Parliamentary
Budget Office

Policy costing

Phase out the current tax treatment of negative gearing and the capital gains tax discount	
Party:	Australian Greens

Summary of proposal:

The proposal has three components.

- Component 1 – Phase out the capital gains tax discount
  - This component would progressively phase out the 50 per cent capital gains tax discount for trusts and individuals for capital gains realised on or after 1 July 2019, and replace it with cost-base indexation (the indexation method).
    - The capital gains tax discount would be phased out by 10 percentage points each year for five years to 1 July 2023. During the transition period, individuals and trusts could elect to apply the relevant capital gains tax discount or the indexation method.
    - In calculating the capital gains for assets under the indexation method, individuals and trusts would be able to index the cost base of assets held for at least 12 months so that tax is only applied to real capital gains. The cost base would be indexed by the consumer price index (CPI).
- Component 2 – End negative gearing for prospective investment properties
  - This component would remove negative gearing arrangements (which allow deductions for investment losses to be made against non-investment income) for all non-business investment properties purchased by individuals, funds, trusts and companies on or after 1 July 2019, with assets purchased prior to this date grandfathered.
    - Deductions would be restricted to the same class of asset in which the losses were incurred.
    - Those affected would not be able to carry forward within-year losses to offset future rental gains, nor to offset the ultimate capital gain when the asset is sold.
- Component 3 – Phase out negative gearing for existing investment properties
  - This component would phase out negative gearing deductions for individuals, funds, trusts and companies with more than one investment property purchased before 1 July 2019, according to the phase-out profile at Attachment A.

All components would have effect from 1 July 2019.

Costing overview

Policy background

Capital gains tax discount

The capital gain from an investment is the difference between proceeds from the sale of the investment and the cost base of the investment (which is generally the purchase price plus any transaction costs associated with the purchase). Through the capital gains tax, capital gains adjusted for the capital gains tax discount are added to taxable income and taxed at the investor's marginal tax rate. Under current policy settings, the capital gains tax discount for individuals and trusts applies at a rate of 50 per cent of the capital gain where investments are held for at least 12 months.

The proposal would phase out the current capital gains tax discount of 50 per cent over five years, and replace it with cost-base indexation. This means that capital gains would be discounted for inflation, with tax payable on only the 'real' value of capital gains. Over the last two decades, assets held for longer than 12 months have grown faster than twice the rate of inflation, meaning that cost-base indexation would be expected to result in a smaller average discount than the existing 50 per cent capital gains tax discount. Cost-base indexation would, however, provide a larger discount to assets that grow at a low or negative rate.

Negative gearing

Under current policy settings, income from investments, such as rent, dividends or interest, form a part of taxable income. Investment-related expenses, such as interest, council rates, depreciation, and maintenance costs, are mostly deductible from taxable income. Where these deductions for property investment exceed the value of investment income from the same asset class, they can be used to offset other income, including other investment income, or income from salary and wages. For the purpose of this costing, 'negative gearing' refers to a situation where investment-related deductions for property exceed the total value of investment-related income for property.

The proposal would end the tax deductibility of negative gearing for property by limiting investment-related deductions (including, but not limited to, interest, council rates, depreciation, and maintenance costs) to the total value of investment-related income within the property asset class. The taxable income of some negatively-geared investors would increase as a result of the proposal, meaning there would be an increase in tax receipts. Assets purchased before 1 July 2019 would be grandfathered from the changes to negative gearing, although individuals, funds, trusts and companies with more than one investment property would have their negative gearing deductions phased out, with the exception of those deductions on their first investment property.

Financial implications

This proposal would be expected to increase both the fiscal and underlying cash balances by $9,477 million over the 2019-20 Budget forward estimates period. The impact reflects an increase in revenue of $9,500 million, partially offset by an increase in departmental expenses of $23 million over this period.

Table 1: Financial implications ($m)[(a)(b)]

	2019–20	2020–21	2021–22	2022–23	**Total to 2022–23**
Fiscal balance	90	1,993	3,197	4,297	**9,477**
Underlying cash balance	90	1,993	3,197	4,297	**9,477**

(a) A positive number represents an increase in the relevant budget balance; a negative number represents a decrease.
(b) Figures may not sum to totals due to rounding.

The proposal would have an ongoing impact that extends beyond the 2019-20 Budget forward estimates period. Revenue would be expected to grow significantly as the proposal matures and the proportion of assets covered by the grandfathering provisions (that is, purchased prior to 1 July 2019) eventually declines to zero. The detailed financial implications of the proposal over the period to 2029-30 are included at Attachment B.

The increase in departmental expenses associated with the proposal would allow the Australian Taxation Office (ATO) to make systems changes, conduct information campaigns, and undertake compliance activities.

Uncertainties

The costing is subject to significant uncertainties, outlined as follows.[1]

- The costing is highly sensitive to key parameters used as inputs. These include, but are not limited to, the level of investment in, the net investment income derived from, and the holding times for negatively-geared dwellings. These inputs have been based on historical information and budget parameters, and can change significantly from year to year due to changes in economic conditions.
- There is uncertainty in the growth of the components of net investment income and capital gains. Periods of lower house price growth and lower turnover would reduce the financial implications of the costing.
- There is uncertainty surrounding the behavioural responses to the proposal, such as individuals holding grandfathered properties for longer, or reducing their overall level of investment in housing. Such responses could have a significant impact on the financial implications of the proposal.
- There may be behavioural impacts in the transition to the new arrangements, such as investors bringing forward purchases of assets to take advantage of grandfathering provisions, or bringing forward the sale of assets to avoid a higher rate of tax on capital gains. The magnitude of such behavioural responses is highly uncertain but could have a material impact on the revenue raised from the proposal in the years around its proposed implementation.
- The proposal may have broader macroeconomic implications, including changes to the levels and growth rates of asset prices and rents. As the timing and magnitude of these impacts are highly uncertain, they have not been taken into account.

[1] There are inherent uncertainties in all policy costings, regardless of who produces them. For a more detailed discussion of the nature and sources of these uncertainties see PBO information paper no. 01/2017, *Factors influencing the reliability of policy proposal costings.*

Key assumptions

The Parliamentary Budget Office has made the following assumptions in costing this proposal.

Growth rates

- Capital gains tax assets and net rental incomes grow, on average, in line with growth in nominal gross domestic product. The CPI grows in line with 2019-20 Budget estimates over the period to 2029-30. Some capital gains tax assets grow at a faster rate, while some grow at a slower rate.
  - The costing is sensitive to these assumptions. When growth in capital gains tax assets is low (or negative), the indexation method is likely to be more generous than the current 50 per cent discount. When growth rates are high, the discount method is likely to be more generous.
  - In the transition period where the capital gains tax discount is phased out, the proportion of individuals and trusts selling capital gains tax assets that would elect to use the indexation method increases each year. The indexation method is generally less concessional than the current 50 per cent capital gains tax discount, but more concessional than the capital gains tax discounts in the proposed transition period given current economic parameters.

Asset holding times

- The average holding time for negatively-geared investment properties is around seven years.
- The average holding time for assets affected by the capital gains tax discount component, which includes other asset classes, is just under nine years.
- Assets affected by the negative gearing and capital gains tax policy proposals are disposed over a maximum period of 20 years.[2]

Behavioural responses

- Bring-forward of asset sales: some investors would bring forward the sale of assets in order to maximise the capital gains tax discount.
  - 5 per cent of affected asset sales would be brought forward from 2019-20 to 2018-19, 2.5 per cent would be brought forward from 2020-21 to 2019-20, and 1.25 per cent would be brought forward by 12 months for each of the remaining three years in the transition period.
- Bring-forward of asset purchases: some taxpayers would bring forward the purchase of assets affected by the negative gearing policy proposal to before the implementation date to take advantage of the grandfathering provisions that would apply to assets purchased before this date.
  - 20 per cent of affected asset purchases in 2019-20 would be brought forward to 2018-19, and 10 per cent of affected asset purchases in 2020-21 would be brought forward to 2018-19.
  - In the absence of this behavioural response, the financial implications of the proposal would be around 2 per cent higher over the period to 2029-30.
- Alternative investments: individuals would increase the use of alternate mechanisms, such as other tax concessions or deductions, to reduce their tax liabilities, noting that such responses do not completely offset the revenue gain in all cases.

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[2] The asset holding time profile assumptions have been based on an examination of ATO rental income schedules, the Australian Bureau of Statistics' (ABS) *Survey of Income and Housing* and the 2012 *Australian Share Ownership study*, conducted by the Australian Securities Exchange.

  - In the absence of this behavioural response, the financial implications of the capital gains tax component of the proposal would be around 5 per cent higher over the period to 2029-30.
  - Individuals affected by the negative gearing component are expected to have a taxable income elasticity of 0.2.[3] In the absence of this behavioural response, the financial implications of the negative gearing component would be around 12 per cent higher over the period to 2029-30.
- Total impact of behavioural responses: in the absence of all behavioural responses incorporated into the costing, the financial implications of the proposal would be around 12 per cent higher over the period to 2029-30.

Methodology

Component 1 – Phase out the capital gains tax discount

- The expected revenue collections were calculated with the current discount (the base scenario) and with the proposed discount (in the transition period) or indexation method.
  - The amount of assessable income from capital gains was estimated for each year over the period to 2029-30, based on current revenue estimates and projections of capital gains tax.
  - An average marginal tax rate for individuals reporting net capital gains was estimated based on historical tax data, expected future income growth, and announced future changes to tax rates.
  - The tax payable in each year under the indexation method was calculated by multiplying the capital gains tax base by the difference in the assumed growth rate and inflation as measured by the CPI, then multiplying this by the average marginal tax rate.
  - The tax payable under the discount method was calculated by multiplying the capital gains tax base by the assumed growth rate, with the discount applied, then multiplying this by the average marginal tax rate.
  - The more generous method was determined by comparing the tax payable under each method.
- The baseline amount of capital gains tax was adjusted to account for the behavioural responses identified above.

Component 2 – End negative gearing for prospective investment properties, and Component 3 – Phase out negative gearing for existing investment properties

- The costing of these components was based on a 16 per cent sample of de-identified personal income tax and superannuation returns for 2016-17, as well as tax schedules for partnerships, trusts and superannuation funds (including self-managed superannuation funds).
- These data were used to estimate the baseline amount by which negative gearing would be expected to decrease taxable income for individuals and funds, including through distributions from partnerships and trusts, over the period to 2029-30.
  - This amount was adjusted to account for the phase-out period, grandfathering provisions and the behavioural responses identified above. The change in tax revenue from the proposal was then calculated using this adjusted amount.

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[3] A taxable income elasticity is a measure of the responsiveness of taxable income to changes in tax rates. It measures the proportional change in declared taxable income resulting from a proportional change in the net-of-tax rate (one minus the marginal tax rate). An elasticity of 0.2 means that if an increase in a marginal tax rate leads to a 1 per cent decrease in the net-of-tax rate, there will be a 0.2 per cent decrease in taxable income.

General methodology

- The capital gains tax component does not materially interact with the negative gearing components, and these interactions have not been separately quantified. Under the proposal, negative gearing deductions denied would not be carried forward to offset the ultimate capital gain when the asset is sold, which means that net capital gains are not directly affected by the denial of deductions.
- This costing takes account of the timing of tax collections.
- Departmental expenses were estimated based on an analysis of previous policies with similar administrative complexity.
- Estimates of revenue have been rounded to the nearest $100 million.
- Departmental expense estimates have been rounded to the nearest $1 million.

Data sources

The ATO provided:

- 2016-17 de-identified personal income tax and superannuation data
- 2016-17 de-identified partnership, trust, fund and self-managed superannuation fund unit record files
- 2016-17 capital gains tax schedule data
- rental income schedules (1999-2000 to 2010-11).

The Treasury provided the economic and policy parameters, and capital gains tax and net rental income forecasts as at the 2019-20 Pre-election Economic and Fiscal Outlook.

ABS, *5609.0 – Housing Finance*, Australia.

ABS, *Survey of Income and Housing 2009-10*, confidentialised unit record files.

The Treasury, 2019. *2018 Tax Benchmarks and Variations Statement*, Canberra: The Treasury.

Australian Securities Exchange, 2012. *Australian Share Ownership Study*.

ATO, *Taxation Statistics 2016-17*.

Emrath, P., 2009. *How Long Buyers Remain in their Homes*, National Association of Home Builders.

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Klemm, A., Liu, L., Mylonas, V. and Wingender, P., 2018. *Are Elasticities of Taxable Income Rising*?, International Monetary Fund.

Attachment A – Phase out the current tax treatment of negative gearing and the capital gains tax discount – phase-out profile for Component 3

The table below details the specification as outlined in the request (that is, the proportion of negative gearing deductions that would be allowed in each year for each investment property acquired prior to 1 July 2019).

Table A1: Component 3 – Phase out negative gearing for existing investment properties: Phase-out profile (percentage of negative gearing deductions allowed)

	2019–20	2020–21	2021–22	2022–23	2023–24	2024–25	2025–26	2026–27	2027–28	2028–29	2029–30
First property[(a)]	100	100	100	100	100	100	100	100	100	100	100
Second or more properties	80	60	40	20	0	0	0	0	0	0	0

(a) The 'first property', for the purpose of this costing, is the property from which rental income was derived at the earliest date across all residential properties owned by the individual, fund, trust or company.

Attachment B – Phase out the current tax treatment of negative gearing and the capital gains tax discount – financial implications

Table B1: Phase out the current tax treatment of negative gearing and the capital gains tax discount – Fiscal and underlying cash balances ($m)[(a)(b)]

	2019–20	2020–21	2021–22	2022–23	2023–24	2024–25	2025–26	2026–27	2027–28	2028–29	2029–30	Total to 2022–23	Total to 2029–30
Revenue													
Component 1 – Phase out the capital gains tax discount	*100*	*1,200*	*1,400*	*1,500*	*1,600*	*1,600*	*1,700*	*1,800*	*1,900*	*2,000*	*2,100*	***4,100***	***16,800***
Component 2 – End negative gearing for prospective investment properties	*..*	*800*	*1,700*	*2,600*	*3,400*	*4,300*	*4,700*	*5,400*	*6,000*	*6,700*	*7,200*	***5,100***	***42,700***
Component 3 – Phase out negative gearing for existing properties	*..*	*..*	*100*	*200*	*200*	*200*	*200*	*200*	*100*	*100*	*..*	***300***	***1,300***
Total – revenue	**100**	**2,000**	**3,200**	**4,300**	**5,200**	**6,100**	**6,600**	**7,400**	**8,000**	**8,800**	**9,300**	**9,500**	**60,800**
Expenses													
Departmental													
Component 1 – Phase out the capital gains tax discount	*-3*	*-2*	*-1*	*-1*	*-1*	*-*	*-*	*-*	*-*	*-*	*-*	***-7***	***-8***
Component 2 – End negative gearing for prospective investment properties	*-6*	*-4*	*-1*	*-1*	*-1*	*-1*	*-1*	*-1*	*-1*	*-1*	*-1*	***-12***	***-19***
Component 3 – Phase out negative gearing for existing properties	*-1*	*-1*	*-1*	*-1*	*-1*	*-1*	*-1*	*-1*	*-1*	*-1*	*-1*	***-4***	***-11***
Total – expenses	**-10**	**-7**	**-3**	**-3**	**-3**	**-2**	**-2**	**-2**	**-2**	**-2**	**-2**	**-23**	**-38**
Total	**90**	**1,993**	**3,197**	**4,297**	**5,197**	**6,098**	**6,598**	**7,398**	**7,998**	**8,798**	**9,298**	**9,477**	**60,762**

(a) A positive number for the fiscal balance indicates an increase in revenue or a decrease in expenses or net capital investment in accrual terms.
A negative number for the fiscal balance indicates a decrease in revenue or an increase in expenses or net capital investment in accrual terms.
A positive number for the underlying cash balance indicates an increase in receipts or a decrease in payments or net capital investment in cash terms.
A negative number for the underlying cash balance indicates a decrease in receipts or an increase in payments or net capital investment in cash terms.

(b) Figures may not sum to totals due to rounding.

.. Not zero but rounded to zero.

\- Indicates nil.