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Tax White Paper Task Force
The Treasury
Langton Crescent
PARKES, A.C.T. 2600

Dear Sirs,

With regard to the Tax Discussion Paper, we would like to submit the undermentioned remarks which relate to your Discussion Question Number 21 and, in particular, to issues relating to negative gearing.

We believe that negative gearing is a fundamental principle accepted within our taxation system and that it must not be tampered with in pursuit of social policy outcomes.

We accept that negative gearing is a factor influencing the savings and investment decisions of Australians but would argue it is just one of a number of factors.

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It is disappointing that negative gearing - a fundamental principle in assessing the way income taxation liabilities are calculated - seems over recent decades to have morphed into Negative Gearing - a taxation minimization "trick" which seems to be available to individuals investing in residential property.

What is particularly disturbing, however, is that some commentators analyzing the affordability of residential housing in Australia are seriously suggesting that the principle of negative gearing be banned so that housing affordability may be increased. We would offer a view that the ability to use negative gearing is simply one of a number of factors which could lead an investor to make an investment in residential housing.

Negative gearing is not a tax concession for the sole use of wealthy landlords. It is a taxation principle, applying to all taxpayers in Australia, in all industries and professions, which accepts that if the taxpayer is genuinely undertaking a business or investment endeavor to earn a profit, then tax deductible costs incurred in undertaking that endeavor before it commences to generate a profit may be applied against other taxable income the taxpayer earns in other activities he or she undertakes.

In preparing a Business Case for any investment proposal being considered, a taxpayer (whether they are a corporation or an individual) will look to assess the post taxation return on their investment. This will involve an estimate of the after tax income earned and after tax expenses incurred during the time the investment is undertaken along with an estimate of the after tax gain realized from the ultimate sale of the investment.

The ability of the taxpayer to be able to utilize the principle of negative gearing, particularly in the early years when the investment may not yet have achieved a profit, may be crucial to the mathematics in the Business Case. Although the taxpayer ultimately intends to make profit, the minimization of post-tax costs in the early formative years of the investment may be crucial in delivering an overall investment return which is considered suitable enough to warrant investment in the first place.

It may be fair to say that in discussing the principle of negative gearing, many Australians reading their daily newspapers would think that its application relates mostly, if not exclusively, to property investment. We would suggest this is not the truth.

If a business expands into a new field of operation to grow its profits, it is legitimately able to apply any losses it initially incurs on that new venture (arising because revenues have yet to overtake costs - costs which could potentially include interest costs) against income it earns from its main endeavor.

Similarly if a business expands into a new geographic location to grow its profits, it is legitimately able to apply any losses it initially incurs at that new location (arising because revenues have yet to overtake costs - costs which could potentially including interest costs) against income it earns from its main location.

In each case, when determining its current taxation liability, the business is effectively utilizing the principle that any net losses incurred in the new venture/new location can be offset against its other profits. If the new venture/new location costs incorporate any interest expense, the business is utilizing the principle of negative gearing.

Like any other business or individual taxpayer seeking to genuinely boost their income and net worth by seeking to earn a profit from an investment of some type, taxpayers investing in residential property have every right to offset any allowable losses they make on their property investment endeavor against the taxable income they earn from other sources.

The fact that so many Australians choose to undertake an investment in residential housing clearly has an impact on pushing up the demand for this type of asset class, and by logical implication, pushing up prices for this asset class.

The fact that so many Australians choose to undertake an investment in residential housing using borrowed funds clearly has an impact on pushing up the demand for this asset class even more, and by logical implication, pushing up prices for this asset class even more.

That some Australians choose to undertake an investment in non-residential property or in listed equities, with the use of borrowed funds, would clearly have an impact on pushing up demand for these asset classes as well. But there doesn't appear to be anyone who has come out publicly and suggested Australian society, in general, would be better off if price growth in these asset classes moderated.

The focus of attention on the impact that the savings and investment decisions of Australians have on residential housing prices is understandable. As a society, we want succeeding generations and new arrivals to have the same opportunities to buy themselves affordably priced homes which we ourselves have enjoyed.

However, those seeking to reduce residential housing costs by imposing some sort of ban on the principle of negative gearing – but presumably only as it could apply to residential property investment – are misguided in our view.

If the containment of residential housing prices is to be considered such an important social issue that we're prepared to consider tampering with basic principles such as the principle of negative gearing, why not go straight to the source of the issue.

Why not simply apply a total ban on residential property investment and allow only owner-occupiers the right to purchase residential properties.

This is clearly an absurd position to take, but in our view, only slightly more absurd than suggesting negative gearing should be banned to try and contain price appreciation in residential housing in this country.

In looking at why Australians put so much of their savings into residential housing investment, we would agree that the ability to offset interest expense incurred on their investment against other income they earn is a factor.

We would suggest that the current Capital Gain Tax regime is a much more important factor. Without the ability to declare only 50% of the capital gain made as taxable income, we believe the Business Case for a considerable number of residential property investment proposals would simply not "stack up".

In arguing, as we have, that the principle of negative gearing must not be tampered with, and in focusing on Discussion Question Number 21, we would also suggest that apart from the influence of CGT and negative gearing on savings and investment decisions, there are a number of other factors which apply. Whilst they perhaps don't generate much publicity or comment individually, collectively they seem to exert considerable influence.

We would argue that the influence of the Baby Boomer generation is having a significant impact. As the "Baby Boomer Bulge" demographic nears and then enters retirement, they have more money than any preceding generation has ever had. They also seem to be facing (if they're lucky) an extended period in retirement due to their increasing longevity. These two factors explain why this group is making increased investments into residential property at this time and, presumably, will continue doing so for quite some time.

We would also argue that the media, in particular the print media, seem to encourage Australians to believe that investment in property, and residential property in particular, is an assured way to enhance their personal wealth. This could be because readers are genuinely seeking such advice. It could also possibly be because newspapers derive substantial revenues from advertising sales to the real estate industry and as such, are happy to print any material supporting investment into residential real estate but may not wish to publish material which questions the merit of investment into residential real estate.

We would also argue that there have been dramatic changes in the Australian banking and finance sectors which have had a profound effect over recent decades.

The deregulation of the Australian banking industry in the 1980's has seen banks able to expand the level of their lending into residential housing – both for owner-occupiers and for investors – as constraints which used to apply to the amounts they could lend for housing were removed.

More recently, changes to capital requirements, where varying amounts of capital need to be held to support particular types of bank advances, have further encouraged our largest banks to focus on housing lending. Housing lending secured by a mortgage requires the least amount of capital per dollar advanced and over recent years, major Australian trading banks have focused an increasing proportion of their lending business into "housing lending".

The changes in the banking industry have also led to an evolution in the broader finance industry. Today we have a proliferation of mortgage brokers who are actively promoting property investment to ever increasing numbers of Australians and then facilitating the borrowing of funds to allow the property investment to actually occur.

In conclusion, we accept that negative gearing is a factor influencing the savings and investment decisions of Australians but would argue it is just one of a number of factors.

We submit that that negative gearing is a fundamental principle accepted within our taxation system and that it must not be tampered with in pursuit of social policy outcomes.

Yours Faithfully

Geoff Cossar
Director