

Proposed Changes to Negative Gearing under the Henry Review

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Key Points:

- The Henry Review of Taxation proposes a change that would reduce the benefit of negative gearing by allowing only 40 per cent of any negative gearing loss to be recognised.
- Any reduction in negative gearing benefits would have a marked negative impact on the demand for housing. Would hurt lower and middle-income earners who dominate ownership of negatively-geared properties, and would worsen rental affordability through a reduced supply of investment housing.
- This brief sets outs some basic facts regarding the Henry recommendation relating to negative gearing.

What is negative gearing?

Negative gearing refers to a form of financial leverage whereby an investor borrows money to buy an asset, but the income generated by that asset (net of other expenses) does not cover the interest on the loan. The investor must fund the shortfall until the asset is sold or until such time earnings outstrip costs. The shortfall is tax deductible against another source of income, for example wages. In order for a negatively-geared property to be an attractive investment usually requires the expectation of a decent capital gain over the longer term.

The tax-deductibility benefit of a negatively geared property firstly involves a greater out of pocket expense (in interest payments) and accordingly, to be an attractive investment option, a negatively-geared property relies on the expectation of a decent capital gain over the longer term.

History of negative gearing in Australia

Negative gearing was introduced in Australia, with one of the aims being to increase the supply of rental properties. In July 1985 the Hawke/Keating government quarantined negative gearing interest expenses (on transactions), so interest could only be claimed against rental income, not other income (with any excess allowed to be carried forward). This decision was reversed in September 1987.

Current treatment: Losses from negatively-geared property investments are currently fully tax-deductible (against personal or company income) under Australian taxation law

Proposed treatment: Recommendation 14 of AFTS (A Fairer Tax System report), if adopted, would mean that taxpayers could recognise only 40 per cent of any loss from a negatively-geared investment property (and conversely, only 40 per cent of any gain

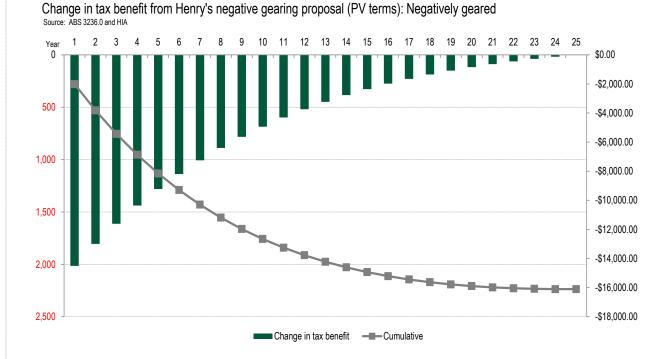




from positively-geared assets would be taxable). Accordingly, the proposed change will favour positively-geared property ownership whilst negatively-geared investors will be adversely impacted by the proposed change.

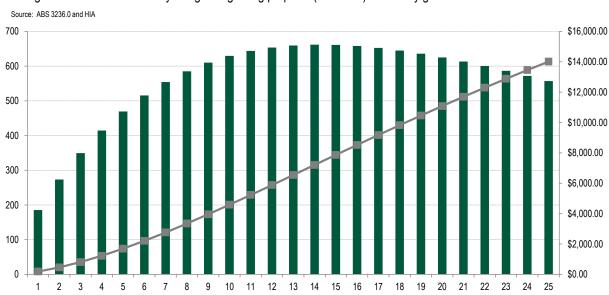
Impact of proposed changes on an average (\$466,000) property

Negatively-geared property: Based on a \$466,000 property with a \$20,000 deposit, a taxpayer on a marginal tax rate of 30 per cent, interest only loan repayments, and a raw rental yield of just under 5 per cent, HIA calculates an investment property owner will be \$2,176 worse off in the first year, and almost \$30,000 worse off over a 25 year period. In present value terms, with a discount rate of 8 per cent, this means a loss of \$16,103 over the 25 year period (see chart below).



Positively-geared property: these investors would benefit from the proposed changes under Henry. Based on the same scenario as above, but with a raw rental yield of just over 8 per cent (traded for lower capital gains expectations), HIA calculates the home owner will be more than \$47,000 better off over a 25 year period, or \$14,010 in present value terms (see chart below).





Change in tax benefit from Henry's negative gearing proposal (PV terms): Positively geared

Overall impact on housing investors and the housing market

There are considerably more investors that are negatively geared than positively geared, meaning that, if implemented, this proposal would net a substantial revenue saving. According to 2006/07 ATO taxation records 1.6 million taxpayers (13.6 per cent) claimed rental income and of those, two in three (1.08 million) negatively geared their investment/s.

Cumulative

Change in tax benefit

Interestingly, these investors predominately do not come from the wealthy end of town. Indeed, 74 per cent of negatively geared investors earn less than \$80,000 in 2009/10 dollars and pay 30 cents in the dollar tax or less. Only 4 per cent paid the top tax rate of 45 per cent.

In spite of the modest incomes and subsequent low marginal tax rates of investors the benefits of negative gearing are substantial as it can simultaneously reduce taxable income levels and place the tax payer in a lower tax bracket. A HIA simulation of ATO tax records indicates that the removal of negative gearing would increase tax receipts by \$3.64 billion, equating to an average increase in costs for the affected investors of around \$2,000 per annum averaged across all private rental properties.

Although nothing about negative gearing is restricted to property as an asset class, negative gearing is usually associated with property due to an attitude among many investors that property is a "sure thing". In other words, investors do have an expectation of decent capital gains from property. In theory, a reduction in negative gearing benefits shouldn't change the relative attractiveness of investing in differing assets classes. However, in reality, due to the fixation on negative gearing property, it will likely move preferences some way towards investing in other assets.

Potential Impact if the Henry Proposal is introduced

The Henry proposal would decrease housing investment and housing supply

Removing what is effectively a multi-billion dollar benefit to rental investors would significantly reduce rental investment in both new and existing property. Money is highly mobile and other asset types will become relatively more attractive.

The removal of negative gearing for two years in 1985 provides a basis for understanding the likely outcomes of any potential reduction in negative gearing (although caution must be taken given that higher interest rates and a significantly higher top marginal tax rate made negative gearing more favourable in the



mid-1980s). Grandfathering of negative gearing arrangements to 'old' investments meant that any impacts such as rental or price impacts were muted in the short term.

The Henry proposal would worsen rental affordability

A reduced rental supply means lower rental vacancies and increased rents (via reduced demand for housing services and increased demand in non-housing areas). Lower rental returns would impact heavily on the predominantly middle income or 'mums and dads' investor and the typically low income renters would pay the price of reduced rental supply via higher rents.

Certainly, the impact of negative gearing in the mid-1980s was to lower both the level and share of rental investment in new and existing property. The impact on the rental market is hard to determine but the likely impact was a lagged increase in rents.

The Government is yet to make any inroads towards fixing Australia's housing supply problems

Henry noted that the supply side of Australia's housing market needs reform, and that this reform should take place prior to the consideration of proposals, such as the negative gearing changes, that will impact housing. This included calls from Henry for:

- a. A review of institutional arrangements (including administration) to ensure planning and zoning do not unnecessarily inhibit supply and affordability; and
- b. Review of infrastructure charges/ developer charges to ensure they appropriately price infrastructure contributions from developers to ensure unnecessary costs are avoided, transparency is improved and regulation is reduced to speed up the development process.

Unfortunately, the COAG process to give effect to the Henry recommendations around housing supply reform (which is being headed by the Treasurers) is moving at a glacial pace and currently holds little prospect of any meaningful outcomes.