment of capital gains on the investment.

Effectively, negative gearing allows for the acceptance of lower rental returns (whose costs are not entirely born by the investor) in exchange for the benefits of the expected capital gains (which are, in turn, also given concessionary tax treatment) (Carrington, Li, & Larkin, 2019, p. 242).

The report entitled *Australia's Future Tax System: Report to the Treasurer*, more commonly known as the Henry Tax Review, observed that investment returns in the Australian residential housing market are likely driven by capital gains rather than by rental yield (Henry, Harmer, Piggott, Ridout, & Smith, 2009b, p. 418).

Although negative gearing is often cited as the key tax concession, it is in fact only attractive to the extent that investors benefit from capital gains, and those capital gains are subject to a significantly lower effective tax rate (Wood, Ong, & Cigdem, 2016, p. 338).

A greater revenue reliance on a small number of high-income earners, paying high average tax rates, imposes pressures on Australia's personal income tax system (Davis, Akroyd, Pearl, & Sainsbury, 2019, p. 15). To the extent that those who face higher marginal personal income tax rates also face a larger tax rate differential between their marginal tax rate on personal income and the marginal tax rate on corporate, superannuation, and capital sources of income, this creates a greater incentive for taxpayers to seek out tax planning opportunities.

The fact that the top marginal tax rate sets in at a relatively low taxable income level favours property investors in Australia, as a large percentage of taxpayers are attracted to investments that will decrease the amount of tax that they pay (Wyatt, McDonald, & Nandha, 2005, p. 155). Negative gearing through investing in residential property is one such avenue available to individual taxpayers.

1. Introduction

Pegasus Economics (Pegasus) has been commissioned by the Housing Industry Association to examine taxation issues in relation to individual investors in residential property in Australia.

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. Rental Deductions and Negative Gearing

2.1 Allowable Rental Deductions and Negative Gearing?

An asset is negatively geared when its interest payments on borrowings used to finance the asset exceed the income it generates, net of other expenses (Henry, Harmer, Piggott, Ridout, & Smith, 2009b, p. 741). Negative gearing commonly refers to the ability to deduct such a loss against another source of income, such as wages. It applies to all investments and not just to residential property (Hulse, Burke, Ralston, & Stone, 2012, p. 17). An asset property owner who has borrowed but also who receives income in excess of interest payments is simply 'geared' (Pender, 1997, p. 19).

Contrary to popular perception, negative gearing is not a specific tax concession for taxpayers with investment properties (The Australian Government the Treasury, 2015, p. 63) and there is no specific law enabling a deduction for a loss in relation to a rental property (Montani, 2017, p. 432). Rather, the ability to deduct rental property expenses arises from section 8.1 of the *Income Tax Assessment Act 1997* (Cth) that allow most deductions. Interest is ordinarily deductible under the general deduction provisions of section 8.1 provided the money borrowed has the required nexus with assessable income – as it must be incurred "in gaining or producing" such income (O'Donnell, 2005, p. 68). So, there's nothing special about the deductibility of interest in the case of negative gearing (Quiggin J. , 2015).

In addition to interest payments on a loan used to finance the property, residential property investors are also able to deduct other rental expenses including, among others, depreciation, repairs and maintenance, utility bills, rates, insurance and management fees (Tunny, 2018, p. 8). The cost of certain buildings and related expenditure can also be deducted over either 25 or 40 years as long as the property is used for income producing purposes as a capital works deduction (Duncan, Hodgson, Minas, Ong, & Seymour, 2018, p. 19).

While deductions for capital works have always been treated as a tax expenditure, up until 2023 the rental deduction categories of 'other rental deductions' (which encompasses expenses such as property maintenance and council rates) and 'interest deductions' were not considered to be tax concessions, and as such, were not previously included in the Treasury's annual *Tax Expenditure Statement*. While last year's tax expenditure statement, the *Tax Benchmarks and Variations Statement 2001* (The Australian Government the Treasury, 2022) made no reference to 'other rental deductions', 'interest deductions' nor negative gearing as a tax concession, the 2023 *Tax Expenditures and Insight Statement* did refer to them explicitly for the first time (The Australian Government the Treasury, 2023, pp. 41-43). The reason as to why rental deductions associated with negative gearing were previously excluded from being categorised as a tax expenditure was because they were considered to be 'a design feature' of the Australian tax system (O'Donnell, 2005, p. 87).

Australian courts have made it quite clear that if there is to be any change to the law on negative gearing, it will require specific legislative amendment, rather than any change in judicial attitude or interpretation (O'Donnell, 2005, p. 70).

2.2 History of Negative Gearing on Rental Properties

Since 1967 the Australian Taxation Office has determined that interest charges incurred by residential property investors are deductible where the amount payable exceeded the expected income (Duncan, Hodgson, Minas, Ong, & Seymour, 2018, p. 18). Apart from a brief hiatus in 1985-87, negative gearing has been an ongoing feature of the Australian tax system (Fane & Richardson, 2004, p. 211).

In 1986 the Hawke Government brought in legislation to quarantine deductions such that they could not be used to reduce tax on other sources of income (Hulse, Burke, Ralston, & Stone, 2012, p. 18). The restrictions affected only real estate purchased after 17 July 1985 (O'Donnell, 2005, p. 70). The reform quarantined any losses made from owning rental properties, so that any excess of deductions over rental income could not be used to reduce tax on other sources of assessable income. However, losses could be carried forward to offset against future rental profits and reduce taxable gains made from other rental properties purchased after that date.

The quarantine measure was justified on three main grounds: (i) taxpayers should not have to subsidise rental property investors; (ii) negative gearing resulted in increased home prices to the detriment of ordinary home buyers; and (iii) an estimated revenue gain (O'Donnell, 2005, p. 70).

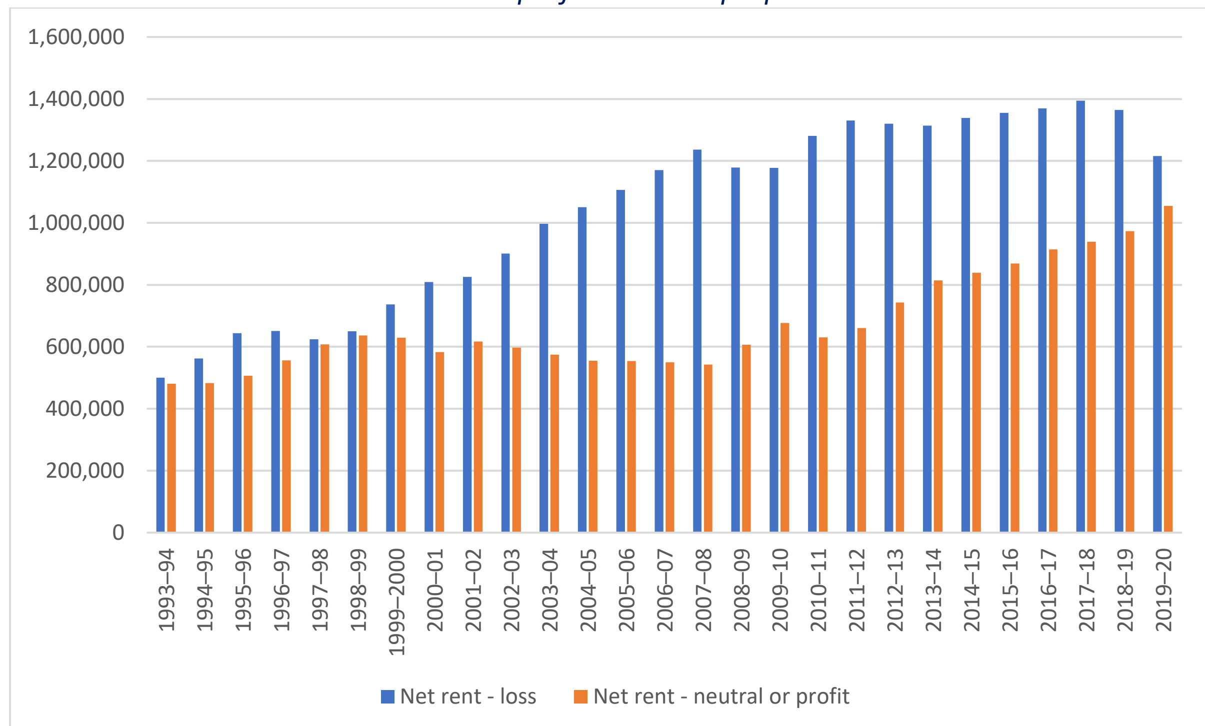
However, the Hawke Government removed the measure, effective from 1 July 1987 (O'Donnell, 2005, p. 70). According to official records, repeal of the measure was justified on two main grounds: (i) uniformity of tax treatment of interest costs for all types of investment; and (ii) the belief that the excessive tax benefits offered to high income earners by negative gearing were adequately countered by other tax reform measures, notably introduction of the capital gains tax regime. There were also unofficial reasons for the quick repeal of the measure, including an impending federal election in 1987 and complaints from NSW facing a state election in 1988.

Since July 1987, negative gearing has been allowed on all forms of investments in Australia (O'Donnell, 2005, p. 70).

2.3 Extent of Negative Gearing and Deductions on Rental Properties

The extent of negative gearing can be measured by the amount of losses recorded on net rent by individual taxpayers. Negative gearing has grown to become one of Australia’s most popular tax wealth creation vehicles, to the extent that a majority of domestic rental housing stock is now negatively geared (O'Donnell, 2005, p. 63). This can be seen below in Figure 1 that compares the number of individual taxpayers that made a net loss on rental properties as compared to individual taxpayers who were either neutral or made a net profit on rental properties.

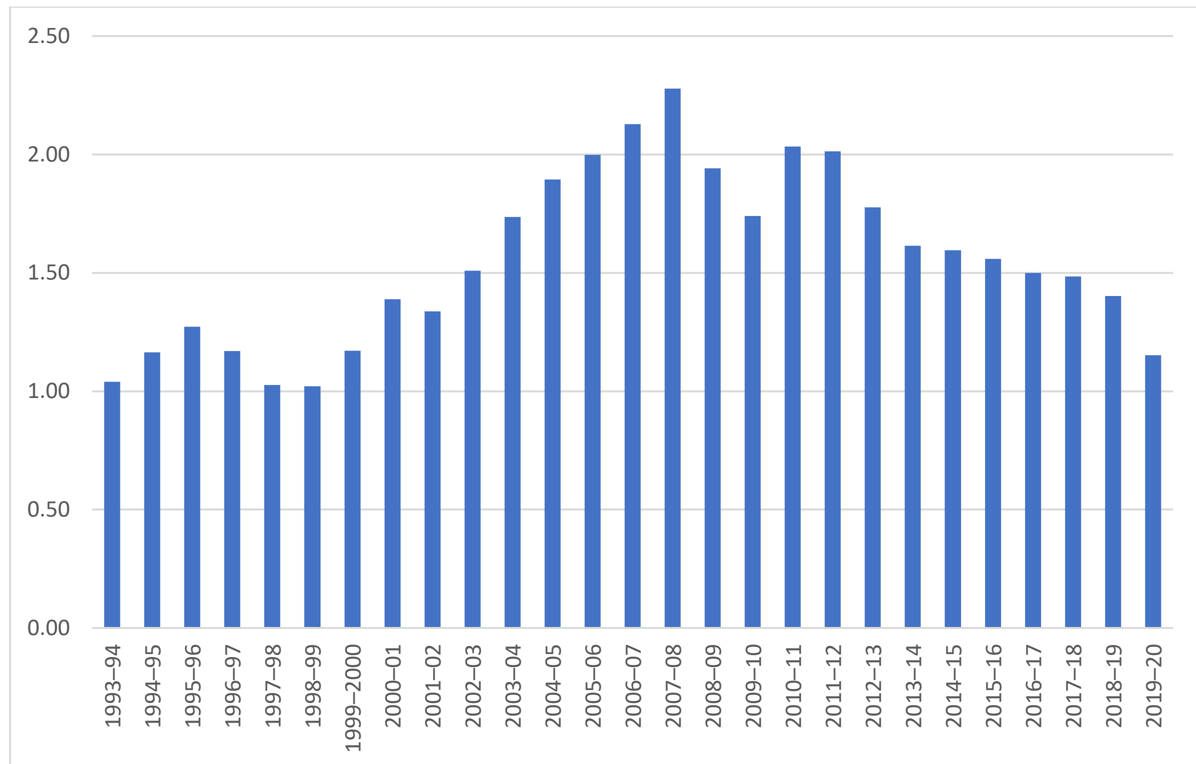
Figure 1: Number of Individual Taxpayers making a net loss on rental properties and those who were either neutral or made a net profit on rental properties – 1993-94 to 2019-20



Source: Australian Taxation Office (2022).

There was a significant uptick in the number of individual taxpayers claiming a net loss on rental properties after 1998-99 that lasted until 2007-08 as compared to the number of individual taxpayers who were either neutral or made a net profit on rental properties. The ratio of individuals claiming a net loss on rental properties as compared to those who were either neutral or making a net profit went from 1.02 in 1998-99, to peak at 2.28 in 2007-08, and has been in trend decline since then. This is outlined in Figure 2 below.

Figure 2: Ratio of the number of individual taxpayers making a net loss on rental properties versus individual taxpayers who are either neutral or made a net profit on rental properties – 1993-94 to 2019-20



Source: Australian Taxation Office (2022).

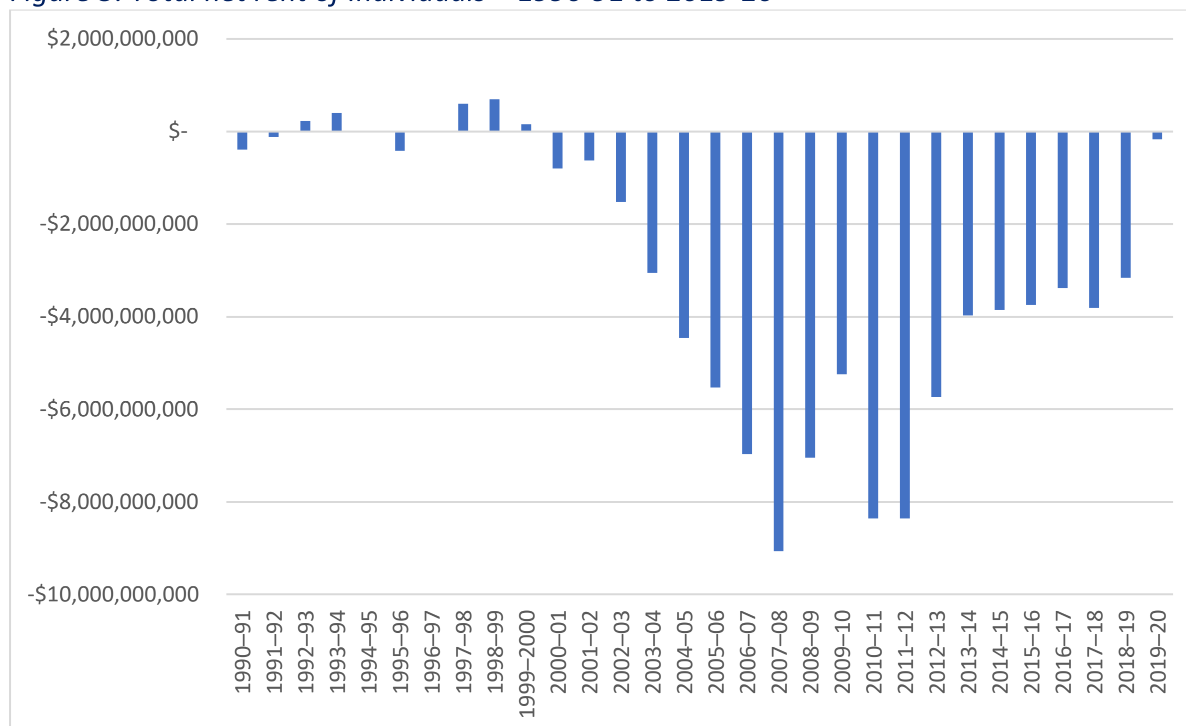
This upward trend in negatively-geared rental properties up until 2007-08 may have been driven by:

d) changes to capital gains tax in 1999-2000 when a 50% discount on capital gains for taxation was adopted, replacing the previous inflation-adjustment of the cost-base method
e) greater availability of finance for investors, including interest-only loans
f) an increase in mortgage interest rates of around 2 percentage points from 1998-99 to 2007-08 (Tunny, 2018, p. 9).

After strong increases over the 2000s in the number of negatively-geared landlords and net rental losses, there appears to have been a levelling off in negatively-geared landlords and substantial reductions in rental losses in recent years (Tunny, 2018, p. 9).

While Australian landlords were generally collectively profitable from 1992-93 until 1999-2000, they were accruing billions in net rental losses from 2002-03 up until 2018-19, although this significantly contracted in 2019-20. This is outlined in Figure 3 below.

Figure 3: Total net rent of Individuals – 1990-91 to 2019-20



Source: Australian Taxation Office (2022).

Net rent for individuals has gone from almost positive $700 million in 1998-99 to net rent losses in excess of $9 billion by 2007-08, but has been trending down since then for all the years that taxation statistics are available.

It is estimated the aggregate tax reduction arising from rental deductions in 2019-20 was in the order to $18.6 billion, and has been estimated that it will reach $24.4 billion in 2022-23 (The Australian Government the Treasury, 2023, p. 41).

In 2019-20, the largest category of rental deductions claims was 'other rental deductions', closely followed by interest deductions with capital works deductions a long way further back. This is outlined in Table 1 below.

Table 1: Rental deductions by income tax return label – 2019-20

Type of deductions	Amount claimed ($ million)	Share of total (%)
Other rental deductions	$24,240	47%
Interest deductions	$22,510	44%
Capital works deductions	$4,500	9%

Source: The Australian Government the Treasury (2023, p. 41).

3. Capital Gains Tax

3.1 Operation of the Capital Gains Tax in Australia

Prior to 1985, Australia had no general tax on capital gains, with most capital gains excluded from the income tax base (Reinhardt & Steel, 2006, p. 11). Of the capital gains taxes that were in operation, the most important was that applying to gains from property held for less than one year, which was introduced in the early 1970s.

In 1985, based on equity grounds, it was argued that, "because real capital gains represent an increase in purchasing power similar to real increases in wages, salaries, interest or dividends, they

should be included in any comprehensive definition of income" (Commonwealth of Australia, 1985, p. 77).

The Hawke Government and tax academics argued that the lack of a capital gains tax distorted investment towards assets providing returns in the form of capital gains, rather than income streams, and provided an incentive to convert income into capital gains (Reinhardt & Steel, 2006, p. 11). It was also argued that, combined with the taxation of dividends, the lack of a capital gains tax created incentives for companies to retain profits, potentially resulting in less efficient investment choices from an economy wide perspective.

The capital gains tax arrangements introduced in 1985 applied to realised gains and losses on assets acquired after 19 September 1985 (Reinhardt & Steel, 2006, p. 11). Certain classes of assets were exempt from the capital gains tax, such as owner-occupied dwellings. From 1985 to 1999, an indexation system applied, so that only real, and not nominal, gains were taxed (Reinhardt & Steel, 2006, pp. 11-12). An averaging system was also in place to reduce the impact of the progressive income tax on realised gains accrued over a period of years (Reinhardt & Steel, 2006, p. 12).

The 1999 Review of Business Taxation chaired by John Ralph AO (Ralph Review) (Ralph, Allet, & Joss, 1999, p. 42) recommended that the indexation system be replaced by a new arrangement whereby individuals only had to include 50% of the nominal capital gain realised on an asset held for at least 12 months. The Ralph Review's recommendations for capital gains taxation were designed to enliven and invigorate the Australian equities markets, to stimulate greater participation by individuals, and to achieve a better allocation of the nation's capital resources (Ralph, Allet, & Joss, 1999, p. 598).

The Ralph Review (Ralph, Allet, & Joss, 1999, p. 598) criticised the indexation system in the following terms:

> *Realisation-based capital gain tax systems generally suffer from a tendency to lock asset holders into less than optimal positions. Providing any further reward for delaying realisation (for example, by means of a stepped rate related to holding period) would, in some cases, exacerbate a lock-in effect.*

Another motivation for the policy change was to make Australian assets more attractive to foreign investors:

> *… the perception has been the Australian tax system imposes tax at full income tax rates. Such misperceptions are not easily corrected and a change in the form of concession to something more akin to the types off concession available abroad would, in the Review's judgement, be more effective in attracting investors to Australian assets. (Ralph, Allet, & Joss, 1999, p. 600)*

4. Personal Income Tax

4.1 Design of the Australian Personal Income Tax System

A tax can apply to a taxpaying population in one of three ways:

- it is progressive if the average rate of tax increases as the base (for example, income or expenditure) increases
- it is proportional if the average rate of tax is constant
- it is regressive if the average tax rate decreases as the base increases (Davis, Akroyd, Pearl, & Sainsbury, 2019, p. 4).

Australia's personal income tax system is relatively progressive (Henry, Harmer, Piggott, Ridout, & Smith, 2009a, p. 23). Personal income tax is calculated by applying a marginal rates scale to a

person's combined income from work and savings (Henry, Harmer, Piggott, Ridout, & Smith, 2009, p. 23).

Australia's personal income tax policy framework is based on nominal marginal tax rates and thresholds that are not indexed over time. This means that growth in taxable income will result in a higher tax incidence across the entire taxpaying population (Davis, Akroyd, Pearl, & Sainsbury, 2019, p. 10). In recent decades policy changes by successive Australian governments, taken together, have had the effect of redistributing personal tax incidence away from lower income earners and towards higher income earners. In doing so this has increased the progressivity of Australia's personal income tax system.

At present, Australia has a relatively high tax-free threshold and four marginal rates above it, along with a large number of tax offsets that alter the marginal rates for people in particular situations. The direction of change has been towards fewer marginal tax rates, from as many as six or seven during much of the 1980s and early 1990s (Henry, Harmer, Piggott, Ridout, & Smith, 2009a, p. 5) to the current four. In this regard, the former Morrison Government legislated new personal income tax scales and tax cuts due to take effect from 1 July 2024 that will reduce the number of marginal rates to only three.

These are so-called stage three tax cuts – the culmination of a seven-year, three-step process that would abolish the 37% bracket that applies to income between $120,000 and $180,000, and apply a 30% rate to all earnings between $45,000 and $200,000 (Kehoe, 2022). However, there is persistent speculation as to whether these stage three tax cuts will actually proceed.

5. Taxation Issues with Residential Property Investment

5.1 Impact from Negative Gearing

Concerns about the impact of negative gearing grew during the 2000s in line with an increase in the number of landlords in general—which grew at more than twice the rate of population growth—and negatively-geared landlords in particular (Tunny, 2018, p. 9).

Negative gearing is a logical feature of the tax system, as it leads to consistent treatment of debt and equity regarding the financing of investments (Tunny, 2018, p. 9). The ability to deduct interest repayments supports neutrality between financing via debt and equity since interest income is taxed when the interest is received (van der Scheer & Beaglehole, 2020, p. 19).

Any tax advantage received by individuals investing in residential property does not come from borrowing (The Australian Government the Treasury, 2015, p. 66).

According to the Organisation for Economic Co-operation and Development (OECD) (2022, p. 103)

> *There is a strong case for allowing taxpayers to deduct the costs they incur to earn taxable income.*

Negative gearing does not, in itself, cause a tax distortion, but it does allow more people to enter the market than those who might have had the equity alone to do so (The Australian Government the Treasury, 2015, p. 63). Purchasers can make bigger investments in property by borrowing, in addition to using their own savings. This behaviour is encouraged by the discount on the capital gains tax (CGT), as larger investments can result in greater capital gains and therefore benefit more from the CGT discount. However, the tax treatment of rental properties does not differ in any fundamental sense from the income tax treatment of other investments, all of which can also be negatively geared (Evans, 2004, p. 41).

According to Professor Sinclair Davidson (2018, pp. 421-422) of RMIT University:

> *Negative gearing is the perfectly understandable principle that expenditure incurred in the production of a taxable asset is itself deductable for the purposes of taxation. There is no plausible basis to argue that the business of being an unincorporated landlord should be singled out for differential tax treatment when large incorporated property management companies are also able to make business related tax deductions.*

Former Secretary of the Commonwealth Treasury, the late Ted Evans (Evans, 2004, p. 41), commented in relation to negative gearing that:

> *The first thing that should be said on this topic - and almost the last - is that there is nothing fundamentally wrong with the income tax treatment of rental properties. It does not differ in any fundamental sense from the income tax treatment of other investments, all of which can also be negatively geared, and many of which are.*

On the other hand, negative gearing has also been criticised from various angles – including that it leads to greater inequality (particularly intergenerational inequality) and it encourages speculation in unproductive assets rather than investment in productive assets and privileges certain investments over others (Blunden, 2016, p. 346). According to John Daley and Danielle Wood from the Grattan Institute (2016, p. 20):

> *Negative gearing in Australia goes beyond generally accepted principles for offsetting losses against gains. It distorts investment decisions and increases the volatility of housing markets. Among its anti-social effects it reduces home ownership and the availability of long-term rentals, but does not materially increase housing supply. It reduces tax collections, imposing pressures on the budget and creating the need for higher taxes or deficits. And it is regressive, benefiting those on high incomes much more than those on low incomes.*

Negative gearing is sometimes blamed for the very substantial rise in house prices that, among other effects, is said to price younger people out of the market (Edgar, 2016).

According to Hazel Blunden (2016, p. 346) a Research Fellow at the Social Policy Research Centre at the University of NSW, Australia’s current rules allowing negative gearing of rental housing investment are widely seen by most economists as unjustifiable and in need of reform. Our review of the relevant academic literature as it relates to negative gearing sheds doubt as to the veracity of this claim.

Dr Steven Hamilton (2019), a Visiting Fellow at the Tax and Transfer Policy Institute at The Australian National University (ANU) has countered in relation to negative gearing that:

> *I’ve been baffled by the number of times I’ve read commentary by otherwise thoughtful people describing negative gearing as a distortion to the property market – as a rort we need to crack down on.*
>
> *But as someone who knows a bit about the economics of taxation, I can say that simply isn’t true.*
>
> *Negative gearing is a natural, orthodox and proper feature of any market for investment. And allowing negative gearing to be tax deductible is an essential component of an efficient tax system.*

According to the late Dr Tom Valentine (2007, p. 25), formerly a Professor of Finance at Macquarie University:

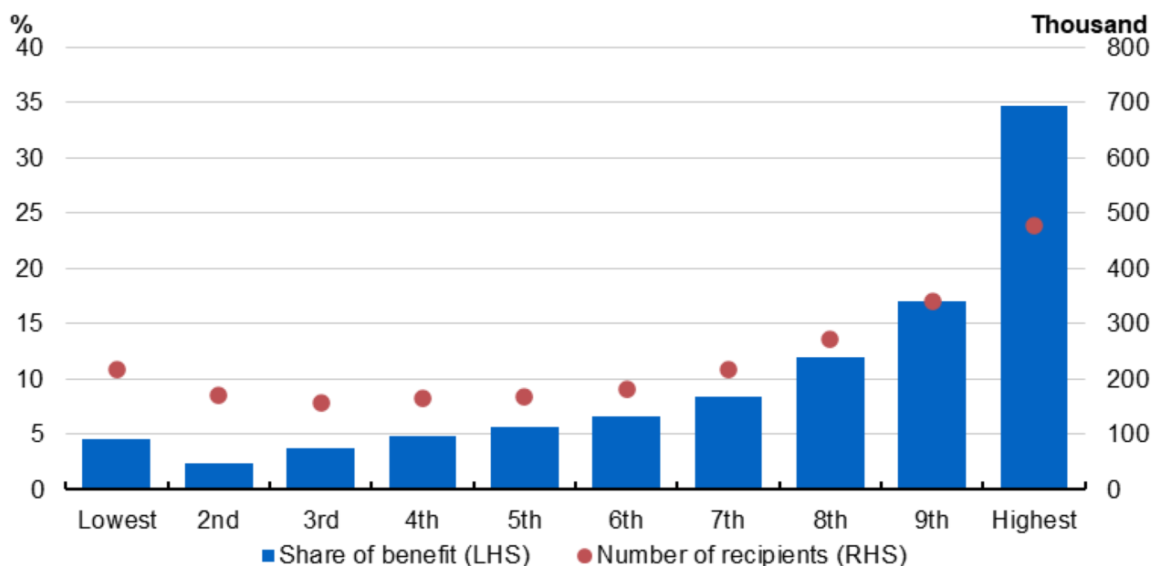
Many politicians, public servants and members of the media view negative gearing unfavourably. They see it simply as a tax avoidance scheme which is abused by the wealthier members of society. This view does not appear to have any merit. Interest costs are a legitimate business expense and there is no reason why they should not be deducted from taxable income. If there is a problem, it arises because of the different tax treatment of capital gains and other forms of income.

Playing with negative gearing would (further) interfere with a fundamental part of the tax system: costs should be deductible against income (Potter, 2016).

Concerns have also been expressed that the benefit of negative gearing is currently heavily skewed towards those who are more affluent, potentially exacerbating income and wealth inequality among the Australian population (Duncan, Hodgson, Minas, Ong, & Seymour, 2018, p. 1). According to academic researcher, now with the Commonwealth Treasury Isla Pawson (2018, p. 134), negative gearing increases the regressive impacts of Australia's tax system and contributes to the upward redistribution of wealth and income .

In 2019–20, 79% of the tax reduction went to people with above median income, and 35% cent of the reduction went to people in the top taxable income decile (The Australian Government the Treasury, 2023, p. 41). Rental deductions are most commonly claimed by those with higher taxable incomes, particularly those in the seventh or higher taxable income decile. The share of the benefit for those in the lowest taxable income decile is driven by both the number of tax filers and their relatively large average deductions. These tax filers tend to have higher incomes before deductions but their claims for expenses associated with maintaining their rental property substantially reduce their taxable income, pushing them into lower deciles. The benefits received from negative gearing by taxpayer deciles is outlined in Figure 4 below.

Figure 4: Share of total tax reduction and claimants by taxable income decile for negative gearing – 2019-20



Source: The Australian Government the Treasury (2023, p. 42).

Rather than supporting the housing supply and boosting construction-related employment, negative gearing has been accused of effectively encouraging speculation and boosting house prices (Pickering, 2014). A concern with house prices deviating from some fundamental value is that they may lead to a more general misallocation of resources within the economy (Cho, Li, & Uren, 2021, p. 377). If house prices are excessively high for a period, then it may lead to excessive investment in the housing sector when in fact resources could be better devoted to other areas of the economy. In

turn, negative gearing has also been accused of causing a misallocation of resources through unproductive speculation (Blunden, 2016, p. 349). Resource misallocation creates a less efficient economy that in turn stifles economic growth.

When judged against some 'standard' tax efficiency benchmarks, the Productivity Commission (2004, p. 117) has declared that it is far from clear that there is a fundamental problem with negative gearing. According to the Productivity Commission (2004, p. 117):

- Negative gearing facilitates risk-spreading among investments. In principle it would seemingly be both inefficient and inequitable to tax the returns from an investment in the year of gain, but not allow deductions that reduce an individual's income in the year of loss. Negative gearing also provides neutrality between investors who borrow and those who use their own equity.
- Were negative gearing more confined in its application, tax arrangements would then favour investment in income-producing assets at the expense of riskier growth assets without the income yield to cover immediate expenses.

5.2 Interaction between Negative Gearing and the Capital Gains Tax

The interaction of negative gearing and the CGT discount provides some investors with a sizeable tax advantage (Daley & Wood, 2016, p. 20). Taxes on capital gains are discounted by 50% and only paid when the asset is sold. But negative gearing arrangements allow investors to deduct losses from wages and salary income that would otherwise be taxed at the full marginal rate.

According to former Secretary of the Commonwealth Treasury, the late Ted Evans (2004, p. 41) when it comes to the tax treatment of rental properties, the policy weakness lies in the concessional treatment of capital gains on the investment. According to Ted Evans (2004, p. 41):

> *It is negative gearing acting in concert with the concessional treatment of capital gains which allow and encourage investors to accept low rental income (i.e. to 'negatively gear') in the expectation that they will eventually profit from the lowly taxed capital gain.*

There is considerable support for the position outlined by Ted Evans. According to Professor John Quiggin (2003) of the University of Queensland:

> *The fundamental problem here is not the tax deductibility of losses but the concessional treatment of capital gains. In principle, at least, losses should be tax deductible. …*

According to the Productivity Commission (2004, p. 120):

> *The interaction of the CGT with high marginal tax rates boosts the incentive to reduce income and delay tax payments until capital gains are realised. In the Commission's view, it is those arrangements, rather than access to negative gearing or capital works deductions, that give rise to most of the potential for inefficient investment.*

Similarly, the 2014 Financial System Inquiry (Murray Report) also recognised there could be problem in relation to the interaction of the CGT discount and negative gearing for investment properties:

> *For assets that generate* ***capital gains****, the tax treatment encourages leveraged investment, which is a potential source of financial system instability. Investors are attracted by the asymmetry in the tax treatment of expenses and capital gains, where individuals can deduct the full interest costs of borrowing (and other*

> *expenses) from taxable income, but only half of their long-term capital gains are taxed. The tax treatment of investor housing, in particular, tends to encourage leveraged and speculative investment in housing. (Murray, Davis, Dunn, Hewson, & McNamee, 2014a, p. 22)*

According to Dr Steven Hamilton (2019) from the ANU, rather than negative gearing creating distortions:

> *The real culprit is the generous 50% discount on the taxation of capital gains. It means that while losses can be written off at the full tax rate, the eventual gain is taxed at only half the full rate.*

Effectively, negative gearing allows for the acceptance of lower rental returns (whose costs are not entirely born by the investor) in exchange for the benefits of the expected capital gains (which are, in turn, also given concessionary tax treatment) (Carrington, Li, & Larkin, 2019, p. 242).

The report entitled *Australia's Future Tax System: Report to the Treasurer*, more commonly known as the Henry Tax Review, observed that investment returns in the Australian residential housing market are likely driven by capital gains rather than by rental yield (Henry, Harmer, Piggott, Ridout, & Smith, 2009b, p. 418).

The Reserve Bank of Australia (RBA) (2003, p. 42) has observed that another difference between investors in Australia and elsewhere is that in most countries the earning of rental income is seen as the most important reason for investing in rental properties. This seems to stand in contrast to the situation in Australia where properties are commonly marketed on the assumption that they do not earn positive taxable income for a considerable period.

Empirical support for the RBA position comes from a research study published by Australian Housing and Urban Research Institute which looked at what motivates rental investors (Seelig, et al., 2009). They found that for most participants, negative gearing was not a deliberate investment strategy, and nor was it a crucial factor in their investment decisions, although nearly all regard it as a 'welcome and generous tool' or 'added bonus' (Seelig, et al., 2009, p. 3). In turn this research study concluded:

> *Negative gearing is not a critical driver for becoming an investor, but it is seen as an important component of the economics of property investment, so it may be hard to remove. (Seelig, et al., 2009, p. 4)*

Instead, most investors saw capital gains as more important than rental income over the short, medium and long term. Indeed, nearly all investors regard property as the 'best investment', and some said they would still invest in property, even if returns were clearly higher in other areas (eg, shares) (Seelig, et al., 2009, p. 3).

Because inflationary gains are not 'income' in a true sense because they simply offset the loss of purchasing power, some discount on returns to savings is justified (Daley & Wood, 2016, p. 11). However, it has been contended the 50% discount on the CGT has overcompensated property investors for inflation (Daley & Wood, 2016, p. 11).

Providing a tax discount for capital gains but not for other investment income does create a distortion in where people choose to invest (Daley & Wood, 2016, p. 15). Capital gains have substantial tax advantages relative to annual earnings. The capital gains discount magnifies the tax advantages because capital gains are not taxed until they are realised. In contrast, Australia's current tax system does not adjust for the effects of inflation on bank deposits, which are assets disproportionately held by the least well off. Rental income, bond yields and returns from overseas shares are also taxed at full marginal rates.

Taxing capital gains more lightly than most other savings income creates an incentive for investors to choose riskier assets that return more via capital gain (Daley & Wood, 2016, p. 15). In conjunction with negative gearing, the tax system creates strong incentives for debt-financed and speculative investments.

Although negative gearing is often cited as the key tax concession, it is in fact only attractive to the extent that investors benefit from capital gains, and those capital gains are subject to a significantly lower effective tax rate (Wood, Ong, & Cigdem, 2016, p. 338).

5.3 Incentives Created by High Marginal Tax Rates

Choices by successive Commonwealth governments have altered marginal personal income tax rates and extended tax thresholds in ways that have reduced the income tax incidence on lower income earners, and increased the income tax incidence on higher income earners (Davis, Akroyd, Pearl, & Sainsbury, 2019). This has also seen an increase in income tax concentration, whereby a narrower proportion of high income earners pay a larger share of total Australian personal income taxes.

A greater revenue reliance on a small number of high-income earners, paying high average tax rates, imposes pressures on Australia's personal income tax system (Davis, Akroyd, Pearl, & Sainsbury, 2019, p. 15). To the extent that those who face higher marginal personal income tax rates also face a larger tax rate differential between their marginal tax rate on personal income and the marginal tax rate on corporate, superannuation, and capital sources of income, this creates a greater incentive for taxpayers to seek out tax planning opportunities.

The complex Australian personal income tax system is characterised by a significant tax avoidance industry (Pope, 2005, p. 317). The high marginal personal income tax rates give rise to three main negative economic effects: work disincentives; distortion effects within the economy, in terms of individual and business decision-making and also the interaction of the tax and welfare systems; and the loss of productive Australian skilled and professional workers offshore.

The fact that the top marginal tax rate sets in at a relatively low taxable income level favours property investors in Australia, as a large percentage of taxpayers are attracted to investments that will decrease the amount of tax that they pay (Wyatt, McDonald, & Nandha, 2005, p. 155). Negative gearing through investing in residential property is one such avenue available to individual taxpayers.

According to economic commentator and former academic economist Judith Sloan (2014):

> *The higher the marginal income tax rate and the lower the rate of capital gains tax, the greater is the incentive to invest in loss-making investments with the potential for high capital gains.*

According to the Productivity Commission (2004, p. 93):

> *Collectively, therefore, the general income tax regime has facilitated highly geared housing investment aimed at reducing current taxable income and deferring tax until capital gains are realised in future years.*

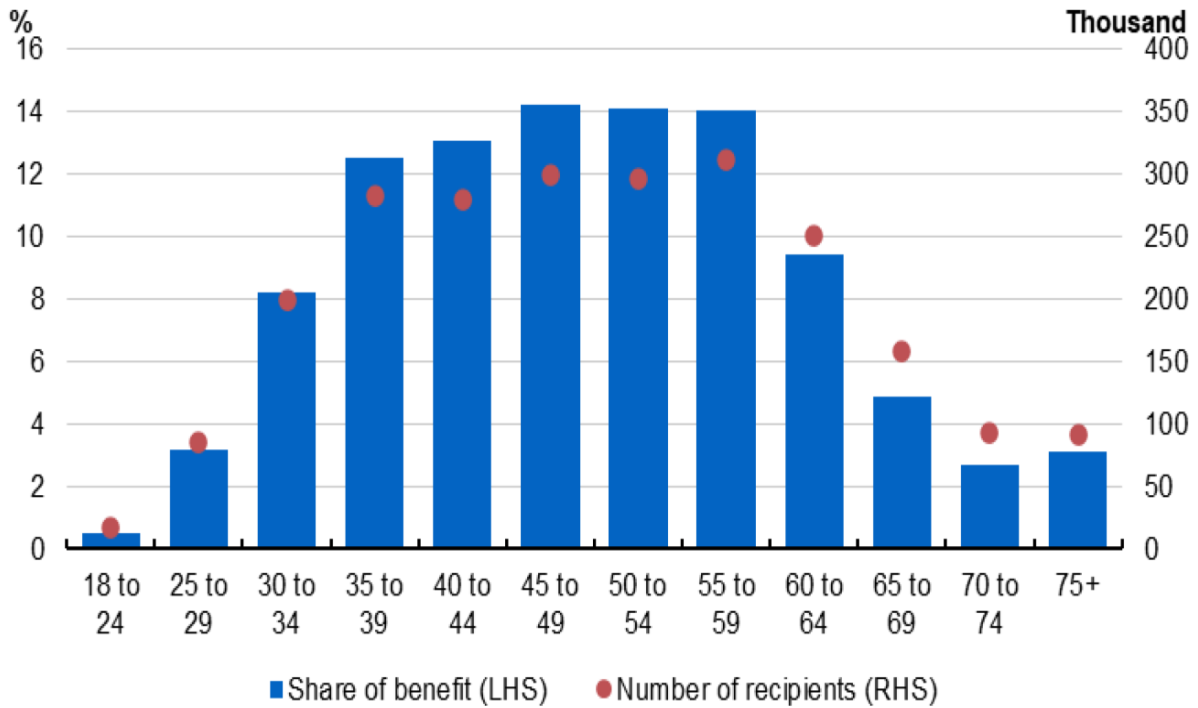
According to the RBA (2003, p. 40):

> *With negatively-geared investments particularly attractive to individuals facing high marginal tax rates, a high share of Australian taxpayers are attracted to property investment to lighten their tax burden. This interaction of high marginal tax rates and negative gearing is frequently emphasised by the property seminar industry.*

The attractiveness of using investment losses to reduce tax on wage income is evident in the age profile of those negatively gearing property (Daley & Wood, 2016, p. 21). Borrowing so much that

the investment makes an annual loss is popular amongst those of working age, but far less prevalent amongst over 60s who are less likely to have labour income that can be offset by the tax loss. The share of the total tax reduction is highest for those in age cohorts between 30 and 59 years old (The Australian Government the Treasury, 2023, p. 43) as outlined below in Figure 5.

Figure 5: Share of total tax reduction and claimant by age for negative gearing – 2019-20



Source: The Australian Government the Treasury (2023, p. 43).

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