

# AROUND THE HOUSE



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## Housing affordability and tax

By **Richard Krever**, Director of the Taxation Law and Policy Research Institute, Monash University

**Taxes matter, and matter a lot, when it comes to housing affordability. The Goods and Services Tax (GST), income tax and stamp duties all play a role in the price of housing and those concerned about the impact of taxes on housing affordability hope the issue will receive close scrutiny in the Commonwealth Government's current review of taxation.**

There may be some disappointment, however. The Rudd government indicated the review, known as the Henry review after its chairman, Ken Henry, secretary of the Treasury, would be comprehensive and carry out a 'root and branch' study of all aspects of the tax system. Unfortunately, however, the review will face some real political limitations.

Headlining the political constraints are the restrictions on the extent to which the review can consider the GST, with the Commonwealth Government being reluctant to get into a stoush with the states who receive the revenue from that tax. The Commonwealth review also can do little with stamp duties as these are levied by state governments. The federal/state political divide has no impact on income tax aspects of housing affordability and in theory the

review can be frank in its assessment and bold in its income tax reform recommendations.

Sadly, however, the prospects for genuine reform remain dim with governments on both sides of the spectrum reluctant to address the significant income tax concessions that reduce housing affordability.

Whatever their merits in terms of policy, the concessions are popular with all governments' key constituencies: middle and upper income families. Still,

there is a possibility that the review will prove the sceptics wrong.

### Stamp duty

On its face, stamp duty is a prime candidate for raising housing costs – the price of almost all property acquisitions is increased by the stamp duty payable by the purchaser. It is, however, not entirely clear that the cost of property would drop if the tax were abolished. While houses are the most important investment for most people

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who buy them, they're not the only asset in the market place and the value of homes cannot climb greatly out of line with the cost of alternative investments. The Australian market may thus discount the value of homes slightly to leave room for the stamp duty. In other words, the price of homes might simply rise to absorb the lost stamp duty if the duty were abolished. While this view is held by many, it's a hypothetical we'll probably never test in practice – cash-strapped state governments are unlikely to consider significant changes to stamp duties in current economic conditions.

### GST

The review's possibly limited capacity to consider GST issues is of concern to some observers. The GST's impact on housing is somewhat perverse. Notionally, both used houses and rental accommodation are exempt from GST. However, the full rate of GST is imposed on the first sale of a house or flat and there is no mechanism for the buyer to recover the GST paid. As a result, it becomes part of the cost and is passed on to all future buyers and renters as an embedded part of the rental charges or subsequent sale price. In an economic sense, all subsequent owners and all renters will bear some GST burden.

Because the GST is imposed only on the first sale, however, any rises in the value of the property which give rise to higher rents or higher resale values down the road will be tax-free. The value of this concession tends to rise with income – the largest subsidy accrues to the very, very rich. This is because the untaxed consumption is much greater for expensive homes or flats than for less expensive units. If a \$400,000 home and a \$4 million home both rise in value to the same extent

– say, 10% – the tax savings to the purchaser of the less expensive home is \$4,000 while the tax concession for the buyer of the more expensive home is \$40,000. And of course rises in property values tend not to be equal – over time, more expensive properties tend to be found in desired locations and as a result rise in value by higher percentages than less expensive properties.

In other words, the GST concession flows largely to the rich. But this phenomenon is not unusual in GST systems – most of the world's GST regimes have similar rules in place for homes and flats. In any case, even if a government were inclined to consider changes, the odds are small of convincing all states and the federal government to agree on an alternative.

### Income tax

There is almost universal agreement that the income tax treatment of houses and apartments has the most significant impact on the cost of housing. Three factors in particular stand out: the 'imputed income' concession for owner-occupiers, the capital gains exemption for primary residences, and the highly controversial 'negative gearing' rules.

#### Imputed income for owner-occupiers

The 'imputed income' concession for owner-occupiers comes about because the tax system does not (currently) tax the value to a homeowner from using his or her own property, while a person who invests in other assets and derives income he or she uses to rent an identical property is fully taxed on the income used to acquire the same benefit. At first blush, it sounds odd to suggest a homeowner should pay tax on the benefit of living in his or her own home. At the same time, the public generally accepts as fair a rule that taxes persons with the same value



invested elsewhere on the full amount of income they derive, even if the income is used to acquire the same benefit – namely, housing.

The income tax law did not always distinguish between these two categories of persons with identical value investments and living in similar circumstances. At one time, the 'imputed income' or benefit of using your own home was taxed similarly to income from other investments. This system is still used in some European countries. It dropped out of Australian law, however, at the initiative of the Labor Party, which saw the removal of tax on imputed income as a means of increasing home affordability.

It is likely that the removal of imputed income from the tax base had precisely the opposite result, however. Because owner-occupied homes generate benefits that are tax-free while gains from all other types of investment are taxed, economists assume the concession has been 'capitalised' into the price of homes – meaning the price has risen in the market to offset the tax benefit not available to other investments.

Whatever the merits of taxing the benefit realised by owner-occupiers similarly to returns from other investments in terms of fairness and efficiency, a rule imposing tax on this imputed income is unlikely to be reinserted in the income tax law any time soon. True, we used to have such a rule. And true, many countries still do it. But no Australian government would be brave

enough to try and explain to existing homeowners that they'd be taxed every year on imputed income from living in their own homes. It would be a policy that was simply too hard to explain and too vulnerable to attack by political opponents.

### Capital gains exemption

The political constraints on reform of imputed income are equally true in respect of the exemption of family homes from tax under Australia's capital gains tax regime. While some sort of capital gains concession for home owners is found in most countries' capital gains tax systems, Australia's full and unlimited exemption is certainly one of the world's most generous concessional regimes. There is no cap on the value of the house or on the amount of the gain and the exemption applies whether the seller owned the home for one year or for half a century.

The exemption in theory is available only for the time a dwelling is the owner's primary residence. If the residence is used for two purposes over time, the gain is prorated over the two uses and there is no need to actually track gains over the period. For example, if a house is used as a primary residence for five years and then rented out for five years, the gain is simply halved for the purpose of the exemption, even though it may have arisen mostly in the first five years or mostly in the second period.

The Australian capital gains rules generally provide a concessional 'rollover' on death. This creates a somewhat anomalous contrast between persons who sell assets and give away the cash in their wills and those who hold on to the assets and transfer them to the next of kin. Those who sell assets and give away the proceeds when they pass away will recognise their gains and pay tax but those who simply give

away the assets on their deaths pay no tax. As a result of concessional 'rollover' rules, the tax is deferred until the next of kin sells the inherited assets. The 'rollover' rules allow a person who inherits property to step into the shoes of the deceased person. The beneficiary is treated as if she or he purchased the property when the testator acquired it, for the original price paid by the testator. The beneficiary also picks up any exemptions that were available to the deceased person. Thus, a child who inherits a parent's principal residence can sell the house and use the parent's entitlement to a capital gains exemption.

As a transitional measure, a special rule applies to persons who inherit a house that was purchased by the testator prior to the inclusion of capital gains in the income tax law on 19 September 1985. Persons who inherit properties that were purchased by the deceased on or before that date are allowed to ignore all gains that have accrued up to that point. Instead, they are treated as if they bought the house for its market value on the day they inherited the property. In effect, this 'bumps up' the cost of the property for the purpose of calculating any future gains if the house is kept and used for something other than the owner's principal residence.

The total exemption from tax for gains realised on principle residences is without doubt the most unfair concession in the capital gains tax rules. It benefits home owners only, with no benefit for renters. It benefits urban owners more than rural owners and inner city homeowners more than suburbanites. The benefit of the exemption is highest for the rich and of little value to lowest income homeowners, both in absolute terms and relative to the cost of property.

More significantly, the capital gains exemption has been fully capitalised

into the price of homes, meaning it is a significant factor in raising the price of homes to levels that are beyond the reach for so many. This result was expected.

When the capital gains tax was adopted in Australia in 1985, many observers were worried what would happen if houses were exempted. They'd seen the example of Canada which exempted houses from its capital gains tax regime and then watched as the tax concession was capitalised into the price of homes in that country, driving them out of reach for first home buyers. Not surprisingly, the same thing happened in Australia.

Political observers are doubtful any government could ever address the capital gains exemption for primary residences – the family home is sacred in Australia and tax concessions for homeowners even more sacred. It could be done, however.

Reform would be possible if it were included in a broader package of income and capital gains reform that tied a shift towards greater taxation of gains on homes to trade-offs elsewhere. The Coalition government did this in 2000 when it removed completely all capital gains concessions for companies as part of a broader package. If the entire corporate sector can be convinced to wear the removal of a significant concession as part of a reform package, it is conceivable homeowners could be similarly convinced.

### Negative gearing

The most controversial income tax rule in terms of housing and possibly the one with the most significant effect on housing affordability is 'negative gearing'. The term refers to a situation where an investor uses borrowed funds to purchase a rental property. On the outgoing side, the investor has deductions for interest payments. On

the income side, the investor derives rental income and property appreciation (capital gains).

Under current Australian law, the interest is a deductible expense and the rental income is taxable every year. There is no tax on the annual capital gain – tax on the gain is deferred until the property is sold and then the gain is half exempt from tax.

The mismatch of expenses (fully deductible annually) and gains (only part, the rental income, is taxed annually while tax on annual capital gains in the value of the property is deferred until the future and then is half exempt) yields tremendous tax benefits. Investors can use the excess interest deductions to shelter other income such as salaries or professional income from tax.

The mismatch is viewed as a form of tax avoidance in most jurisdictions. In Australia, those taking advantage of the loophole claim it benefits renters. They assert that a rule which provides landlords with large tax savings encourages the building of more rental properties and makes it possible for landlords to charge less rent, since they also have returns directly from the government in the form of tax savings.

In fact, negative gearing most likely has exactly the opposite result. The market responds to the tax benefit by pushing up the price of housing – the tax benefit is ‘capitalised’ into the price of houses. While all types of investments can be negatively geared, housing is more likely to attract negative gearing because it tends to have a better record of steady rises in value over the longer term. As house prices rise and become unaffordable for many, pressure on the rental market increases and landlords can raise rents.

Also, the rise in the price of houses encourages owners to increase rental



charges so yields are in line with the rising capital values.

As negative gearing or abusing the mismatch of current interest deductions and deferred and partially exempt capital gains is considered a form of tax avoidance in most jurisdictions, tax systems usually have rules to prevent the practice.

These take the form of ‘quarantining’ rules which restrict interest deductions to annual income generated by investments. These are not normally aimed only at rental properties – known as ‘passive loss’ rules or ‘dual income tax’ rules, they generally apply to all investment income and interest on all debts used to fund the purchase of investment assets.

Australia remains one of the few jurisdictions with no negative gearing quarantining rules. A narrow rule aimed only at real estate investments was adopted briefly in the mid-1980s but it coincided with a shortage of rental housing and dramatic increases in housing rental rates caused by factors unrelated to the tax reform.

Nervous politicians, concerned that they might be wrongly blamed for exacerbating the rental accommodation crisis, withdrew the measure within a year of its adoption.

Measures to overturn the tax minimisation benefits from negative gearing would increase the fairness and efficiency of the tax system and ultimately benefit home buyers and renters. But negative gearing is not used only by the very wealthy. It has become popular as a tax minimisation device across the board and the middle class comprises a sizeable proportion of negatively geared investors. Aware of how greatly this preferred constituency would be affected by any changes, politicians from both major parties time and again vow to leave negative gearing untouched, whatever other changes may be made to the tax system.

It would appear there is little prospect of finding a government willing to tackle the issue. It is, however, conceivable that the Henry review may come up with a fix as part of a broader package.

While a negative gearing measure per se is unlikely to find any traction, it may be possible to wrap negative gearing rules into broader reforms to the taxation of investments and savings if the review comes to the task of reform with a broad enough vision.

Hopefully it will – this may be a once-in-a-generation opportunity to address these issues. ☺