

APPENDIX C: TAX CONCESSIONS FOR OWNER-OCCUPIED HOUSING

This appendix sets out the treatment of tax concessions relating to the consumption of owner-occupied housing and presents estimates of the tax expenditure for 2004-05 to 2007-08 and forward projections for the next four financial years.

The tax expenditure estimates for owner-occupied housing attempts to measure the assistance provided to taxpayers due to the various tax concessions, relative to a benchmark. As such, these expenditures cannot be interpreted as indicators of the tax revenues that would arise from changes to policy. This is because they do not take into account the effects of taxpayer behavioural responses that arise from changes in policy or the design features of any policy changes that might be contemplated.

Tax concessions for owner-occupied dwellings fall into two broad categories which are related to capital gains and ordinary income tax.

The capital gains tax (CGT) main residence exemption implies a 100 per cent CGT discount for owner-occupied dwellings. However, the 50 per cent CGT discount for individuals (if they have held the asset for at least 12 months) means that even in the absence of the main residence exemption, owner-occupiers would only be liable for tax on the discounted capital gain of the dwelling, rather than the full capital gain.

Owner-occupied housing can be viewed as an investment by the owner which yields a stream of income in the form of the value of the accommodation that housing provides. Tenure neutrality and tax neutrality benchmarks have been developed (Flood and Yates 1987, 1989) that go beyond the traditional benchmark approach of considering a taxation system where the concessions are completely removed. A tenure neutral benchmark ensures that all owners (and consumers) of housing receive the same tax treatment, irrespective of their status as owner-occupiers or otherwise. A tax neutral benchmark ensures that the tax treatment of housing investments is the same as other non-housing investments, for example, shares or savings, and the tax treatment of housing consumption is the same as other non-housing consumption. Both the tenure neutrality and tax neutrality benchmarks raise the issue of the taxation of mutual income, which is whether members of a household can be taxed on the value of services they provide within the household – or more specifically, whether a household can be taxed on the value of rental services it provides to itself.

This appendix considers three benchmarks for owner-occupied housing in an attempt to address issues around tenure neutrality and mutuality.

The **first benchmark** (see Table 1) formalises the notion that owner-occupiers are simultaneously both producers of housing (through their ownership of the dwelling)

and consumers of housing (through their residence in the dwelling). This means that the owner-occupier may be considered to be two separate entities, a housing producer (landlord) and housing consumer (tenant).

There are three main components to the tax concessions for owner-occupied housing against this benchmark.

- The *capital gains tax* main residence exemption means that owner-occupiers pay no tax on the capital gain of their owner-occupied housing. This is effectively a 100 per cent CGT discount. In the benchmark, the capital gains on owner-occupied housing would be subject to the 50 per cent CGT discount for individuals (or the indexation method of assessing capital gains for properties acquired before 21 September 1999). The value of the 50 per cent CGT discount would be added to the value of the tax expenditure *CGT discount for individuals and trusts* (E11).
- The *imputed rent* paid by the owner-occupier-as-tenant to the owner-occupier-as-landlord is not taxed. That is, if the owner-occupied dwelling was instead rented to someone other than the owner-occupier, the rental income would be taxed at the owner's marginal tax rate. By effectively renting their dwelling to themselves, the owner-occupier avoids paying tax on the imputed rent they can be considered to be paying to themselves. In the benchmark the owner-occupier-as-tenant and the owner-occupier-as-landlord are considered separately, which has the effect of taxing imputed rent identically to ordinary rent.
- The general *income tax* benchmark includes deductions for expenses incurred in earning income. Since imputed rent is treated as taxable income by the owner-occupied housing benchmark, deductions incurred in generating that income must also be included. This includes the provision under the benchmark for negative gearing of owner-occupied housing, where these deductions exceed the imputed rental income and can then be used to offset any assessable income.
- The main source of such income tax deductible expenses is interest payments on mortgage repayments. Other deductions include, for example, capital works deductions for major capital improvements, however amounts claimed in such deductions cannot then be included in the cost base of the property for capital gains tax purposes.

The rationale for choosing this tax benchmark would be two-fold. As mentioned in section 3.5, it avoids double-counting of the *Capital gains tax discount for individuals and trusts* (E11) when considering the *Capital gains tax main residence exemption* (E4). However, the more important consideration is the inherently equitable nature of a tenure neutral treatment. That is, by treating owner-occupiers and other consumers of housing in the same manner and subjecting them to the same tax considerations, it is ensured that all consumers of housing are treated equally, and allows for meaningful evaluations of the tax concessions afforded to one group compared to the other.

Under the income tax benchmark used for the Tax Expenditures Statement outlined in section 4.2, imputed rent from owner-occupied housing is not included in income because of the mutuality principle which suggests that taxpayers' internal transactions (the paying of rent to themselves) should not be taxed.

The **second benchmark** (Table 2) thus removes both imputed rent and any deductions for associated expenses such as mortgage interest payments and other housing deductions, leaving only capital gains tax considerations.

The second benchmark removes the eligibility for deductions on the basis that they were associated with imputed rental income, which is not taxed. However, this neglects the fact that the owner-occupiers still receive income in the form of capital gains. Thus, it is still possible to make a case for allowing deductions in the presence of (expected) capital gains while imputed rent is untaxed. This is because deductions are generally allowed against relevant expenses incidental to capital investments as long as the investment is made with the intention of receiving capital gains.

The **third benchmark** (Table 3) continues the non-taxation of imputed rent on mutuality grounds, but allows partial deductions of mortgage interest and other expenses related to the capital gain in recognition that deductions should be allowed to the extent that capital gains on owner-occupied housing are taxable under the benchmark¹.

Estimates

Estimates of the main components of the capital gains tax main residence exemption under the three benchmarks are presented in Tables 1, 2 and 3 and the projections for the forward estimates period are based on assumptions that are consistent with historical growth rates². The estimates presented are particularly sensitive to owner-occupied housing turnover rates and the housing duration profile (number of years after which capital gain is realised), both of which are survey based.

References

Flood, J and Yates, J 1987, *Housing subsidies study*, Australian Housing Research Council, Canberra: Australian Government Publishing Service.

Flood, J and Yates, J 1989, *Housing subsidies and income distribution*, *Housing Studies*, 4(3): pp 193-210.

1 A pro-rated partial deduction is inconsistent with the concept of tax neutrality, since other capital investments, such as shares, do not have such a system of partial pro-rated deductions. The partial deduction was 50 per cent.

2 The 50 per cent discount is treated as the last component and so has a higher marginal tax rate applied to it than to the full capital gain.

Appendix C: Capital gains tax main residence exemption

Table C1: Capital gains tax main residence exemption with imputed rent and full deductibility

	2004-05	2005-06	2006-07	2007-08	2008-09	2009-10	2010-11	2011-12
	\$m	\$m	\$m	\$m	\$m	\$m	\$m	\$m
Tax								
1 Tax on capital gains	37,000	39,500	38,500	43,500	41,500	40,500	40,000	39,500
2 Tax on imputed rent	18,500	19,000	19,500	21,000	21,500	22,500	23,500	25,000
Sub-total	55,500	58,500	58,000	64,500	63,000	63,000	63,500	64,500
Less offsets								
3 50 per cent discount on capital gains	-19,500	-22,000	-21,500	-24,000	-22,500	-22,000	-22,000	-21,500
Sub-total	-19,500	-22,000	-21,500	-24,000	-22,500	-22,000	-22,000	-21,500
4 Interest deductions	-5,500	-6,000	-6,000	-6,500	-7,000	-7,500	-8,000	-8,500
5 Other deductions	-10,500	-10,500	-10,500	-10,500	-11,000	-11,500	-12,000	-12,500
Sub-total	-16,000	-16,500	-16,500	-17,000	-18,000	-19,000	-20,000	-21,000
Total tax expenditures	20,000	20,000	20,000	23,500	22,500	22,000	21,500	22,000

Table C2: Capital gains tax main residence exemption with no imputed rent or deductibility

	2004-05	2005-06	2006-07	2007-08	2008-09	2009-10	2010-11	2011-12
	\$m	\$m	\$m	\$m	\$m	\$m	\$m	\$m
Tax								
1 Tax on capital gains	37,000	39,500	38,500	43,500	41,500	40,500	40,000	39,500
2 Tax on imputed rent	0	0	0	0	0	0	0	0
Sub-total	37,000	39,500	38,500	43,500	41,500	40,500	40,000	39,500
Less offsets								
3 50 per cent discount on capital gains	-19,500	-22,000	-21,500	-24,000	-22,500	-22,000	-22,000	-21,500
Sub-total	-19,500	-22,000	-21,500	-24,000	-22,500	-22,000	-22,000	-21,500
4 Interest deductions	0	0	0	0	0	0	0	0
5 Other deductions	0	0	0	0	0	0	0	0
Sub-total	0	0	0	0	0	0	0	0
Total tax expenditures	17,500	17,500	17,000	19,500	19,000	18,500	18,000	18,000

Appendix C: Capital gains tax main residence exemption

Table C3: Capital gains tax main residence exemption with no imputed rent and partial deductibility

	2004-05	2005-06	2006-07	2007-08	2008-09	2009-10	2010-11	2011-12
	\$m	\$m	\$m	\$m	\$m	\$m	\$m	\$m
Tax								
1 Tax on capital gains	37,000	39,500	38,500	43,500	41,500	40,500	40,000	39,500
2 Tax on imputed rent	0	0	0	0	0	0	0	0
Sub-total	37,000	39,500	38,500	43,500	41,500	40,500	40,000	39,500
Less offsets								
3 50 per cent discount on capital gains	-20,000	-22,000	-21,500	-24,000	-23,000	-22,000	-22,000	-21,500
Sub-total	-20,000	-22,000	-21,500	-24,000	-23,000	-22,000	-22,000	-21,500
4 Interest deductions	-2,500	-3,000	-3,000	-3,000	-3,000	-3,500	-3,500	-4,000
5 Other deductions	-5,000	-5,000	-5,000	-5,000	-5,000	-5,000	-5,500	-6,000
Sub-total	-7,500	-8,000	-8,000	-8,000	-8,000	-8,500	-9,000	-10,000
Total tax expenditures	9,500	9,500	9,000	11,500	10,500	10,000	9,000	8,000

