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Quarantining Interest Deductions for Negatively Geared Rental Property Investments

Jim O'Donnell*

Abstract

Negative gearing has become a popular tax shelter in Australia. Australia is one of few countries to generally allow interest deductions for negatively geared rental property investments. Although the tax benefits of negative gearing at the investor level are quite well known, the tax policy arguments for and against negative gearing have not been thoroughly examined.

This is a paper about tax policy. It surveys the arguments for and against negative gearing. According to tax policy criteria, should negative gearing be allowed? Many commentators have speculated on what effect negative gearing has on the economy. Does it increase house prices and make home ownership less affordable? Or does it make accommodation more affordable by increasing the number of rental properties? Are there broader economic effects? Does it distort investment? Does it contribute jobs to the economy? Does it have an effect on interest rates? What is its impact on the tax revenue? A number of false assumptions have been made on both sides of the debate, undermining the arguments for and against negative gearing. Informed by quantitative and statistical analysis, this paper evaluates those assumptions and concludes that on balance there is a strong case for closing the tax shelter.

The final part of this paper considers alternative vehicles for denying negative gearing. Drawing on overseas experience, this paper evaluates the tax policy implications of various options for quarantining interest deductions. One critical question for tax policy debate is to determine the appropriate level for quarantining measures. Should they be confined to real estate investments or broadly cover all types of investments? As with all tax reform, closing the tax shelter will necessarily have impact on other tax policy settings. Tax policy gains may be achieved in some areas but this might be at the expense of others. By examining the tax policy effect of alternative measures, this paper discusses which option for quarantining interest deductions and eliminating negative gearing would work best in the Australian tax system.

INTRODUCTION

Negative gearing is a well-recognised taxation strategy in Australia. It has grown to become one of Australia's most popular tax shelters,¹ to the extent that a majority of our rental housing stock is now negatively geared.²

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¹ Australian Bureau of Statistics, *Australian Social Trends 1999*, "Housing – Housing Stock: Rental Investors". Cf. Tax Institute of Australia "Tax Reform: Let there be no half measures" (1998) 1 *Tax Specialist* 185, 203, which remarkably describes negative gearing as "a much misunderstood term". As an indicator of its popularity as a tax shelter, Australian Taxation Office, *Taxation Statistics 2001-02* indicates that at 30 June 2002 the number of negatively geared rental property investors exceeded the number of trusts in Australia by more than two-thirds.

² Tax Institute of Australia "Tax Reform: Let there be no half measures" (1998) 1 *Tax Specialist* 185, 203. Refer also to Figure 7 below.

While many investors are attracted to negative gearing as a legitimate method to help generate wealth and reduce tax, most of us are either unaware or do not care about the broader economic consequences of negative gearing and its tax policy implications.

Most major OECD countries have disallowed the tax advantages of negative gearing. For apparently political reasons, Australia has resisted. In 1985 the Australian government experimented with removing the tax shelter by enacting legislation that quarantined interest deductions on negatively geared real estate investments. This proved so unpopular the then Labor government repealed the quarantining provisions after only two years. Fortuitously, Labor returned to power at the 1987 election winning a record number of seats (86) in the House of Representatives.³

Learning from this experience, no Australian government has since looked to reopen the tax policy debate on negative gearing. Some commentators have formed the view that negative gearing is an entrenched part of Australian taxation, attaining the status of a 'sacred cow'.⁴

However, it now appears a new movement is gaining force in the Australian community, a swelling undercurrent of increased willingness to question this tax shelter. Welfare representatives have been lobbying for change for some time, and they are not alone anymore. Opposition to negative gearing has been a policy platform of the Australian Democrats in recent years. In the media, we are now observing more frequent open criticism of negative gearing by members of parliament on both government and opposition benches.⁵ Although the Government has so far been able to dismiss protests from the welfare sector, minority parties and outspoken MPs, the Reserve Bank of Australia has also now weighed into the debate, stamping its arguments with compelling economic force. How long can the Government keep a lid on the debate?

HOW NEGATIVE GEARING WORKS

Rental properties are negatively geared for tax purposes⁶ when all rental deductions, including interest outgoings, depreciation and repairs, exceed rental income.⁷ This produces a tax loss. In Australia, this loss can be offset against other assessable income, thereby providing a tax saving to the investor and often taking their taxable income into a lower marginal tax bracket.⁸

³ Newman, G. (1999) *Federal Election Results: 1949-1998, Research Paper 8, 1998-99*, Statistics Group, Parliament of Australia, Canberra, 9 February 1999.

⁴ Weekes, P. "Tax Call on Depreciation" *The West Australian*, 29 March 2004, p.36.

⁵ Garnaut, J. "Level Top Tax Rates: Turnbull" *Sydney Morning Herald*, 15 March 2005.

⁶ Negative gearing can also occur in the commercial sense, where interest expenditure exceeds net rental income, however due to statutory deductions, such as building write-off and depreciation, it is possible to have negative gearing for tax purposes for properties that are positively geared in commercial terms.

⁷ Negative gearing is generally associated with investment property, although the same tax avoidance strategy is also being applied to shares through investment vehicles such as 'leveraged equities': see e.g. ACOSS "Taxation in Australia: home truths and international comparisons" *ACOSS Info 347*, June 2003, p.23.

⁸ See e.g. Hanegbi, R. "Negative Gearing: Future Directions" (2002) *7 Deakin Law Review* 349, 353, 354. Refer to the definitions in Nygh, P.E. & Butt, P. (eds) (1997) *Butterworths Concise Australian legal dictionary*, Butterworths, Sydney, p.270; CCH (1991) *The CCH Macquarie Dictionary of Accounting*, Student Edition, CCH Australia Limited, Sydney, pp.153-4; and Hamson, D. & Ziegler, P. "The

When the timing of losses and gains is considered, the benefits of negative gearing are even greater. In addition to the immediate tax benefit available from offsetting the rental loss against other income, the investor's exposure to tax will generally be limited to the capital gain realised when the property is sold, which is taxed on a deferred and reduced basis and, in some cases (e.g. if a pre-CGT asset) it is not taxed at all.⁹

The net effect of negative gearing is that the investor can come out ahead in economic terms and still reduce their tax liability.¹⁰ From a tax policy point of view, this represents a double departure from a comprehensive definition of income.

THE TAX POLICY DEBATE

The tax policy debate on negative gearing in Australia does not rest on any single issue or criterion. Tax design is shaped by the need to raise revenue and also by considerations of efficiency, equity, simplicity and enforceability.¹¹

Revenue

If the primary objective of taxation is to raise government revenue, then the fact that negative gearing results in a loss of government revenue needs to be weighed in the balance when deciding whether this tax shelter is something that Australia can afford. Statistics indicate about \$2 billion in tax revenue is lost to negative gearing each year, and this figure is rising.

Efficiency

The efficiency or neutrality criterion has emerged in recent times as the core criterion for evaluating taxation measures.¹² Under this criterion, it is important to consider whether allowing rental losses to be offset against other income has a distortionary effect on the Australian economy, and if so, whether any of these distortions are desirable or intended.

Below is a selection of efficiency related arguments examined in this paper:

- Negative gearing has led to increased house prices.
- Negative gearing has led to an increase in the number of dwellings available for rental accommodation and, in turn, lower rents.
- Negative gearing has led to increased employment and increased activity and investment in the residential construction sector.

Implications of Negative Gearing Restrictions and Capital Gains Taxation on Investment" (1986) 3 *Australian Tax Forum* 369.

⁹ By allowing rental losses to be offset against other income, negative gearing further encourages the conversion of income on revenue account into capital gains. See e.g. Hamson, D. & Ziegler, P. "The Implications of Negative Gearing Restrictions and Capital Gains Taxation on Investment" (1986) 3 *Australian Tax Forum* 369.

¹⁰ Hanegbi, R. "Negative Gearing: Future Directions" (2002) 7 *Deakin Law Review* 349, 353-4; Hamson, D. & Ziegler, P. "The Implications of Negative Gearing Restrictions and Capital Gains Taxation on Investment" (1986) 3 *Australian Tax Forum* 369; Hanegbi, R. "Submission – Housing Affordability" 21 October 2003; cf. Frankovic, J. "Why Interest Should be Considered a Current Expense" (2001) 49(4) *Canadian Tax Journal* 859, 868-70.

¹¹ OECD (2001) *Tax and the Economy: A Comparative Assessment of OECD Countries*, OECD Tax Policy Studies, Paris, p.17.

¹² Review of Business Taxation, *A Tax System Redesigned*, Report, July 1999; OECD (2001) *Tax and the Economy: A Comparative Assessment of OECD Countries*, OECD Tax Policy Studies, Paris, p.17.

- Negative gearing encourages investment in assets such as property and shares that appreciate in value, rather than capital used in other areas of production that add value to the economy.
- Negative gearing increases demand for loan finances and, in turn, leads to overheating of the economy and puts upward pressure on Australian interest rates.
- Negative gearing exacerbates the effects of economic downturns as investors are forced to unwind their debts by cutting back spending.
- Negative gearing has contributed to declining birth rates.
- A number of important questions can also be asked of the macroeconomic effects of negative gearing. Looking beyond this paper, for example:
- What is the impact of negative gearing on the level of investment in Australia?
- Does negative gearing affect Australia's international competitiveness?
- Does negative gearing increase or reduce the overall level of employment, wealth and production (GDP) in Australia?

Equity

It is important to consider what distributional effects, if any, arise from negative gearing. Does negative gearing expand the divide between rich and poor?

It has been argued that negative gearing offends principles of distributional justice by favouring wealthier and higher income taxpayers, who own substantial landholdings, at the expense of the poor and low-income earners who struggle to find accommodation and cannot afford to purchase their own home.

Compliance

Compliance issues are just as important to keep in mind when evaluating any single tax measure as they are when considering the overall design of the tax system. Compliance issues have become more prominent in Australia in recent years thanks largely to advances in the ATO's Annual Compliance Program and also in the area of tax compliance research.¹³

The ATO has on more than one occasion identified the rental property sector as a major problem area for tax compliance.¹⁴ Unfortunately for the ATO, the revenue problem arising from negative gearing is not simply a compliance issue. It is questionable that increased scrutiny of rental deductions alone would arrest the growth in rental losses.

A multitude of compliance issues could be raised about negative gearing. To mention one issue, consider the psychological effect on taxpayers of removing the tax shelter of negative gearing.

¹³ See e.g. Evans, C., Ritchie, K., Tran-Nam, B. and Walpole, M. "Taxation Compliance Costs: Some Recent Empirical Work and International Comparisons" (1998) 14 *Australian Tax Forum* 93.

¹⁴ Australian Taxation Office, *Compliance Program 2004-05*, August 2004, p.7.

A tax measure that is generally seen as unfair or arbitrary in its incidence can generate reluctance among taxpayers to comply.¹⁵ Applying this to quarantining, it is debatable whether the removal of negative gearing would give rise to improved attitudes of compliance (through a greater degree of respect for the tax system), or if it would encourage more extreme forms of tax planning (as it is so popularly entrenched in our tax system).

There is little doubt that successive federal governments in Australia have had the same clear expectations on how taxpayers would react if told they can no longer claim full interest deductions on their investments. For many taxpayers, rental property investments (made attractive by negative gearing) represent a substantial part of their retirement savings (their 'superannuation') – which would be made unattractive and put at economic risk if negative gearing is abolished. Perhaps negative gearing is now too entrenched to make its removal a possibility.

Is there a more serious danger that negative gearing conveys the wrong message to taxpayers – that it is acceptable to minimise tax, to lower your taxable income and access a lower marginal tax rate? Some might query whether this message is necessarily unhealthy, particularly if the result on the other side of the ledger is a healthy boost for investment.¹⁶

Simplicity

Under this criterion, consider for example whether the Australian tax system would be a more complex system, with higher compliance costs, if we introduced quarantining measures. It is also important to ask whether such measures would necessarily stop the revenue leakage. Looking to overseas experience, which method of quarantining would work best in Australia? Should Australia consider going back to the measures we had in the 1980s?

International

Does overseas experience present a clear solution? Would Australia become internationally more competitive if we took a path taken by one of the other OECD nations to restrict or deny the tax shelter? What would be the effect of introducing quarantining measures on international capital flows into and outside Australia?

Political

The political context must also be taken into account when discussing tax policy and possible tax reform. Legislative change has no chance unless there is the political will to consider and debate the issues and popular agreement to the change. The current political reality about negative gearing is that the Australian government believes it would be political suicide to contemplate removing the tax shelter.¹⁷

THE LEGAL CASE FOR NEGATIVE GEARING

The deductibility of interest expenditure is at the heart of negative gearing.

¹⁵ OECD (2001) *Tax and the Economy: A Comparative Assessment of OECD Countries*, OECD Tax Policy Studies, Paris, p.20

¹⁶ Consider Frey, B.S. (1983) *Democratic Economic Policy: A Theoretical Introduction*, Basil Blackwell, London, p.138.

¹⁷ For example, Federal Treasurer Peter Costello has repeatedly ruled out changes to negative gearing rules: Mellish, M. & Hepworth, A. 'RBA Targets Negative Gearing' *Australian Financial Review*, 15 November 2003 <http://afr.com/articles/2003/11/14/1068674383089.html>.

In Australia, interest is ordinarily deductible under the general deduction provisions of sec.8-1 of the 1997 Act, and previously sec.51(1),¹⁸ provided the money borrowed has the required nexus with assessable income – as it must be incurred “in gaining or producing” such income.¹⁹

Looking at the deductibility of expenses generally, in cases where there is a disproportion between the outgoings and assessable income, the courts have been prepared to consider the advantages sought by the taxpayer, their subjective purpose, motive or intention, in determining whether the outgoings are deductible.²⁰

By definition, negative gearing involves a disproportion between outgoings and assessable income. It arises only where the deductible expenses, including interest, outweigh the assessable income from an investment in an income year.

However, the courts in Australia have protected the tax shelter of negative gearing without normally considering the subjective purpose of the taxpayer or making a contextual and active enquiry for the reasons the expenditure was incurred.²¹

Interest will normally be deductible where, from an objective evaluation of the facts, the borrowed funds are used for an income producing purpose such as to purchase an income producing property.²²

The fact that an income producing property is negatively geared will not normally affect the deductibility of the interest.²³ Nor does the fact that the investor acquired and holds the property to make a capital gain.²⁴

¹⁸ See generally Pagone, G.T. “Tax Deductibility of Interest” *TIA WA State Convention*, 21 August 1998, published in Taxation Institute of Australia, 1998-99 Convention Papers, Vol.1, pp.41-53; Dabner, J. “Interest Deductibility – Australia and Canada Compared” [1999] May/June *CCH Journal of Australian Taxation* 172; Trethewey, J. “Taxation Aspects of Real Estate Transactions – Part 1: Expenses” (1994) 29 *Taxation in Australia* 239; Abadee, S. & Evans, C. (1995) *Tax and the Private Residence*, CCH Australia, Sydney, pp.105-8.

¹⁹ Grbich, Y. “Revisiting the Main Deduction Provision: Clear Concepts for a Mass Decision-Making Tax System” (1990) 17 *Melbourne University Law Review* 347, 348, 349. This is a matter of characterisation and normally depends on how the borrowed funds are used.

²⁰ See e.g. *Magna Alloys & Research Pty Ltd v FCT* (1980) 11 ATR 276; *FCT v Ilbery* (1981) 81 ATC 4661; *Ure v FCT* (1981) 81 ATC 4100; *FCT v Kowal* (1984) 84 ATC 4001; *Fletcher & Ors. v Commissioner of Taxation* (1991) 173 CLR 1; *McGuinness v FCT* (1992) 92 ATC 4006; *FCT v Roberts and Smith* (1992) 37 FCR 246; *Steele v DCT* (1999) 197 CLR 459; *Hart v FCT* [2002] FCAFC 222 per Hill J.

²¹ See the discussion in this paper below on *FCT v Janmor Nominees Pty Ltd* (1987) 19 ATR 254.

²² See e.g. Pagone, G.T. “Tax Deductibility of Interest” *TIA WA State Convention*, 21 August 1998, published in Taxation Institute of Australia, 1998-99 Convention Papers, Vol.1, pp.41-53, and the following examples: *FCT v Munro*; *British Imperial Oil Co. Ltd. v FCT* (1926) 38 CLR 153; *FCT v Total Holdings (Australia) Pty Limited* (1979) 79 ATC 4279; *Alliance Holdings Limited v FCT* (1981) 81 ATC 4637; *Travelodge Papua New Guinea Ltd v Chief Collector of Taxes* (1985) 85 ATC 4432; *Reliance Finance Corporation Pty Limited v FCT* (1987) 87 ATC 4146; *Sheil v FCT* (1987) 87 ATC 4430; *Commissioner of Taxation v Riverside Road Lodge Pty Ltd (In Liq)* (1990) 90 ATC 4567; *Kidston Goldmines Ltd v FCT* (1991) 91 ATC 4538; *FCT v Roberts and Smith* (1992) 92 ATC 4380, 4388-9; *Hayden v Commissioner of Taxation* (1996) 68 FCR 19; *Temelli v FCT* (1997) 97 ATC 4716.

²³ Krever, R. “Law Reform and Property Interests: Attacking the Highly Geared Rental Property Loophole” (1985) 10 *Legal Services Bulletin* 234, cited in Hanegbi, R. “Negative Gearing: Future Directions” (2002) 7 *Deakin Law Review* 349, 354. See also Trethewey, J. “Taxation Aspects of Real Estate Transactions – Part 1: Expenses” (1994) 29 *Taxation in Australia* 239, 241.

²⁴ Refer to *Assistant Treasurer Press Release ‘Taxation of Capital Protected Products’*, 30 May 2003 and *Taxation Determinations TD 2005/4 to TD 2005/7*, 30 March 2005. Contrast the ATO’s approach to

The Australian government has generally supported the tax shelter of negative gearing, despite its growing burden on the tax revenue.²⁵

In December 1967, the Commissioner of Taxation issued an income tax ruling giving tacit approval to negative gearing.²⁶

On 30 June 1983 the Treasurer announced that the Commissioner would not be changing the long standing practice of allowing deductions in full for interest on moneys borrowed to invest in rent-producing properties where the interest and other outgoings exceeded the rental income in any year.²⁷ This came after a brief period when the Victorian Deputy Commissioner took matters into his own hands by denying real estate investors in Victoria a deduction for interest expenses to the extent they exceeded rental income.²⁸

However by 1985 the government came to realise that negative gearing of rental properties was one of Australia's most popular tax shelters. The *Draft White Paper* on 'Reform of the Australian Tax System', published in June 1985, estimated that negative gearing of rental properties cost the revenue about \$175 million per annum, and recommended quarantining measures.²⁹

QUARANTINE MEASURES IN AUSTRALIA

To implement the Draft White Paper recommendation, the government introduced legislative changes, appearing as Subdiv.G of Div.3 of Pt.III of the *Income Tax Assessment Act 1936*, which effectively abolished negative gearing for real estate

apportionment of interest deductions where investors in shares or other listed securities borrow using financial products that have a capital protection feature.

²⁵ On the Australian executive government's stance on negative gearing, see Taxation Ruling *IT 166* "Income tax: interest on money borrowed to acquire an income producing asset", 14 December 1967, withdrawn 2 July 1997; Treasurer Press Release No. 45 of 30 June 1983; Taxation Ruling *IT 2167* "Apportionment of Losses and Outgoings in Relation to Income-Producing Properties that are not wholly used for Deriving Rental Income", 4 July 1985, paragraph 3; Treasurer (1985) *Reform of the Australian Taxation System: Draft White Paper*, AGPS, Canberra; Taxation Ruling *IT 2343* "Income Tax: Limitation on Deduction for Interest on Borrowings Financing Rental Investments" 28 July 1986, withdrawn 3 September 1997. On the legislature's stance on negative gearing, see Subdiv G of Div 3 of Pt III of the 1936 Act; Commonwealth, *Parliamentary Debates*, House of Representatives, 17 April 1986, pp.2553-4 (Hurford, Minister for Immigration and Ethnic Affairs); and Commonwealth, *Parliamentary Debates*, House of Representatives, 29 October 1987, p.1720 (Duffy, Minister for Trade Negotiations). See also generally Leibler, M. "Taxation Deductions for Losses from Highly Geared Rental Investments: Issues of Law and Policy" (1984) 1 *Australian Tax Forum* 39; Krever, R. "Law Reform and Property Interests: Attacking the Highly Geared Rental Property Loophole" (1985) 10 *Legal Services Bulletin* 234; Krever, R. "Apportioning Interest Expenses" (1985) 1 *Australian Tax Forum* 413; Hamson, D. & Ziegler, P. "The Implications of Negative Gearing Restrictions and Capital Gains Taxation on Investment" (1986) 3 *Australian Tax Forum* 369; and Hanegbi, R. "Negative Gearing: Future Directions" (2002) 7 *Deakin Law Review* 349.

²⁶ Taxation Ruling *IT 166* "Income Tax: Interest on Money Borrowed to Acquire an Income Producing Asset", 14 December 1967, withdrawn 2 July 1997 (following the decision in *Steele v. FC of T* 97 ATC 4729). See also Richards, R. "Interest on Money Borrowed to Acquire an Income Producing Asset" (1985) 55(9) *The Australian Accountant* 76.

²⁷ Treasurer Press Release No. 45 of 30 June 1983. See also Taxation Ruling *IT 2167* "Apportionment of Losses and Outgoings in Relation to Income-Producing Properties that are not wholly used for Deriving Rental Income", 4 July 1985, paragraph 3.

²⁸ Hanegbi, R. "Negative Gearing: Future Directions" (2002) 7 *Deakin Law Review* 349, 354 citing Krever, R. "Apportioning Interest Expenses" (1985) 1 *Australian Tax Forum* 413.

²⁹ Treasurer (1985) *Reform of the Australian Taxation System: Draft White Paper*, AGPS, Canberra, pp.42, 46.

investors. The restrictions affected only real estate purchased after 17 July 1985. The reform quarantined any losses made from owning rental properties, so that any excess of deductions over rental income could not be used to reduce tax on other sources of assessable income.³⁰ However, losses could be carried forward to offset against future rental profits and reduce taxable gains made from other rental properties purchased after that date.³¹

This quarantine measure was justified on three main grounds: (i) taxpayers should not have to subsidise rental property investors; (ii) negative gearing resulted in increased home prices to the detriment of ordinary home buyers; and (iii) an estimated revenue gain of \$55m in 1986-87, \$100m in 1987-88, rising to \$195m in 1990-91 and subsequent years.³²

Due to various pressures, in one of the more remarkable backflips in Australian tax policy history, the government removed the measure, effective from 1 July 1987.³³ According to official records, repeal of the measure was justified on two main grounds: (i) uniformity of tax treatment of interest costs for all types of investment; and (ii) the belief that the excessive tax benefits offered to high income earners by negative gearing were adequately countered by other tax reform measures, notably introduction of the capital gains tax regime.³⁴ There were also unofficial reasons for the quick repeal of the measure, including an impending federal election and complaints from NSW facing a State election.³⁵

Since July 1987, negative gearing has been allowed on all forms of investments in Australia.³⁶

JUDICIAL APPROVAL OF NEGATIVE GEARING

Australian courts have made it quite clear that if there is to be any change to the law on negative gearing, it will require specific legislative amendment, rather than any change in judicial attitude or interpretation.³⁷

³⁰ The quarantining of interest deductions is a recommendation revived recently by ACOSS in "Taxation in Australia: Home Truths and International Comparisons" *ACOSS Info* 347, June 2003, p27 (Recommendation 4).

³¹ Hamson, D. & Ziegler, P. "The Implications of Negative Gearing Restrictions and Capital Gains Taxation on Investment" (1986) 3 *Australian Tax Forum* 369, 372, cited in Hanegbi, R. "Negative Gearing: Future Directions" (2002) 7 *Deakin Law Review* 349, 355. On difficult interpretation issues relating to implementation of the quarantining measures, see also Taxation Ruling *IT 2343* "Income Tax: Limitation on Deduction for Interest on Borrowings Financing Rental Investments" 28 July 1986, withdrawn 3 September 1997, and Gotterson, A. "Tax Brief: Negative Gearing" (1986) 57(5) *Chartered Accountant in Australia* 26-27.

³² Commonwealth, *Parliamentary Debates*, House of Representatives, 17 April 1986, pp.2553-4 (Hurford, Minister for Immigration and Ethnic Affairs).

³³ By virtue of sec.82KZD(1A), the quarantining measure did not apply to the 1987-88 and subsequent income years.

³⁴ Commonwealth, *Parliamentary Debates*, House of Representatives, 29 October 1987, p.1720 (Duffy, Minister for Trade Negotiations).

³⁵ Tax Institute of Australia "Tax Reform: let there be no Half Measures" (1998) 1 *Tax Specialist* 185, 204

³⁶ Hanegbi, R. "Negative Gearing: Future Directions" (2002) 7 *Deakin Law Review* 349, 355.

³⁷ On the judiciary's stance on negative gearing, see e.g. *FCT v Janmor Nominees Pty Ltd* (1987) 19 ATR 254; and *FCT v Hart* [2004] HCA 26, which confirmed the "legitimacy" of negative gearing.

*Janmor Nominees*³⁸ is the landmark case on negatively gearing rental properties. The decision in that case was handed down after the quarantine measures were repealed but was based on the law in place before those measures were introduced. The Court held that high gearing alone does not deprive interest payments of the character of outgoings incurred in gaining or producing assessable income. Merely because expenses exceed receipts does not justify a severance of outgoings into components, nor render the outgoings of a private, domestic or capital nature, nor activate any deeper enquiry into why the expenditure was incurred in determining whether a deduction should be allowed at all or whether it should be apportioned.³⁹

The precedent established in *Janmor Nominees* could be criticised on the basis that the Court has either ignored or applied inadequately the legal nexus and apportionment requirements of sec.8-1. If the courts were prepared to revisit *Janmor Nominees*⁴⁰ and the legal nexus and apportionment requirements, deductions from negative gearing could be effectively quarantined by relying on sec.8-1 without the need for legislative amendment. (Given the widespread acceptance of the *Janmor Nominees* decision by the courts in subsequent cases, by consecutive governments and by the ATO in its rulings, this possibility will probably never amount to more than wishful thinking).

The legitimacy of negative gearing on rental properties was confirmed by the High Court in 2004 in *Hart's case*,⁴¹ where the taxpayers maximised their loss from negative gearing by using a split loan and capitalising interest on their rental property while initially only paying off the mortgage on their family home. The High Court denied part of the interest deduction under Part IVA, but had no reason to upset the Full Federal Court's finding that the full interest expenditure was otherwise deductible under sec.8-1.

TWO CRITICAL ASSUMPTIONS

On closer examination, and as an appropriate starting point for analysis, it appears that two fundamental assumptions underlie the major arguments in the current policy debate on negative gearing.

- 1) Negative gearing increases house prices.
- 2) Negative gearing increases housing stock.

A core problem in the debate is that these assumptions have not been adequately tested. If they are wrong then the arguments that rely on them are misinformed and the direction of the policy debate has been misguided. If we are to have a meaningful debate on tax reform, we need to be reliably informed and make a choice between sound arguments based on correct and reliable information rather than on false assumptions.

On the first assumption, supporters of the tax shelter claim that increased house prices benefit homeowners, and refer to the fact that most Australians own their own home. Conversely critics claim it redistributes wealth and is inequitable to those who cannot afford their own home.

³⁸ *FCT v Janmor Nominees Pty Ltd* (1987) 19 ATR 254 (decision 7 September 1987).

³⁹ *FCT v Janmor Nominees Pty Ltd* (1987) 19 ATR 254, 262ff.

⁴⁰ *FCT v Janmor Nominees Pty Ltd* (1987) 19 ATR 254 (decision 7 September 1987).

⁴¹ *FCT v Hart* [2004] HCA 26 (27 May 2004).

On the second assumption, supporters claim that increased housing stock has led to lower rents and more affordable housing, which has also been good for construction, jobs and the economy. Critics assert that it has distorted investment away from production, and also argue this has led to increased housing debt and interest rates, with negative side effects for the Australian dollar and the economy.

It is impossible to resolve the debate without testing these critical assumptions. This paper below tests these assumptions and evaluates the related arguments using empirical evidence drawn from economic and taxation statistics.

ECONOMIC DATA

The most probative way of testing economic arguments about negative gearing is to test the statistical relationship over time between negative gearing rental losses and relevant economic variables. The strength of a statistical relationship between two variables can be found by ascertaining the correlation coefficient. The coefficient works on a scale from -1 to $+1$. A coefficient of 0 indicates no linear relationship between two variables. Plus 1 indicates a positive linear relationship between the variables. Minus 1 indicates a negative (inverse) linear relationship. Whether a coefficient is statistically significant depends on the magnitude of the coefficient and the number of data pairs from which the coefficient is derived.⁴²

Table 1 below provides a matrix of correlation coefficients for negative gearing rental losses and a range of relevant economic variables. Data on all the variables except “negative gearers” and “negative gearing rental losses” (which are derived from ATO Statistics) are sourced from the Australian Bureau of Statistics (using ABS definitions) over a period up to 17 years (1987 to 2004). The correlation coefficients shown in the table are obtained by comparing variations in each of the variables over a common period of time. Statistically significant values appear in **bold**.⁴³

⁴² A relatively high coefficient may not be statistically significant if it is derived from only a small number of data pairs. For example, if there are only 4 data pairs, a coefficient as high as 0.949 will still not be significant. Conversely, a relatively low coefficient could be significant if there are a large number of data pairs. For example, a coefficient of 0.25 would be significant if derived from 62 data pairs. See e.g. Bluman, A.G. (1992) *Elementary statistics: a step by step approach*, WCB, Dubuque, Appendix C, Table I “Critical Values for the PPMC”.

⁴³ The results shown in Table 1 are derived from Australian Taxation Office, *Taxation Statistics 1999-2000*, table 7; Australian Taxation Office, *Taxation Statistics 2000-01*, table 5, part D; Australian Taxation Office, *Taxation Statistics 2001-02*, table 5; Australian Bureau of Statistics, *Catalogue No. 6401.0* “Consumer Price Index, Australia”, 28 April 2004; Australian Bureau of Statistics, *Catalogue No. 8731.0* “Building Approvals, Australia”, 5 May 2004, table 10I; Australian Bureau of Statistics, *Catalogue No. 6248.0* “Wage and Salary Earners, Australia”, 11 April 2002 (discontinued), table H1 (construction, seasonally adjusted); Australian Bureau of Statistics, *Catalogue No. 6416.0* “House Price Indexes: Eight Capital Cities” 4 March 2004; Australian Bureau of Statistics, *Catalogue No. 5206.0* “Australian National Accounts: National Income, Expenditure and Product”, 3 March 2004; Reserve Bank of Australia, Statistics, *Interest Rates and Yields: Money Market and Commonwealth Government Securities*, table D05. The statistical analysis relies on Bluman, A.G. (1992) *Elementary statistics: a step by step approach*, WCB, Dubuque. Note for statistical correlation significance, there are 15 d.f. for all variable categories shown in the table, except “negative gearing rental losses”, “negative gearers” and “rental investors”, which have 6 d.f. and “construction jobs” with 12 d.f., except when joined with the previous 3, then only 4 d.f. This means a correlation coefficient magnitude in excess of 0.482 (15 d.f.), 0.707 (6 d.f.), 0.532 (12 d.f.) and 0.811 (4 d.f.) is significant (at 95% confidence, or 5% alpha).

TABLE 1: THE RELATIONSHIP BETWEEN NEGATIVE GEARING AND OTHER ECONOMIC DATA

CORRELATION	Negative gearing rental losses								
Negative gearers	0.9407	Negative gearers							
Rental investors	-0.7309	0.6999	Rental investors						
Invest. property loans	0.6073	0.3910	-0.2494	Investment property loans					
House prices	-0.2528	-0.5134	0.1896	-0.8830	House prices				
Dwelling approvals	-0.4516	-0.7075	0.1968	0.3624	-0.5254	Dwelling approvals			
Construction jobs	0.4375	-0.5036	0.4428	0.4837	-0.4629	0.5314	Construction jobs		
Capital formation	-0.7568	-0.7630	-0.4838	0.5766	0.5981	0.6016	0.8780	Capital formation	
Interest rates	0.4675	0.6573	0.4796	0.2719	0.7093	0.0916	0.2108	0.2286	Interest rate
Inflation	0.5832	0.4889	0.4793	0.3368	-0.0617	-0.0112	0.2604	0.2609	0.8097

Where there is a statistically significant correlation between negative gearing and another factor, it makes it possible to conclude that negative gearing could have an effect on that other variable, even causal, provided other possibilities can be excluded.

Where there is a weak correlation (close to 0), it makes it possible to exclude negative gearing as a factor that may affect the other variable. Therefore it should be noted that all the values shown in Table 1 under the column “negative gearing rental losses” might be useful.

The following key observations can be made from the coefficients in Table 1:

- There is a strong correlation between the number of negative gearers and the amount of negative gearing rental property losses.
- House prices have a strong positive relationship with interest rates and to a lesser extent with the amount invested in private fixed capital formation. House prices also have a significant inverse relationship with outstanding investment property loans. However, it is notable that house prices have no observable relationship with any other indicated variable, including negative gearing. This suggests that house prices rise anyway, regardless of negative gearing.
- Negative gearing appears to have a significant inverse relationship with capital formation and with the number of rental investors. Curiously, this means that negative gearing tends to fall as the level of capital formation and the number of rental investors rise. A similar relationship exists between the number of negative gearers and dwelling approvals and with capital formation.
- There is a positive correlation between negative gearing and interest rates. The relationship is not statistically significant but justifies closer attention.

These observations are relied upon in the next section of this paper, which tests two critical assumptions in the debate on negative gearing.

TESTING THE ASSUMPTIONS

Increased house prices

Housing prices have risen dramatically in the past few years,⁴⁴ but have fallen in recent times.⁴⁵ From a ratio of housing prices to average incomes, Australia has amongst the most expensive housing in the developed world.⁴⁶

On the other hand, the recent housing price boom in Australia is not unique. Since the mid-1990s, several other countries have recorded larger house price rises than Australia.⁴⁷

When it quarantined interest deductions on real estate investments in 1985, the government made an admission that negative gearing increased real estate prices.⁴⁸ In theory, by making property ownership more attractive to investors than it otherwise would be, it is contended that negative gearing leads to an increased demand for residential property and, in turn, real estate prices rise. It is argued that house prices continue to rise from negative gearing until the tax savings has been 'capitalised' into the price.⁴⁹ Economic modelling and research has been relied on to substantiate this price effect.⁵⁰

As Figure 1 shows, explosive growth in house prices really began in 1988. Some explain this by contending that removal of negative gearing restrictions in late 1987 brought investors back into the real estate market.⁵¹

The better view is that house prices rise anyway, regardless of negative gearing. They fluctuate widely around long-term trends.⁵² Many factors affect real estate prices. One factor is believed to be current income tax policy.⁵³ Statistics do not support the contention that negative gearing is an influential factor. Statistics show there is no observable relationship between negative gearing and house prices.⁵⁴ Other factors

⁴⁴ See e.g. Walkley, P. "Negative Thinking" (2003) 121 *The Bulletin* 62.

⁴⁵ Australian Bureau of Statistics, *Catalogue No. 6416.0* "House Price Indexes: Eight Capital Cities" 4 March 2004 and 2 September 2004.

⁴⁶ Hanegbi, R. "Submission – Housing Affordability" 21 October 2003, p.1, citing Ellis, L. & Andrews, D. "City Sizes, Housing Costs, and Wealth", *Research Discussion Paper No. 2001-08*, Economic Research Department, Reserve Bank of Australia, 2001, at 6.

⁴⁷ Productivity Commission, *First Home Ownership*, Inquiry Report No.28, 31 March 2004, p.19.

⁴⁸ Commonwealth, *Parliamentary Debates*, House of Representatives, 17 April 1986, p.2553 (Hurford, Minister for Immigration and Ethnic Affairs).

⁴⁹ Hanegbi, R. "Negative Gearing: Future Directions" (2002) 7 *Deakin Law Review* 349, 356, citing Hamson, D. & Ziegler, P. "The Implications of Negative Gearing Restrictions and Capital Gains Taxation on Investment" (1986) 3 *Australian Tax Forum* 369, 372.

⁵⁰ Britten-Jones, M. & McKibbin, W.J. "Tax Policy and Housing Investment in Australia" (1989) *Research Discussion Paper No.8907*, Reserve Bank of Australia, p.21, cited in Hanegbi, R. "Negative Gearing: Future Directions" (2002) 7 *Deakin Law Review* 349, 356.

⁵¹ Hughes, B. *et al* (1990) *State of Play 6: the Australian economic policy debate*, Allen & Unwin, Sydney, p.246.

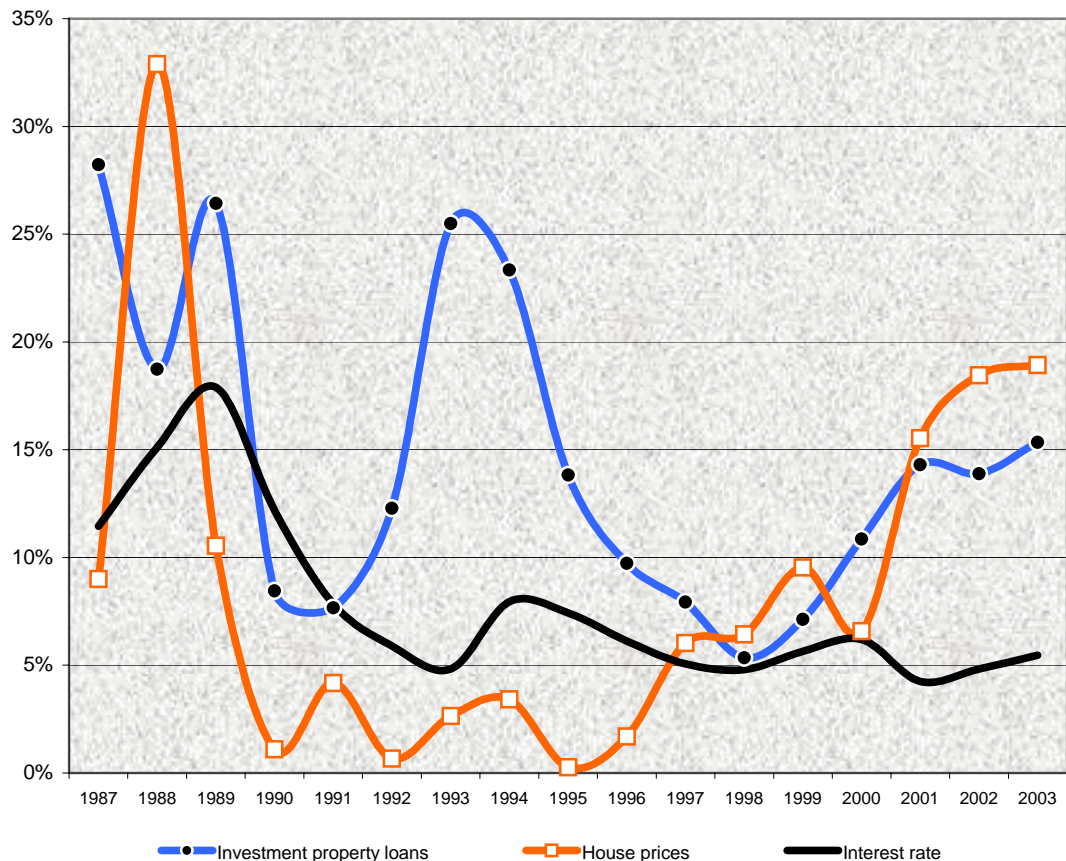
⁵² Productivity Commission, *First Home Ownership*, Inquiry Report No.28, 31 March 2004, p.39.

⁵³ Hanegbi, R. "Submission – housing affordability" 21 October 2003.

⁵⁴ From data obtained from Australian Taxation Office, *Taxation Statistics 1999-2000*, table 7, Australian Taxation Office, *Taxation Statistics 2000-01*, table 5, and Australian Bureau of Statistics, *Catalogue No. 6416.0* "House price indexes: Eight capital cities" 4 March 2004, the Pearson product moment correlation coefficient between the two is measured at -0.2528 . This is insignificant and indicative of no linear relationship between the variables. In magnitude, it is well below the critical value of 0.707 (at a significance level of 0.05) for a data series of 8 years (6 degrees of freedom). See e.g. Bluman, A.G. (1992) *Elementary statistics: a step by step approach*, WCB, Dubuque, pp.377-383, 554.

need to be considered, including interest rates and private fixed capital formation, the latter being a factor related to both negative gearing and house prices.

FIGURE 1: GROWTH IN HOUSE PRICES AND INVESTMENT PROPERTY LOANS AND MOVEMENTS IN INTEREST RATES IN AUSTRALIA 1987–2003⁵⁵



The gap between growth in house prices and housing loans in 1988 can be explained by the October 1987 stock market crash, when investors sold out of equities seeking better returns from residential property. Growth in investor property loans resurged as more investors entered the real estate market, forcing a credit squeeze as house prices soared and interest rates climbed to record levels.⁵⁶

The rise in house prices and investment loans in recent years can also be attributed to tax reforms including introduction of the CGT discount in September 1999, and the GST and first home owner grants after June 2000.

The Productivity Commission, in its 2004 housing affordability inquiry, found that negative gearing is just one feature of Australia's income tax system that may be

⁵⁵ Australian Bureau of Statistics, *Catalogue No. 6416.0 "House Price Indexes: Eight Capital Cities"* 4 March 2004; Australian Bureau of Statistics, *Catalogue No. 6401.0 "Consumer Price Index, Australia"* 28 April 2004; Reserve Bank of Australia, Statistics, *Interest Rates and Yields: Money Market and Commonwealth Government Securities*, table D05 bank lending classified by sector.

⁵⁶ Hughes, B. *et al* (1990) *State of Play 6: The Australian Economic Policy Debate*, Allen & Unwin, Sydney, p.246.

contributing to house price pressures, although in principle negative gearing does not favour private investment in rental housing over other passive investments. While it recommended broader review of a range of features of the income tax system, the Productivity Commission indicated that the focus should be on the capital gains tax regime.⁵⁷

Increased housing stock

It has been argued that negative gearing increases the availability of rental properties in the long run by increasing new housing construction.⁵⁸ Support is given for this view in a 1989 Reserve Bank study that found a lowering of tax incentives available to real estate investors leads to a decrease in the construction of real estate.⁵⁹ Those who run this argument also refer to the slowdown of new residential construction for the period when negative gearing was abolished.⁶⁰

Statistics do not support the argument that negative gearing leads to an increase in the number of dwellings, as there is no firm correlation between the two variables.⁶¹ There is also no observable relationship between negative gearing and construction activity or rental property loans. Curiously, the inverse relationship suggested by the statistics between negative gearing and the number of rental property investors supports a contrary conclusion.⁶² This may give weight to the hypothesis that as negative gearing is capitalised into rental housing prices, the return on the capital invested is diminished.

It is fallacious to assume interchangeability in negative gearing and the construction of new dwellings. Rental property investors do not need to build because they can purchase from owner-occupiers or other investors. Housing stock levels need not change to accommodate an increase in rental property investment. What might be expected to change is the ratio of rental premises compared to owner occupied dwellings.

It is also misleading to claim, as the real estate industry did at the time, that the previous Government's decision to remove the tax benefits of negative gearing for new residential property investments was the primary reason for a collapse in property markets in the mid 1980s. The main reasons were increases in interest rates and the greater attractiveness of shares as an investment vehicle. And, it must be noted, the 'collapse' was confined largely to Sydney.⁶³

⁵⁷ Productivity Commission, *First Home Ownership*, Inquiry Report No.28, 31 March 2004, chapter 5.

⁵⁸ Hanegbi, R. "Negative Gearing: Future Directions" (2002) 7 *Deakin Law Review* 349, 359.

⁵⁹ Britten-Jones, M. & McKibbin, W.J. "Tax Policy and Housing Investment in Australia" (1989) *Research Discussion Paper No.8907*, Reserve Bank of Australia, p.21, cited in Hanegbi, R. "Negative Gearing: Future Directions" (2002) 7 *Deakin Law Review* 349, 359.

⁶⁰ Hanegbi, R. "Negative Gearing: Future Directions" (2002) 7 *Deakin Law Review* 349, 359, citing Australian Bureau of Statistics Catalogue No. 8750.0.

⁶¹ Even if it does, a subsidy for purchasers of newly constructed housing might be considered a more efficient and direct method to encourage the construction of new dwellings. See e.g. Hanegbi, R. "Submission – Housing Affordability" 21 October 2003, p.3.

⁶² On these statistical relationships, refer to the table of correlation coefficients at Table 1 of this paper.

⁶³ May, A. "Unit Defence" *Sydney Morning Herald*, 10 April 2003; Badcock, B.A. & Browett, M.H. (1993) "The Responsiveness of the Private Rental Sector in Australia to Changes in Commonwealth Taxation Policy", in *Housing Studies* Vol.6 No.3; Beer, G. "Work Incentives under a New Tax System" *Paper for 2002 Conference of Economists*, Adelaide, October 2002.

CONTRADICTED ARGUMENTS

Having formed a view that several critical assumptions about negative gearing are false, it is important to isolate the arguments that rely on them. The major arguments contradicted by the statistics are summarised in Table 2 and are discussed in turn below.

TABLE 2: SUMMARY OF ARGUMENTS BASED ON THE FALSE ASSUMPTIONS

Tax Policy Criteria	Summary of Contradicted Arguments
Equity	Negative gearing rewards home ownership due to rising house prices
Equity	Negative gearing discriminates against non-home owners (the young and poorer sections of the community) by locking them out of the real estate market with increased house prices
Equity	Negative gearing makes rental accommodation more affordable by lowering rents as a result of an increased supply of rental properties and lower costs for landlords
Efficiency	Negative gearing is good for the economy because it has led to increased jobs and activity in the residential construction sector
Efficiency	Negative gearing leads to a substitution of investment from productive capital formation into real estate and other appreciating assets

Negative gearing rewards home ownership

Australia has a high rate of home ownership. If negative gearing has raised house prices, the one group clearly benefited by it is homeowners, who represent approximately two-thirds of the population.⁶⁴

This argument is contradicted by the statistics, which indicate there is no relationship between negative gearing and house prices.

Wealth inequality

“Home ownership is falling. It is harder than ever for younger or poorer Australians to become homeowners.”⁶⁵

Statistics show that home ownership for first homebuyers is becoming increasingly difficult to attain, even after direct measures such as the first home owners grants have been implemented.

For example, in March 2004 the percentage of first homebuyers fell to a record low of 12.5%, a continuation of the general decline since the record high of 25.8% set in July 2001.⁶⁶

⁶⁴ Hanegbi, R. “Negative Gearing: Future Directions” (2002) 7 *Deakin Law Review* 349, 365; Australian Bureau of Statistics, *Catalogue No. 4130.0* “Housing Occupancy and Costs, Australia”, 15 October 1999.

⁶⁵ Senator Andrew Murray, Australian Democrats, *Press Release Number 03/485*, 3 July 2003.

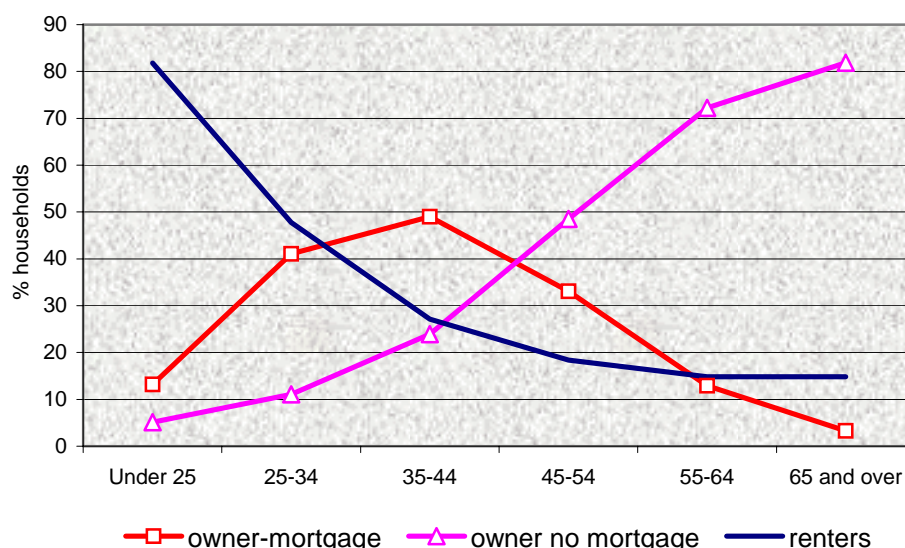
⁶⁶ Australian Bureau of Statistics, *Catalogue No. 5609.0* “Housing Finance, Australia”, 12 May 2004.

If negative gearing has led to increased real estate prices, it has advantaged people who own real estate at the expense of those who do not.⁶⁷

Assuming this to be correct, the broad effect of rising real estate prices is a redistribution of wealth from those who do not own real estate to those who do, from the poorer to the wealthier sections of the community.⁶⁸

Higher real estate prices will tend to ‘lock out’ some people (usually younger persons and lower income earners) who have not yet entered the real estate market.⁶⁹ It can accelerate increases in house prices, making it harder for people to buy their first home.⁷⁰ A recent study has confirmed that while young homeowners are likely to have particularly high leverage, young households in general are less likely to be homeowners.⁷¹ It is relevant to look at the demographics of home ownership, as shown in Figure 2.

FIGURE 2: AGE OF OWNER OCCUPIERS AND RENTERS, 1995-96⁷²



The proportion of baby boomers owning rental property is notably high when compared to ownership by 18-34 year olds, who held 23% and 19% of rental

⁶⁷ See e.g. Hanegbi, R. “Negative Gearing: Future Directions” (2002) 7 *Deakin Law Review* 349.

⁶⁸ People who own real estate are clearly advantaged when prices rise. The benefit can be realised by selling the property or borrowing against the increased equity. People who have not yet entered the real estate market, and those who wish to upgrade to real estate of greater value, are clearly disadvantaged by increased real estate prices. See e.g. Hanegbi, R. “Negative gearing: future directions” (2002) 7 *Deakin Law Review* 349, 356-7.

⁶⁹ Hanegbi, R. “Negative Gearing: Future Directions” (2002) 7 *Deakin Law Review* 349, 357.

⁷⁰ May, A. “Unit Defence” *Sydney Morning Herald*, 10 April 2003.

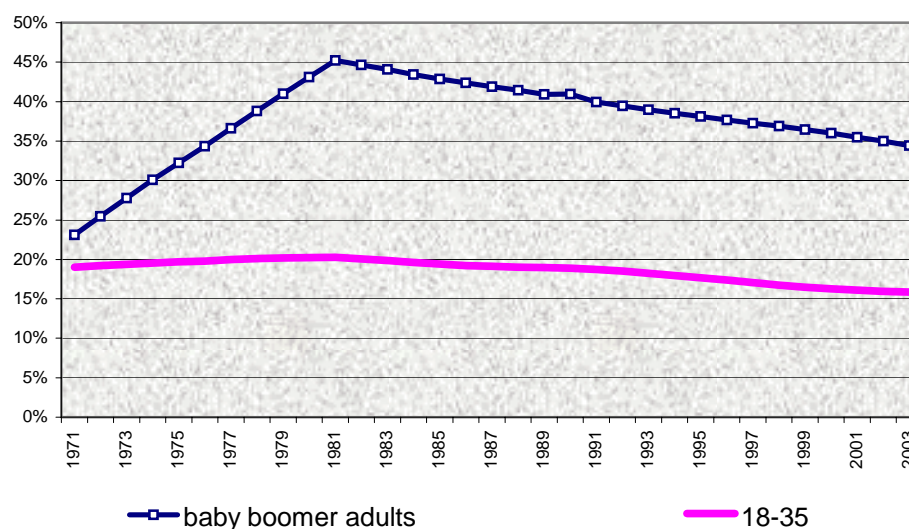
⁷¹ Ellis, L., Lawson, J. & Roberts-Thomson, L. “Housing Leverage in Australia”, *Research Discussion Paper 2003-09*, Economic Group Reserve Bank of Australia, July 2003, p.31.

⁷² Australian Bureau of Statistics, *Australian Social Trends 1998* “Housing - housing stock: wealth in the family home”.

properties in 1993 and 1997 respectively, but who represented 18.2% and 17.1% of the adult population.⁷³

It is also important to understand the demographics of home ownership when considering political implications. While negative gearing and home ownership are generally more associated with the baby boomer generation, Figure 3 illustrates that as a percentage of the voting population, baby boomers are a significant but declining force.

FIGURE 3: ADULT BABY BOOMERS AND 18-35 YEAR OLDS AS A PERCENTAGE OF VOTING AGE AUSTRALIANS⁷⁴



Affordability of homeownership for younger Australians is a serious issue. However, the absence of a statistically significant relationship between negative gearing and house prices suggests that blame should not rest with negative gearing.

Lower rents

Renting has become unaffordable for many Australians.⁷⁵

There are two ways negative gearing could lead to lower rents: (i) by increasing the supply of rental properties; and (ii) by lowering costs for landlords.⁷⁶

Economic analysis of the Australian real estate market has given support to the theory that in the long term, the tax shelter of negative gearing increases the supply of rental properties and leads to lower rents.⁷⁷

⁷³ Australian Bureau of Statistics, *Catalogue No. 3201.0* "Population by Age and Sex, Australian States and Territories", 19 December 2003, Table 9.

⁷⁴ Australian Bureau of Statistics, *Catalogue No. 3201.0* "Population by Age and Sex, Australian States and Territories", 19 December 2003, Table 9.

⁷⁵ Senator Andrew Murray, Australian Democrats, *Press Release Number 03/485*, 3 July 2003, who observed that more than 60% of renters on low or moderate incomes pay unaffordable rents (more than 30% of their income).

⁷⁶ Tax Institute of Australia "Tax reform: Let there be no half measures" (1998) 1 *Tax Specialist* 185, 204, cited in Hanegbi, R. "Negative Gearing: Future Directions" (2002) 7 *Deakin Law Review* 349, 360.

As the theory goes, because residential housing stock is fixed in the short term, negative gearing is not expected to increase the supply of rental accommodation or materially affect rents in the short term. In the long term, however, if negative gearing increases the supply of rental accommodation more than it increases demand, it could lead to lower rents.⁷⁸

The critical flaw in this argument is the assumption that negative gearing increases the supply of rental properties. This premise is contradicted by statistical evidence that there is no firm correlation between negative gearing and the number of dwellings.

Those who support negative gearing, and the argument that it leads to lower rents, often refer to the state of the Sydney property market in the period when the tax shelter was abolished between 1985 and 1987. During this period there were large rental increases in parts of Sydney.

It involves a quantum leap in logic, a *non sequitur*,⁷⁹ to imply from this that negative gearing leads to lower rents. It is not possible to attribute the rise in Sydney conclusively to the abolition of negative gearing. There was no real increase across the rest of Australia and in fact many cities experienced a real decrease in rents over the same period.⁸⁰

Moreover, it is doubtful that landlords would pass on the benefits of negative gearing to tenants in the form of lower rents. First it is doubtful that negative gearing reduces costs to landlords. Second, it is doubtful that any benefit can be passed on if it is already fully capitalised in the price of the property. Third, it is doubtful that landlords have the altruism to defy market forces and pass on lower costs to tenants.⁸¹

Statistics indicate the rise in housing costs for private renters in Australia is comparable to the rise in house prices.⁸² If house prices rise then housing loans and

⁷⁷ Britten-Jones, M. & McKibbin, W.J. "Tax Policy and Housing Investment in Australia" (1989) *Research Discussion Paper No.8907*, Reserve Bank of Australia, p.21, cited in Hanegbi, R. "Negative Gearing: Future Directions" (2002) 7 *Deakin Law Review* 349, 361.

⁷⁸ Hanegbi, R. "Negative Gearing: Future Directions" (2002) 7 *Deakin Law Review* 349, 360.

⁷⁹ In logic, this reasoning involves the classical fallacy that succession in time implies a causal relationship. This fallacy is often cited in the Latin maxim *post hoc, ergo propter hoc*. See e.g. Nygh, P.E. & Butt, P. (eds) (1997) *Butterworths Concise Australian legal dictionary*, Butterworths, Sydney, pp.277, 309.

⁸⁰ Hanegbi, R. "Negative Gearing: Future Directions" (2002) 7 *Deakin Law Review* 349, 361; Hanegbi, R. "Submission – housing affordability" 21 October 2003, p.3, citing Badcock, B.A. & Browett, M.H. (1993) "The Responsiveness of the Private Rental Sector in Australia to Changes in Commonwealth Taxation Policy", in *Housing Studies* Vol.6 No.3, and Hayward, D. and Burke, T. "Justifying the Unjustifiable" (1988) 7(8) *Australian Society* 16, and <http://www.smh.com.au/articles/2003/08/24/1061663676588.html?from=storyrhs> quoting ANZ Chief Economist Saul Eslake.

⁸¹ Cf. Hanegbi, R. "Negative Gearing: Future Directions" (2002) 7 *Deakin Law Review* 349, 361, citing Krever, R. "Law Reform and Property Interests: Attacking the Highly Geared Rental Property Loophole" (1985) 10 *Legal Services Bulletin* 234.

⁸² Between 1995-96 and 2000-01, for example, real average weekly housing costs for private renters rose by 4% from \$166 to \$173. Over the same period, the mean value of all owner-occupied dwellings in Australia rose by 5% from \$171,000 to \$180,000. This rise in house values was not reflected in average weekly housing costs for owners with a mortgage, which fell from \$227 to \$220. This reflects the substantial falls in housing loan interest rates over the period. See Australian Bureau of Statistics, *Catalogue No. 4130.0.55.001* "Housing Occupancy and Costs, Australia", 21 April 2004; Australian Bureau of Statistics, *Australian Social Trends 1998* "Housing - housing stock: wealth in the family home".

borrowing costs would also be higher. There is little reason why landlords should not pass on the increased costs in the form of higher rents.

Even if negative gearing does make renting more affordable, there are more direct, efficient, well-targeted and equitable ways to achieve this outcome.⁸³

Construction jobs and the economy

It is claimed that negative gearing has increased jobs and activity in the residential construction sector, growing our residential housing stock and contributing about 3% to the economy.⁸⁴

The claim that residential housing contributes about 3% to the economy may be true. However, the view that negative gearing has contributed to jobs and activity in this sector is, with respect, misconceived.

After the Victorian Deputy Commissioner denied negative gearing in 1983, supporters of negative gearing observed economic dislocation, due to a stifling of real estate investment and declining growth in the housing sector. The Federal Minister for Housing and Construction concurred with this observation.⁸⁵

It was predicted that the construction industry would falter and the decline would flow on to other industries and employment levels would suffer.⁸⁶ Statistics later proved this prediction was unfounded.

Worker numbers in the construction industry have varied cyclically with dwelling approvals and have broadly followed movements in house prices and investment property loans. Figure 4 shows a decline in dwelling approvals in the 1985-86 and 1986-87 years, followed by a strong upwards swing in 1987-88 and 1988-89. While this corresponds in time with the introduction and removal of the quarantining measures, it does not necessarily follow that negative gearing has led to increased construction jobs. Movements in construction activity spanning the quarantining period can be attributed to cyclical factors affecting the state of the economy, as indicated in Figure 5.⁸⁷

⁸³ For example, a program of increased rental assistance. See e.g. Hanegbi, R. "Negative Gearing: Future Directions" (2002) 7 *Deakin Law Review* 349, 362; Hanegbi, R. "Submission – Housing Affordability" 21 October 2003, p.3; Senator Andrew Murray, Australian Democrats, *Press Release Number 03/423*, 13 June 2003.

⁸⁴ See e.g. Senator Andrew Murray, Australian Democrats, *Press Release Number 03/485*, 3 July 2003.

⁸⁵ Leibler, M. "Taxation Deductions for Losses from Highly Geared Rental Investments: Issues of Law and Policy" (1984) 1 *Australian Tax Forum* 39, 52, citing 8 *Commonwealth Record No.27*, p.981 (7 July 1983).

⁸⁶ Leibler, M. "Taxation Deductions for Losses from Highly Geared Rental Investments: Issues of Law and Policy" (1984) 1 *Australian Tax Forum* 39, 52-3.

⁸⁷ As can be seen in the graph below, there are repeated troughs in employment in the construction industry and at the same time in the wider economy, with the sharpest downturn during the recession in 1990 and 1991.

FIGURE 4: GROWTH AND DECLINE IN CONSTRUCTION JOBS AND DWELLING APPROVALS⁸⁸

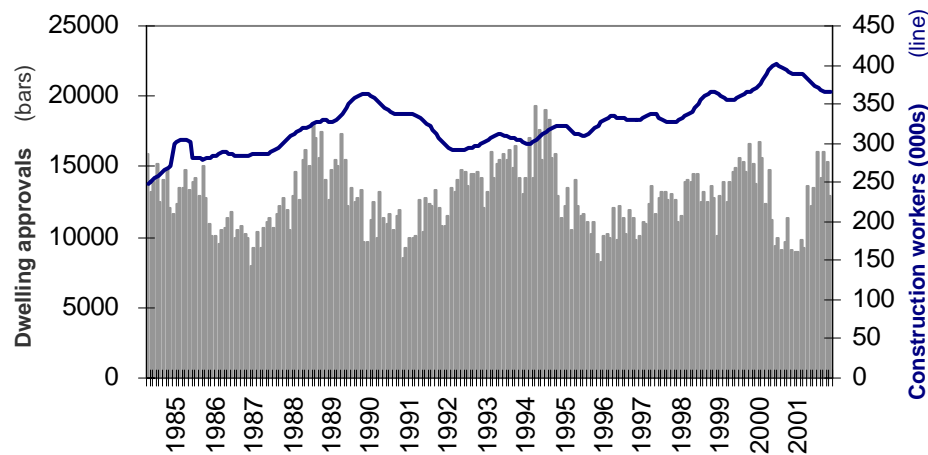
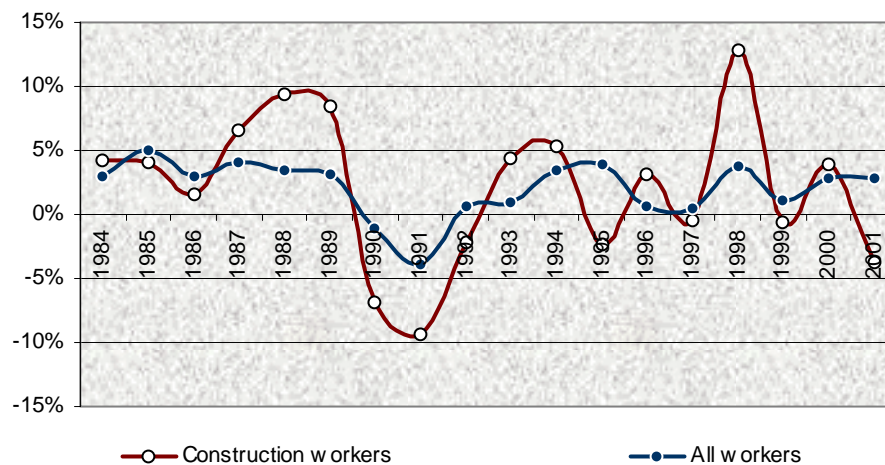


FIGURE 5: GROWTH & DECLINE IN NUMBER OF CONSTRUCTION WORKERS & ALL WORKERS⁸⁹



The fact that there is a negative correlation between negative gearing and building approvals and worker numbers in the construction sector contradicts the argument that negative gearing has led to increased jobs and activity in that sector.

It is not possible to conclude that jobs would be lost if negative gearing was abolished. In fact, statistics support the converse argument that higher rental losses from negative gearing may retard jobs growth and activity in the sector. The data is consistent with the hypothesis that when more people are attracted to rental property investments, they

⁸⁸ Australian Bureau of Statistics, *Catalogue No. 8731.0* “Building Approvals, Australia”, 5 May 2004, table 10I; Australian Bureau of Statistics, *Catalogue No. 6248.0* “Wage and Salary Earners, Australia”, 11 April 2002 (discontinued), table H1 (construction, seasonally adjusted).

⁸⁹ Australian Bureau of Statistics, *Catalogue No. 6248.0* “Wage and Salary Earners, Australia”, 11 April 2002 (discontinued), table H1 (seasonally adjusted).

look to buy established houses rather than build new ones, and therefore the level of housing stock is not affected.⁹⁰

Even if it can be proven that negative gearing does encourage construction of new housing, there are more direct and efficient ways to achieve this.⁹¹

Distortion of investment

Critics of negative gearing argue that the tax shelter encourages investment in assets such as property and shares that appreciate in value, rather than capital used in other areas of production that add value to the economy.⁹² Pointing to the recent growth in investment in inner city apartments and other rental properties,⁹³ critics claim that policies intended to ignite investment in new technologies have instead fuelled an old-fashioned Australian property boom.⁹⁴

The tax system is not neutral, and offends the tax design principle of efficiency, if tax shelters, such as negative gearing, lead to an over-investment in dwellings, or the over-gearing of rental properties.⁹⁵

Statistics support the view that when negative gearing in rental properties increases, growth in fixed capital investment tends to fall, and *vice versa*. They show a strong negative linear relationship between negatively geared rental property losses and private fixed capital formation.⁹⁶

⁹⁰ On the relationship between negative gearing and increased investment in rental properties, see the discussion above on the argument that negative gearing has increased housing stock.

⁹¹ Hanegbi, R. "Negative Gearing: Future Directions" (2002) 7 *Deakin Law Review* 349, 359, citing Australian Bureau of Statistics, *Catalogue No. 8750.0*. See also Hanegbi, R. "Submission – Housing Affordability" 21 October 2003, p.3; Australian Bureau of Statistics, *Catalogue No. 8750.0* "Building Activity Australia, Dwelling Unit Commencements, Preliminary" 18 March 2004; and Australian Bureau of Statistics, *Catalogue No. 5609.0* "Housing Finance, Australia", 12 May 2004. Some would now regard the benefits of the first homeowners' grants as illusory. Although they had an initial impact on construction, it only provided short-term relief, since the grants may have largely fed increased construction costs and house prices.

⁹² Senator Andrew Murray, Australian Democrats, *Press Release Number 03/423*, 13 June 2003; Australian Democrats, *Press Release Number 03/485*, 3 July 2003; Hanegbi, R. "Submission – housing affordability" 21 October 2003, p.2; May, A. "Unit Defence" *Sydney Morning Herald*, 10 April 2003, citing the fact that former Industry Minister Senator John Button once questioned why people would invest in manufacturing at all, when better tax breaks were available from Gold Coast apartments.

⁹³ ACOSS "Taxation in Australia: Home Truths and International Comparisons" *ACOSS Info 347*, June 2003, p.23. See also Senator Andrew Murray, Australian Democrats, *Press Release Number 03/423*, 13 June 2003; and Hanegbi, R. "Submission – Housing Affordability" 21 October 2003.

⁹⁴ ACOSS "Taxation in Australia: Home Truths and International Comparisons" *ACOSS Info 347*, June 2003, p.23.

⁹⁵ The availability of depreciation deductions on capital of production may be thought to provide a comparable tax incentive for investment in productive assets. However, throwing tax expenditure at a problem caused by other tax expenditure is not the ideal solution for a tax system. Just as two wrongs don't make a right, it hard to accept that the distortions caused by negative gearing and the CGT discount could be neutralised by the depreciation deduction, as rental property investors also claim deductions for depreciation and building write-off.

⁹⁶ From data obtained from Australian Taxation Office, *Taxation Statistics 1999-2000*, table 7, Australian Taxation Office, *Taxation Statistics 2000-01*, table 5, and Australian Bureau of Statistics, *Catalogue No. 5206.0* "Australian National Accounts: National Income, Expenditure and Product", 3 March 2004, table 33, the correlation coefficient between the two is measured at -0.80991 . This is significant because it exceeds in magnitude the critical value of 0.754.

This does not mean there is a causal relationship. It does not necessarily follow that negative gearing causes investment dollars to be pulled out of fixed capital formation. Observations below suggest four possible alternatives: (i) the relationship could work in the other direction, i.e. investment in fixed capital leaves fewer dollars for investment in negatively geared rental properties; (ii) the relationship may be caused by a third variable, e.g. investment loan finance or interest rates; (iii) there could be a complexity of interrelationships among many variables; or (iv) the relationship may be coincidental.⁹⁷

First, it may be observed that there is no statistically significant relationship between fixed capital formation and the number of rental property investors.⁹⁸

Second, there was no significant rise in private fixed capital formation when the tax shelter of negative gearing was abolished in the 1986 and 1987 years.⁹⁹ Nor was there any drop in private capital formation growth when the tax shelter was reinstated in the 1988 year. In fact, there was a near record 22.1% and 22.8% rise in 1988 and 1989 respectively.¹⁰⁰

Third, while there is evidence that negative gearing increases investment in rental properties, this does not mean it takes valuable investment dollars away from productive capital into the construction of new dwellings.¹⁰¹

Fourth, even if there was a linear causal relationship between negative gearing and fixed capital formation, it cannot be assumed that there is an equal rate of substitution. The fact that the amount of funds invested in fixed capital formation each year far exceeds the total equity in rental properties that are negatively geared indicates that major changes in negative gearing activity and rental property investment would probably not have as large an impact on fixed capital investment.

In the 1997 year, for example, over \$93.6 billion was invested on private fixed capital formation in Australia.¹⁰² As at 30 June 1997, after taking into account investment loan finance,¹⁰³ an estimated \$66.1 billion was invested in equity in negatively geared

⁹⁷ On the alternative statistical explanations, see e.g. Bluman, A.G. (1992) *Elementary Statistics: A Step by Step Approach*, WCB, Dubuque, pp.382-3.

⁹⁸ From data obtained from Australian Taxation Office, *Taxation Statistics 1999-2000*, table 7, Australian Taxation Office, *Taxation Statistics 2000-01*, table 5, and Australian Bureau of Statistics, *Catalogue No. 5206.0 "Australian National Accounts: National Income, Expenditure and Product"*, 3 March 2004, table 33, the correlation coefficient (-0.4838) suggests at best a weak relationship between the two variables.

⁹⁹ The rise in 1986 (12.0%) and 1987 (9.3%) were both close (within 0.3 standard deviations) to the mean rate of growth (9.6%) for the period 1961-2003. See Australian Bureau of Statistics, *Catalogue No. 5206.0 "Australian National Accounts: National Income, Expenditure and Product"*, 3 March 2004, table 33.

¹⁰⁰ Australian Bureau of Statistics, *Catalogue No. 5206.0 "Australian National Accounts: National Income, Expenditure and Product"*, 3 March 2004, table 33.

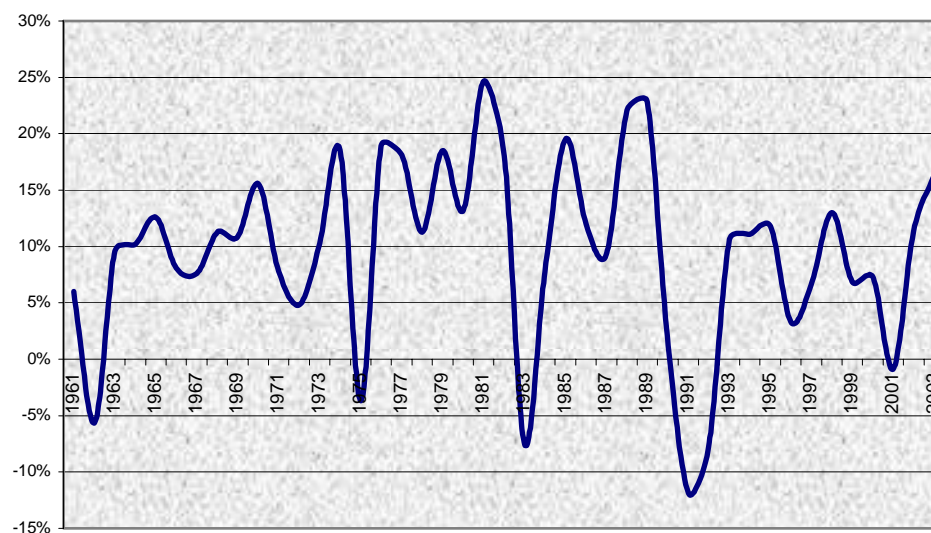
¹⁰¹ Refer to the argument on increased investment in rental properties in the discussion above addressing the assumption that negative gearing has led to increased housing stock.

¹⁰² Australian Bureau of Statistics, *Catalogue No. 5206.0 "Australian National Accounts: National Income, Expenditure and Product"*, 3 March 2004, table 33.

¹⁰³ Rather than averaging investment loans across all rental properties, this estimate is made from calculating the ratio of number of negatively geared investors to the number of investors who claimed rental interest deductions. For 1997, it is estimated that 78.2% of investment loan funds were borrowed by negatively geared investors. Applied to \$40.4 billion in private investment loans, this gives an estimate of \$31.6 billion outstanding loans by negatively geared investors. See Australian Taxation

rental properties.¹⁰⁴ Note that negative gearing rental losses that year are small in comparison (\$2.78 billion).¹⁰⁵

FIGURE 6: GROWTH AND DECLINE IN PRIVATE FIXED CAPITAL FORMATION, 1961-2003¹⁰⁶



The economic data suggests but does not compel the conclusion that the tax shelter of negative gearing leads to a substitution of investment from productive capital into rental properties.

SUPPORTED ARGUMENTS

The major arguments that are supported by the statistics are summarised in Table 3 and are discussed below.

Office, *Taxation Statistics 1996-97*, table 6: Individuals, Items for income years 1986-87 to 1996-97; Reserve Bank of Australia, Statistics, *Interest Rates and Yields: Money Market and Commonwealth Government Securities*, table D05 bank lending classified by sector; and discussion of the impact of negative gearing on housing finance below.

¹⁰⁴ In 1997 the estimated total value of private rental properties was \$181.1 billion. There were an estimated 1,448,800 private rental properties in Australia. The estimated median value was \$125,000. The estimated value of negatively geared properties was \$97.656 billion. Taxpayers who negatively geared accounted for approximately 53.9% of all taxpayers who reported as rental property investors. Applying this proportion to the estimated total number of rental properties (1,448,800), there were an estimated 781,248 negatively geared rental properties in 1997. The estimated value is found by multiplying this figure by the estimated median value of \$125,000. See Australian Taxation Office, *Taxation Statistics 1999-2000*, table 7; Australian Taxation Office, *Taxation Statistics 2000-01*, table 5; and Australian Bureau of Statistics, *Australian Social Trends 1999*, "Housing – Housing Stock: Rental Investors".

¹⁰⁵ Australian Taxation Office, *Taxation Statistics 1999-2000*, table 7, Australian Taxation Office, *Taxation Statistics 2000-01*, table 5.

¹⁰⁶ Australian Bureau of Statistics, *Catalogue No. 5206.0 "Australian National Accounts: National Income, Expenditure and Product"*, 3 March 2004, table 33.

TABLE 3: SUMMARY OF ARGUMENTS SUPPORTED BY THE STATISTICS

Tax Policy Criteria	Summary of Supported Arguments
Revenue	Negative gearing results in a loss of government taxation revenue of approximately \$2 billion each year and growing
Equity	Negative gearing rewards taxpayers on higher marginal rates more than lower income taxpayers
Efficiency	Negative gearing attracts significantly more loan finance to rental properties than owner-occupied dwellings, and more investment loans are used for negatively geared rental properties than positively geared properties
Efficiency	Statistics suggest a positive correlation between negative gearing and interest rates, but the relationship is not significant. Further research is required. If negative gearing does affect interest rates then it would also have an impact on the value of the Australian dollar.
Efficiency	Negative gearing has been linked to declining birth rates, as higher real estate prices lead to increased mortgage commitments for young families. However, there may be stronger factors linked to the decline, including perhaps the increasing proportion of women in the workforce.

Loss of Taxation Revenue

The revenue leakage from negative gearing is significant, estimated at close to \$2 billion and rising.

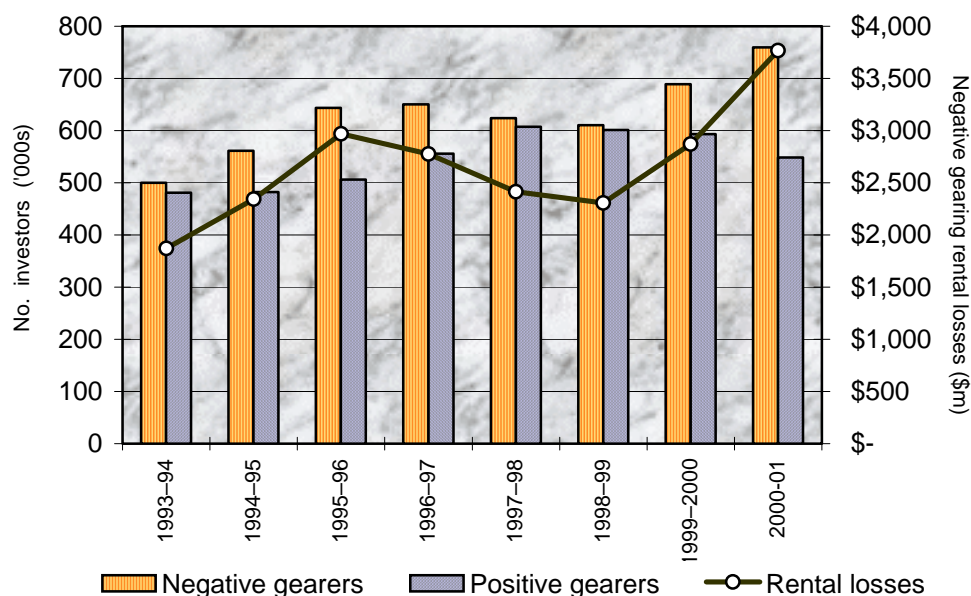
Figure 7 shows there has been an alarming rise in the amount of negative gearing rental losses and in both the number and proportion of rental property investors who take advantage of negative gearing.

Negative gearing has an impact on the revenue comparable to the CGT discount.¹⁰⁷

During the 1999 Senate Inquiry into Business Taxation Reform, negative gearing was identified as the largest source of revenue leakage from proposed Ralph capital gains tax reforms (including introduction of the 50% CGT discount). Professor Krever explained to the Inquiry that he expected the tax revenue costs from negative gearing to 'balloon significantly' as the mismatch between immediate interest deductions and the taxable portion of capital gains is enormous and so too is the incentive for tax minimisation by negative gearing.¹⁰⁸

¹⁰⁷ The CGT discount for individuals and trusts is one of the largest categories of tax expenditure, reported at \$2.36 billion. See Department of Communications, Information, Technology and the Arts, *Tax expenditures statement 2003*, pp.8-9.

¹⁰⁸ Commonwealth of Australia, *Senate Finances and Public Administration References Committee, Inquiry into Business Taxation Reform*, Canberra, Senate Printing Unit, 1999, pp.23-33 and Evidence, 11 November 1999, p.105.

FIGURE 7: GROWTH IN NEGATIVE GEARING OF RENTAL PROPERTIES 1993-94 TO 2000-01¹⁰⁹

CGT exacerbates the revenue leakage problem as negative gearing enables income to be converted to capital. While the revenue loss from negative gearing has the same effect as a tax expenditure,¹¹⁰ unlike the CGT discount it is excluded from tax expenditure reporting. At first glance, one might query whether this is for political reasons – as the Government is spared the embarrassment of revealing how much this tax shelter really costs. However the official reason for the exclusion is that negative gearing is considered ‘a design feature’ of the Australian tax system. Many Australians may find it difficult, however, to understand why negative gearing qualifies as a design feature of their tax system whereas the CGT discount does not.¹¹¹

Negative gearing has led to a blow out in rental property deductions, leaving the ATO with a revenue leakage problem. The Commissioner of Taxation has on more than one occasion publicly acknowledged the rental property sector as a major tax compliance problem. Frustrated by government policy to protect negative gearing, the ATO has only been able to caution taxpayers with increased audit activity.

¹⁰⁹ Australian Taxation Office, *Taxation Statistics 1999-2000*, Table 7: Personal Tax, Selected items for income years 1993-94 to 1999-2000; Australian Taxation Office, *Taxation Statistics 2000-01*, table 5

¹¹⁰ In recognition of the cost to the revenue of rental property investments, the current Howard government has announced it will take measures to improve compliance in the area of rental property deductions and capital gains. It has not provided an estimate of the revenue expected to be clawed back in the crackdown. It seems anomalous that the government is seeking ways to crack down on deductions and capital gains in the rental property sector, while at the same time maintain negative gearing as a tax shelter draining billions in revenue dollars. See Treasurer, *Press Release No. 40*, 11 May 2004. Cf. reports from the budget that the Government “plans to steal back more than \$1 billion across the board through a crackdown on tax evasion, from big business to individual”, with the ATO to receive \$326 million over 4 years to run new audits and reviews: Middleton, K. “Costello Spends up to Woo Middle Australia”, *The West Australian*, Budget04, 12 May 2004, p.2.

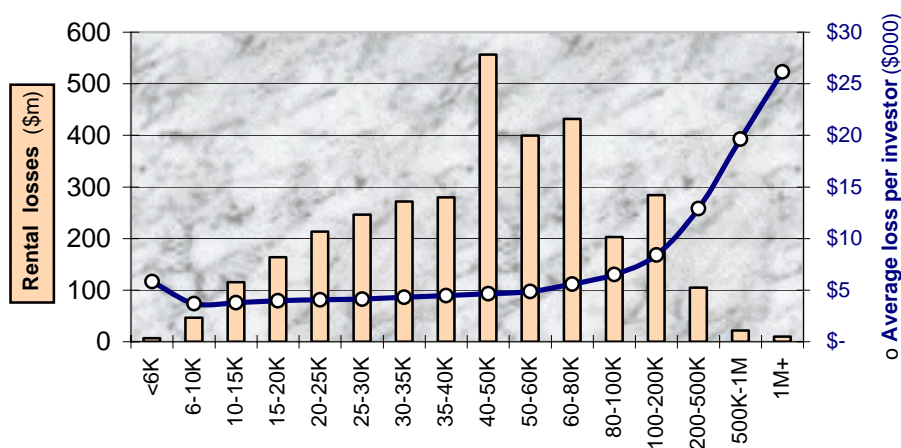
¹¹¹ Cf. Department of Communications, Information, Technology and the Arts, *Tax Expenditures Statement 2003*, p.2.

In the ATO’s 2004-05 Compliance Program, the Commissioner observed a growing imbalance between rental property income and deductions. In 2002-03 there was an 8% increase in rental property income but a 13% increase in rental deductions. This imbalance led the ATO to believe there may be significant non-compliance. The ATO response is to carry out around 4,600 reviews and audits of rental income and expenses in 2004-05.¹¹² However, so long as negative gearing is allowed, it is hard to believe that increased audit activity alone will have any major impact in reversing the revenue loss.

Equity Argument

Figure 8 illustrates that negative gearing rewards taxpayers on higher marginal rates more than lower income taxpayers.

FIGURE 8: 2000-01 NEGATIVE GEARING OF RENTAL PROPERTIES ACCORDING TO INCOME LEVEL



Efficiency Arguments

One major efficiency argument supported by the statistics is that negative gearing attracts significantly more loan finance to rental properties than owner-occupied dwellings, and more investment loans are used for negatively geared rental properties than positively geared properties.

In a speech given to the Sydney Institute in April 2003, Reserve Bank Governor Ian Macfarlane raised concerns about rising debt due to investor housing.¹¹³ The Reserve Bank carried out a study and found that households that are negatively geared on investment property (and thus declaring a loss on their rental income) are much more likely to have a mortgage, and to have higher leverage when they do have a mortgage. This finding indicates a sub-group of the population is willingly engaging in leveraged asset accumulation, and taking the associated financial risks.¹¹⁴

¹¹² Australian Taxation Office, *Compliance Program 2004-05*, August 2004, p.7.

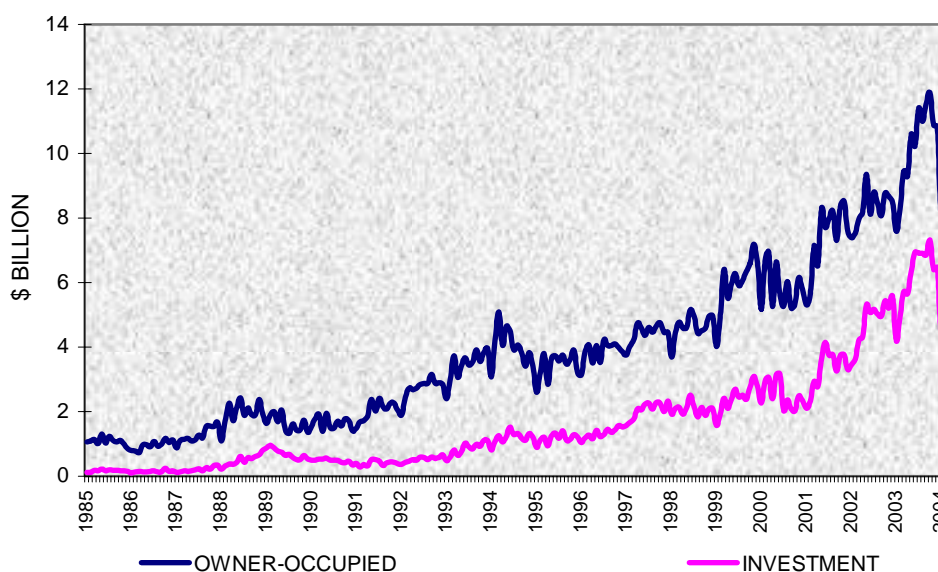
¹¹³ ACOSS “Taxation in Australia: Home Truths and International Comparisons” *ACOSS Info 347*, June 2003, pp.23-24, quoting from “Do Australian Households Borrow too much?” *Speech to the Sydney Institute*, 4/4/03.

¹¹⁴ Ellis, L., Lawson, J. & Roberts-Thomson, L. “Housing Leverage in Australia”, *Research Discussion Paper 2003-09*, Economic Group Reserve Bank of Australia, July 2003, p.31.

Statistics indicate a disproportionately high amount of household borrowing is attributable to rental properties rather than owner-occupied dwellings. On analysis, the average rental property is geared approximately two-thirds more than the average owner-occupied property in Australia.¹¹⁵

Figure 9 illustrates the rising proportion of housing finance used for investment properties.

FIGURE 9: NEW MONTHLY HOUSING FINANCE COMMITMENTS FOR OWNER-OCCUPIED AND INVESTMENT PROPERTY, BY VALUE, 1985-2004¹¹⁶



Impact on interest rates and the economy

There is an authoritatively held view that negative gearing can contribute to overheating in the economy, as was the case in the late 1980s, leading to pressure on the Reserve Bank to raise interest rates. Linked to high levels of debt finance and

¹¹⁵ This calculation is based on ratios obtained by comparing statistics on the number of owner-occupied and rental properties, and on the amount of outstanding loans on owner-occupied and rental properties. A figure of 1.6526 is obtained by dividing the ratio of loans (rental vs. owner-occupied) (0.4933) by the ratio of number (rental vs. owner-occupied) (0.2985): Australian Bureau of Statistics, *Media Release 4130.0.55.001* "More Home Owners have a Mortgage", 21 April 2004; Australian Bureau of Statistics, *Catalogue No. 5609.0* "Housing Finance, Australia", 12 May 2004; cf. ATO, *Taxation Statistics 2000-01, Table 5, Part D*, which represents the number of taxpayer investors who held rental properties, not the number of rental properties. Some taxpayers held multiple rental property investments. In 1997, for example, just over three-quarters of rental property investors held just one rental property: Australian Bureau of Statistics, *Australian Social Trends 1999*, "Housing – Housing Stock: Rental Investors". This is comparable to the ratio of 0.2939 at 30 June 1998: Australian Bureau of Statistics, *Catalogue No. 4130.0* "Housing Occupancy and Costs, Australia", 15 October 1999.

¹¹⁶ Australian Bureau of Statistics, *Catalogue No. 5609.0* "Housing Finance, Australia", 12 May 2004, Table 11.

interest rates, there is a view that an over-investment in assets such as residential property can be harmful to the economy.¹¹⁷

On this view, negative gearing can exacerbate the effects of economic downturns as investors are forced to unwind their debts by cutting back spending.¹¹⁸

However, the relationship between negative gearing and interest rates is a matter of some conjecture. Many hold the view that negative gearing increases demand for housing loans, thereby placing upward pressure on interest rates.¹¹⁹

This theory is supported by the loanable funds view of interest rate determination, under which the supply of loanable funds (savings) and the demand for loanable funds (investment) are brought into equilibrium by interest rate movements. While it is recognised that the state of demand and supply of loanable funds is an important set of influences upon interest rates, there are many other factors.¹²⁰

At a glance, it is impossible to say to what extent negative gearing affects interest rates. Statistics show a positive correlation between negative gearing and interest rates, but the relationship is not significant.¹²¹ Econometric research may be needed, first to ascertain the extent to which negative gearing affects the demand and supply of housing finance; and second to ascertain the extent to which the state of demand and supply of housing finance affects interest rates.

The link between negative gearing and the value of the Australian dollar relies on the link with interest rates. Few economists would deny there is a positive relationship between interest rates and the value of a currency.¹²² If negative gearing does increase interest rates and lead to a stronger Australian dollar, it could have a serious impact on trade flows and the economy.¹²³

¹¹⁷ May, Alex "Unit Defence" *Sydney Morning Herald*, 10 April 2003, citing Macfarlane, I.J. (1989) *Money, credit and the demand for debt*, Reserve Bank Bulletin; Senator Andrew Murray, Australian Democrats, *Press Release Number 03/423*, 13 June 2003; Senator Andrew Murray, Australian Democrats, *Press Release Number 03/485*, 3 July 2003.

¹¹⁸ May, Alex "Unit Defence" *Sydney Morning Herald*, 10 April 2003, citing Macfarlane, I.J. (1989) *Money, credit and the demand for debt*, Reserve Bank Bulletin.

¹¹⁹ See e.g. Australian Democrats, *Press Release Number 03/485*, 3 July 2003.

¹²⁰ See e.g. Hughes, B. *et al* (1990) *State of Play 6: The Australian Economic Policy Debate*, Allen & Unwin, Sydney, p.126.

¹²¹ The correlation coefficient is 0.4675, which is below the statistically significant level (0.707) for the number of data pairs in the series.

¹²² Australia has had a floating exchange rate since 9 December 1983. See e.g. Hughes, B. *et al* (1990) *State of Play 6: the Australian economic policy debate*, Allen & Unwin, Sydney, pp.108-113. In simple terms, when interest rates rise in Australia, for example, but not elsewhere, overseas investors will normally wish to take advantage of the increased return on Australian dollars by moving investments into Australia. This puts upward pressure on the Australian dollar. As investment dollars flow into Australia, there is an arbitrage of currency upwards until equilibrium is reached.

¹²³ See e.g. Hughes, B. *et al* (1990) *State of Play 6: the Australian economic policy debate*, Allen & Unwin, Sydney, chapter 5. A stronger Australian dollar would encourage imports but discourage exports. This could lead to higher current account deficits, which would be bad for the economy. It would make it difficult for our exporters, for example, from the resources and agricultural industries. However, a stronger dollar could also have a positive effect on Australia's capital account. It should make it easier to service our foreign debt and encourage the inflow of investment capital into Australia. This would be good for the economy, especially those who import expensive capital items, such as Qantas and its commercial aircraft.

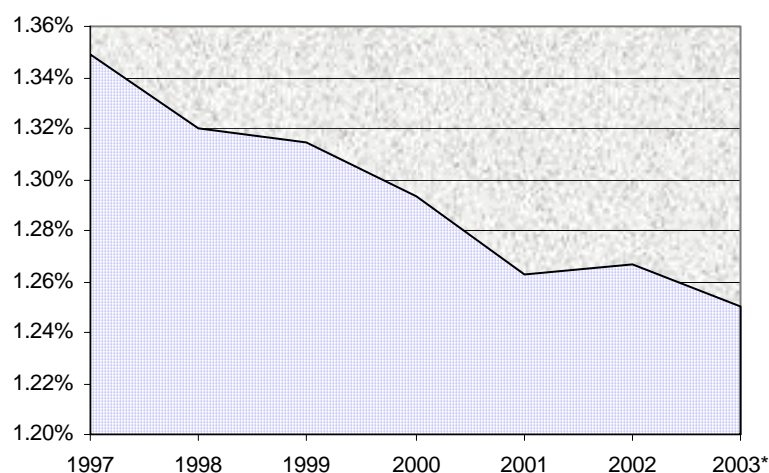
Declining birth rates

Statistics reveal a declining birth rate in Australia, as indicated in Figure 10.¹²⁴

The declining birth rate has an impact on government policy and reform of the tax system.¹²⁵ Some also consider the relationship works in the other direction, in that birth rates can be affected by government policy and by the design of the tax system.

In his 2004-05 Budget, Treasurer Peter Costello announced measures to provide greater financial encouragement for Australians to have more children.¹²⁶

FIGURE 10: BIRTH RATES IN AUSTRALIA, PER CAPITA, PER ANNUM, 1997 – 2003



Apart from more obvious incentives such as monetary assistance provided by the Government under its family payment package, it is necessary to look deeper into the Australian tax system to consider the impact of design features, such as negative gearing, on birth rates.

Negative gearing has been linked as a contributing factor to the declining birth rate, on the basis that higher real estate prices lead to increased mortgage commitments for young families.¹²⁷ Insofar as this argument turns on the effect of negative gearing on household debt and interest rates, this appears to be a sound argument. However, statistically the relationship is unproven, and there may be stronger factors linked to this decline, such as the increasing number of women in the workforce.¹²⁸

¹²⁴ Australian Bureau of Statistics, *Catalogue No. 3101.0 "Australian Demographic Statistics"*, 18 March 2004. The rate shown in the graph below for the 2003* year is annualised from available 2003 March, June and September quarter data.

¹²⁵ See e.g. Review of Business Taxation, *A Tax System Redesigned*, Report, July 1999, pp.9-10.

¹²⁶ Treasurer, *Budget Speech 2004-05*, 11 May 2004 (e.g. increased maternity payment and family tax benefit). There appears to be some merit in encouraging breeding, given Australia's ageing population, as more taxpayers will be needed in the next 10 to 20 years as baby boomers move into retirement. See McIntosh, G. (1998) *The 'Boomer Bulge': Ageing Policies for the 21st century*, Research Paper 4, 1998-99, Statistics Group, Parliament of Australia, Canberra, 24 November 1998.

¹²⁷ Hanegbi, R. "Negative Gearing: Future Directions" (2002) 7 *Deakin Law Review* 349, 357.

¹²⁸ Apps, P. & Rees, R. "Fertility, Female Labour Supply and Public Policy" (2001) *IZA Discussion Paper No 409*, Bonn.

INTERNATIONAL COMPARISONS

Australia is one of few countries that allow negative gearing on real estate and other investments. Few of the major OECD nations allow a tax shelter for negatively geared rental properties, as many have enacted measures to quarantine and restrict interest deductions on investment properties.¹²⁹

TABLE 4: INTERNATIONAL COMPARISON – NEGATIVE GEARING, INVESTMENT HOUSING¹³⁰

Country	Is negative gearing allowed?
Australia	Yes
Japan	Yes
New Zealand	Yes
United States	Restricted
United Kingdom	No
Canada	Restricted
Netherlands	No
Sweden	Restricted
Germany	Restricted
France	Restricted

A comparison of international quarantining measures

Negative gearing is not permitted in the U.K. and the Netherlands. Interest deductions are restricted in the U.S., Sweden, Germany, France and Canada. There is not a high degree of uniformity or overlap of approach to the quarantining of interest deductions overseas. The overseas measures are compared below. In general, while a fairly broad approach is applied in the U.S. (with passive investment rules) and a somewhat narrower approach applies in the U.K. (where investment income is quarantined under a specific schedule), in most countries rental income is given quite specific tax treatment that differs from other jurisdictions.

Little comment needs to be made in relation to Japan¹³¹ and New Zealand,¹³² which like Australia allow negative gearing on investment housing. However, it may be noted that previously in New Zealand the Commissioner for Inland Revenue denied negative gearing on rental properties by administratively quarantining the interest

¹²⁹ See e.g. Senator Andrew Murray, Australian Democrats, *Press Release Number 03/485*, 3 July 2003.

¹³⁰ Cf. Productivity Commission, *First Home Ownership*, Inquiry Report No.28, 31 March 2004, p.85, table 5.3.

¹³¹ Reference can be made to Japanese Ministry of Finance 2003, *An Outline of Japanese Taxes* <http://www.mof.go.jp/english/tax/taxes2003e.htm> and CCH, *2002 International Master Tax Guide*, CCH Australia Limited, Sydney, JPN ¶3-060.

¹³² Reference can be made to New Zealand Inland Revenue, *Rental Income*, May 2003, <http://www.ird.govt.nz/library/publications/geninfo/ir264.pdf>; CCH, *2002 International Master Tax Guide*, CCH Australia Limited, Sydney, NZL ¶3-030 and ¶3-060.

deduction to the amount of net rental income.¹³³ This administrative quarantine no longer applies.

The U.S. has an extensive system of limitations on deductibility, including ‘passive activity loss’ rules.¹³⁴ While interest is generally deductible¹³⁵ there are notable limitations.¹³⁶

Rental income is treated as passive income. Unless the individual actively participates in the rental activity, losses from rental property may be limited. Individuals who actively participate in the rental activity may be able to deduct up to \$US25,000 of loss against other income. No additional loss is available for individuals whose modified adjusted gross income exceeds \$US150,000.¹³⁷

Interest is only deductible on rental properties to the extent it does not exceed the taxpayer’s net investment income,¹³⁸ however the excess may be carried forward up to 20 years and offset against future net investment income. Alternatively it can be offset against capital gains realised on the sale of U.S. real estate.¹³⁹

The U.K. adopts a schedular system to quarantine deductions for investments. Losses from one activity source can only be offset against future income from the same source. Rental property losses are quarantined to income from real property under Schedule A.¹⁴⁰

Whereas each Schedule and Case has its own detailed expense rules, generally expenditure may be deducted if it is incurred wholly and exclusively in gaining income that is *prima facie* liable to income tax. Losses and outgoings of a capital, private or domestic nature are expressly excluded from deductibility. Each Schedule and Case has its own loss rules. Generally there is no facility to set off a loss under one Schedule against income from another, with a notable exception for losses incurred in a trade, profession or vocation (assessable under Schedule D, Cases I and

¹³³ Losses incurred on certain tax shelter activities (including rental investments) in excess of a threshold (\$10,000) were not deductible against income from other sources in the same income year: CCH, *1992 New Zealand Master Tax Guide*, CCH, Auckland, pp. 304-8; and other provisions permitted the ‘claw-back’ of certain deductions previously allowed by subjecting to tax an amount equal to the lesser of the profit from the sale of the relevant property and the total of the deductions allowed where that property is sold within 10 years of acquisition: see e.g. Treasurer (1985) *Reform of the Australian Taxation System: Draft White Paper*, AGPS, Canberra, p.51.

¹³⁴ These rules were adopted in response to the widespread use of tax shelters in the 1970s and 1980s. They restrict the deductibility of losses that arise in any activity in which the taxpayer does not ‘materially participate’. This has been administratively construed to require the taxpayer spend at least 500 hours per year on the activity. While there are a number of other situations that satisfy material participation, special rules apply to real estate activities. See e.g. Ault, H.J. et al (1997) *Comparative Income Taxation: A Structural Analysis*, Kluwer Law International, London, p.245.

¹³⁵ *Internal Revenue Code*, sec.163(a).

¹³⁶ Interest deductions for non-corporate taxpayers are quarantined to “net investment income”. A deduction for investment interest expenditure is limited to investment income, including realised capital gains in some cases. See e.g. Ault, H.J. et al (1997) *Comparative Income Taxation: A Structural Analysis*, Kluwer Law International, London, pp.245-6.

¹³⁷ CCH, *2002 International Master Tax Guide*, CCH Australia Limited, Sydney, USA ¶3-030.

¹³⁸ *Internal Revenue Code*, sec.163(d).

¹³⁹ Saunders, R. (2003) *International Tax Systems and Planning Techniques*, Longman Law, Tax and Finance, Sweet & Maxwell Limited, London, B4.13.2.

¹⁴⁰ Ault, H.J. et al (1997) *Comparative Income Taxation: A Structural Analysis*, Kluwer Law International, London, pp.247, 249.

II). Otherwise, except for losses from employment (for which there is no provision), income losses can generally be carried forward indefinitely but can only be offset against future income from the same source.¹⁴¹

In Canada interest is not generally deductible as it is considered a capital expense for income tax purposes.¹⁴² Interest can be deducted in limited instances where income is gained from a business or property.¹⁴³

The prospect of a capital gain alone will not be sufficient to make interest expenditure deductible, however if there is a reasonable possibility that the investment will eventually generate ordinary income in excess of the interest expense, a deduction for the interest will normally be allowed. Specific restrictions apply to certain real estate investments. For example, interest incurred during construction of a building is capitalised and added to the cost of the building, and taken into account when the building begins to generate an income stream or when it is sold, not when the expense is incurred.¹⁴⁴

There are also rules designed to prevent passive investors from sheltering income from losses.¹⁴⁵

Under case law in Canada, a rental property is not normally considered a business in the hands of an individual unless extended services, substantially beyond the mere provision of space, are provided. Where the rent constitutes business profit, net income is computed by including the right to deduct interest and depreciation. However, rental income will usually be defined as 'specified investment business income' rather than active business income.¹⁴⁶

In the Netherlands, there are no general restrictions on using losses from one income category to offset against income from any other category.¹⁴⁷ However, for interest to be deductible in computing net rental income, the real estate must be part of a business operation for a private individual.¹⁴⁸ Normally this requirement will not be satisfied for rental properties.

In Sweden a credit is allowed for losses in respect of income from capital at a rate of 30% for losses up to \$15,000 which can be offset against income from other

¹⁴¹ CCH, *2002 International Master Tax Guide*, CCH Australia Limited, Sydney, GBR ¶3-060.

¹⁴² Cf. Frankovic, J. "Why Interest should be Considered a Current Expense" (2001) 49(4) *Canadian Tax Journal* 859.

¹⁴³ *Income Tax Act*, sec.18(1)(b)&(c) and sec.20(1)(c); CCH, *2002 International Master Tax Guide*, CCH Australia Limited, Sydney, CAN ¶1-100 and CAN ¶3-060.

¹⁴⁴ *Income Tax Act*, sec.18(3.1); Frankovic, J. "Why Interest should be Considered a Current Expense" (2001) 49(4) *Canadian Tax Journal* 859, 870.

¹⁴⁵ CCH, *2002 International Master Tax Guide*, CCH Australia Limited, Sydney, CAN ¶3-060

¹⁴⁶ Saunders, R. (2003) *International Tax Systems and Planning Techniques*, Longman Law, Tax and Finance, Sweet & Maxwell Limited, London, B9.13.1.

¹⁴⁷ Ault, H.J. et al (1997) *Comparative Income Taxation: a Structural Analysis*, Kluwer Law International, London, pp.247-8.

¹⁴⁸ Saunders, R. (2003) *International Tax Systems and Planning Techniques*, Longman Law, Tax and Finance, Sweet & Maxwell Limited, London, B7.13.1.

categories. For losses in excess of \$15,000 the credit rate is 21% and is restricted to current year losses where the gain on the investment is deferred.¹⁴⁹

In Germany rental income is one of seven income categories.¹⁵⁰ Losses can be carried forward against future income or offset against previous income, but a limit applies to the amount of losses that can be carried back.¹⁵¹ Losses in particular income categories can generally be applied against income in other categories.¹⁵²

In France there are separate categories of income. Restrictions apply to certain categories of losses. For real estate losses, the first €10,700 can be set off against other income, but to the extent it arises from interest outgoings, it must be amortised over a 10 year period against future rental income. The excess losses over €10,700 not due to interest paid may only be carried forward against future rental income for a maximum period of 5 years.¹⁵³

Rental income in France is not subject to withholding tax and is assessable with other income as declared in the annual tax return, although it must be returned in a special schedule attached to the tax return. A restrictive list of expenses can be deducted against rental income, which includes interest expenses related to acquisition costs and finance expenses.¹⁵⁴

HOW SHOULD INVESTMENT LOSSES BE QUARANTINED IN AUSTRALIA?

Given that Australia has had negative gearing for the better part of the last half-century, how can negative gearing be reliably quarantined?

As can be seen from the above international discussion, losses can be quarantined in a variety of ways – on an entity basis, on a time basis, and on the basis of category of income or gain against which the loss can be offset.¹⁵⁵

The most severe approach to quarantining, which existed in the provision we had affecting interest deductions for real estate investments between 1985 and 1987, is to deny a deduction outright to the extent it exceeds assessable income from the asset. Yet it would not seem a fair result for expenditure incurred to produce income, whether in the form of a revenue or capital gain, to fall into a black hole by permanently excluding it from the determination of tax liability (i.e. as a deduction or in CGT cost base) to the extent no income is actually derived from the investment.

From a tax policy point of view, the quarantining of losses from the negative gearing of investment assets may be considered in the wider context of our CGT regime.

¹⁴⁹ Ault, H.J. et al (1997) *Comparative Income Taxation: a Structural Analysis*, Kluwer Law International, London, pp.246, 248.

¹⁵⁰ CCH, *2002 International Master Tax Guide*, CCH Australia Limited, Sydney, DEU ¶3-010.

¹⁵¹ CCH, *2002 International Master Tax Guide*, CCH Australia Limited, Sydney, DEU ¶3-060.

¹⁵² Ault, H.J. et al (1997) *Comparative Income Taxation: A Structural Analysis*, Kluwer Law International, London, pp.247-8.

¹⁵³ CCH, *2002 International Master Tax Guide*, CCH Australia Limited, Sydney, FRA ¶3-060; Ault, H.J. et al (1997) *Comparative Income Taxation: A Structural Analysis*, Kluwer Law International, London, pp.247-8.

¹⁵⁴ CCH, *2002 International Master Tax Guide*, CCH Australia Limited, Sydney, FRA ¶3-030 and FRA ¶3-060.

¹⁵⁵ Cf. Donnelly, M. & Young, A. "Policy Options for Tax Loss Treatment: How does Canada Compare?" (2002) 50(2) *Canadian Tax Journal* 429.

Similar arguments apply to the quarantining of interest deductions on investment assets and the concessional CGT treatment in Australia. For a quarantining model, consideration may also be given to the way our CGT regime restricts the offset of capital losses only against capital gains.¹⁵⁶

One of the reasons the government gave to justify repeal of our quarantine provisions in 1987 was that negative gearing was adequately countered by measures such as the CGT regime. With the effluxion of time this justification appears doubtful. The fact that capital gains are subject to taxation in Australia at best provides only a part answer, since capital gains are taxed concessional in Australia compared with most other sources of income. This arises because capital gains are taxed on a deferred, realisation basis, and is also due to the availability of exemptions and concessions such as the general CGT discount.

A case can be made for tying our approach to quarantining with our CGT regime. Few people choose to invest with the purpose of making a loss, although that is always a risk of most investments. Investment assets are acquired for the purpose of producing income, whether as a stream of revenue from year to year, such as rent or dividends from shares, or as a capital gain on disposal of the investment, or a combination of the two. The taxing provisions should take into account the fact a taxpayer's return on an investment can take a combination of revenue stream and capital gain and adjust the deduction of losses accordingly.¹⁵⁷ At the same time the provisions should not penalise an investor who makes a loss overall, when considering both the revenue stream and the proceeds of sale on disposal.

Three Approaches for Quarantining Interest Deductions on Investments

It could be argued that rental (or other investment) losses attributable to interest expenditure in excess of net rental income do not have the required nexus with other income derived by the taxpayer in the current year. Rather, they have a stronger connection to either future net rental income from that investment and ultimately, if no future net income is derived from the investment to offset the net rental losses, the assessable income attributable to any capital gain realised from the investment.

Three different approaches to quarantining reflecting this proposition are detailed below. Each approach will also have its own transitional issues as well as long-term costs and benefits.

1. Asset by Asset Approach

Quarantining could apply at the strictest level, on an asset-by-asset basis. The most severe approach, and the one repealed in 1987, would be to deny the revenue loss from the investment outright any year.

¹⁵⁶ Sec.102-5; cf. Evans, C. & Sandford, C. "Capital Gains Tax – The Unprincipled Tax?" (1999) 5 *British Tax Review* 387; Krever, R. "The Taxation of Capital Gains" in Ross, S. & Burgess, P. (eds) (1996) *Income Tax: A Critical Analysis*, 2ed, Law Book Co, Sydney, p.77.

¹⁵⁷ Consider the ATO and Government policy position on the requirement to apportion interest deductions for capital protected loan products used by share investors indicated in *Assistant Treasurer Press Release 'Taxation of Capital Protected Products'*, 30 May 2003 and *Taxation Determinations TD 2005/4 to TD 2005/7*, 30 March 2005. Efficiency arguments suggest a more consistent and principled approach could be taken across all investments to require the apportionment of interest expenditure between income production (deductible under sec.8-1 to the extent that income is produced) and capital (included in cost base for CGT purposes).

A less severe approach would be to allow such a loss to be carried forward and offset against any net income from that specific asset in later years. Ultimately, any accumulated losses on that property carried forward to the time it is sold could be applied against the capital proceeds in determining the capital gain (prior to applying the general CGT discount) realised on that asset.

This quarantining approach could apply to CGT assets on an asset-by-asset basis. Options to consider include whether to allow the accumulated losses to give rise to a capital loss on disposal of the asset or whether to allow such losses to only reduce a capital gain to nil and then allow any balance as a deduction on revenue account against any other income or category of income derived by the taxpayer. Consideration could also be given whether to exclude CGT exempt assets from this quarantining.

2. All Investment Assets Approach

At the other extreme, the broadest approach to quarantining interest deductions would be to allow the net income and losses from all investment assets of the taxpayer each year (this could be defined as all CGT assets) to be pooled together to determine the taxpayer's overall net investment income. An overall net loss for an income year could be carried forward and offset against net investment income in future years.

Under this broad approach, given the possibility of the taxpayer has a range of investment assets, one might question what should happen to any accumulated investment loss at the time of disposal by the taxpayer of their assets.

The simplest option under this approach would do nothing, that is not require any of the accumulated loss to be offset against capital proceeds, but allow the accumulated loss to be carried forward indefinitely until future investment income is derived.

Another option under this approach may be to require the taxpayer to offset any accumulated investment losses against any capital gains from any investment asset as they arise in any year (but only to the extent of eliminating the capital gains and not to give rise to capital losses). This may have the unintended consequence of encouraging the deferral of capital gains as it would be more valuable to the taxpayer to offset the accumulated loss against revenue gains.

A more complex option under this approach would be to require the taxpayer to keep a record of the net losses accumulated from each of the investment assets and apportion part of the accumulated loss back to an asset when it is sold, to be offset against any capital proceeds from that asset to determine the capital gain or loss from the asset.

3. Pooling Assets Approach

A middle approach to quarantining interest deductions on investment assets is to pool assets according to category of investment. Under this approach, income and losses from investments in each category (such as 'real estate' or 'share/equity' investments) would be pooled together each year to determine the overall net income or loss in each category. All categories with net income would be included in the taxpayer's assessable income. A net loss in a category can be carried forward and offset against net income in that same category in a later year. This approach would require an added layer of legislation to define each investment category. This approach could be implemented with similar effect to a schedular system (such as that implemented in

the U.K., France or Germany) or in a similar way to the quarantining “passive investment” rules in the U.S.

Again, an issue may arise as to how to deal with accumulated net losses when assets within the category are sold. Again, the easiest option would be to do nothing. Thus the accumulated losses would not have to be offset against capital proceeds. Another option would be to require the taxpayer to offset any accumulated investment losses in that category against capital gains on investments in that same category as they arise in any year. This would only apply to the extent of eliminating the capital gains and not give rise to any capital losses. A more complex option would be to require the taxpayer to keep a record of the net losses accumulated from each of the investment assets in the category and apportion part of the accumulated loss back to an asset in that category when it is sold, to be offset against any capital proceeds from that asset to determine the capital gain or loss from the asset.

Efficiency Arguments and Quarantining

Efficiency is arguably the main tax policy criterion to consider when comparing the quarantining approaches.

What economic distortions would arise in Australia if government reintroduced quarantining measures to deny negative gearing. While this may depend on the precise type of quarantining measures enacted, if confined to rental investments this could create a bias in favour of other investments. The solution is not necessarily to extend quarantining to all types of investment. Doing that might well remove bias in choice of investment but consider what impact, if any, it would have on the overall level of investment in the economy. Would it have a serious effect on corporate capital formation?

In relation to the criterion of efficiency, all three approaches to quarantining outlined above – the “asset-by-asset” approach, the broad “all investment assets” approach, and the “pooling of assets” approach – are compatible. None discriminate between categories of investment, although the potential for this lies under the pooling approach (this possibility is clear from overseas experience). They all provide for uniformity in tax treatment of the interest costs for all types of investments and therefore would overcome the major justification by the government for removal of quarantining in 1987.

However, by avoiding the criticism that each quarantining measure could discriminate between different types of investment, all three approaches are potentially exposed to a broader efficiency based criticism. By deferring and ultimately denying the excess interest deductions, it might be argued that they discriminate against all investments, and in particular appreciating types of investments, i.e. assets expected to provide a return weighted more from a capital gain than from an income stream. While full interest deductions could be claimed on depreciating assets used in income production, interest deductions would generally be denied on appreciating assets to the extent they exceed income from those assets.

On the other hand, some may consider this distortionary effect to be desirable from the point of view of counterbalancing the distortion already built into our capital gains tax system in favour of passive, appreciating assets.¹⁵⁸

This broader efficiency argument does not apply equally to each of the above three approaches. The greatest level of quarantining, with the greatest scope for deferral and conversion to capital account (for offset against capital gains) applies under the “asset by asset” approach. As a result, that approach would be expected to have the strongest impact in reducing the tax revenue lost to negative gearing and potentially the strongest impact in distorting investment away from appreciating assets.

The broader “all investment assets” approach would be expected to have the weakest impact on plugging the tax shelter and distorting investment away from appreciating assets because any investment losses from one asset could be offset against income from other investment assets in the same income year and, if necessary, future income years. Depending on the taxpayer and their mix of investments, there could be very little deferral of the negative gearing losses. However, by preventing the taxpayer from applying the losses against other sources of income, and mitigating the accumulated effect of continued losses from negative gearing from year to year, at least some of the revenue leakage arising from negative gearing could be prevented. It is anticipated this approach would give rise to the least conversion of the losses to capital account to be offset instead against capital gains.

The approach of “pooling assets” according to category of investment would be expected to produce an outcome somewhere between the other two more extreme approaches in deferring the point in time of utilising those investment losses and the possibility of converting those losses to capital account for offset instead against capital gains.

The final point to consider on the efficiency criterion is the question of international tax neutrality. The middle “pooling” approach appears the method most consistent with the quarantining measures adopted by the major OECD nations. Some might therefore seek to argue that the “pooling” approach has the advantage of providing greater harmony for our income tax system internationally. These considerations should not be underestimated in an increasingly globalised economic system. At the margin, this has the potential to make Australia more internationally competitive by promoting greater tax neutrality and encouraging the free flow of international investment.

Equity and Quarantining

In relation to the tax policy criteria of equity, to the extent that negative gearing widens income inequality, vertical equity would be best served by the strictest quarantining approach (asset by asset) and least by the broadest approach (all investment assets). Horizontal equity is served well by all three approaches, as they all apply the quarantine broadly across all investment (CGT) assets.

None of the three approaches address the cumulative distributional inequality arising from decades of allowing the tax shelter. However, query whether any quarantining measure could adequately reverse this effect in any event?

¹⁵⁸ Krever, R. “The Taxation of Capital Gains” in Ross, S. & Burgess, P. (eds) (1996) *Income Tax: A Critical Analysis*, 2ed, Law Book Co, Sydney, p.77.

Simplicity and Compliance Costs

Which of the three approaches would best serve the criterion of simplicity?

While all three approaches would be expected to add some complexity to an already complex system of taxation of income and capital gains, the complexity of each approach would appear to depend mostly on which option is taken in requiring the losses to be converted over to capital account and deferred for offset against realised capital gains.

The simplest method for taxpayers is probably the outright denial of interest deductions in excess of net investment income under the “asset by asset approach”, similar to the quarantining measures we had in place for real estate investments between 1985 and 1988. An outright denial of excess interest under the “pooling” approach would be marginally more complex than the “all investment assets” approach, owing to the need to divide specific investments between defined categories.

Under the asset by asset and pooling approaches, the compliance cost burden on taxpayers, encompassing both “pure” and “social” compliance costs,¹⁵⁹ would increase as the number and variety of investments increases. Assuming many of these costs are deductible, an interesting question arises whether those costs should be deductible against any other assessable income of the taxpayer or quarantined to each investment or category of investment.

The level of complexity and compliance burden on the taxpayer also increases where deferral and conversion over to capital account is required. It appears the greatest burden would arise under the “pooling” and “all investment assets” approaches where the taxpayer is required to keep a record of net losses accumulated from each of the investment assets in each category and apportion part of the accumulated loss back to an asset in that category when it is sold, to be offset against any capital proceeds from that asset to determine the capital gain or loss from the asset.

The Politics of Quarantining

Tax policy is not just about tax policy criteria. A clear lesson from the number of failed proposals emanating from Ralph Review of Business Taxation is that it is impossible to ignore the political context and the likelihood of a proposed tax reform being accepted. Would different political consequences arise for each of the three quarantining approaches? Consider which approach would be the least unpopular with voters?

For many investors the rental property has become the repository for their retirement savings, instead of superannuation, as a sound base for wealth generation. To deny such investors the tax subsidy offered by negative gearing may bring about the need for some of these investors to consider alternative, more tax effective forms of investment for retirement. Any quarantining measure would therefore not be expected to be popular among any investors.

An asset-by-asset approach that targets rental property investment alone would be expected to receive the most opposition from the 1.3 million plus taxpayers who

¹⁵⁹ Cf. Evans, C., Ritchie, K., Tran-Nam, B. and Walpole, M. “Taxation Compliance Costs: Some Recent Empirical Work and International Comparisons” (1998) 14 *Australian Tax Forum* 93.

declare rental income. On the other hand, the ability to offset unused interest deductions against capital gains on sale of the property could make the measures more palatable to such voters.

If quarantining applied asset-by-asset but across all CGT assets, rental property investors may well feel less targeted and so it may attract less resistance from these voters. Yet most if not all investors would be caught by these measures, and few would be agreeable to the additional cost to investment from removal of the tax subsidy as well as the increased complexity in administering their tax on investments. Quarantining would make the tax treatment of investment more complex at a time when many already perceive CGT as too complex and costly to administer.

A pooling assets approach, according to category of investment (such as the schedular approach applicable in the U.K.), would not give as much opportunity for investors to continue to utilise interest deductions and offset investment losses against other income as the all investment assets approach, but would give greater scope for this than the asset-by-asset approach. However, more complexity and compliance costs in record keeping would follow from the pooling approach, as well as the possibility for dispute arising from definitional problems as to whether an asset falls for treatment under a particular category, especially if there are a number of different categories of investment and tax treatment differs in each category.

An all investment assets approach would be expected to have the greatest chance of acceptance among investors and voters, as it would give them the greatest opportunity to utilise and offset rental property and other investment losses. Additional record keeping and compliance costs could weigh against this approach, depending on which specific option is taken, but to a lesser extent perhaps than the pooling approach.

Legislative Amendment for Quarantining

All three approaches can be tied in with our existing capital gains tax provisions, which already provide for the inclusion of non-capital expenditure, incurred by a taxpayer in connection with the continuing ownership of an asset, in the asset's cost base for the purposes of calculating CGT liability. Sec.110-25(4) of the *Income Tax Assessment Act 1997* includes such non-capital costs in the third element of the cost base of a CGT asset, except to the extent that the expense is deductible. This includes interest on money borrowed to acquire an asset.

Under the asset-by-asset approach, little legislative amendment to the CGT provisions would be needed. Net investment losses, comprising carry forward interest expenditure, could be accumulated and included in cost base of the CGT asset and offset against capital proceeds realised on sale of the investment.

The main amendment that would be required under the asset-by-asset approach is to include a provision in the income tax legislation limiting the deductibility of interest to the amount of net income from the asset and allowing for carry forward and deferral. Legislatively, this quarantine could be limited to CGT assets, as defined in sec.108-5. Thus a provision could be included under Division 36 stating that interest deductions on money borrowed to acquire or hold a CGT asset cannot give rise to a loss in any income year but can be carried forward and applied against assessable income derived

from that asset in a later income year. This approach implies a stricter level of tracing to income from the asset than the other two quarantining approaches.¹⁶⁰

Given that the mischief of the tax shelter of negative gearing is a tax saving for individuals, a decision could be made to limit the appropriate quarantine measures to individual taxpayers. Losses made by other entities are subject to their own rules for carry forward in any event.¹⁶¹

The accumulated balance of such losses carried forward when a CGT event arises for that asset may be treated as a non-capital cost of ownership of that asset and included in the third element of the cost base of the asset. If appropriate, certain types of CGT assets, e.g. personal use assets, collectables, motor vehicles or exempt assets, and other assets such as trading stock and other business assets, could be excluded from this quarantining.

The other two approaches are expected to be more complex and more difficult to practically enforce, both in the provisions limiting the deductibility of interest and providing for deferral of the deductions and in the amendments required to the CGT provisions, depending on the choice of option requiring the conversion of the losses to capital account. The simplest option under both approaches would be to not allow any conversion of the losses to capital account.

Under the “all investment assets” approach, assuming a conversion to capital account is to be allowed, the accumulated loss would need to be apportioned to each individual asset when they are sold and that part converted to capital account and offset against the capital proceeds.

Under the “pooling” approach, the deductibility and deferral provisions in the income tax legislation would need to define and regulate each category of investment for deductibility of the interest. Assuming a conversion to capital account is to be allowed, the amendments to the CGT provisions would be a little more complex, to deal with the conversion of pooled accumulated losses according to each investment category into amounts to be offset against capital proceeds either on the basis of each individual asset or on a pooling of CGT assets according to each category of investment.

Given that the mischief of the tax shelter is a tax saving for individuals, a decision could be made to limit the appropriate quarantine measures to individual taxpayers. Losses made by other entities are subject to their own rules for carry forward in any event, although quarantining does not apply on an asset-by-asset basis.¹⁶² Therefore limiting the measures to individuals could fuel argument based on the efficiency

¹⁶⁰ On tracing and interest deductions, see e.g. King, J. “Interest Deductions” (2001) 4(5) *The Tax Specialist* 265; and McIntyre, M.J. “Tracing Rules and the Deduction for Interest Payments: A Justification for Tracing and a Critique of Recent U.S. Tracing Rules” http://www.law.wayne.edu/mcintyre/text/Interest_AUS-sm.pdf. The view has been expressed that “tracing is a familiar, fundamental and necessary feature of any net income tax system”: McIntyre, M.J. “An Inquiry into the Special Status of Interest Payments” [1981] *Duke Law Journal* 765, 771.

¹⁶¹ Refer to Schedule 2F of the *Income Tax Assessment Act 1936* (trust loss measures); Divisions 165, 170 and 175 (losses made by companies); and the table under sec.36-25 indicating the special rules about tax losses.

¹⁶² Schedule 2F (trust loss measures) and Division 36 (losses made by companies) of the *Income Tax Assessment Act 1936*.

criteria that they discriminate against individuals and distort the choice of investor decision (in particular who is to obtain finance for the investment) away from individual taxpayers and towards other entities.

Recommendation

This paper recommends that Australia adopt an “asset by asset” approach to quarantining because it provides the strongest solution for closing the tax shelter. At the same time, it is expected to give rise to the least complexity and compliance burden on taxpayers and probably requires the least legislative amendment. While no quarantining approach is expected to be politically popular, an asset-by-asset approach may well be seen as more politically acceptable than the pooling approach, but less popular than the all investment assets approach, which gives the greatest opportunity for using and offsetting investment losses.

CONCLUSIONS

Both critics and supporters of negative gearing have based their arguments primarily on two critical assumptions. One is that negative gearing has increased house prices. The other is that negative gearing has increased housing stock. Both assumptions are misguided.

In relation to house prices, in the absence of statistical correlation, the better view is that house prices rise anyway, regardless of negative gearing, and can be explained by other factors.

In relation to housing stock, although statistics indicate that negative gearing has led to an increase in real estate investment, they contradict the argument that negative gearing has led to an increase in the number of dwellings.

Arguments based on these false assumptions are flawed. There is no empirical foundation for arguing in support of negative gearing that it rewards home ownership or that it results in lower rents or increased activity in the construction industry.

Ultimately there is no compelling policy reason why Australia should continue to retain the tax shelter. Negative gearing results in a significant loss in government revenue, measured in billions of dollars. In return it has provided few indisputable benefits. It appears that negative gearing has increased income inequality, and statistics also support the conclusion that it has had a major effect on housing finance, with a disproportionately high level of housing finance invested in rental properties. Its effect on interest rates is debatable and further research is needed.

How best to remove the tax shelter, and whether Australia has the political will to deal with the issue, is also a matter for debate. Having regard to ongoing concerns about investment neutrality, the quarantining of interest deductions should apply to all investment assets, not just rental properties.¹⁶³ The recommended approach for Australia is a specific “asset by asset” approach to quarantine interest deductions. Losses arising from interest expenditure in relation to CGT assets (investments) should be allowed to be carried forward against future net income from the same asset and ultimately against capital gains arising on a CGT event happening to that asset.

¹⁶³ See e.g. ACOSS “Taxation in Australia: Home Truths and International Comparisons” *ACOSS Info* 347, June 2003, p27 (Recommendation 4).

This promises the strongest solution for closing the tax shelter. At the same time, it is expected that this approach would probably be the most practically enforceable, requiring the least legislative amendment and giving rise to the least complexity and compliance burden on taxpayers. Whether it would be politically acceptable is another matter entirely.

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