Negative gearing: separating fact from fiction

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Abstract: Negative gearing is commonly understood among the wider public to mean a concession in the tax law that allows a taxpayer to deduct a loss made on a geared residential rental property against other income, thereby reducing the taxpayer's tax exposure. However, as practitioners, we know that this understanding is misconceived. It also misses the broader policy context within which negative gearing exists. The poor quality of the discourse on negative gearing in the lead up to last year's election was disappointing. It was apparent that it had been an unexamined subject for so long that myths had solidified into truths in the minds of both defenders and detractors. While the re-election of the government means there will be no changes to negative gearing for now, it is clear that the subject is not going to go away. This article examines the various claims made about one of the most controversial tax policies in Australia's history, and in doing so, reveals an opportunity for a value-added client service.

Introduction

One of the most frequently made statements about negative gearing is that it's a legislated tax concession. However, there is no specific law enabling a deduction for a rental loss. Rather, the ability to deduct rental property expenses arises from the same 25 words in s 8-1 of the *Income Tax Assessment Act 1997* (Cth) that allow most deductions. So, although some might think they are availing themselves of a specific concession when claiming a deduction for a rental loss, they in fact do no such thing. Rather, the rental income and expenses are simply combined with a taxpayer's other assessable income and allowable deductions. This is why speaking in terms of "abolishing" the negative gearing "tax concession" is meaningless — there's nothing to abolish. Rather, what that really means is the opposite — to discriminate against the asset class that is residential property, by carving out an exception to the normal rules.

Interestingly, Australia and New Zealand are the only developed countries that don't interfere with the deductibility of negative gearing losses for residential property. All others either quarantine or restrict it in some way, and the UK, Netherlands and Japan in fact outright deny any deduction.[1]

Lost tax revenue

It has been claimed that the government loses billions of dollars in tax revenue each year from the rental losses deducted. However, this fails to take account of the fact that the bulk of negatively geared rental losses are made up of interest payments to Australian banks. The banks (and their Australian shareholders) pay income tax straight back to the government. Accordingly, this "lost tax revenue" criticism of negative gearing is unfounded, or at least wildly exaggerated.

Reduction in house prices

A rather fervent claim made is that restricting the deductibility of negative gearing losses would cause a reduction in the demand for housing, with a resulting significant reduction in house prices. The possible impact from different models of restricting negative gearing has been studied by various bodies, and the conclusion is a modest, one-off, fall of 1–2%.[2] Accordingly, the evidence does not support this claim.

Increase in rents

Another claim is that restricting negative gearing will cause a significant increase in residential rents. This is largely based on the short-lived quarantining of negatively geared rental losses from 1985 to 1987. For properties acquired after 17 July 1985, the losses were quarantined and carried forward, and could only be deducted against future rental profits and capital gains. All existing properties were grandfathered from the changes. The argument is that the quarantining caused investors to leave the market, reducing the supply of rental properties relative to tenant demand, resulting in rents rising significantly. It is also claimed that the rise was exacerbated by new investors increasing rents to cover the additional tax burden (even though it was only a timing difference).

The changes were reversed from 1 July 1987. Over that period, these were the inflation-adjusted movements in residential rents in our five largest cities:[3]

Sydney	↑	Up
Perth	↑	Up
Melbourne	←→	Even
Brisbane	↓	Down
Adelaide	↓	Down

Rents rose only in Perth and Sydney, and in fact went down in Brisbane and Adelaide. The evidence is that these changes reflected local factors, such as differing points in the normal vacancy cycle, which explains why there were also falls. The other point to make is that a new investor subject to the quarantining rules demanding a higher rent would hardly have been able to compete for tenants against all the existing investors. So, the evidence does not support the claim that restricting negative gearing will increase rents.

Even playing field

It has been argued that it is appropriate not to interfere with negative gearing because that ensures an "even playing field" across all asset classes. You can borrow to invest in other asset classes such as shares, business and commercial property, and are allowed a deduction for your interest and other expenses. The argument follows that discriminating against residential property would be unfair.

However, the reality is that different factors come into play with different asset classes and different kinds of owners such that tax policy frequently interferes with an otherwise even playing field. There are many examples, but notable ones include the legislated exemption from capital gains tax (CGT) for the family home, and the small business relief CGT concessions.

If one subscribes to the "even playing field" argument in support of negative gearing, that is, that there should be consistent tax treatment across all asset and owner classes, with no account taken of any factors unique to any particular class, then one would argue that the family home should be subject to CGT just like other assets, and that there should be no small business CGT relief concessions.

Just as there are factors particular to, for example, the family home that warrant a departure from the normal rules, there might well be factors particular to residential property that give similar cause, but which do not trouble other asset classes. This is canvassed further below. This kind of situation is precisely why, when warranted, tax policy does discriminate. Accordingly, the "even playing field" defence of negative gearing does not withstand scrutiny.

Middle/low-income users

Two-thirds of people claiming a negatively geared rental loss have a taxable income below $80,000.[4] The claim is thus made that negative gearing is used mostly by middle- and low-income people, rather than by wealthy people. However, the $80,000 figure is *after* claiming the negative gearing loss. Measuring this statistic by the *pre-loss* taxable income would be a better reflection of reality. Also, most middle/low-income investors have only one property, whereas the dollar amount of negative gearing losses claimed is skewed towards people in high-income occupations, who tend to have multiple properties.[4] This claim also takes no account of negatively geared properties held in trusts, companies, and SMSFs, which are vehicles not typically used by middle/low-income people. In summary, this claim is based on an incomplete statistic, taken at face value. When analysed more comprehensively, the statistics show that the claim is misleading.

Tax minimisation strategy

Negative gearing is sometimes described as a tax minimisation strategy. A deductible outgoing of $100 incurred by someone on the top tax rate might reduce their tax bill by $49, but that still leaves them $51 out of pocket. If that's all there was to it, negative gearing is hardly a smart strategy. When assessing a potential investment, taxation outcomes should always be a secondary consideration behind the expected commercial return.

The real purpose of borrowing to leverage into a bigger investment footprint is to amplify capital growth, advancing the investor's net wealth over time. While rental losses are incurred in the earlier years, the investor's intent typically is for the growth in the property's value to exceed the losses. However, as we will see later, that's actually an oversimplification, and therein lies a service offering for clients.

> *"The reality is that all except one of the claims about negative gearing … do not stand up to scrutiny."*

Broader policy context

The above wealth creation strategy from negative gearing might make sense from an individual perspective, but is actually the very basis of the main criticism of negative gearing. The claim is that, in combination with the 50% discount on capital gains, negative gearing artificially inflates demand for houses (as investments), fuelling speculative growth in house prices.[5] This reduces housing affordability, which has fallen since the 1980s to problematic levels. The ratio today of household debt — mostly comprising the home mortgage — to disposable income is significantly higher than it was thirty years ago,[6] leading to a number of wider social problems.

To state the obvious, of course we all like to hold assets that grow in value. But the point being made by promulgators of this criticism is that this *kind* of growth (ie speculative) in *this* asset class (ie residential property) does not add any productive value to the economy, and comes with social costs that cannot be ignored. Their purpose in arguing for restricting negative gearing is to curb undesirable economic behaviour that results in benefit for some, but at a cost to others.

Encourages housing supply

An often-repeated defence of negative gearing is that it encourages investment in rental properties, thus increasing the supply of housing, and therefore improving housing affordability. However, 93% of property lending is for purchasing established houses,[7] which *doesn't* add to the supply of housing. Accordingly, this defence is a fallacy. The main criticism of negative gearing noted above is therefore left to stand. Remember that the criticism is not of negative gearing on its own, but in combination with the 50% discount on capital gains.

Financial advancement

Another claim is that negative gearing is the only way for some people to get ahead financially. However, only about 10% of taxpayers have a negatively geared rental property,[8] so we're only talking about a small minority.

In any event, this prompts a pertinent question: how many people actually know whether or not their negatively geared property has advanced their wealth? The accumulating rental loss diminishes the investor's wealth. If the property becomes positively geared, that diminution starts to reverse. Few properties become positively geared, so the goal for most investors is for the capital gain on eventual sale to exceed the accumulated rental loss. However, this approach is not quite correct. The reason is that rental losses are deductible in full, whereas a capital gain on sale of a property held for at least 12 months is reduced by the 50% discount (except for companies).

This asymmetrical tax treatment means the capital gain required to break even is not simply equal to the accumulated rental loss. An investor who assumes it is will likely get it wrong when assessing whether or not an investment has advanced their wealth, or by how much.

In order to know whether a negatively geared property has advanced a person's wealth, these three questions must be answered:

(1) What is the accumulated *after-tax* rental loss?

(2) What is the required sale price (factoring in selling costs) that will produce an *after-tax* capital gain equal to the answer to question 1.? This is the property's "break-even" sale price.

(3) What is the property's estimated current market value?

The answers to the first two questions can be worked out as at any point in time, and they are continually changing. Only when an investor knows the break-even sale price can they then compare it to the property's current value, and know whether or not it has advanced their wealth.

It seems that virtually nobody with a negatively geared property monitors the answers to all three questions, with perhaps only the third one receiving any attention. If people generally don't actually know whether their negatively geared property has advanced their wealth, this claim is meaningless.

Summary

A summary of the various arguments for and against the current policy settings is set out in Table 1.

The reality is that all except one of the claims about negative gearing — both for and against — do not stand up to scrutiny. This has caused much distraction and misinformation in the discourse on the subject. The one claim about negative gearing that has some validity is — in conjunction with the 50% discount on capital gains — the resulting contribution to unproductive speculative growth in house prices, and thus reduced housing affordability. It might be expected that if there is an issue that requires attention, it would be particular to residential property, and of no bother to other asset classes. That is the case here. Not only that, but it impacts all participants in the asset class (and aspiring participants), not just investors.

Having become aware of new facts, exposed claims as myths, and acknowledged that tax policy does discriminate when warranted, we as practitioners are better placed to engage in the discourse on whether there is a case for the policy settings for negative gearing to be changed or left as they are. Of course, individual tax policy settings do not operate in a vacuum — each is like a piece in a jigsaw puzzle. In the jigsaw puzzle of Australia's tax system, it would be fair to say that the pieces do not fit together well. Negative gearing is but one of those pieces, and genuine reform can only be achieved when all of the pieces — income tax, capital gains tax, GST, state taxes etc — are reformed to fit together more neatly.

Calculating break-even sale price

Aside from being better equipped to engage on the subject, another positive outcome from the above discussion is that it reveals an opportunity for a service offering to clients. Practitioners can offer to clients to work out the break-even sale price for their negatively geared rental property. The client can then compare to the estimated current market value of the property, revealing whether or not it has advanced their wealth at that point in time. As noted above, the asymmetrical tax treatment between rental losses and the capital gain means the capital gain required to break even is not simply equal to the accumulated rental loss.

The example below illustrates a process for calculating the break-even sale price for a client's negatively geared rental property.

Example: Break-even sale price for a rental property

Property details[9]

	$
Original cost base	445,000[10]
Borrowing costs	5,000
Total	450,000
Funded by:	
Owner's contribution	90,000
Bank debt	360,000[11]
Total	450,000

The accumulated after-tax rental loss for this property is summarised in Table 2.

The break-even sale price for this property is that which will produce an after-tax capital gain equal to the accumulated after-tax rental loss of $47,580. To determine that, work out the property's current cost base, and nominate the anticipated tax rate that would apply to the capital gain that would arise if sold now, as follows:

Capital gain's elements

Current cost base	$405,000[13]
Anticipated tax rate[12]	0.39
CGT discount	50%

Table 1

Arguments for leaving negative gearing as is	Valid?	Arguments for restricting negative gearing	Valid?
Restricting will significantly reduce house values	No	Remove a "tax concession"	No
Restricting will significantly increase rents	No	Redress "lost" tax revenue	No
Even playing field	No	Fuels unproductive, speculative growth in house prices; reduces housing affordability	Yes, but in combination with the 50% discount on capital gains
Used by low/middle-income people	No		
Tax reduction strategy	No		
Increases housing supply	No		
Only way for some to get ahead financially	No		

Table 2: Accumulated after-tax rental loss

	2016-17 *(estimated)* $	2015-16 $	2014-15 $	2013-14 $	2012-13 $	Total $
Rental income[14]	22,000	22,000	21,000	21,000	20,000	
Total deductions[14,15]	(38,000)	(37,000)	(36,000)	(36,000)	(37,000)	
Net loss per tax return	(16,000)	(15,000)	(15,000)	(15,000)	(17,000)	(78,000)
Marginal tax rate[12]	0.39	0.39	0.39	0.39	0.39	
Tax saving	6,240	5,850	5,850	5,850	6,630	30,420
After-tax loss	(9,760)	(9,150)	(9,150)	(9,150)	(10,370)	(47,580)

We can now work out the required pre-tax capital gain to achieve an after-tax capital gain of $47,580, as follows:

Required pre-tax capital gain

	$
Capital gain	59,106 [16]
Capital gains tax	(11,526)[17]
After-tax capital gain	47,580

Now we determine the break-even sale price by adding the required pre-tax capital gain (ie capital growth) to the current cost base as follows:

	$
Cost base	405,000
Capital growth required	59,106
Break-even sale price	**464,106** [18]

We have determined that in order to break even on this property, the client will need to achieve a sale price, net of selling costs, of $464,106. This can now be compared to the property's estimated current market value to determine whether or not the investment so far has advanced the client's wealth. It is worth noting that, in this example, the asymmetrical tax treatment is why only a $59,106 pre-tax capital gain is required to break even, despite a higher accumulated pre-tax rental loss of $78,000.

As a test check, here is a summary of the client's net cash outlay over the course of the investment, and what the net cash position would be after selling the property for the break-even sale price.

Reconcile cash position[19]

Net cash outlay	$	$
Owner's contribution		90,000
Total after-tax rental loss	47,580	
Non-cash deductions[20]	(45,000)	2,580 [21]
Total		92,580

Net cash position after sale	$
Sale proceeds	464,106 [18]
CGT per above	(11,526)
Repay bank debt	(360,000)
Net cash	92,580

The test check confirms that the net cash outlay and inflow are equal. The above would provide useful information for a client in assessing the performance of their rental property investment. This process can also be applied to any other kind of negatively geared investment.

Conclusion

In undertaking an evidence-based analysis, many claims made by both defenders and detractors of negative gearing are revealed as unsupported, or simply myths. This enables us to focus on what actually matters when engaging in the discourse on whether or not any changes to current policy settings are warranted. Our analysis also reveals a service offering practitioners can provide to clients — working out the break-even sale price for a negatively geared investment. That's a rather worthwhile thing for a client to know.

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References

1 J O'Donnell, *Quarantining interest deductions for negatively geared rental property investments*, 2005. Updated for policy change in Japan.

2 For example, see The Grattan Institute, *Negative gearing and capital gains tax reform*, April 2016.

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5 Reserve Bank of Australia, *Submission to the Inquiry into home ownership*, House of Representatives Standing Committee on Economics, June 2015. D Murray, et al, *Financial system enquiry*, November 2014.

6 International Monetary Fund, *Global housing watch*, October 2016.

7 Australian Bureau of Statistics, *Lending finance*, 2013.

8 Reserve Bank of Australia, *Submission to the Inquiry into home ownership*, House of Representatives Standing Committee on Economics, June 2015.

9 The property is taken to be wholly input-taxed. Therefore, no GST liabilities arise, and no input tax credits are available.

10 Includes all incidental costs, depreciable items.

11 Interest-only.

12 For this example, the 37c rate plus 2c Medicare levy is used. This assumes that the pre- and post-rental loss taxable incomes are both within the $87,000 – $180,000 tax rate band. If the pre/post-taxable incomes fall into different tax rate bands, you will need to calculate a proportionally blended tax rate.

13

	$
Original cost	445,000
Five years' depreciation and capital works deductions	(40,000)
Current cost base (includes depreciable items)	405,000

The cost base will change constantly due to the capital works (post-May 1997 properties) deduction.

For simplicity, it is assumed the market value of depreciable items is equal to their tax written down value.

14 Taken directly from the rental schedule in the client's tax returns.

15 Deductions each year include a total of $8,000 for depreciation and capital works, and $1,000 borrowing costs write-off.

16 $47,580/[1 – (50% × 0.39)] = $59,106. No account has been taken of the time value of money.

17 Capital gain of $59,106, less 50% discount, × 39% = $11,526.

18 Net of all selling costs.

19 If the break-even sale price were being calculated before the borrowing costs have been fully deducted, will need to incorporate the remainder deduction into determining the after-tax accumulated rental loss.

20 The depreciation, capital works and borrowing cost deductions totalling $9,000 per year are added back, as these are not cash outlays. They are part of the original costs of the property, and have already been accounted for in the owner's $90,000 equity contribution.

21 It is interesting to note that the tax saving from the above permissible write-offs significantly reduces the investor's net cash outlay, outside of the equity contribution. In this example, it amounts to less than $10 per week (ie $2,580/5 years/52 weeks).