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Tax insights
Talking tax reform: Property

Understanding the context of the current tax settings for the property industry

The practice of “negative gearing” has provoked strong responses from many special interest groups, principally around questions of equity and housing affordability. The principal thrust of the Tax Discussion Paper is both to support negative gearing and to debunk a number of the popular myths around the deductibility of interest payments. The paper points out that the potential tax advantage will often be greater on the disposal side due to the discounted CGT rate (this is particularly the case at present with good capital growth and a low interest rate environment).

From recent media reports and research articles it appears that this messaging has not worked. Existing views in the community around negative gearing are entrenched and there is little evidence of a lessening of the passion around the debate.

Do the CGT and negative gearing influence savings and investment decisions, and if so how?

To date, both major parties have given some indication of their positions in respect of negative gearing:

- Prime Minister Tony Abbott when asked "Can you rule out any changes to negative gearing?" replied in absolute terms "Yes". In respect of the CGT discount, the Treasurer has stated that he is "reluctant to interfere" with the capital gains tax regime
- Shadow Treasurer Chris Bowen was reportedly considering limiting negative gearing concessions to new houses or just one investment property. He has publicly stated that any changes proposed for negative gearing would be taken to the next election; people who've invested in good faith with existing rules will not be disadvantaged; and any policy will not risk reducing the supply of new housing or, if possible, improve the situation with the supply of new housing.
- However, Labor leader Bill Shorten has played down these comments stating "we think there's a lot of focus that needs to be on the supply side. Negative gearing changes are not the focus of the Labor Party."

The States and Territories (States) also impose a range of property taxes which comprised around 9 per cent of taxation in Australia in 2012, compared to the OECD average of around 5 per cent (Tax Discussion Paper p.19).

To date, two of the States have comprehensively reviewed their own taxation systems with an eye to making major reforms – South Australia recently completed its review and announced its planned reforms in the 2015-16 State Budget on 19 June 2015; the ACT completed its review in 2012 and is implementing the resulting recommendations on an ongoing basis.

Remarks by the Federal Treasurer after the Council on Federal Financial Relations meeting on 9 April 2015 suggest the Commonwealth's tax reform agenda is being embraced by the States and that all are keen to actively participate in both the Tax reform and Federation reform processes. Notably, he went on to say that he and the State Treasurers had agreed that "officials would undertake dedicated work in improving the taxation arrangements between the States and for the States, and would undertake that work immediately". The Treasurers meet again in August to discuss the recommendations from those officials.

These remarks suggest that the other States might also now be closely analysing the reform opportunities available to them, and possibly doing so in a co-ordinated way. If political differences can be put to one side, a consensus around reforms and reform timing could offer some important benefits for the property industry particularly around complexity and efficiency.

Reform is needed as some of the taxes themselves, or the way in which these taxes are levied, are inefficient in that they distort the behaviour of taxpayers, and are complex to administer.

Broad based land taxes are an efficient tax, because the amount of land is fixed and land cannot be moved, making taxes difficult to avoid. However the way in which land tax is currently levied is inconsistent and has the potential to distort land use:

- Apart from the ACT, all States that levy land tax currently calculate liability on the basis of aggregate land holdings. The Henry Review considered that this approach in combination with progressive rate scales creates a significant bias against large-scale land holdings
- Some States use unimproved land value whilst others use market value to determine land value
- The land tax base is narrowed by exemptions and tax-free thresholds. The principal exemptions are for owner-occupied housing and primary production.

Land taxes with narrow bases and high rates, together with aggregation provisions, disadvantage large commercial property owners, impacting on investment.

Conveyance duty is considered to be a highly inefficient tax and highly volatile. Removing conveyance duty would remove a number of adverse impacts on the property market such as:

- Discouraging businesses from undertaking productivity enhancing purchases of existing land and capital
- Discouraging householders from moving to more appropriate housing (which has implications for work mobility, productivity and congestion due to commuting times)
- Reducing incentives to renovate rather than relocate (diverts investment towards making existing housing larger rather than into more affordable and newer housing)
- Discouraging development of new housing (as the incidence of tax is heaviest on developers who hold land for a short time).

For funds that invest in property, conveyance duty is complex given the:

- Different State based treatment
- Differences in the treatment of listed and non-listed widely held structures
- Limited restructuring relief.

Fund managers should note that the Tax Discussion Paper also acknowledges that there is a case for extending the range of collective investment vehicles that can be offered by Australian fund managers. Despite a number of taxation and regulatory issues, Treasury is intending to consult with industry stakeholders in the coming months with a view to proposing some options in the Green Paper.

The Johnson Review 'Australia as a financial centre: Building on our strengths' and Murray Review 'Financial System Inquiry' both recommended that the Government consider enabling fund managers to use CIV structures that are more common overseas. The Board of Taxation also reviewed tax arrangements applying

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to CIVs in 2011. The Government released this report on 4 June 2015.

Implications for property industry

Consultation about the Green Paper options will happen later this year:

- Both the Government and the Opposition are particularly focused on housing affordability, therefore any submission containing sensible suggestions to improve pressures on housing supply are likely to be embraced
- International competitiveness is also a focus. A broadening of the CIV regime will benefit Australia due to the flow-on employment and income effects in fund administration and related support.

Should negative gearing be reformed, some options are:

- Discounting net rental income at the same rate as capital gains
- Discounting net rental income along with other savings type income (including rental losses)
- Quarantining net rental income (losses) against future capital gains on the same or like investments
- Quarantining net rental income (losses) against future net rental income.

Any limitation on negative gearing and/or a removal of the CGT discount could have significant impacts on the property market although many of these effects are disputed. Some of the possible effects are that:

- Any denial of negative gearing will lead investors to demand higher gross rental yields and therefore reduce housing investment in the short to medium term

- Any new discount applied to savings will, other things equal, increase investment in housing in the short to medium term by positively geared investors, resulting in decreases in rental yields
- The residential property market will cease to be dominated by small investors
- Investor demand will alter towards housing with greater rental yields and longer investment horizons (as opposed to short term capital gains).

The imposition of grandfathering provisions protecting existing investors could mute any of these potential impacts over the short term, at the cost of increased complexity.

Land tax reform is possible given the need of States for predictable and sufficient revenue streams.

Land tax reform is possible given the need of States for predictable and sufficient revenue streams. It is pertinent to consider the options that South Australia considered in its state taxes review in respect of potential land tax reforms (which could be adopted by other States) such as:

- Levying land tax based on the square-metre value of land (which would impact more on properties in the CBD and wealthier beach-side suburbs)
- Reforming land tax aggregation by either abolishing aggregation or reforming aggregation to a basis similar to NSW, Victoria or Queensland
- Abolishing conveyance duty and replacing it with a broad-based land tax (this may include taxing the principal place of residence or introducing a flat rate of land tax with no or a very low tax-free threshold).

Ultimately, South Australia announced it will abolish conveyance duty on commercial real property (progressively between 1 July 2016 and 1 July 2018), but without making any material changes to its land tax regime. It has ruled out replacing residential conveyance duty with a broad based property tax, being a change it regards as needing wider consultation and community acceptance.

Should other States decide to replace conveyance duty with a broad-based property tax, this change would need to be accompanied with measures to compensate entities that had purchased properties in recent years that could be potentially taxed twice. Some of these transitional options could be to:

- Apply a broad based land tax only after the property is subsequently transferred
- Provide credits for conveyance duty paid on recent property purchases, or
- Phase out conveyance duty over a long period (In the ACT, conveyance duty will be phased out over 20 years).

There are also lessons in the recent reforms to conveyance duty in the ACT. The abolition of conveyance duty resulted in significant municipal rate increases for commercial properties (note however, the dual role of the ACT government in both levying state-level taxes and municipal rates). This could have been managed better by pre-releasing rate projections covering the phasing-in period of the new tax regime enabling entities to better prepare for the increases.

Deloitte perspectives

In principle, a deduction for interest irrespective of the income-earning investment, is a cost incurred in earning income or carrying on a business and should be treated like any other tax deductible expense.

The two key concerns with investment property interest deductibility appear to be around housing affordability and equity, neither of which has unqualified support:

- The Henry Review, whilst acknowledging the impact of tax settings on housing affordability also considered that factors such as growth in average household incomes, increased credit availability and low interest rates have contributed to strong growth in demand. On the supply side, factors such as strong population growth, planning and zoning laws, and building and environmental regulations have also put pressure on supply. Any 'solution' to housing affordability needs to encompass many of these drivers of demand and supply

- From an equity perspective, if we accept that taxpayers on higher marginal rates are benefiting more from the deductibility of interest, we must also accept that they are also incurring real losses in respect of this activity and therefore are entitled to a deduction for business or investment losses
- If negative gearing is to be denied on an equity basis, the following inconsistencies need to be explored and resolved:
  - Why should there be a difference in claiming interest for housing as opposed to other types of passive investment activity or even active business activity?
  - Why should there be a difference in the claiming of interest as opposed to other types of investment housing expenses such as insurance, rates or repairs and maintenance? (These will also increase with the size of the investment property and buyer spending capacity)
  - Should the focus of reform be based on the premise that some taxpayers benefit disproportionately from the subsequent CGT discount, due to the fact that they have a better purchasing and savings capacity (both with or without borrowing)?

The CGT discount was originally introduced to enliven and invigorate the Australian equities market to stimulate a greater participation by individuals and to achieve a better allocation of Australia's capital resources. The Tax Discussion Paper process this year may be the right time to discuss the continuing appropriateness of the level of the CGT discount and the type of entities that are entitled to it. A discussion in respect of the appropriateness and extent of the CGT discount should also consider all asset classes, not merely real estate.

There is certainly scope for design improvements and base broadening of land tax, which could offer greater efficiency.

Land tax should not apply to the capital improved value of a property, as this would discourage investment and cause distortions in decision making. A low broad based, flat property tax and a removal of land tax aggregation would encourage larger commercial property interests which would in turn generate more investment in the States, including low cost and retirement housing.

Conveyance duty on non-residential property should also be reviewed as it currently constitutes a barrier to business expansion and investment. The role of conveyance or transfer duty should be to recoup the costs of transferring property by the State. In this manner, a lower flat fee that represents the administrative cost of transfer would be more appropriate.

From a red tape reduction perspective, the existing land tax and conveyance duty rates, concessions and exemptions are complicated and difficult to administer. At minimum, the tax settings for these tax imposts should be standardised across States, particularly given there is no real competitive tension between States given the immobility of land.

Public policy should focus on increasing housing supply to alleviate the housing shortage for low income households. Whether this is achieved via the direct allocation of public funds or by the introduction of taxation incentives, or a combination of both, should be the subject of further debate.

As discussed, a number of forums have suggested that Australia should have access to a broader set of appropriate vehicles to sell to global investors which can be taxed on a flow-through basis. There should also be capacity for existing flow-through vehicles to easily and at minimal cost transition to such new vehicles. The Board of Taxation has already undertaken a review for the Government and it would seem that this review would be the appropriate starting point for considering options for the Green Paper on Tax Reform

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