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Quarantining Interest Deductions for Negatively Geared Rental Property Investments

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When the timing of losses and gains is considered, the benefits of negative gearing are even greater. In addition to the immediate tax benefit available from offsetting the rental loss against other income, the investor's exposure to tax will generally be limited to the capital gain realised when the property is sold, which is taxed on a deferred and reduced basis and, in some cases (e.g. if a pre-CGT asset) it is not taxed at all.[9]

The net effect of negative gearing is that the investor can come out ahead in economic terms and still reduce their tax liability.[10] From a tax policy point of view, this represents a double departure from a comprehensive definition of income.

THE TAX POLICY DEBATE

The tax policy debate on negative gearing in Australia does not rest on any single issue or criterion. Tax design is shaped by the need to raise revenue and also by considerations of efficiency, equity, simplicity and enforceability.[11]

Revenue

If the primary objective of taxation is to raise government revenue, then the fact that negative gearing results in a loss of government revenue needs to be weighed in the balance when deciding whether this tax shelte

A tax measure that is generally seen as unfair or arbitrary in its incidence can generate reluctance among taxpayers to comply.[15] Applying this to quarantining, it is debatable whether the removal of negative gearing would give rise to improved attitudes of compliance (through a greater degree of respect for the tax system), or if it would encourage more extreme forms of tax planning (as it is so popularly entrenched in our tax system).

There is little doubt that successive federal governments in Australia have had the same clear expectations on how taxpayers would react if told they can no longer claim full interest deductions on their investments. For many taxpayers, rental property investments (made attractive by negative gearing) represent a substantial part of their retirement savings (their 'superannuation') – which would be made unattractive and put at economic risk if negative gearing is abolished. Perhaps negative gearing is now too entrenched to make its removal a possibility.

Is there a more serious danger that negative gearing conveys the wrong message to taxpayers – that it is acceptable to minimise tax, to lower your taxable income and access a lower marginal tax rate? Some might query whether this message is necessarily unhealthy, particularly if the result on the other side of the ledger is a healthy boost for investment.[16]

Simplicity

Under this criterion, consider for example whether the Australian tax system would be a more complex system, with higher compliance costs, if we introduced quarantining measures. It is also important to ask whether such measures would necessarily stop the revenue leakage. Looking to overseas experience, which method of quarantining would work best in Australia? Should Australia consider going back to the measures we had in the 1980s?

International

Does overseas experience present a clear solution? Would Australia become internationally more competitive if we took a path taken by one of the other OECD nations to restrict or deny the tax shelter? What would be the effect of introducing quarantining measures on international capital flows into and outside Australia?

Political

The political context must also be taken into account when discussing tax policy and possible tax reform. Legislative change has no chance unless there is the political will to consider and debate the issues and popular agreement to the change. The current political reality about negative gearing is that the Australian government believes it would be political suicide to contemplate removing the tax shelter.[17]

THE LEGAL CASE FOR NEGATIVE GEARING

The deductibility of interest expenditure is at the heart of negative gearing.

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[15] OECD (2001) *Tax and the Economy: A Comparative Assessment of OECD Countries*, OECD Tax Policy Studies, Paris, p.20

[16] Consider Frey, B.S. (1983) *Democratic Economic Policy: A Theoretical Introduction*, Basil Blackwell, London, p.138.

[17] For example, Federal Treasurer Peter Costello has repeatedly ruled out changes to negative gearing rules: Mellish, M. & Hepworth, A. 'RBA Targets Negative Gearing' *Australian Financial Review*, 15 November 2003 http://afr.com/articles/2003/11/14/1068674383089.html.

In Australia, interest is ordinarily deductible under the general deduction provisions of

The Australian government has generally supported the tax shelter of negative gearing, despite its growing burden on the tax revenue.[25]

In December 1967, the Commissioner of Taxation issued an income tax ruling giving tacit approval to negative gearing.[26]

On 30 June 1983 the Treasurer announced that the Commissioner would not be changing the long standing practice of allowing deductions in full for interest on moneys borrowed to invest in rent-producing properties where the interest and other re tax revenu investors. The restrictions affected only real estate purchased after 17 July 1985. The reform quarantined any losses made from owning rental properties, so that any excess of deductions over rental income could not be used to reduce tax on other sources of assessable income.[30] However, losses could be carried forward to offset against future rental profits and reduce taxable gains made from other rental properties purchased after that date.[31]

This quarantine measure was justified on three main grounds: (i) taxpayers should not have to subsidise rental property investors; (ii) negative gearing resulted in increased home prices to the detriment of ordinary home buyers; and (iii) an estimated revenue gain of $55m in 1986-87, $100m in 1987-88, rising to $195m in 1990-91 and subsequent years.[32]

Due to various pressures, in one of the more remarkable backflips in Australian tax policy history, the government removed the measure, effective from 1 July 1987.[33] According to official records, repeal of the measure was justified on two main grounds: (i) uniformity of tax treatment of interest costs for all types of investment; and (ii) the belief that the excessive tax benefits offered to high income earners by negative gearing were adequately countered by other tax reform measures, notably introduction of the capital gains tax regime.[34] There were also unofficial reasons for the quick repeal of the measure, including an impending federal election and complaints from NSW facing a State election.[35]

Since July 1987, negative gearing has been allowed on all forms of investments in Australia.[36]

JUDICIAL APPROVAL OF NEGATIVE GEARING

Australian courts have made it quite clear that if there is to be any change to the law on negative gearing, it will require specific legislative amendment, rather than any change in judicial attitude or interpretation.[37]

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[30] The quarantining of interest deductions is a recommendation revived recently by ACOSS in “Taxation in Australia: Home Truths and International Comparisons” *ACOSS Info 347*, June 2003, p27 change in j2“Taxa

Janmor Nominees[38] is the landmark case on negatively gearing rental properties. The decision in that case was handed down after the quarantine measures were repealed but was based on the law in place before those measures were introduced. The Court held that high gearing alone does not deprive interest payments of the character of outgoings incurred in gaining or producing assessable income. Merely because expenses exceed receipts does not justify a severance of outgoings into components, nor render the outgoings of a private, domestic or capital nature, nor activate any deeper enquiry into why the expenditure was incurred in determining whether a deduction should be allowed at all or whether it should be apportioned.[39]

The precedent established in *Janmor Nominees* could be criticised on the basis that the Court has either ignored or applied inadequately the legal nexus and apportionment requirements of sec.8-1. If the courts were prepared to revisit *Janmor Nominees*[40] and the legal nexus and apportionment requirements, deductions from negative gearing could be effectively quarantined by relying on sec.8-1 without the need for legislative amendment. (Given the widespread acceptance of the *Janmor Nominees* decision by the courts in subsequent cases, by consecutive governments and by the ATO in its rulings, this possibility will probably never amount to more than wishful thinking).

The legitimacy of negative gearing on rental properties was confirmed by the High Court in 2004 in *Hart's case*,[41] where the taxpayers maximised their loss from negative gearing by using a split loan and capitalising interest on their rental property while initially only paying off the mortgage on their family home. The High Court denied part of the interest deduction under Part IVA, but had no reason to upset the Full Federal Court's finding that the full interest expenditure was otherwise deductible under sec.8-1.

TWO CRITICAL ASSUMPTIONS

On closer examination, and as an appropriate starting point for analysis, it appears that two fundamental assumptions underlie the major arguments in the current policy debate on negative gearing.

1) Negative gearing increases house prices.
2) Negative gearing increases housing stock.

A core problem in the debate is that these assumptions have not been adequately tested. If they are wrong then the arguments that rely on them are misinformed and the direction of the policy debate has been misguided. If we are to have a meaningful debate on tax reform, we need to be reliably informed and make a choice between sound arguments based on correct and reliable information rather than on false assumptions.

On the first assumption, supporters of the tax shelter claim that increased house prices benefit homeowners, and refer to the fact that most Australians own their own home. Conversely critics claim it redistributes wealth and is inequitable to those who cannot afford their own home.

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[38] *FCT v Janmor Nominees Pty Ltd* (1987) 19 ATR 254 (decision

On the second assumption, supporters claim that increased housing stock has led to lower rents and more affordable housing, which has also been good for construction,

TABLE 1: THE RELATIONSHIP BETWEEN NEGATIVE GEARING AND OTHER ECONOMIC DATA

CORRELATION	Negative gearing rental losses	Negative gearers	Rental investors	Investment property loans	House prices	Dwelling approvals	Construction jobs
Negative gearers	**0.9407**						
Rental investors	**-0.7309**	0.6999					
Invest. property loans	0.6073	0.3910	-0.2494				
House prices	-0.2528	-0.5134	0.1896	**-0.8830**			
Dwelling approvals	-0.4516	**-0.7075**	0.1968	0.3624	-0.5254		
Construction jobs	0.4375	-0.5036	0.4428	0.4837	-0.4629	0.5314	
Capital formation							

TESTING THE ASSUMPTIONS

Increased house prices

Housing prices have risen dramatically in the past few years,[44] but have fallen in recent times.[45] From a ratio of housing prices to average incomes, Australia has amongst the most expensive housing in the developed world.[46]

On the other hand, the recent housing price boom in Australia is not unique. Since the mid-1990s, several other countries have recorded larger house price rises than Australia.[47]

When it quarantined interest deductions on real estate investments in 1985, the government made an admission that negative gearing increased real estate prices.[48] In theory, by making property ownership more attractive to investors than it otherwise would be, it is contended that negative gearing leads to an increased demand for residential property and, in turn, real estate prices rise. It is argued that house prices continue to rise from negative gearing until the tax savings has been ‘capitalised’ into the price.[49] Economic modelling and research has been relied on to substantiate this price effect.[50]

As Figure 1 shows, explosive growth in house prices really began in 1988. Some explain this by contending that removal of negative gearing restrictions in late 1987 brought investors back into the real estate market.[51]

The better view is that house prices rise anyway, regardless of negative gearing. They fluctuate widely around long-term trends.[52] Many factors affect real estate prices. One factor is believed to be current income tax policy.[53] Statistics do not support the contention that negative gearing is an influential factor. Statistics show there is no observable relationship between negative gearing and house prices.[54] Other factors

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[44] See e.g. Walkley, P. “Negative Thinking” (2003) 121 *The Bulletin* 62.

[45] Australian Bureau of Statistics, *Catalogue No. 6416.0* “House Price Indexes: Eight Capital Cities” 4 March 2004 and 2 September 2004.

[46] Hanegbi, R. “Submission – Housing Affordability” 21 October 2003, p.1, citing Ellis, L. & Andrews, D. “City Sizes, Housing Costs, and Wealth”, *Research Discussion Paper No. 2001-08,* Economic Research Department, Reserve Bank of Australia, 2001, at 6.

[47] Productivity Commission, *First Home Ownership,* Inquiry Report No.28, 31 March 2004, p.19.

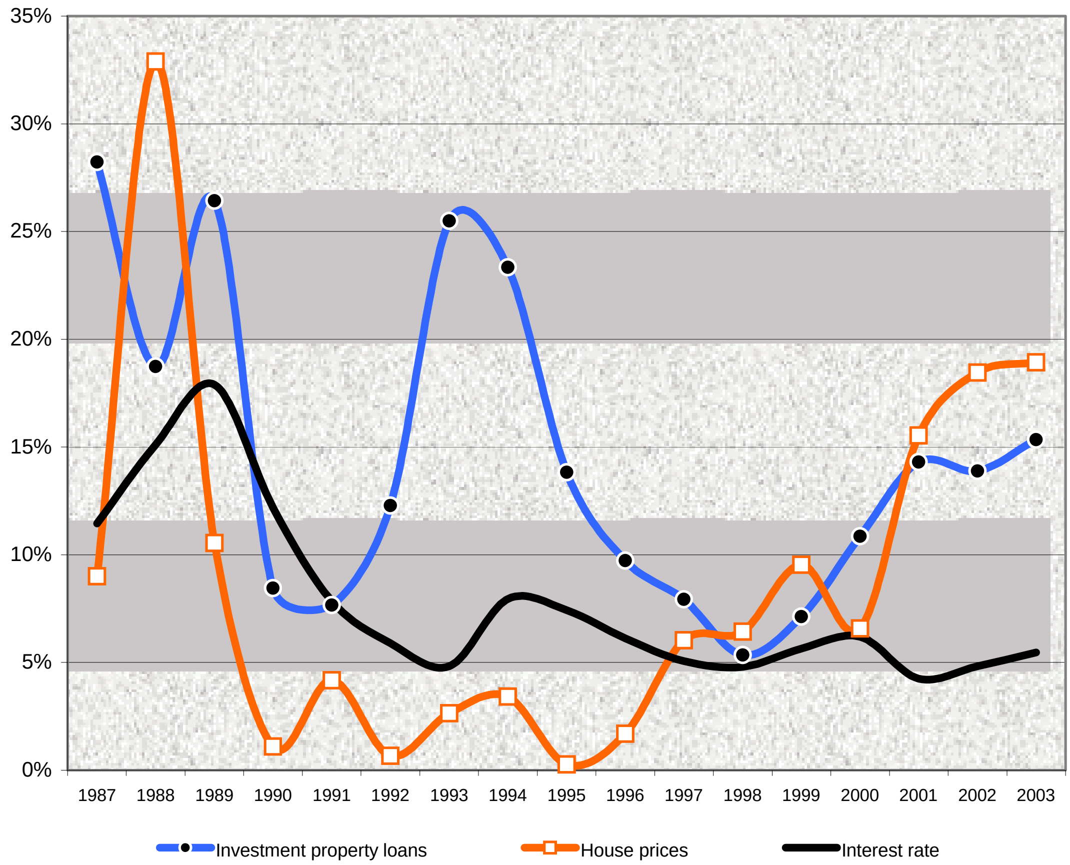
[48] Commonwealth, *Parliamentary Debates*, House of Representatives, 17 April 1986, p.2553 (Hurford, Minister for Immigration and Ethnic Affairs).

[49] Hanegbi, R. “Negative Gearing: Future Directions” (2002) 7 *Deakin Law Review* 349, 356, citing Hamson, D. & Ziegler, P. “The Implications of Negative Gearing Restrictions and Capital Gains Taxation on Investment” (1986) 3 *Australian Tax Forum* 369, 372.

[50] Britten-Jones, M. & McKibbin, W.J. “Tax Policy and Housing Investment in Australia” (1989)e *Research Discussion Paper No.8907,* Reserve Bank of Australia, p.21, cited in Hanegbi, R. “Negative W.J. “Tax P

need to be considered, including interest rates and private fixed capital formation, the latter being a factor related to both negative gearing and house prices.

FIGURE 1: GROWTH IN HOUSE PRICES AND INVESTMENT PROPERTY LOANS AND MOVEMENTS IN INTEREST RATES IN AUSTRALIA 1987–2003 [55]



The gap between growth in house prices and housing loans in 1988 can be explained by the October 1987 stock market crash, when investors sold out of equities seeking better returns from residential property. Growth in investor property loans resurged as more investors entered the real estate market, forcing a credit squeeze as house prices soared and interest rates climbed to record levels.[56]

The rise in house prices and investment loans in recent years can also be attributed to tax reforms including introduction of the CGT discount in September 1999, and the GST and first home owner grants after June 2000.

The Productivity Commission, in its 2004 housing affordability inquiry, found that negative gearing is just one feature of Australia's income tax system that may be

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[55] Australian Bureau of Statistics,

contributing to house price pressures, although in principle negative gearing does not favour private investment in rental housing over other passive investments. While it recommended broader review of a range of features of the income tax system, the Productivity Commission indicated that the focus should be on the capital gains tax regime.[57]

Increased housing stock

It has been argued that negative gearing increases the availability of rental properties in the long run by increasing new housing construction.[58] Support is given for this view in a 1989 Reserve Bank study that found a lowering of tax incentives available to real estate investors leads to a decrease in the construction of real estate.[59] Those who run this argument also refer to the slowdown of new residential construction for the period when negative gearing was abolished.[60]

Statistics do not support the argument that negative gearing leads to an increase in the number of dwellings, as there is no firm correlation between the two variables.[61] There is also no observable relationship between negative gearing and construction activity or rental property loans. Curiously, the inverse relationship suggested by the statistics between negative gearing and the number of rental property investors supports a contrary conclusion.[62] This may give weight to the hypothesis that as negative gearing is capitalised into rental housing prices, the return on the capital invested is diminished.

It is fallacious to assume interchangeability in negative gearing and the construction of new dwellings. Rental property investors do not need to build because they can purchase from owner-occupiers or other investors. Housing stock levels need not change to accommodate an increase in rental property investment. What might be expected to change is the ratio of rental premises compared to owner occupied dwellings.

It is also misleading to cl03085 2 pr

CONTRADICTED ARGUMENTS

Having formed a view that several critical assumptions about negative gearing are false, it is important to isolate the arguments that rely on them. The major arguments contradicted by the statistics are summarised in Table 2 and are discussed in turn below.

TABLE 2: SUMMARY OF ARGUMENTS BASED ON THE FALSE ASSUMPTIONS

Tax Policy Criteria	Summary of Contradicted Arguments
Equity	Negative gearing rewards home ownership due to rising house prices
Equity	Negative gearing discriminates against non-home owners (the young and poorer sections of the community) by locking them out of the real estate market with increased house prices
Equity	Negative gearing makes rental accommodation more affordable by lowering rents as a result of an increased supply of rental properties and lower costs for landlords
Efficiency	Negative gearing is good for the economy because it has led to increased jobs and activity in the residential construction sector
Efficiency	Negative gearing leads to a substitution of investment from productive capital formation into real estate and other appreciating assets

Negative gearing rewards home ownership

Australia has a high rate of home ownership. If negative gearing has raised house prices, the one group clearly benefited by it is homeowners, who represent approximately two-thirds of the population.[64]

This argument is contradicted by the statistics, which indicate there is no relationship between negative gearing and house prices.

Wealth inequality

> "Home ownership is falling. It is harder than ever for younger or poorer Australians to become homeowners." [65]

Statistics show that home ownership for first homebuyers is becoming increasingly difficult to attain, even after direct measures such as the first home owners grants have been implemented.

For example, in March 2004 the percentage of first homebuyers fell to a record low of 12.5%, a continuation of the general decline since the record high of 25.8% set in July 2001.[66]

[64] Hanegbi, R. "Negative Gearing: Future Directions" (2002) 7 *Deakin Law Review* 349, 365; Australian Bureau of Statistics, *Catalogue No. 4130.0* "Housing Occupancy and Costs, Australia", 15 October 1999.
[65] Senator Andrew Murray, Australian Democrats, *Press Release Number 03/485*, 3 July 2003.
[66] Australian Bureau of Statistics, *Catalogue No. 5609.0* "Housing Finance, Australia", 12 May 2004.

properties in 1993 and 1997 respectively, but who represented 18.2% and 17.1% of the adult population.[73]

It is also important to understand the demographics of home ownership when considering political implications. Whi

As the theory goes, because residential housing stock is fixed in the short term, negative gearing is not expected to increase the supply of rental accommodation or materially affect rents in the short term. In the long term, however, if negative gearing increases the supply of rental accommodation more than it increases demand, it could lead to lower rents.[78]

The critical flaw in this argument is the assumption that negative gearing increases the supply of rental properties. This premise is contradicted by statistical evidence that there is no firm correlation between negative gearing and the number of dwellings.

Those who support negative gearing, and the argument that it leads to lower rents, often refer to the state of the Sydney property market in the period when the tax shelter was abolished between 1985 and 1987. During this period there were large rental increases in parts of Sydney.

It involves a quantum leap in logic, a *non sequitur*,[79] to imply from this that negative gearing leads to lower rents. It is not possible to attribute the rise in Sydney conclusively to the abolition of negative gearing. There was no real increase across the rest of Australia and in fact many cities experienced a real decrease in rents over the same period.[80]

Moreover, it is doubtful that landlords would pass on the benefits of negative gearing to tenants in the form of lower rents. First it is doubtful that negative gearing reduces costs to landlords. Second, it is doubtful that any benefit can be passed on if it is already fully capitalised in the price of the property. Third, it is doubtful that landlords have the altruism to defy market forces and pass on lower costs to tenants.[81]

Statistics indicate the rise in housing costs for private renters in Australia is comparable to the rise in house prices.[82] If house prices rise then housing loans and

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[77] Britten-Jones, M. & McKibbin, W.J. "Tax Policy and Housing Investment in Australia" (1989) *Research Discussion Paper No.8907*, Reserve Bank of Australia, p.21, cited in Hanegbi, R. "Negative Gearing: Future Directions" (2002) 7 *Deakin Law Review* 349, 361.

[78] Hanegbi, R. "Negative Gearing: Future Directions" (2002) 7 *Deakin Law Review* 349, 360.

[79] In logic, this reasoning involves the classical fallacy that succession in time implies a causal relationship. This fallacy is often cited in the Latin maxim *post hoc, ergo procter hoc.* See e.g. Nygh, P.E. & Butt, P. (eds) (1997) *Butterworths Concise Australian legal dictionary*, Butterworths, Sydney, pp.277, 309.

[80] Hanegbi, R. "Negative Gearing: Future Directions" (2002) 7 *Deakin Law Review* 349, 361; Hanegbi, R. "Submission – housing affordability" 21 October 2003, p.3, citing Badcock, B.A. & Browett, M.H. (1993) "The Responsiveness of the Private Rental Sector in Australia to Changes in Commonwealth Taxation Policy", in *Housing Studies* Vol.6 No.3, and Hayward, D. and Burke, T. "Justifying the Unjustifiable" (1988) 7(8) *Australian Society* 16, and http://www.smh.com.au/articles/2003/08/24/1061663676588.html?from=storyrhs quoting ANZ Chief Economist Saul Eslake.

[81] Cf. Hanegbi, R. "Negative Gearing: Future Directions" (2002) 7 *Deakin Law Review* 349, 361, citing Krever, R. "Law Reform and Property Interes

borrowing costs would also be higher. There is little reason why landlords should not pass on the increased costs in the form of higher rents.

Even if negative gearing does make renting more affordable, there are more direct, efficient, well-targeted and equitable ways to achieve this outcome.[83]

Construction jobs and the economy

It is claimed that negative gearing has increased jobs and activity in the residential construction sector, growing our residential housing stock and contributing about 3% to the economy.[84]

The claim that residential housing contributes about 3%e is little reaso2ring has in

FIGURE 4:

look to buy established houses rather than build new ones, and therefore the level of housing stock is not affected.[90]

Even if it can be proven that negative gearing does encourage construction of new housing, there are more direct and efficient ways to achieve this.[91]

Distortion of investment

Critics of negative gearing argue that the tax shelter encourages investment in assets such as property and shares that appreciate in value, rather than capital used in other areas of production that add value to the economy.[92] Pointing to the recent growth in investment in inner city apartments and other rental properties,[93] critics claim that policies intended to ignite investment in new technologies have instead fuelled an old-fashioned Australian property boom.[94]

The tax system is not neutral, and offends the tax design principle of efficiency, if tax shelters, such as negative gearing, lead to an over-investment in dwellings, or the over-gearing of rental properties.[95]

Statistics support the view that when negative gearing in rental properties increases, growth in fixed capital investment tends to fall, and *vice versa*. They show a strong negative linear relationship between negatively geared rental property losses and private fixed capital formation.[96]

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[90] On the relationship between negative gearing and increased investment in rental properties, see the discussion above on the argument that negative gearing has increased housing stock..

[91] Hanegbi, R. "Negative Gearing: Future Directions" (2002) 7 *Deakin Law Review* 349, 359, citing Australian Bureau of Statistics, *Catalogue No. 8750.0*. See also Hanegbi, R. "Submission – Housing Affordability" 21 October 2003, p.3; Australian Bureau of Statistics, *Catalogue No. 8750.0* "Building Activity Australia, Dwelling Unit Commencements, Preliminary" 18 March 2004; and Australian Bureau of Statistics, *Catalogue No. 5609.0* "Housing Finance, Australia", 12 May 2004. Some would now regard the benefits of the first homeowners' grants as illusory. Although they had an initial impact on construction, it only provided short-term relief, since the grants may have largely fed increased construction costs and house prices.

[92] Senator Andrew Murray, Australian Democrats, *Press Release Number 03/423*, 13 June 2003; Australian Democrats, *Press Release Number 03/485*, 3 July 2003; Hanegbi, R. "Submission – housing affordability" 21 October 2003, p.2; Mayts, ants as ill797s3/TTwy

This does not mean there is a causal relationship. It does not necessarily follow that negative gearing causes investment dollars to be pulled out of fixed capital formation. Observations below suggest four possible alternatives: (i) the relationship could work in the other direction, i.e. investment in fixed capital leaves fewer dollars for investment in negatively geared rental properties; (ii) the relationship may be caused by a third variable, e.g. investment loan finance or interest rates; (iii) there could be a complexity of interrelationships among many variables; or (iv) the relationship may be coincidental.[97]

First, it may be observed that there is no statistically significant relationship between fixed capital formation and the number of rental property investors.[98]

Second, there was no significant rise in private fixed capital formation when the tax shelter of negative gearing was abolished in the 1986 and 1987 years.[99] Nor was there any drop in private capital formation growth when the tax shelter was reinstated in the 1988 year. In fact, there was a near record 22.1% and 22.8% rise in 1988 and 1989 respectively.[100]

Third, while there is evidence that negative gearing increases investment in rental properties, this does not mean it takes valuable investment dollars away from productive capital into the construction of new dwellings.[101]

Fourth, even if there was a linear causal relationship between negative gearing and fixed capital formation, it cannot be assumed that there is an equal rate of substitution. The fact that the amount of funds invested in fixed capital formation each year far exceeds the total equity in rental properties that are negatively geared indicates that major changes in negative gearing activity and rental property investment would probably not have as large an impact on fixed capital investment.

In the 1997 year, for example, over $93.6 billion was invested on private fixed capital formation in Australia.[102] As at 30 June 1997, after taking into account investment loan finance,[103] an estimated $66.1 billion was invested in equity in negatively geared

[97] On the altern

rental properties.[104] Note that negative gearing rental losses that year are small in comparison ($2.78 billion).[105]

FIGURE 6: GROWTH AND DECLINE IN PRIVATE FIXED CAPITAL FORMATION, 1961-2003 [106,]

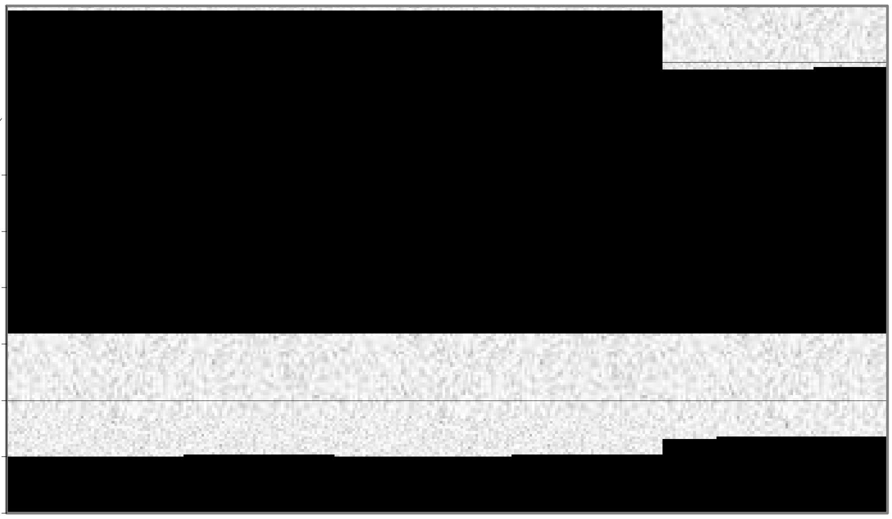

TABLE 3: SUMMARY OF ARGUMENTS SUPPORTED BY THE STATISTICS

Tax Policy Criteria	Summary of Supported Arguments
Revenue	Negative gearing results in a loss of government taxation revenue of approximately $2 billion each year and growing
Equity	Negative gearing rewards taxpayers on higher marginal rates more than

FIGURE 7: GROWTH IN NEGATIVE GEARING OF RENTAL PROPERTIES 1993-94 TO 2000-01 [109]

In the ATO's *2004-05 Compliance Program*, the Commissioner observed a growing imbalance between rental property income and deductions. In 2002-03 there was an 8% increase in rental property income but a 13% increase in rental deductions. This imbalance led the ATO to believe there may be significant non-compliance. The ATO response is to carry out around 4,600 reviews and audits of rental income and expenses in 2004-05.[112] However, so long as negative gearing is allowed, it is hard to believe that increased audit activity alone will have any major i

Statistics indicate a disproportionately high amount of household borrowing is attributable to rental properties rather than owner-occupied dwellings. On analysis, the average rental property is geared approximately two-thirds more than the average wing is

INTERNATIONAL COMPARISONS

Australia is one of few countries that allow negative gearing on real estate and other investments. Few of the major OECD nations allow a tax shelter for negatively geared rental properties, as many have enacted measures to quarantine and restrict interest deductions on investment properties.[129]

TABLE 4: INTERNATIONAL COMPARISON – NEGATIVE GEARING, INVESTMENT HOUSING[130]

Country	Is negative gearing allowed?
Australia	Yes
Japan	Yes
New Zealand	Yes
United States	Restricted
United Kingdom	No
Canada	Restricted
Netherlands	No
Sweden	Restricted
Germany	Restricted
France	Restricted

A comparison of international quarantining measures

Negative gearing is not permitted in the U.K. and the Netherlands. Interest deductions are restricted in the U.S., Sweden, Germany, France and Canada. There is not a high degree of uniformity or overlap of approach to the quarantining of interest deductions overseas. The overseas measures are compared below. In general, while a fairly broad approach is applied in the U.S. (with passive investment rules) and a somewhat narrower approach applies in the U.K. (where investment income is quarantined under a specific schedule), in most countri deduction to the amount of net rental income.[133] This administrative quarantine no longer applies.

The U.S. has an extensive system of limitations on deductibility, including 'passive activity loss' rules.[134] While interest is generally deductible[135] there are notable limitations.[136]

Rental income is treated as passive income. Unless the individual actively participates in the rental activity, losses from rental property may be limited. Individuals who actively participate in the rental activity may be able to deduct up to $US25,000 of loss against other income. No additional loss is available for individuals whose modified adjusted gross income exceeds $US150,000.[137]

Interest is only deductible on rental properties to the extent it does not exceed the taxpayer's net investment income,[138] however the excess may be carried forward up to 20 years and offset against future net investment income. Alternatively it can be offset against capital gains realised on the sale of U.S. real estate.[139]

The U.K. adopts a schedular system to quarantine deductions for investments. Losses from one activity source can only be offset against future income from the same source. Rental property losses are quarantined to income from real property under Schedule A.[140]

Whereas each Schedule and Case has its own detailed expense rules, generally expenditure may be deducted if it is incurred wholly and exclusively in gaining income that is *prima facie* liable to income tax. Losses and outgoings of a capital, private or domestic nature are expressly excluded from deductibility. Each Schedule

II). Otherwise, except for losses from employment (for which there is no provision), income losses can generally be carried forward indefinitely but can only be offset against future income from the same source.[141]

In Canada interest is not generally deductible as it is considered a capital expense for income tax purposes.[142] Interest can be deducted in limited instances where income is gained from a business or property. [143]

The prospect of a capital gain alone will not be sufficient to make interest expenditure deductible, however if there is a reasonable possibility that the investment will eventually generate ordinary income in excess of the interest expense, a deduction for the interest will normally categories. For losses in excess of $15,000 the credit rate is 21% and is restricted to current year losses where the gain on the investment is deferred.[149]

In Germany rental income is one of seven income categories.[150] Losses can be carried forward against future income or offset against previous income, but a limit applies to the amount of losses that can be carried back.[151] Losses in particular income categories can generally be applied against income in other categories.[152]

In France there are separate categories of income. Restrictions apply to certain categories of losses. For real estate losses, the first €10,700 can be set off against other income, but to the extent it arises from interest outgoings, it must be amortised over a 10 year period against future rental income. The excess losses over €10,700 not due to interest paid may only be carried forward against future rental income for a maximum period of 5 years.[153]

Rental income in France is not subject to withholding tax and is assessable with other income as de30 18d82031 Tm(Renta34Tw 3159 553.820.82031 Tm(me in France /r .8 1 Tf0.0043 T

Similar arguments apply to the quarantining of interest deductions on investment assets and the concessional CGT treatment in Australia. For a quarantining model, consideration may also be given to the way our CGT regime restricts the offset of capital losses only against capital gains.[156]

One of the reasons the government gave to justify repeal of our quarantine provisions in 1987 was that negative gearing was adequately countered by measures such as the CGT regime. With the effluxion of time this justification appears doubtful. The fact that capital gains are subject to taxation in Australia at best provides only a part answer, since capital gains are taxed concessionally in Australia compared with most other sources of income. This arises because

the U.K., France or Germany) or in a similar way to the quarantining "passive investment" rules in the U.S.

Again, an issue may arise as to how to deal with accumulated net losses when assets within the category are sold. Again, the easiest option would be to do nothing. Thus the accumup areoj7.98 001088pAn28 /Paibe t9 1(th898 0 rh Tc -0.00349 Tw6ra5. 8 0 0 10.98 0 10.9

On the other hand, some may consider this distortionary effect to be desirable from the point of view of counterbalancing the distortion already built into our capital gains tax system in favour of passive, appreciating assets.[158]

This broader efficiency argument does not apply equally to each of the above three approaches. The greatest level of quarantining, with the greatest scope for deferral and conversion to capital account (for offset against capital gains) applies under the "asset by asset" approach. As a result, that approach would be expected to have the strongest impact in reducing the tax revenue lost to negative gearing and potentially the strongest impact in distorting investment away from appreciating assets.

The broader "all investment assets" approach would be expected to have the weakest impact on plugging the tax shelter and distorting investment away from appreciating assets because any investment losses from one asset could be offset against income from other investment assets in the same income year and, if necessary, future income years. Depending on the taxpayer and their mix of investments, there could be very little deferral of the negative gearing losses. However, by preventing the taxpayer from applying the losses against other sources of income, and mitigating the accumulated effect of continued losses from negative gearing from year to year, at least some of the revenue leakage arising from negative gearing could be prevented. It is anticipated this approach would give rise to the least conversion of the losses to capital account to be offset instead against capital gains.

The approach of "pooling assets" according to category of investment would be expected to produce an outcome somewhere between the other two more extreme approaches in deferring the point in time of utilising those investment losses and the possibility of converting those losses to capital account for offset instead against capital gains.

The final point to consider on the efficiency criterion is the question of international tax neutrality. The middle "pooling" appro

Simplicity and Compliance Costs

Which of the three approaches would best serve the criterion of simplicity?

While all three approaches would be expected to add some complexity to an already complex system of taxation of income and capital gains, the complexity of each approach would appear to depend mostly on which option is taken in requiring the losses to be converted over to capital account and deferred for offset against realised capital gains.

The simplest method for taxpayers is probably the outright denial of interest deductions in excess of net investment income under the “asset by asset approach”, similar to the quarantining measures we had in place for real estate investments between 1985 and 1988. An outright denial of excess interest under the “pooling” approach would be marginally more complex than the “all investment assets” approach, ow

criteria that they discriminate against individuals and distort the choice of investor decision (in particular who is to obtain finance for the investment) away from individual taxpayers and towards other entities.

Recommendation

This paper recommends that Australia adopt an "asset by asset" approach to quarantining because it provides the strongest solution for closing the tax shelter. At the same time, it is expected to give rise to the least complexity and compliance burden on taxpayers and probably requires the least legislative amendment. While no quarantining approach is expected to be politically popular, an asset-by-asset approach may well be seen as more politically acceptable than the pooling approach, but less popular than the all investment assets approach, which gives the greatest opportunity for using and offsetting investment losses.

CONCLUSIONS

Both critics and supporters of negative gearing have based their arguments primarily on two critical assumptions. One is that negative gearing has increased house prices. The other is that negative gearing has increased housing stock. Both assumptions are misguided.

In relation to house prices, in the absence of statistical correlation, the better view is that house prices rise anyway, regardless of negative gearing, and can be explained by other factors.

In relation to housing stock, although statistics indicate that negative gearing has led to an increase in real estate investment, they contradict the argument that negative gearing has led to an increase in the number of dwellings.

Arguments based on these false assumptions are flawed. There is no empirical foundation for arguing in support of negative gearing that it rewards home ownership or that it results in lower rents or increased activity in the construction industry.

Ultimately there is no compelling policy reason why Australia should continue to retain the tax shelter. Negative gearing results in a significant loss in government revenue, measured in billions of dollars. In return it has provided few indisputable benefits. It appears that negative gearing has increased income inequality, and statistics also support the conclusion that it has had a major effect on housing finance, with a disproportionately high level of housing finance invested in rental properties. Its effect on interest rates0 1097n8 0 0 10.98 491.94104 35327.08154 Tm(loTw 10.98 0 0 10. Tj)Tject

This promises the strongest solution for closing the tax shelter. At the same time, it is expected that this approach would probably be the most practically enforceable, requiring the least legislative amendment and giving rise to the least complexity and compliance burden on taxpayers. Whether it would be politically acceptable is another matter entirely.

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