NEGATIVE GEARING AND CAPITAL GAINS TAX REFORM

The case for reforming two of our most unfair tax breaks to create a fairer housing market for all

Reforming Negative Gearing and the Capital Gains Tax discount would be one of the most effective ways to remove the massive structural inequity in our tax system, to restore fairness to our housing market, and to generate over $117 billion in revenue over the next ten years.

> QUICK FACTS

- The CGT discount is Australia's 6th largest tax expenditure and will cost $6.8 billion in the 2016-17 financial year.
- The CGT discount goes mostly to the very wealthy, with over 73% of the benefit flowing to the top 10% of income earners.
- Negative gearing costs almost $4 billion each year, and over half the benefits go to the top 20% of households.[i]
- There's no reason why wealthy Australians who generate income from investments such as property should be taxed at a different rate than everyone else.
- The Reserve Bank is among an overwhelming number of groups pushing for reform of these tax breaks.
- Figures from the Parliamentary Library show on average, residential property investors using both negative gearing and capital gains discounts are receiving a benefit of about $4500 per year, but this rises to $9200 for households in the highest income quintile.[ii]
- The top 10 negative gearing electorates are all Liberal electorates[iii].
- The Prime Minister and his wife own nine properties between them, including five investment properties.

Largest 10 average net rental loss by electorate

Electorate	Net Rental Loss	Party	Representative
Wentworth	-$20,248	Liberal	Malcolm Turnbull
Curtin	-$19,216	Liberal	Julie Bishop
Kooyong	-$17,169	Liberal	Josh Frydenberg
Bradfield	-$16,969	Liberal	Paul Fletcher
Higgins	-$16,659	Liberal	Kelly O'Dwyer
Warringah	-$16,423	Liberal	Tony Abbott
North Sydney	-$15,895	Liberal	Trent Zimmerman
Brisbane	-$15,666	Liberal	Teresa Gambaro
Goldstein	-$15,068	Liberal	Andrew Robb
Ryan	-$14,857	Liberal	Jane Prentice

Source: The Australia Institute / The Drum 2016[iv]

> A HOUSING SYSTEM IN CRISIS

Australia's chronic undersupply of affordable housing is at a crisis point. Years of under-investment in affordable supply has been accompanied by decades of generous subsidies to property investors and speculators which has driven prices up as investors out-compete first home buyers. Our housing market is now one of the most unaffordable in the world.

The Greens' proposal to reform negative gearing and the capital gains discount is based on models outlined in consecutive reports by a wide range of advocates and economists including the Reserve Bank of Australia and overwhelmingly by housing, taxation, and social welfare advocates.

> THE GREENS' PROPOSAL

In June 2016 the independent Parliamentary Budget Office (PBO) provided the Greens with **updated costings of the combined effect** of phasing out the capital gains tax discount and removing negative gearing.

Specifically, the PBO estimated the Greens proposal is to:

- Progressively phase out the 50% capital gains tax (CGT) discount for trusts and individuals for capital gains realised on or after 1 July 2016, by a reduction of 10% each year for five years to be phased out entirely by 1 July 2020; and
- Remove negative gearing for all non-business assets purchased by individuals, funds, trusts, partnerships and companies on or after 1 July 2016, with assets purchased prior to this date grandfathered.

The PBO estimated the Greens proposal would raise $14.426 billion over forward estimates (2016-17 to 2019-20) and a total of $117.3 billion over the next ten years.

> WHAT IS THE CGT DISCOUNT?

Broadly speaking, Capital Gains Tax (CGT) is paid when an asset is sold for more than it was purchased for, minus some deductions. Since 1999, Australia has had a 50 % discount on CGT if the asset was held for more than 12 months by an individual or a trust. The discount means that only half the capital gain made on an investment is subject to tax.

For example, if an investment property was purchased for $200,000 and later sold for $500,000 - the investor made a capital gain of $300,000 – but only 50 per cent (or half) of that amount is actually taxed. The tax applies to capital gains realised when an asset is sold[v]. Owner-occupied housing is exempt.

> HOW MUCH DOES IT COST?

The Capital Gains Tax discount is Australia's sixth largest tax expenditure.[vi] According to the Treasury's *Tax Expenditure Statement* the capital gains discount will cost $6.84 billion in 2016-17, and $7.6 billion in 2017-18 in lost revenue.

Property investment makes up the highest proportion of assets attracting the capital gains discount (40%) followed by shares (37%) and other assets (20%) including art and collectables[vii].

> WHO BENEFITS FROM CGT DISCOUNTS?

Data overwhelmingly shows the vast majority of benefits go to the wealthy.

NATSEM data shows 73% of capital gains discounts go to the top 10% of households by income levels (Figure 1)[viii].

The most recent ATO data also shows 506,070 individuals reported a net capital gain in the 2012-13 income year; of these 70% had a taxable income over $180,000, and only nine per cent had taxable incomes less than $80,000.[ix]

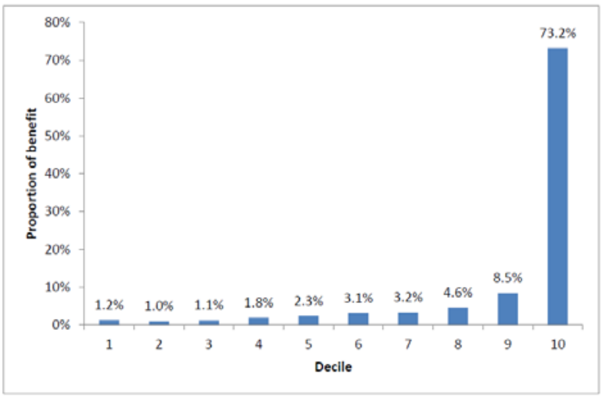


Figure 1: Distribution of the CGT discount by household income (Source: NATSEM, ATO Taxation Statistics updated to 2014-15 in The Australia Institute 2015)

> WHY WAS IT INTRODUCED?

Capital gains tax was introduced in 1985 by the Keating government as part of a tax base-broadening package. The discount was introduced by the Howard Government in 1999, following a report by the Ralph Review of Business Taxation, which recommended that only half of capital gains be taxed 'to encourage greater investment in venture capital' and to 'support a stronger investment culture amongst Australian households[x].'

It certainly achieved its purpose - Australians have one of the highest rates of investment in OECD countries, particularly in property – but at a massive cost.

> WHAT IS NEGATIVE GEARING?

Negative gearing allows investors to deduct losses made on rental properties from their other income, reducing their overall annual tax liability.

> HOW MUCH DOES IT COST?

The Australia Institute using NATSEM figures estimates that negative gearing of residential investment property is currently reducing tax revenue by $3.7 billion per year.[xi]

The Grattan Institute has also estimated that negative gearing of real estate alone costs Federal Government coffers about $4 billion a year[xii]

In June 2015, the Parliamentary Budget Office estimated the Greens' proposal to remove negative gearing (with assets purchased prior to July 2015) would raise $42.48 billion over the next ten years to 2024-25.

A tax subsidy for investors worth about $4 billion a year is the equivalent of a cheque for $1781.43 for every Australian citizen[xiii].

> WHO BENEFITS FROM NEGATIVE GEARING?

The biggest winners from negative gearing are the nation's highest income earners:

- Over half of individual taxpayers with negatively geared rental housing investments are in the top 10% of personal taxpayers, with 30% earning over $500,000.[xiv]
- The tax benefit of negative gearing is 10 times more for the highest income earners than for the lowest.
- The number of people using negative gearing is almost four times higher for those with incomes of $150,000 than for those earning $50,000 or less.
- 1930 millionaires collectively claimed rental property losses of $115m – a tax deduction worth almost $60,000 each.

The majority of property investors are in the two highest income quintiles (Figure 2).

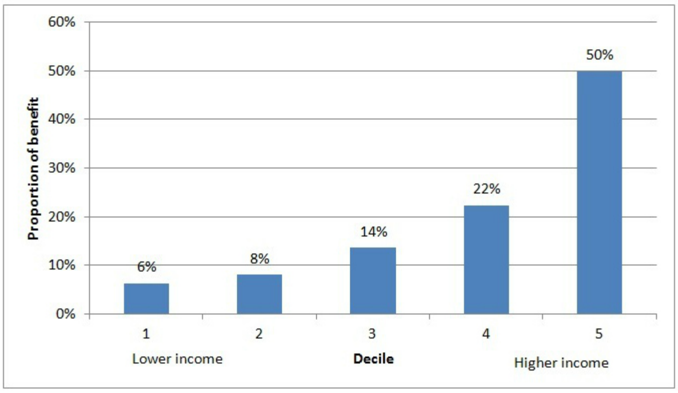


Figure 2: Benefits of Negative Gearing by Income (Source: Australia Institute Top Gears report)

It shows as income increases so does the average 'loss' or deduction claimed. The average net property loss reported in 2011-12 was $10,870; but for those earning between $250,000 - $500,000 the average loss was $38,500[xv].

The proportion of low to moderate income earners who are negatively geared is very low: only 10% of people earning a total income of $50,000-$100,000 are claiming a net property loss[xvi].

If negative gearing were removed, 95% of people earning $50,000 or less would be unaffected, along with 90% of people earning a total income of $50,001 to $80,000[xvii].

The Greens' comprehensive Fact Sheet 'Negative Gearing at a Glance' outlines the 8 most common myths and facts associated with it.

> THE COMBINED IMPACT OF NEGATIVE GEARING AND THE CGT DISCOUNT

One of the major problems in our housing market is the way the current capital gains discount encourages negative gearing and speculation in the property market, which drives up housing costs and locks out first home buyers. It also creates a rental market stacked in favour of investors rather than tenants.

Normally investors would not be interested in an investment that is expected to run at a loss. But many are happy to purchase property where the rental income doesn't cover the interest payments because in the future, they expect to make large capital gains, which are taxed at a massive discount when they sell it.

When the headline rate of capital gains tax was cut to half the income tax rate by then Prime Minister John Howard in 1999 it made negative gearing much more attractive and also sparked a climb in house prices[xviii]. Figures clearly show as soon as the capital gains discount was introduced, Australia suddenly became a 'nation of losers' (Figure 3).

In the financial year before the discount was introduced property investors actually reported a net rental income of $219 million, but in 2000-2001 suddenly investors reported almost half a billion dollars in *losses*, with the amount rising radically over the next ten years to $7.9 billion in 2011-12

Not only does capital gains tax discount encourage property investors to speculate on massive windfall gains that they are not taxed fairly on, but the benefits of the combined negative gearing and capital gains discount, worth about $7.7 billion per year, are skewed towards higher income earners:

- 56 per cent of the benefit goes to the top 10 per cent of income households
- Just four per cent of the benefit goes to the bottom 20 per cent of households

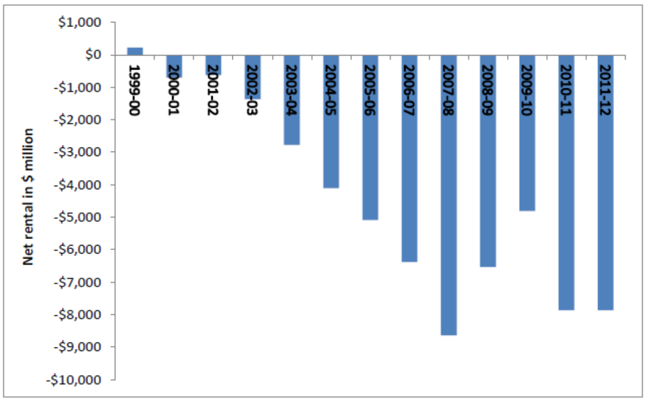


Figure 3: Net rental loss (negative gearing) over time since the introduction of the CGT discount. Source: ATO (2014) Taxation Statistics 2011-12, Individual tables, Table 13.

Data also shows the dollar value of the combined benefit is also worth much more to higher income earners (Figure 4).:

- The weekly dollar value of the benefit of the discount is worth $1 to the lowest income quintile but $6 per week to the middle quintile and $30 per week to the highest quintile
- The top 20% receive thirty times the benefit received by the lowest bracket, and five times the benefit that middle income earners receive.

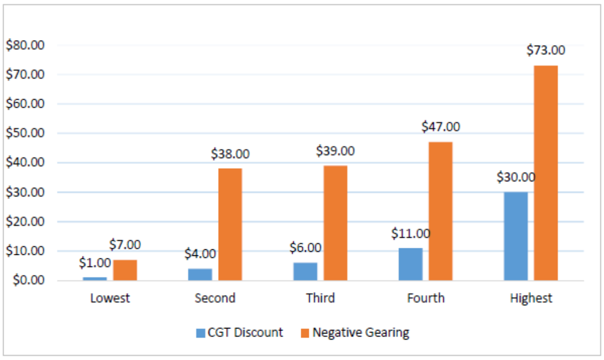


Figure 4: Which households (by income quintile) benefit from the capital gains tax discount and negative gearing? Source: ACOSS 2015 using Yates (2010) data

> CAN THESE TAX BREAKS BE JUSTIFIED?

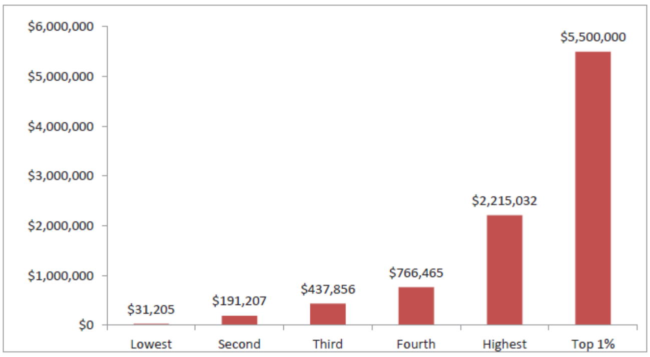
A core principle of any modern tax system is that it is fair, progressive, and has integrity in the way it rewards work and savings. Both negative gearing and the capital gains tax discount fail on all counts and are almost impossible to justify.

Is it fair?

The discount goes to people who are generating income through *assets* (like property, shares and art) rather than income. This is all the more important given inequality in Australia is now driven by the distribution of assets not income. In fact asset inequality is at least 14 times worse than income inequality in Australia. The top 20 per cent have five times more income than the bottom 20 per cent - but hold 71 times more wealth (Figure 5)[xix].

Given households with higher incomes are on average invested more heavily in investment properties and shares[xx] than lower income households, they obtain the greatest benefit from the CGT discount. ABS data shows:

- Households in the lowest income quintile own on average of $4500 in investment property assets, compared with those in the highest income quintile who own $467,000.
- Households in the lowest income quintile own on average $400 in shares, compared with $75,400 for those in the highest quintile[xxi].



Source: ABS (2013) *Household wealth and wealth distribution, Australia, 2011-12.*

Figure 5: The distribution of wealth in Australia, showing the average value of assets held by household income quintiles. (Source: The Australia Institute, 2014)

A tax system that is designed to provide significant discounts to the most wealthy and reinforces asset and income inequality is fundamentally unfair.

Is it progressive?

The concession undermines the progressivity of the income tax system, that is, as people's income rises so does their ability to pay more tax. Instead, the discount provides a massive incentive for the wealthy to avoid paying higher marginal tax rates by structuring their tax affairs so that more of their income is in the form of capital gains[xxii].

This means the higher the marginal income tax rate, the higher the benefit they receive from the concession. For example, a taxpayer on the top rate of 46.5% benefits from a 23 per cent discount; but a taxpayer on the zero marginal rate (income under $18,000) gets no benefit at all[xxiii].

A tax system that is designed to enable the rich to access higher discounts and actively avoid tax paid on income, and where the majority of the lost revenue accrues to high income households is the opposite of progressive.

Does it have integrity?

The capital gains tax concession discriminates against those earning income from savings and work – rather than those who have accumulated assets. No credible argument exists to justify why the creation of wealth through assets should be taxed at a different rate than the creation of wealth through income.

Anglicare Australia says in its submission to the Taxation White Paper:

'There are also issues of concern regarding the integrity of a system if it offers some of the more affluent members of our society a way of paying less tax. As detailed discussions of capital gains tax exemptions and negative gearing and superannuation point out, the tax system as it exists provides many tax minimising opportunities for those with greater resources, which are simply not available to the majority of taxpayers. If the tax system is to serve its broader purpose it needs to have integrity at its heart.'

> WHO SUPPORTS REFORM?

The Reserve Bank of Australia recently added its voice to the growing number calling for a review of negative gearing and the capital gains tax discount. Its submission to the government's inquiry into Home Ownership in June 2015 highlighted the way they work together to encourage leveraged investment in property and make capital gain-producing assets more attractive than income producing assets. The RBA concluded:

"Given the value Australian and other households place on home ownership, policy should not unduly advantage property investors at the expense of prospective owner-occupier households. Financial stability considerations would suggest that tax and regulatory frameworks should avoid encouraging over-leveraging into property by investors.[xxiv]*"*

This is in addition to an overwhelming number of prominent economists and peak social bodies who have made public statements and submissions to the government's Tax White Paper calling for reform. Many groups pushing for a review of the discount are saying the Australian community should expect to get something significant in exchange for that kind of benefit, and that it's a much fairer place to generate revenue than raising the GST.

Economists including Saul Eslake, and even Tony Shepherd, former Business Council president and former chair of Tony Abbott's Commission of Audit support complete removal of the CGT discount. Mr Shepherd recently said the 50 percent discount was "too generous" and he could see no reason for continuing it:

"I'm personally in favour of bringing the CGT rate up to the income tax rate… I can't see any reason to treat capital gains any different from income gains. I'm personally in favour of putting the rate up to the income tax rate, I can't see any reason for treating it differently, and I think it probably leads in some respects to a greater emphasis on negative gearing[xxv]*".*

Those against reform remain limited to those directly benefiting from the current arrangement, most notably property industry peak bodies including the Real Estate Institute of Australia and the Property Council.

> POSITION OF OTHER PARTIES

The Coalition promised a comprehensive tax review with 'everything on the table' but then refused to include negative gearing and capital gains tax. They have ignored their own Treasury advice that the very wealthy benefit the most from negative gearing[xxvi] and continue to deliberately misrepresent the basic facts on the incomes of people using negative gearing ad the impacts on the housing market if it were removed[xxvii].

The Greens welcome Labor's commitment to reforming negative gearing and the CGT discount, but believe it does not go far enough and may make speculation and oversupply of top end 'off the plan' apartments even worse.

Labor's plan would:

- from 2017 only allow negative gearing for new housing, but grandfather current negative gearing arrangements
- reduce the capital gains discount from 50% to 25%
- generate revenue worth $590m over forward estimates and $32 billion over 10 years.

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[i] https://www.theguardian.com/australia-news/2016/jun/18/labor-seizes-on-treasury-advice-that-wealthy-get-most-from-negative-gearing

[ii] The Grattan institute using ABS 2013 data (2013) Renovating Housing Policy calculated tax concessions for residential property investors (including capital gains discounts) costs about $6.8 billion a year. Grattan Institute 2013.Older data by Yates (2010) used by ACOSS (2015) show in 2005-06 households in the top quintile were receiving an average benefit $3796 per year from negative gearing (with an additional $1562 from the capital gains discount on investment property) – worth about $103 per week, compared with $416/year or about $8 per week for those in the lowest quintile.

[ii] The theoretical ideal would be taxing capital gains

[iii] Matt Grundoff 'Guess whose electorate gears the most'. The Drum, ABC 27 April 2016 at http://www.abc.net.au/news/2016-04-27/grudnoff-facts-about-negative-gearing/7362012

[iv] http://www.abc.net.au/news/2016-04-27/grudnoff-facts-about-negative-gearing/7362012

[v] The theoretical ideal would be taxing capital gains as they accrue rather than just as they are realised, as deferring taxation favours capital gains over other forms of income and encourages 'lock in' of assets (a preference for holding on to existing assets). But the high administrative and compliance costs in valuing all the assets and the problems for those having to pay tax on gains not yet realised make this impractical.

[vi] Treasury, Tax Expenditures Statement 2014 *January 2015*

[vii] Capital gains tax: historical trends and forecasting frameworks. John Clarke, Tax Analysis Division, Australian Treasury. At http://treasury.gov.au/~/media/Treasury/Publications%20and%20Media/Publications/2014/Economic%20Roundup%20Issue%202%202014/Documents/PDF/03Clark.ash

[viii] 'Top Gears' The Australia Institute April 2015

[ix] ATO Taxation Statistics, 2012-13 Individuals, Table 3. Note the data on capital gains by asset type only includes those individuals who have submitted a capital gains tax schedule. In 2012-13, this was only 245,600 of the 506,070 individuals that reported a net capital gain.

[x] 'Review of Business Taxation - A Tax system redesigned'. July 1999 at http://www.rbt.treasury.gov.au/publications/paper4/

[xi] The Australia Institute (2015) *Top Gears – How Negative Gearing and CGT Benefits the top 10 per cent* at http://www.tai.org.au/content/top-gears-how-negative-gearing-and-capital-gains-tax-discount-benefit-drive-house-prices

[xii] http://www.abc.net.au/news/2014-07-07/janda-few-positives-to-be-found-in-negative-gearing/5576662

[xiii] The Australian population was 23.846 million according to the ABS population clock at 8 June 2015 http://www.abs.gov.au/ausstats/abs%40.nsf/94713ad445ff1425ca25682000192af2/1647509ef7e25faaca2568a900154b63?OpenDocument

[xiv] RBA 2014 Financial stability review, September 2014 Box C: Households investment property exposures, evidence from tax and survey data, cited in ACOSS 2015.

[xv] Parliamentary Library research using ATO Taxation Statistics, 2011-1

[xvi] *Source: Parliamentary Library using ATO Taxation Statistics for 2011-12 (latest available data).*

[xvii] Parliamentary Library using ATO Taxation Statistics for 2011-12 (latest available data). This is because just 5% of taxpayers earning below $50,000 and only 9.6% of taxpayers earning between $50,000-$80,000 have net rental property losses.

[xviii] PM's audit chief Tony Shepherd says it's time to more properly tax super, capital gains', June 22, 2015 Peter Martin The Age, at http://www.smh.com.au/federal-politics/political-news/pms-audit-chief-tony-shepherd-says-its-time-to-more-properly-tax-super-capital-gains-20150622-ghukru.html#ixzz3hpflwXq1

[xix] Richard Denniss and Charles Richardson, 2014, The Australia Institute.

[xx] ABS 2011-12 Household wealth and wealth distribution – Table 10 and 6

[xxi] BS 2011-12 Household wealth and wealth distribution – Table 6 – Net worth quintiles, Household assets and liabilities

[xxii] '…income streams are being readily converted into capital gains streams'; Bernie Fraser, Trevor Boucher, John Freeland, Bob Gregory and Alison McClelland, *A Fair and Adequate Tax System*, May 1999, p 18.

[xxiii] The Australia Institute: Tax Equity, Reforming capital gains taxation in Australia, David Ingles, April 2009

[xxiv] Reserve Bank of Australia (2015) Submission to the Inquiry into Home Ownership. House of Representatives Standing Committee on Economics. June 2015

[xxv] Mr Shepherd quoted speaking at a Committee for Economic Development of Australia conference in Canberra on Monday 22 June 2015, cited in 'CGT discount too generous: Tony Shepherd'. Australian Financial Review, Australia. Joanna Mather. 23 June 2015 [xxv] PM's audit chief Tony Shepherd says it's time to more properly tax super, capital gains. Peter Martin June 22, 2015.

[xxvi] https://www.theguardian.com/australia-news/2016/jun/18/labor-seizes-on-treasury-advice-that-wealthy-get-most-from-negative-gearing

[xxvii] See for example ABC FactCheck March 2016 which found then Treasurer Joe Hockey's claim abolishing negative gearing would push up rents "doesn't stack up" at