Real Estate Institute of Australia

ATTACHMENT 2 TO
REIA SUBMISSION ON
HOUSING
AFFORDABILITY
DATED 2 APRIL 2008

REIA PROSPOSAL FOR CHANGE TO CAPITAL GAINS TAX

PROPOSAL

1. The REIA proposes that there may be merit in developing changes to Capital Gains Tax (CGT) through a sliding tax scale and/or expanding small business concessions on CGT to include individuals, in order to help stabilize the real property market in the future and help to provide for self-funded retirement.

BACKGROUND

2. A healthy and steady property market is good for the socio-economic development of Australia. REIA has advocated policies which are designed to sustain a healthy property market largely on the basis of the life-cycle of home ownership and wealth creation through property investment and provision for aged care. The REIA continues to advocate to Government that home ownership should be "the fourth pillar of superannuation".

3. CGT is often analysed and criticised in the media and public debate largely because it is seen to have contributed significantly to the property boom and made housing less affordable. The Prime Minister has publicly stated that "… people have argued from time to time, perhaps not as loudly, for an alteration in the existing capital gains tax regime for housing, once again it's not an argument that's ever found any favour with me and I think unlikely to find favour with anybody in my Government" (Address to CSR on 21 March 2005). The REIA welcomes this statement by the Prime Minister but recognises that there may be merit in the evolution of CGT as socio-economic circumstances dictate.

4. Two significant events may give cause to review CGT. Firstly, the property boom post mortems and secondly the ageing population in Australia which was highlighted by Government in the Intergenerational Report. This paper outlines scope for change which might be considered by Government in order to:

a. help stabilize the real property market in the future by providing disincentives for short term speculation, combined with incentives for long term property investment, and eventual reward for selling the property thereby also freeing up supply, and
b. promote self-funded retirement including superannuation.

DRIVERS FOR CHANGE IN CGT

5. One of the primary objectives of the Federal Government is to ensure stable, sustainable economic growth for Australia. Policies that are helping to achieve a sound sustainable domestic economy in a dynamic global economy are the monetary policy driven by the Reserve Bank of Australia (RBA) and the Government's drive for taxation, industrial relations, and social reform.

6. Since May 2002, through five upward adjustments in interest rates and rhetoric to talk down property investment, the RBA has been able to assist slowing a very rapid growth in domestic demand to a more sustainable trend. Household spending has declined, the rate of debt growth, which had reached unprecedented levels has slowed, and the unsustainable rate of growth in the housing sector between 1997 and 2003 has abated. The 'soft landing' of the housing sector is expected to result in a much more sustainable level of growth for housing construction, and home purchases by owner-occupiers and investors in the foreseeable future.

7. The major tax reforms introduced by the Government in the last two Budgets (2004-05 and 2005-06) have, *inter alia,* reduced the tax burden on the majority of tax-payers and provided an opportunity for increased savings and investment. Among the tax reforms, the Government stated that the abolition of the superannuation surcharge would simplify the operation of the superannuation system, boost the savings of affected individuals, and provide incentives for individuals to make additional voluntary savings through the superannuation system. This in turn, would help reduce the future burden of social welfare payments from the Federal Budget. The Government has expressed concern about the budgetary implications of the rapidly increasing proportion of Australia's population nearing, or having reached retirement age. REIA considers that additional tax reforms through simple yet significant modifications to the existing CGT laws could provide additional benefits for self-funded retirees and further reduce future reliance on the Government for welfare and income support programs for retirees.

8. In response to the Government Inquiry into First Home Ownership, the Productivity Commission stated in their report of March 2004 that, in relation to the need for a review of aspects of the personal income tax regime that may have recently contributed to excessive investment in rental housing, "The focus of the review should be on the Capital Gains Tax provisions. However, it should also assess 'second best' options for addressing distortions in incentives to invest in housing and other asset markets, including: restrictions on negative gearing and changes to the capital works deduction provisions for buildings. Pending such a review, it would not be appropriate to make housing-specific changes to negative gearing rules or to capital gains tax arrangements". There has been no review.

CAPITAL GAINS TAX

Key Aspects of CGT

9. It is apparent from the 135 pages of the ATO 2003-04 Guide to CGT that there are many factors and circumstances that determine the amount of CGT payable when a CGT event happens. Most CGT events involve a CGT asset. The most common CGT assets are land and buildings, shares in a company, or units in a unit trust. Less well-known assets include contractual rights, options, foreign currency, leases, licences and goodwill.

10. Some CGT events, such as the disposal of a CGT asset, happen often and affect many different taxpayers. Other CGT events are rare and affect only a few taxpayers, for example, those concerned directly with capital receipts and not involving a CGT asset.

11. CGT is payable on any capital gains made that are included in a taxpayer's annual tax return. There is no separate tax on capital gains. It is a component of the taxpayer's income tax. Currently, CGT is generally payable on a taxpayer's **net capital gain** at the taxpayer's marginal rate.

12. Net capital gain is the difference between total capital gains for the year and total capital losses (from business and other assets), less any relevant **CGT discount or concessions.** Any capital gains made during a year must be included as assessable income in an income tax return.

CGT Discount and Concessions

13. If a CGT event that gives rise to a capital gain happened after 21 September 1999 and the asset has been owned by the taxpayer for at least 12 months, a CGT discount of 50% may be applicable to individuals (including partners and partnerships) and trusts. This discount is not available for companies. There are further rules for beneficiaries entitled to a share of a trust capital gain.

14. Special rules apply to depreciating assets that have limited effective lives and can reasonably be expected to decline in value over the time they are used.

15. In addition, concessions are available for small business. The following concessions are available *only* for small business.

a. The **small business 15-year exemption** provides a total exemption for a capital gain on a CGT asset if the asset has been owned continuously for at least 15 years and the relevant individual is 55 years old or over and retiring, or is permanently incapacitated. This concession applies to active assets only, ie assets that are part of the business.

b. The **small business 50% active asset reduction** provides a 50% reduction of a capital gain. An active asset is one that is part of the business. Rental income is specifically excluded from the definition of active asset.

c. The **small business retirement exemption** provides an exemption for capital gains up to a lifetime limit of $500,000. If the recipient is under 55 years old, the amount must be paid into a superannuation (or similar) fund.

d. The **small business rollover** provides a deferral of a capital gain if a replacement asset is acquired. However, a capital gain may be made equal to the deferred gain if the replacement asset is disposed of or its use changes in particular ways. In this case the deferred capital gain is in addition to any capital gain made on disposal of the replacement asset.

The Purpose of CGT Concessions

16. Informal advice to REIA from the Commonwealth Treasury was that the CGT concessions for small business were introduced to specifically assist owners of small business to either expand their business or to provide for their self-funded retirement. The policy is in recognition of the contribution of small business to the national economy including employment, and the difficulty experienced by many small business people of adequately providing for their self-funded retirement whilst simultaneously needing to reinvest in their business ventures.

17. Treasury also advised that these concessions were considered to be inappropriate for individuals because generally, individuals are able to more readily acquire assets specifically for their self-funded retirement.

POSSIBLE CHANGES TO CGT

18. Against this background and the great range of possible scenarios that could be formulated for modelling possible changes to CGT, a pragmatic approach has been adopted to provide two models:

a. a simple model for modifying CGT applicable to a real property CGT asset event is proposed, and

b. the concessions to small business are examined with a view to determining possible changes to the CGT legislation that may also be appropriate for individuals as further incentives to promote the acquisition of **real property** to assist self-funded retirement.

A "Rate of Declining CGT" Model

19. The graph at Annex A shows a model that would meet the objective of taxing speculative investors at higher rates of CGT compared to long-term investors. Key features of the model are:

a. It is simple.

b. If a speculator in real property bought off-the-plan with a view to making quick capital gains by selling within four years for example, the CGT payable within 1 year would be 75% after which the rate would decrease on a linear sliding scale to 60% at the end of Year 4.

c. The rate of CGT payable on realisation of a sale of real property would decline over a 10-year period to 30% by Year 10 and would remain at that level thereafter. The 10 year period will ensure that the investment is outside the limits of the historical period between property booms of about seven years.

d. The model clearly provides an incentive for investors in property to hold the investment for at least 6 years if CGT in excess of the current 50% rate is to be avoided.

e. The final rate of 30% CGT after 10 years means that the tax liability would still be at the taxpayer's marginal rate but would be calculated on 30% of the realised capital gain rather than 50%.

Such a model would potentially curtail "off-the-plan" speculative property investment and "get rich quick" schemes. It provides an incentive for individuals to invest in property in the longer term with a view to making a significant contribution to their self-funded retirement.

20. Given the precedent of excluding individuals and large companies from the CGT concessions to small businesses, it should be feasible for a model of declining CGT on property for individuals to be considered as a realistic possibility.

Possible Adaptations of the Concessions to Small Business

21. REIA supports each of the existing CGT concessions for small business. It is suggested, however, that the first concession, namely the small business 15-year exemption be modified to include individuals. This change would therefore allow an individual of 55 years or over and retiring, or who was permanently incapacitated, and who has owned an asset for at least 15 years to be exempt from CGT. Currently, the best that an individual can do who is ineligible for a small business CGT concession is to be eligible for the CGT 50% discount.

22. If the change suggested in Paragraph 22 was introduced, individuals would be encouraged to invest in property for the longer term. With the assistance of negative gearing to enable individuals to invest in property that they otherwise would not be able to afford, combined with the prospect of a 100% CGT exemption after 15 years of ownership, could be expected to have a significant effect on increasing the number of individuals investing in property for the longer term. There is also an incentive to sell property at retirement. Moreover, by selling property of long standing to "roll over" gains into a superannuation fund, this would help to free up the supply of property particularly in inner city suburbs.

23. It would also seem appropriate that the lifetime limit of $500,000 on the small business retirement exemption be raised significantly. That limit was introduced into the legislation in July 1997 and has not been changed since that time. However, over the last eight years the CPI has increased 23%, full-time adult average total weekly earnings have increased 40%, median weekly house rents have risen approximately 40% and median house prices in Sydney and Melbourne have risen 114% and 93% respectively. It would therefore, be appropriate that the limit of $500,000 be increased to $1,000,000 where it could remain for say five years before being reviewed again.

LIKELY IMPACTS ON THE FEDERAL BUDGET

24. Because of the complexities of estimating CGT across the range of asset classes, it is difficult to determine the order of magnitude that the proposed model of a rate of declining CGT on property might have on the Federal budget. This will need to be costed.

25. Table 1 illustrates the number of individuals, companies and funds that have paid tax on net capital gains for the tax years 1997-98 to 2002-03.

Table 1. Net Capital Gains Subject to Tax, 1997-98 to 2002-03.

	1997-98	1998-99	1999-00	2000-01	2001-02	2002-03
Taxable individuals No.	734,282	809,787	857,458	1,176,926	919,083	663,045
Taxable companies No.	12,614	14,160	15,922	14,508	14,246	12,064
Taxable funds No.	40,326	47,263	56,781	76,172	70,148	50,792
Total number with capital gains No.	**787,222**	**871,210**	**930,176**	**1,267,606**	**1,003,477**	**725,901**
Net capital gains $m	17,462	19,889	21,068	16,516	13,019	10,743
Tax payable on net gains $m	**3,779**	**5,224**	**5,329**	**4,230**	**3,598**	**3,253**

Source: ATO, Taxation Statistics.

26. From Table 1, the total number of taxpaying entities (individuals, companies and funds) that were liable for, and paid CGT on their net capital gains, steadily increased in the years immediately preceding the introduction of "A New Tax System (*ANTS*)" in July 2000 and reached a peak in 2000-01. The introduction of *ANTS* not only brought in the GST but changes to CGT as well, and there is little doubt that these major changes to Australia's taxation system impacted on the number of taxpayers claiming net capital gains at that time. Another major influence was the beginning of the unprecedented rapid escalation in property prices that began in 1998-99 and continued through to the end of 2004. Apart from showing the movements from year to year in tax payable on net capital gains, Table 1 shows that the annual amounts of tax payable on net gains ranged from $3.2 billion to $5.3 billion. REIA is unable to determine what effect the proposals outlined in this paper may have on these estimates.

SUMMARY

27. REIA supports recent Government action to remove the superannuation surcharge to encourage individuals to make additional voluntary savings through the superannuation system for self-funded retirement. However, by making some simple yet significant changes to the CGT laws, additional incentives could be provided to individuals for increasing their contributions towards self-funded retirement and further reducing the burden of social welfare and income support programs for retirees in the Federal budget.

28. There are two broad possibilities for change: first, a declining rate of CGT, and second, expanding small business CGT concessions to individuals.

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Annex:
A. Rate of Declining CGT

ANNEX A TO
REIA PROPOSAL FOR CHANGE TO CGT
DATED 15 SEPTEMBER 2005