Negative Gearing Redeemed

Submission to Re:think – Better tax system, better Australia

By Lorraine May 2015

Executive Summary

Negative Gearing is currently being criticised in the press with reports of the government losing billions of dollars in revenue to demon investors, of the benefits accruing mainly to the already wealthy and of young people being locked out of the housing market.

In this submission I look at negative gearing as part of the whole system of housing in Australia and question whether the government should expect to make any revenue gain from housing those who cannot afford to buy a home. The government does not, after all, make any revenue from home owners.

I am putting forward a simple and totally new way of approaching the tax treatment of rental housing. My solution would increase home ownership, decrease rents, eliminate the loss of government revenue where deductions exceed rental income and reduce the cost of government rental assistance and the dependence on social housing. All without undue stress to existing investors. Landlords could become heroes, taking on the ownership and management of some of the social infrastructure needed to give homes to all Australians, instead of being considered as demons hell bent on reducing their tax.

Negative Gearing Redeemed

Let's look at the current system

Negative Gearing of residential rental property has received a lot of bad press in the last few months with the perception that the government loses revenue, the benefits accrue mainly to the wealthy and young people are being locked out of the housing market by high prices.

Negative gearing of residential rental property occurs where an investor claims a tax deduction for their rental property that is higher than the amount of rent that they receive, with the main cost usually being the interest on the loan to buy the property. This net loss can be deducted from their income from other sources, reducing the tax they pay on this other income. These investors hope to eventually make a capital gain when they sell and this gain is taxed at a lower rate than their normal income, currently 50% lower.

Rental properties are generally called positively geared where the rent received is higher than the deductions claimed, so some additional tax is payable. These positive income properties may not actually be geared at all, but this is the usual terminology and I will use it here.

In this submission I want to look at the whole housing situation in Australia and where negative gearing fits in. I will then suggest a way forward that benefits everyone.

We have been told that negative gearing is costing the government in lost tax revenue as overall rental deductions are now higher than total rental income. We have not been told whether the gain to the government in capital gains tax (CGT) on rental housing makes up the difference, but for the purpose of my proposed changes this is not really relevant.

From a government revenue point of view we have tax on rental income (TR), less tax refunded for rental cost deductions (DR) plus CGT on rental properties sold (CR). This is the total revenue gain or loss to the government on private rentals.

But we also need to add into the equation the amount that the government is saving by not providing social housing to those who are renting privately. This saving is reduced, of course, by the rental assistance paid by Centrelink to low income families. We will call this net saved amount SH for social housing.

So the total benefit that accrues from housing is

TR – DR + CR +SH

There is currently controversy over DR having recently become higher than TR, which in a low interest rate environment is somewhat surprising. The reason for this is most likely that house prices and therefore interest payments on loans have risen faster than rents over the last few years. This may also have been influenced by higher loan to price ratios.

We do not have any way to quantify whether this loss of government revenue is compensated for by the amount of CR received because CGT on rentals is not specifically identified in the figures released by the ATO.

We can be confident, however that the saving to the government of the cost of supplying extra social housing for some or all of the families currently in private rentals would be considerable.

But now for a different perspective

The first question we should be asking is whether the government should make any revenue at all from housing for those who can't afford or don't want to own their own homes. The government does not, after all, make any revenue from home owners. This is because those owning homes pay no rent, claim no deductions and their homes are not subject to CGT.

Let us consider a scenario where there are very few private rental homes available and most people own their own homes. Those who are unable to afford to buy a house would live in rental accommodation owned and managed by the government, with the only private renters being young working people who were not yet ready to buy a house and some families whose work patterns involve regular geographic relocation.

Most Australians would probably agree that this would actually be a good state for the housing situation to be in. Most of us want every Australian to have a place to call home, either rented or owned, which is affordable for them and which is not making huge profits for the already wealthy or providing tax revenue to the government.

Under this scenario the government would receive little or no tax on rents, there would be little or no tax lost to rental deductions and little or no CGT on selling houses. Private rentals would be more or less revenue neutral. However the government would likely have a much greater cost of social housing, which we called SH, than at present.

So to reduce the cost of SH we want some of our landlords back in the system renting out houses to at least the upper band of those who can't afford to buy. These people can then be housed adequately at less cost to the taxpayer.

But these landlords will only want to be in the system if they are making at least some profit – we live in a capitalist economy and we don't expect ordinary people to offer charity housing. We don't want to give landlords huge profits, but we do want to give them some incentive to provide homes to other Australian families who for some reason or other can't or don't want to buy their own home. We want rents to be as low as practical for these people. We also want houses to be as affordable as possible for families and young working people who do want to buy their own home.

Landlords take risks when they buy rental property. While most tenants are great, some tenants omit paying rent or cause damage. The investor may not make any profit when they sell, particularly when stamp duty and selling costs are taken into consideration. Landlords do need some reward for the risks that they take.

With the right tax structure, landlords could be heroes taking on some of the ownership and management of the housing infrastructure needed to give everyone a home, rather than being seen as demons hell bent on reducing their tax.

The way out of all this

So here is a way forward. We declare all aspects of residential housing to be a tax free space for houses owned by individuals, up to a maximum of three, whether owner occupied or rented out. There would be no tax payable on rental income, no deductions against other income for rental house costs and no CGT on the sale of any home.

This idea may seem startling at first, but it actually makes perfect sense and the new system would benefit all Australians.

Rents would fall

Rents would fall in general as there would no longer be a tax component in the amount charged as rent.

Those who have positively geared houses and gain more rent than they claim in deductions could reduce their rent as they no longer need to pay tax on the income. Rental house investments have to compete with each other and also with other forms of income such as bank interest and dividends which are taxable, so rents could be lower as rent would be tax free income.

Negative Gearing would simply disappear

There would no longer be any negative gearing as such on housing for small investors. It would simply disappear.

The government would no longer be losing revenue in the situation where tax on rental income (TR) was less than tax refunded for rental deductions (DR).

There would be no CGT on rental houses (CR) but since the government does not get any CGT on owner occupied housing this CR is really only bonus revenue anyway.

House prices would stabilise or fall slightly

House prices would stabilise or fall sightly as there would be no tax component in the selling price for investors.

Those who no longer wanted to be landlords because they could no longer claim a net rental loss against their other income may sell their houses. With less competition from investors these houses could be bought by owner occupiers. The current owners would not be disadvantaged as they would be selling free of CGT and could sell at a lower price and still make the same return.

The cost of rent assistance and social housing would be reduced

With more people owning their own homes and rents lower, there would be less need for rent assistance and less need for social housing. The housing cost equation would become zero for TR, DR and CR but SH would also be lower giving an overall saving to the government.

For residential accommodation businesses

The tax free status of housing would be restricted to investors owning three or less rental properties, with those owning more deemed to be rental accommodation businesses. These investors could continue to claim losses against other income under normal business income rules but would no longer have access to a discount on capital gains tax when they sell.

If we gave these investors a two year window to reduce their number of properties to three or less with current CGT rules applying, they would have time to adjust to the new system.

For residential housing owned by companies the normal business tax arrangements would continue to apply. The company would declare rental income and deduct any losses. Companies are not entitled to any discount on the CGT that they pay.

Bona fide rental accommodation businesses that use other non-incorporated business structures would also be treated in the same way, but would no longer have access to a discount on their CGT.

In summary

By making residential housing a tax free space for small investors we would increase home ownership, decrease rents, eliminate the loss of government revenue where deductions exceed rental income and reduce the cost of government rental assistance and the dependence on social housing.

We would be lining up the tax treatment of owned and rented homes, so the government would no longer be gaining tax revenue from rent paid by families who are unable to afford their own home.

Small investors would be taking on the ownership and management of some of the social infrastructure needed to give homes to all Australians.

Existing negatively geared investors owning three or less homes could sell their houses free of CGT if they no longer wanted to be landlords. This would give them some compensation for losing the tax benefit they currently enjoy.

Rental accommodation businesses would continue to operate under current business tax rules but would not have access to a discount on the CGT when properties are sold.