Tax Facts

A knowledge-based series by the Tax and Transfer Policy Institute

Australia's Tax Policy: What Is Negative Gearing?

What is gearing?

Gearing is borrowing money to invest. There are many different types of investments: stocks and shares, property, land, gold, private businesses, higher education, et cetera, and their rates of return (that is, the income generated by the asset) vary.

When investors borrow money from financial institutions, such as banks, they pay interest to the lender. This interest is referred to as the *cost of borrowing*. Depending on various factors like the amount borrowed, risk profile of the borrower, risk of the investment venture, and expected returns, the interest rate charged by the lender varies.

When the financial returns from an investment are sufficient to cover the cost of borrowing and still return a profit to the borrower, they are known to be *positively geared*. For example, if the cost of borrowing is 10%, and the investment returns an income of 15%, the investor makes a net profit of 5%. On the other hand, if the income is only 8%, then the investor makes a net loss of 2%. In this case, the investment is *negatively geared*.

Why invest in loss-making assets?

In some cases, investment losses occur due to circumstances beyond an investor's control. In other cases, however, an investor may willingly invest in a loss-making venture. One such reason is that they expect the value of the asset (for instance, in a company, value of land or property) to increase in the future. Therefore, when they sell the asset at a later stage, they may be able to make a net profit, even after considering the accumulated losses over time. Some investments can also provide security for the future: a working individual may buy an investment property with the view to living there in retirement.

What about the role of tax policy?

The tax system allows losses on investments to be deducted from an individual's assessable income [see our tax fact #6 on **tax offsets or tax deductions**]. Let us say you buy a property and decide to rent it out. If the rent on the property does not cover the expenses (interest on borrowing and other borrowing costs like loan establishment fees, property management fees, repairs and maintenance, amongst others), then the net loss that you incur can be deducted from your assessable income, thereby reducing the total tax you are required to pay.

Negative gearing reduces investors' taxable income. For instance, an individual with an assessable income of $90,000 will normally pay $20,797 in tax. However, if they have invested in a negatively geared asset and make a loss of $7,000, this reduces their taxable income to $83,000. This subsequently lowers their total tax bill to $18,522.

In the example presented above, net losses from an investment can be deducted from total assessable income. In some cases, however, tax policies can ring-fence an investment. Ring-fencing financially separates income or losses from a particular investment for accounting reasons. For instance, profits and losses from natural resource extraction (like oil or minerals) could be ring-fenced in order to tax them at a higher rate. Another example would be ring-fencing investment income; this would preclude investors from deducting investment losses from other types of income, like labour income.

Why allow tax deductions for negatively geared investments?

In theory, an ideal tax system would apply equally to losses and gains. By allowing investors to deduct their losses in full, they are not discouraged from taking risk. Some degree of risk-taking is important since it contributes to economic growth. In exchange, investors' full return on investment (capital gain) is also taxed when the investment is sold. Allowing the deductibility of investment losses (negative gearing) helps ensure the symmetry of an ideal tax system.

In practice, however, the current tax system is not ideal. First, the current system taxes different forms of investment at distinct tax rates. Contributions to superannuation, for instance, are taxed differently from investment in housing. By doing so, the tax system changes the optimal composition of investors' portfolios. Second, the current tax system taxes losses and gains asymmetrically. While losses can be deducted in full, capital gains are taxed preferentially at a 50% discount.

Combined, the distortions of the current tax system encourage investment in certain forms of investment and in negatively geared assets, like property. As a result, negative gearing has benefited individuals and groups who were able to take advantage of the asymmetric tax treatment of losses and gains.

Policy changes to negative gearing

There have been calls from various groups to change the negative gearing tax policy, on the basis that it favours certain classes of people and offers unfair benefits to them. One of the primary reforms suggested is to ring-fence investment income. Other suggestions include limiting the amount of losses that can be adjusted, restricting negative gearing based on an individual's income, or limiting it to new construction, in the case of property investments.

Reducing or restricting negative gearing to certain types of investment, or classes of investors, will further distort investment portfolios. It would also induce price effects on affected asset classes. For example, eliminating the deductibility of losses from property investment would reduce property investment. A decrease in the demand for housing (fewer buyers), would reduce property prices; the magnitude of such a reduction is an empirical question dependent on a particular policy's design.

TTPI appreciates the research assistance provided by Prasad Giribalan for the preparation of this Tax Fact.

Cite as: TTPI (2019), *Australia's Tax Policy: What is Negative Gearing?*, Tax Fact #12, Tax and Transfer Policy Institute, Canberra.

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