Master Builders Australia

Submission to the House of Representatives Standing Committee on Economics' Inquiry into Tax Deductibility

January 2016

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1 Introduction

1.1 Master Builders Australia is the nation's peak building and construction industry association which was federated on a national basis in 1890. Master Builders Australia's members are the Master Builder state and territory Associations. Over 126 years the movement has grown to over 32,000 businesses nationwide, including the top 100 construction companies. Master Builders is the only industry association that represents all three sectors, residential, commercial and engineering construction.

1.2 The building and construction industry is a major driver of the Australian economy and makes a major contribution to the generation of wealth and the welfare of the community, particularly through the provision of shelter. At the same time, the wellbeing of the building and construction industry is closely linked to the general state of the domestic economy.

2 Overview

2.1 The Federal Government has asked the House of Representatives Standing Committee on Economics (HRSCE) to undertake an inquiry into the simplification of Australia's personal and company income system.

2.2 The Terms of Reference for the Inquiry call for the HRSCE to:

> *"… examine some options to simplify the personal and company income tax system, with a particular focus on options to broaden the base of these taxes in order to fund reductions in marginal rates. Matters to be examined include:*
>
> *The personal tax system as it applies to individual non-business income, with particular reference to the deductibility of expenditure of individuals in earning assessable income, including but not limited to an examination of comparable jurisdictions such as the United Kingdom and New Zealand; and*
>
> *The company income tax system, with particular reference to the deductibility of interest incurred by businesses in deriving their business income.*

2.3 Master Builders' position is the Australian taxation system must be efficient, globally competitive and fair if the nation is to meet the major economic and public policy challenges ahead. It must also keep Australia as an attractive destination for domestic and foreign investment and to maintain capital inflows to meet the nation's financial needs.

2.4 More needs to be done to ensure the tax system rewards entrepreneurship and reduces compliance costs for business, particularly small business. In this context, the Federal Government's current tax review is an opportunity to lay down a pathway to holistic taxation reform which will deliver a more globally competitive, and efficient taxation regime in Austraia.

3 Master Builders Tax Reform Agenda

3.1 The current inquiry is taking place against the background of a major review of the structure, performance and future direction for Australian's taxation system (see, Australian Government, 2015).

3.2 Master Builders has been active, and will continue to be actively engaged, in this process, advocating for a better taxation system which promotes Australia's international competitiveness, rewards entrepreneurship and initiative, and reduces the tax compliance burden for both business and personal income taxpayers.

3.3 The Australian taxation system must be efficient, globally competitive and fair if the nation is to meet the major economic and public policy challenges ahead, to keep Australia as an attractive destination for investment and to maintain capital inflows.

3.3.1 Key challenges are: structural integrity of the budget, ageing of the population; globalisation of the world economy; continuing structural change; lifting productivity performance; and improving international competitiveness.

3.4 Master Builders rejects the proposition that increasing any given tax (for example, the Goods and Services Tax rate) in isolation to cover higher and/or inefficient government spending is genuine tax reform. Rather, it is little more than merely increasing the tax burden on business and personal taxpayers.

3.5 The building and construction sector is one of the most intensely taxed in Australia, and bears a direct and indirect tax burden from all levels of government — Federal, State and Territory and Local.

3.5.1 This high and onerous tax burden distorts investment decisions, discourages entrepreneurship and innovation, reduces business investment and employment opportunities, and diverts scarce resources into unproductive and unnecessarily costly tax compliance within a key sector of the Australian economy.

3.5.2 These impacts, in turn, reduce housing affordability, increase housing stress and add to the fiscal burden on governments for housing assistance.

3.6 Master Builders' high level tax reform priorities call for:

- a comprehensive review of the narrow GST base;
- any increase in the GST rate must not be undertake n without first effecting comprehensive tax reform;
- reducing the company tax rate to not more than 25 per cent;
- reducing the differential between the higher marginal personal income tax rates and the company tax rate;
- simplifying tax compliance, especially for small business to free up entrepreneurial energies for more productive purposes, such as generating investment, employment and productivity;
- retaining the tax exempt status of home ownership and negative gearing;
- providing incentives for the removal of inefficient state taxes including infrastructure taxes, charges and levies; and,
- introducing a reducing, stepped rate of capital gains tax.

3.7 Master Builders believes a holistic approach to tax reform is essential. Measures must not be considered in isolation or as single issue trade-offs. Rather, the tax "blueprint" must be a comprehensive, detailed, and specific package that allows zero "wriggle room" in terms of execution.

3.8 The current inquiry has an important role to play in the ongoing tax reform program of work, and we welcome the opportunity to contribute to its deliberations.

4 General Deductions

4.1 Master Builders notes the Terms of Reference for the current inquiry ask the Committee to consider the tax deductibility for business and/or personal taxpayers of other expenses incurred in earning assessable income.

4.2 At the same time, we are cognisant the Federal Government in its ongoing tax reform consultations has sought public comment on a proposal which could impact the capacity of small business to claim deductions for certain expenses incurred in earning an assessable income (Australian Government, 2015: 119 – 120).

4.3 Under the potential arrangement (which, to be clear, has only been 'flagged' for public discussion, and is not formal government policy) small businesses could be subject to a much lower, even zero, rate of taxation, which would be 'funded' by reducing, if not eliminating, the multiplicity of tax concessions provided to such businesses.

4.4 Master Builders has an open mind about, and would welcome the opportunity to discuss further with tax policy makers, the 'zero rate' proposal, subject to:

- the composition and nature of the overall package involved (that is, the tax concessions being 'traded-off' for the reductions in the tax rate); and,
- there being an overall reduction in the tax burden carried by small business – that is, they be net better off as a result of the new package.

5 Negative Gearing

5.1 An important deduction of expenditure for individuals in earning assessable income are the expenses associated with holding an investment property.

5.1.1 The Australian Taxation Office (ATO, 2015) reports almost 1.97 Million personal income taxpayers claimed net negative rental income of almost $5.4 Billion (or an average of just over $2740 per claimant) in the 2012/13 financial year (the latest for which figures are available).

5.2 This situation is particularly relevant for individuals whose investment property is 'negatively geared'.

5.3 Key characteristics of a negatively geared investment property include:

- mortgage interest repayments exceed net income from the property;
    - net income from the property is rental income less other (non-interest) deductible expenses (such as insurances, property agent fees, depreciation); and,
- where there is net income from the property, this loss can be applied against other income, such as salary and wages.

5.4 For example, if an individual has mortgage interest repayments of say $25,000 per annum, net income from the property of say $15,000 per annum, then taxpayer can apply the difference (of $10,000) against their other income.

5.5 The taxation treatment of investment properties (which includes negative gearing) has been given expansive consideration in recent reviews (both completed and ongoing) of Australia's taxation system, most notably:

- the "Australia's Future Tax System" review (also known as the "Henry Report; Australian Government (2009); and,
- the current "RE: Think" tax reform process (Australian Government, 2015).

5.6 Without rehearsing the full discussion of the taxation treatment of investment properties in each of these documents, it is worth highlighting some of their key points.

5.7 The "Henry Report" (Australian Government, 2009) in their final report concluded (at page 418), inter alia:

- changing the taxation of investment properties could have an adverse impact in the short to medium term on the housing market; and,
- changes to the tax treatment of investment property should only be adopted following reforms to the supply of housing (for example, land release policies).

5.8 Taken as a whole, the Henry Report concluded (at page 420):

> *"A range of other policies are likely to have a more significant impact on housing supply than tax settings.*
>
> *The tax system is unlikely to be an effective instrument to move housing prices toward a particular desired level and the tax system is not the appropriate tool for addressing the impact of other policies on housing affordability."*

5.9 The Abbott/Turnbull Government's tax reform process (Australian Government, 2015) also makes a number of important observations (at pages 63 to 65 inclusive) about the operation of 'negative gearing' within the Australian taxation system.

5.10 These observations include:

- the tax treatment of investment in real estate is the same as that for investment in any other asset which produces current incomes;
- many of the reasons people invest in residential property rather than other assets have little to do with taxation;
- negative gearing of itself does not cause a tax distortion;
- negative gearing allows more people to enter the asset market (for example, residential property) than would otherwise be the case (for example, if they relied on equity funding alone);

- negative gearing promotes consistency of treatment between debt and equity funding (through its treatment of interest expenses); and,
- any taxation advantages for individuals investing in residential property do not come from borrowing (that is, negative gearing) but rather from the tax treatment of any capital gains on the asset concerned.

6 Housing Investor Profiling

6.1 Public conversation on taxation reform all too often (mis)represents negatively geared housing investors as 'high income, professional elites'.

6.2 A careful analysis of the ATO's 'Two Per Cent Sample File' of PAYE taxpayers (for the 2012/13 financial year) – which contains confidentialised data reports for more than 238,000 personal income taxpayers – shows this picture of housing investors is, quite simply, wrong.

6.3 Analyses by Master Builders of the 'Two Per Cent Sample File' has produced a set of socio-demographic profiles of personal income taxpayers who are negatively geared housing investors.

6.4 (While Master Builders acknowledges the ATO as the source of the data set used in this analysis, the design and execution of, and the inferences drawn from, the analyses and the modelling are ours alone.)

6.5 Our modelling and analyses focused on three key socio-demographic characteristics of personal income taxpayers, namely age, occupation, and income.

6.6 Age: the incidence of 'negative gearing' appears to be highest in the 35 to 39 years (14.9 per cent of such taxpayers), and the 30 to 34 years, and the 40 to 44 years age groups (both at around 14.2 per cent of such taxpayers).

6.6.1 Looked at another way, almost two-thirds (62 per cent) of taxpayers claiming 'negative gearing' were in the 25 to 49 years age cohort.

6.7 Occupation: the Clerical and Administrative, the Technical and Trades, and the Community and Personal Services Workers groups together account for almost one-third (33.2 per cent) of 'negative geared' taxpayers.

6.8 Income: more than one-third (34.9 per cent) of all 'negatively geared' taxpayers earned less than $39,999 in the 2012/13 financial year;

- just over half (50.2 per cent) earned less than $59,999 in the 2012/13 financial year; with,
- almost two-thirds (65.4 per cent) earning less than $79,999 per annum.

6.9 The analyses (Master Builders, 2015: see Attachment) indicates the most important socio-demographic drivers of the different likelihoods of being positively versus negatively geared are likely to be age, life-partnered status, and occupation, while salary, gender and state of residence appear to be less important.

6.10 Looked at another way, the socio-demographic profile of a person most likely to have net negative rental income would be:

- female, in a life-partnered relationship, working in a professional or community/personal service occupation, with an income of between $40,000 and $80,000 per annum, aged between 40 and 59 years, and living in Queensland.
- That is, they are <u>not</u> the 'high income elites' claimed by some commentators – rather someone closer to Mr and Mrs Average Australia.

7 Master Builders' Position on Negative Gearing

7.1 Master Builders recognises it is appropriate for the Federal Government, from time to time, to review the design, performance and impact of its taxation system.

7.2 However, Federal Government must provide certainty to investors in housing stock, of whatever form, on the tax treatment of such investments.

7.3 Master Builders' regards 'negative gearing' as a vital element for ensuring supply of more affordable residential housing for lower income earners and for those who elect to rent as a life-style choice.

7.4 Analyses by Master Builders estimate negative gearing accounts for:

- between 9 and 11 per cent of new housing supply each year, or
- more than 41,400 new dwellings in the 2014 and 2015 financial years, and
- homes for just over 110,300 people in those two years alone.

7.5 Hypothetically, had negative gearing not been available to housing investors in the 2014/15 financial year, and public housing been called upon to fill the resulting housing supply gap:

- Federal, State and Territory Governments would have been called upon to fund the supply of nearly 22,900 homes;
- at a potential cost to public revenue (ie: taxpayer) of almost $16.1 Billion.

7.6 Clearly, without an effective 'negative gearing' arrangement the supply of housing would be lower, and/or the rents charged for available rental housing would be higher.

7.7 Similarly, absent 'negative gearing' there would likely be substantial additional fiscal pressure on Federal, State/Territory and Local Governments to:

- directly provide public-rental housing (thus taking on a greater hands-on role as landlord); and/or,
- provide additional financial assistance to meet the higher (non-subsidised) housing costs carried by socially disadvantaged members of society.

7.8 Master Builders endorses:

- the Henry Report's conclusion it would be premature to unsettle existing taxation arrangements before concrete action was taken to address wider problems of housing affordability and supply; and,
- the Tax Discussion Paper's assessment negative gearing of itself does not cause a tax distortion, and has the positive effect of adding to (much needed) housing supply.

7.9 Against this background, Master Builders strongly recommends the Federal Government leave unchanged the current arrangements for the taxation treatment of investment properties until such time as the wider impediments to housing affordability and supply are effectively resolved.

8 Conclusion

8.1 Master Builders welcomes the opportunity to provide a submission to the House of Representatives Standing Committee on Economics for its inquiry into tax deductibility.

8.2 As over-arching principles, Master Builders believes:

- the Australian taxation system must be efficient, globally competitive and fair if the nation is to meet the major economic and public policy challenges ahead;
- more needs to be done to ensure the tax system rewards entrepreneurship and reduces compliance costs for business, particularly small business; and,
- in this context, the Federal Government's current tax review is an opportunity to lay down a pathway to holistic taxation reform which will deliver a more globally competitive, and efficient taxation regime in Australia.

8.3 More specifically in the context of the terms of reference for the current review, Master Builders:

- has an open mind about, and would welcome the opportunity to discuss further, the 'zero tax rate for small business proposal contained in the Federal Government's 'Re: Think" tax discussion paper; and,
- believes the current arrangements for the taxation treatment of investment properties remain unchanged until such time as the wider impediments to housing affordability and supply are effectively resolved.

9 Bibliography

Australian Government (2009), “Australia’s Future Tax System”, Federal Treasury, Canberra, (also known as ‘The Henry Report’).

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Master Builders Australia (2015) “Negative Gearing: An Analysis of the ATO’s 2 % Sample File”, Master Builders Australia, Canberra