



THE UNIVERSITY OF
MELBOURNE

21 November 2003

Inquiry into first home ownership
Productivity Commission
LB2 Collins Street East
MELBOURNE VIC 3000

Dear Sir/Madam,

**Productivity Commission Inquiry on First Home Ownership:
Submission in relation to income tax and capital gains tax issues concerning
residential investment properties**

The purpose of this submission is to comment on certain income tax issues which the Commission's Issues Paper¹ (September 2003) has identified as relevant to the affordability and availability of housing for first home buyers.

We also wish to address certain comments on tax issues made in the Submission by the Reserve Bank of Australia (November 2003)².

1. Introduction

The Commission's Issues Paper and the Submission by the Reserve Bank of Australia correctly identify the current income tax and capital gains tax ("CGT") arrangements concerning investments in residential properties as matters affecting the affordability of housing for first home buyers.

However, with respect, we do not agree with the statement in the Submission by the Reserve Bank (at page 54) that "*the taxation arrangements that apply to rental properties in Australia are the same as those that apply to other forms of investment; there are no concessions or restrictions that apply specifically to rental properties*" (emphasis added).

It is important that this widely held misconception be dispelled.

The current taxation treatment of negatively geared resident investment properties is now significantly more favourable than the taxation treatment accorded many other business investments, as a result of tax law changes made by the federal government in September 1999 on the advice of The Review of

¹ Productivity Commission, *First Home Ownership. Issues Paper September 2003*

² Reserve Bank of Australia, *Productivity Commission Inquiry on First Home Ownership. November 2003.*



Business Taxation conducted by Mr John Ralph³. The combined effect of a number of the tax reforms made in September 1999 has been to create a significant distortion of investment incentives in favour of negatively geared residential property investment. These investment distortions have artificially inflated investment demand for residential investment properties. They have also placed first home buyers⁴ at a competitive disadvantage in bidding for residential properties, because the tax benefits available to property investors are not available in equal measure to first home buyers.

2. Tax law changes in September 1999: residential investment property given unique preferential status

As a result of tax law changes made in September 1999, an individual investor in residential property, who uses borrowed funds to finance the investment, is now entitled to two favourable tax outcomes:

- First, if they hold the property for more than 12 months, the capital gain on sale is taxed as a discount capital gain – only half the capital gain is subject to tax⁵ (“*the CGT discount benefit*”);
- Second, in the period prior to sale they can deduct the excess of interest expense over rental income against their other income without restriction⁶ (“*the unrestricted negative gearing benefit*”).

It is simplistic, and in our respectful submission quite wrong, to state that the CGT discount benefit and the unrestricted negative gearing benefit are a general feature of the tax system available for all kinds of investment. This is not how the tax system operates in practice.

First, the CGT discount benefit is only available to limited types of assets, of which land and buildings are a particularly prominent example⁷ – many kinds of asset are simply not eligible for the CGT discount.

Second, the potential for the unrestricted negative gearing benefit in relation to investment in residential property is not a benefit generally available in relation to all types of investments – many kinds of investment lack the tax characteristics which are necessary to give rise to the negative gearing benefit.

Third, and most importantly, it is not the case that all types of investment allow the CGT discount benefit *to be combined* with an unrestricted negative gearing benefit – again, many kinds of investment lack the tax characteristics necessary to allow this combination of tax benefits.

³ The Review of Business Taxation, *A Tax System Redesigned*.

⁴ In this submission we take a first home buyer to be a person purchasing a home in which to live.

⁵ *Income Tax Assessment Act 1997*, Division 115.

⁶ *Income Tax Assessment Act 1997*, section 8-1.

⁷ Another would be shares held for investment purposes primarily to earn dividend income.



Indeed, *as a matter of income tax law and practice*, and in current market conditions, residential investment properties are likely superior to all other kinds of investment as a vehicle for the combination of negative gearing and CGT discount benefits.

We think it is reasonable to conclude that the unique capacity of residential property investment to combine these benefits produces an artificially inflated investment demand for residential properties in the Australian market.

3. Detail of tax law changes made in September 1999 in favour of residential investment properties

In the context of residential property investment, it is important to understand, but often overlooked, that there were other significant changes made to the tax laws which accompanied the introduction of the CGT discount benefit in September 1999.

First, the class of assets eligible for CGT treatment was significantly reduced. In particular, a wide range of depreciating assets used in active business operations was removed from CGT treatment. All depreciable plant and equipment and intellectual property, as well as assets used in research and development, were removed from CGT treatment. While the goodwill of a business remains eligible for CGT treatment, the Australian Taxation Office has succeeded in having the meaning of goodwill for CGT purposes narrowly defined by the High Court⁸. ***In short, this means that the full benefit of the CGT discount can only be secured by making passive investments in non-business investments – such as residential property investment.***

Second, the position is exacerbated by the fact that, in the case of investments in improvements to land, a capital works deduction analogous to depreciation is available for buildings and non-plant structures which become part of the land⁹. If the land and buildings are sold, the capital works deductions will be subtracted from the cost base used in determining the amount of the capital gain on the sale¹⁰. However, as the Reserve Bank submission correctly notes, since the capital gain on sale attracts the CGT discount, and so is only subject to tax as to 50 percent of the gain, this means that only half the capital works deduction is ever recovered on the sale of the land and buildings. ***This puts this form of investment in a highly preferential position compared to investment in other types of business asset.***

Third, the CGT discount treatment was not made available to private companies. Hence the benefit of the CGT discount is effectively denied where individuals wish to make an investment though the corporate form – which will typically be

⁸ See *FCT v Murry* (1998) 193 CLR 605.

⁹ *Income Tax Assessment Act 1997*, Division 43.

¹⁰ *Income Tax Assessment Act 1997*, section 110-45.



the case where the investment is in a new business, or in innovative activity such as research and development. Again, ***the practical effect of this is to limit the full benefit of the CGT discount to investment in passive assets such as residential property investment.***

Fourth, at the same time as the CGT discount for passive investments was introduced, loss quarantining rules were introduced to prevent individuals claiming unrestricted negative gearing benefits in relation to investments in active businesses. The so-called “non-commercial loss rules”¹¹ were introduced to deal with losses arising from unprofitable business activities conducted by individuals. The effect of the rules is that losses from such activity can no longer be deducted without restriction against income from other activity; in general, the loss arising from the activity can only be deducted in future years against income from the same activity, and if it never produces the income, the loss is permanently denied.

Strangely, a specific exception was inserted into the loss quarantining rules for investments in property and shares – i.e. passive investments eligible for the CGT discount benefit¹². For these investments, the unrestricted negative gearing benefit was retained. ***In short, negative gearing was denied for investment in risky active business operations which might be expected to show losses, and preserved for passive investment in land and shares – in particular, investment in residential properties.***

Fifth, at same time as these changes were made, accelerated depreciation for plant and equipment used in active business operations was abolished and replaced with effective life depreciation. ***This abolition of accelerated depreciation further reduced the relative attractiveness of investment in active businesses as against passive investments.***

It is important to consider the interactive effect on investment decisions of negative gearing having been preserved for passive investments, while accelerated depreciation was abolished for active investments. The level of debt financing which can be obtained by an individual to finance a passive investment in residential property is substantially higher than the level of debt which can be obtained to finance investment in active business operations. This is because the residential property offers better security for the lender. Hence, investment in active business in turn requires a relatively higher level of equity funding, which only gives rise to tax benefits to the extent that the investment of the funds is made in assets eligible for depreciation. With accelerated depreciation being abolished, the relative superiority of passive investment in residential property has been further reinforced by the tax laws.

¹¹ See Division 35 of *Income Tax Assessment Act 1997*.

¹² See section 35-5(2) of *Income Tax Assessment Act 1997*. A similar exception for negative-gearing was made in related rules concerning pre-payments: *Income Tax Assessment Act 1936*, section 82KZME(5).



Sixth, and finally, it is critical to understand that *it is not the case that all types of investment so easily allow the CGT discount benefit to be combined with an unrestricted negative gearing benefit*. Only certain types of investment asset have the tax characteristics needed to achieve this combination of benefits. Among these, as a matter of income tax law and practice, residential property investment is almost unique in its suitability.

It is often overlooked that interest expense incurred in earning a CGT discount gain is not deductible¹³. Interest expense is only deductible if incurred for the purpose of earning income or other gains of a non-capital nature. Therefore, to obtain the unrestricted negative gearing benefit in respect of an investment, it is necessary to find a type of investment asset which not only produces discount capital gains on sale, but also produces income or other gains of a non-capital nature in the period before the investment is sold. Residential investment properties are peculiarly well suited to this type of investment, because they produce income in the form of rent while the property is held, as well as discount capital gains on sale.

Further, it has been the long-standing practice of the Australian Taxation Office to allow the full amount of the interest expense on residential investment properties to be deducted as a negative gearing benefit, even where the rental income is so far below the interest expense that the investment will only make sense if it produces a discount capital gain. This gives the residential investment property tax outcomes which are enjoyed by few other types of investment asset.

Possibly, the only other type of common non-debt investment which is capable of producing the unique combination, of a CGT discount benefit and unrestricted negative gearing, is a passive investment in shares, because shares also produce income in the form of dividends. However, the changes wrought to the tax laws in September 1999 suffered from the misfortune that their introduction was soon followed by a period of increased volatility and lower returns in world equity markets, which has apparently reduced the general attractiveness of share investment relative to investment in residential property.

As such, it is not surprising that the tax law changes have combined with these broader investment conditions to produce a serious investment distortion in favour of residential investment properties.

4. Competitive disadvantage for first home buyers

The distortion of investment demand created by the preferential tax status accorded residential property investment, under current law and practice, is of itself undesirable. However, in the context of the residential home market, it has

¹³ See section 51AAA of *Income Tax Assessment Act 1997*



another aspect which is of particular concern to the subject of the inquiry, namely the affordability of housing for first home buyers.

First home buyers are not subject to CGT on a sale of the home¹⁴. However, this concession provides no financial assistance in respect of the initial purchase of the home.

What is more important is that the negative gearing benefits of residential property investment are denied to first home buyers¹⁵. First home buyers must fund the purchase and the associated debt repayments totally from their own savings and after-tax income; investors, by contrast, are given the funding support of the negative gearing benefit. This means that the after-tax cost to the first home buyer of purchasing a first home is substantially higher than the after-tax cost to an investor of making an equivalent residential property investment.

As a result, the tax system introduces a systemic distortion of competitive forces in the residential property market. One component of the market - first home buyers – simply cannot compete on equal financial terms with the other component of the market – property investors.

One response to this problem would be the introduction of deductibility of mortgage interest expense for first home buyers. The US tax regime has such a deduction, which is subject to a number of equitable limitations¹⁶. However, this would have the potential to further inflate demand for residential property investment and would not be appropriate unless combined with other measures designed to moderate the preferential tax status of negatively geared residential property investment. We turn to these other measures below.

5. Need for measured response to investment distortions introduced by post-September 1999 tax law

It is clear that something needs to be done to correct the investment distortions which the September 1999 tax law changes have created in favour of residential investment properties.

It is also clear that a measured response is required. Individuals have taken on substantial investment commitments in reliance on the tax regime established in September 1999. They have a legitimate expectation that the essential features of that regime should not be subject to fundamental change, before they are given due opportunity to rearrange their investments without suffering financial loss.

¹⁴ Subdivision 118B of *Income Tax Assessment Act 1997*.

¹⁵ Under section 8-1 of *Income Tax Assessment Act 1997*, interest expense is deductible only if incurred to earn assessable income.

¹⁶ Section 163(h) of Internal Revenue Code, Title 26 US Code.



As the preceding analysis shows, the main problem with the current taxation arrangements for residential property investment is the unique and highly preferential *combination* of the unrestricted negative gearing benefit and the CGT discount benefit. This combination leads to an artificial investment demand for residential properties.

It follows that it would be inappropriate and unnecessary to address the problem by simply removing the negative gearing benefit for residential property investment. Likewise there would be little merit in simply removing the CGT discount benefit for residential property investment.

Rather, the preferred approach must be a well-considered *moderation* of the excessively preferred tax status which results from the *combination* of the negative gearing benefit with the CGT discount benefit in the one form of investment. Further, any such moderation of the preferred tax status needs to be phased in over a reasonable period of years.

We note that such an approach would be somewhat different to the blunt removal of negative-gearing for rental investment properties introduced, and then repealed, by the federal government in 1985¹⁷.

6. Moderation of combination of negative gearing and CGT discount benefit

The key to moderating the *combined* operation of the unrestricted negative gearing benefit and the CGT discount benefit for investment in residential property, is to recognise that the interest expense on the property is being incurred in part to earn the rental income and in part to earn the discount capital gain on sale.

The current law fails to recognise this, because it allows a full rate deduction for the negative gearing interest expense in the period while the property is held, but then only taxes half the offsetting gain on sale (due to the CGT discount).

Once this is explicitly recognised, it is relatively easy to develop reform proposals which will moderate, rather than remove altogether, the attractive tax features of residential property investment.

We would propose two broad reform options, which we describe in general terms below.

¹⁷ See sections 82KZC – 82KZK of *Income Tax Assessment Act 1936*.



7. Option A: Moderated restriction of negative gearing benefit by reference to CGT discount

One broad reform option is a phased-in moderation (but not a total removal) of the unrestricted negative gearing benefit for residential property investments.

As noted above, the tax law should explicitly recognise that, in economic substance, the negative gearing expense on a residential property investment is being incurred in part to earn rental income and in part to earn the discount capital gains. We would propose that over, say, a five year period, the tax law should move to a position where:

- Some proportion of the negative gearing loss (say half) on a residential property investment¹⁸ should be eligible for deduction without restriction against all other income of the taxpayer; and
- Some proportion of the negative gearing loss (say half) should be subject to a moderate restriction on deductibility – namely it should only be deductible against income and gains from other CGT assets of the kind which are subject to the CGT discount benefit on sale – such as other passive investments in land and shares.

To phase this in over a period, the proportion of unrestricted to restricted negative gearing loss might initially commence at, say, 90/10, and trend down to 50/50 over a number of years.

8. Option B: Moderated restriction of CGT discount benefit by reference to negative gearing benefit

A second broad reform option is to require a partial recapture of the negative gearing benefit on sale of the property.

The negative gearing benefit is allowed as a deduction at 100% of the net loss as it is incurred from year to year. However, when the net loss is recovered by the gain made on the sale of the property, only 50% of the gain is subject to tax due to the CGT discount. The tax system is therefore failing to properly match the capital gain with the negative gearing benefit.

We would propose that over, say, a five year period, the tax law should move to a position where:

- Some proportion of the capital gain on sale (say half) should be eligible for the CGT discount without restriction; and

¹⁸ It may be appropriate to extend this measure to other passive investment assets.



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- Some proportion of the capital gain on sale (say half) should only be eligible for the CGT discount to the extent that it exceeds the total amount of negative gearing loss previously claimed on the investment.

To phase this in over a period, the proportion of unrestricted to restricted CGT discount might initially commence at, say, 90/10, and trend down to 50/50 over a number of years.

We note that special restrictions on deductibility of losses or other tax benefits associated with particular aspects of certain kinds of investment activity would by no means be unusual in Australian taxation law. There are many other examples¹⁹.

We trust the Commission will find our submission of assistance, and we would be more than happy to assist in any matters concerning taxation arrangements as the inquiry progresses.

Yours sincerely,

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¹⁹. See M. Stewart, 'Venturing Towards Flow Through Taxation of Limited Partnerships: It's Time to Repeal Division 5A' (2003) 32 *Australian Tax Review* 171-195. For example, *Income Tax Assessment Act 1936*, section 51AD; Division 16D, sections 82KL, 82KK and 82KH; section 82KZME; Schedule 2C; *Income Tax Assessment Act 1997*, Division 35, Division 243.