Submission No. 25 - Mr Mike Buckley - received 19/03/2018 - authorised for publication 28/03/2018.

Submission to Public Accounts Committee consideration of the methodology to establish rates for unit-titled residences

Introduction

This submission addresses the rationale for the change to the general rating formula for multi-unit dwellings and its consistency with the tax principles set out in the ACT Taxation Review 2012.

The submission identifies inadequacies in the arguments presented in support of the new tax arrangement. These inadequacies are explained by reference to an actual case study. Further, the tax has introduced an inconsistency into the determination of the general residential rate whereby multi-unit property owners are assessed on the value of an asset they don't own.

Lastly, the submission provides an alternative approach to raising additional revenue from Units Plans without introducing an inconsistent general rating formula for multi-unit dwellings and single residences. Further work needs to be undertaken to establish a threshold to exclude multi-unit dwellings with relatively low average unimproved land values (AUV) from the additional impost.

Background

The Government announced its new methodology for determining the general rates for multi-unit dwellings to apply from 1 July 2017 in the 2016-17 Budget.

The nature and rationale for the measure was set out at page 258 of Budget Paper No.3 in the Taxation Reform Chapter. To quote from the statement:

> 'In Stage Two of the tax reform program, it is appropriate that the charging structure for general rates becomes more equitable between different housing types. From 1 July 2017, the Government will change the general rates calculation for multi-unit dwellings to base it on the total AUV [three-year average unimproved land value] of the land rather than the individual AUV of the unit (consistent with changes to Land Tax).'

Two arguments were made in support of the measure. First, because of the progressive nature of the general rate the magnitude of the rate increases for properties with lower AUVs has been less that those with higher AUVs. Second, that the AUV of a house can be higher than that of a unit even where both properties have a comparable market value.

Before addressing the change to the general rating methodology for multi-unit dwellings and the rationale for the change it is necessary to consider how general rates are determined and the principles which underpin the government's tax reform program.

General Rates Methodology

The General Rate has two components, a fixed charge and a valuation charge – see formula at page 3. The fixed charge is the same for all residences whereas the valuation component varies according to the average unimproved land value (AUV) of the property. The valuation component is progressive which means that the rate of tax applied to the unimproved land value increases on a sliding scale. In 2016-17 tax was levied at 0.276% for properties with an AUV of $150 000 or less. Whereas, a property which has an AUV greater than $600 001 will pay the tax at 0.575% for any AUV above that level.

The ACT Taxation Review May 2012 reviewed the determination of general rates in the Territory. The review found that '[T]he general rates system provides the ACT with a broad, transparent and efficient tax base on which to raise the taxation revenue required to provide services' (page 175). The Review also made several observations and recommendations. Pertinent to this inquiry is the observation that:

> 'Under the ACT's current rating system, smaller blocks pay a larger amount of general rates on a dollar per square metre basis than larger blocks. This imposes a disproportionate burden on households that consume and use land more efficiently. It reduces the overall progressivity of general rates.'

The Taxation Review did not identify any inequity in the general rate treatment of multi-unit dwellings as compared with single dwellings.

Tax Reform

Following the ACT Taxation Review the Government commenced a program of tax reforms which encompassed the phased removal of harmful taxes such as stamp duty on insurance products and residential conveyances. Revenue foregone from these taxes was to be replaced by an increase in general rates and more transparent charges e.g. emergency fire service levy. This Review did not, however, propose a change to the rating system of multi-unit residences.

The ACT Taxation Review noted that the fixed component of the general rate was the same irrespective of the size of the property and recommended that the tax system be made more equitable by increasing the progressive nature of the tax. To that end an additional tax fifth tax bracket was added to the rating scale for determining the valuation component of the general rate. The new bracket added a higher rate of tax for residences with an AUV greater than $600,000. The top tax bracket was previously $450,000.

Assessment of rationale for the new rating system of multi-unit residences

1. The observation that the increase in the general rate for residences with relatively low AUVs has been less than that of properties with higher AUVs implies that this was an unintended outcome and at odds with the rationale for the first stage of the tax reform measure. As the ACT Taxation Review noted, properties with a relatively low AUV paid more in general rates when measured on the basis of tax paid per square metre of land and recommended that this 'inequity' be addressed.

   The achievement of the policy objective has now been recharacterized as a justification for changing the rating methodology for multi-unit dwellings.

2. The comparison between the market value of a city unit and a dwelling in Charnwood and their respective AUVs is deceptive and irrelevant. The fixed component of the general rate is the same for all residential dwellings irrespective of location or the size of the block. The valuation-based component of the general rate is calculated according to the unimproved land value of the residential block. The reference to the market value of the property which comprises both the land value and the capital structure is not relevant to any assessment of the equity of the tax.

The principal reason why the dwelling in Charnwood has a higher AUV (and a higher general rate) than a city apartment is explained by the amount of land it occupies. The fact that multi-unit dwellings pay less in general rates than single dwellings with similar market values is not an equity issue as understood by the ACT Taxation Review 2012.

Assessment of the change to the general rate calculation for multi-unit dwellings

Prior to 1 July 2017 the general rate for single dwellings and multi-unit residences was calculated on a consistent basis. (ACT Revenue Office June 2016) Prior to July 2017 the general rate formula multi-unit dwellings was:

1. FC + (AUV*UE*P)

Post July 2017

2. FC+(AUV*P)*UE

(FC – fixed charge, AUV – three-year average of unimproved land value, UE - individual unit entitlement, P – rating factors or percentages)

The part of the formula in parenthesis is the valuation-based component of the general rate.

By shifting the UE component of the formula outside the parenthesis (and changing its order in the equation) means that the marginal rate is applied to the entire value of the unit title plan and not just the unit holder's share of the unimproved land value of the unit's title plan.

If the 'single block' treatment was applied on consistent basis, that is the unit title's plan is treated as a single residence, then the fixed charge would only be applied once. However, that approach would result in significantly less revenue being collected.

Instead, formula 2 is a hybrid of the two possible treatments - each unit pays the fixed charge and then the marginal rate is applied as if the unit title's plan is a singe dwelling.

As a strategy for raising more revenue the change is a very effective sleight of hand. However, it has introduced an inconsistency into the tax system by levying a tax on the value of an asset which is not owned by the taxpayer.

The change which has been made to the rating formula is also inconsistent with the methodology applied in NSW.

Barton Case Study

The case study included in the submission uses data from a Units Plan in Barton and its immediate single dwelling neighbours. The unimproved land value data was at June 2016.

The Units Plan comprises 116 residences occupying 4699 sqm – approximately 40.5 sqm per unit. The four single dwellings occupy 4239 sqm on Macquarie Street and face the multi-units complex. The average block size for the single dwellings was 1060 sqm.

Table 1 Barton Unimproved land values (ULV) and general rate payable

	ULV	Ave General Rate	ULV/m^2	Rate/m^2
Units Plan	$9,438,000	$989	$2008	$25
Single dwellings	$3,779,000	$5,274	$891	$5

As shown in Table 1, the average general rate levied on the single dwellings is significantly higher than the general rate payable by residences in the multi-unit complex. The ACT community, however, is not disadvantaged by this. By utilising land more effectively, the unimproved value of Territory land is increased ($2008 m^2 as opposed to $891 m^2). This strengthens the revenue base of the Territory. Moreover, as the Barton case study demonstrates, unit owners pay five times as much in rates as neighbouring single dwellings when assessed on rates paid per square metre of land occupied.

The absolute difference in rates does not take account of household structure (nor does the formula for assessing the general rate). In 2016-17 a single bedroom unit in the Units Plan paid $923 in general rates. If a neighbouring four-bedroom single dwelling had four occupants sharing the property, the individual share of the general rate would have been $1 390. If the number of occupants is considered, the absolute difference in the rate paid between a single dwelling and the unit would then be less than 50 per cent, not five times as much.

Table 2 Alternative rating formulas and revenue outcomes for Barton Case Study

	Consistent Treatment	Single Block	Hybrid
Units Plan	$115,732	$54,875	$142,850
Single dwellings	$21,096		

Table 2 reports the revenue outcomes from applying variations on the general rating formula. Column 1 shows the total of general rate paid by all owners within the Units Plan and the neighbouring single dwellings using the 2016-17 methodology. Column 2 shows the revenue that would have been collected if the Units Plan was rated as a single block using the 2016-17 rating parameters. While this approach is not consistent with the rating of multi-unit complexes in other jurisdictions it still raises twice the revenue that would have been raised if the multi-unit complex was replaced by a single dwelling.

Column 3 shows the rates that would have been collected in 2016-17 from the Units Plan had the current hybrid methodology applied in 2016-17 rather than from July 2017. The hybrid methodology increases the overall payment of general rates paid by Unit Plan residences by 23 per cent. This is an average – rates for some units increased by 18 per cent and for others by 37 per cent.

Applying the benchmark for assessing equity used by the ACT Taxation Review in 2012, then the conclusion to be drawn is that the rating calculation introduced post July 2017 has only made the inequity in general rates worse.

The inequity has been exacerbated as the rating percentage is applied to the unimproved land value of the Units Plan as a whole. In the case of the Barton Units Plan, this means that the highest marginal rate of tax is applied to $8 837 000 of land value when calculating the value component of the general rate. Prior to July 2017 only four of the 116 units in the Units Plan had an AUV greater than $150 000. The new methodology means that all units in the Unit Plans are assessed on the basis that their AUV is above $600 000 (and therefore rated at the top rate of 0.575%).

Why the reference to the market value of a residences is wrong?

General rates (and Land Tax) are assessed on the basis of the unimproved land value of the residence. Market value of a property takes account of the value of the land and any structure which is built on it.

Unimproved land value is the traditional basis for calculating general rates. The ACT Taxation Review considered this issue and recommend only a minor change to this, specifically to incorporate certain site development costs in the valuation methodology. The Government did not adopt the recommendation even though it would have raised more revenue and improved consistency with NSW.

Basing the tax on unimproved land value is seen to have the advantage of not discouraging new development. Assessing the general rate on the market value of a property could mean that at the margin households will invest less in their houses than they otherwise would have. (The current tax system e.g. capital gains tax exemption for the principal residence and negative gearing of property may encourage over investment, but two wrongs don't make a right.)

By referring to the market value of a residence to assess the equity of the general rate the government has introduced an apples and oranges comparison. In adopting a market value benchmark, the Government has also failed to take account of some fundament differences between multi-units and single dwellings.

In the case of single dwellings, a significant proportion of the market value consists of what is underneath the building. By way of example from Barton, the most recent single dwelling sale on Macquarie Street was for $1.3 million in July 2016. At that time the unimproved land value was $933 000. In 2016 the insured value of the common property of the Barton Units Plan was $55 million, more than 5 times the value of its land.

The principal asset of the unit owner is the building structure. For that reason, the Unit Titles Act requires Owners Corporations to protect the value of the building. For example, its insurance policy is to cover the building to the maximum extent possible. The Owners Corporation is required to prepare a sinking fund to cover the replacement of aged assets. Also, fire and emergency obligations are greater for multi-unit complexes than single dwellings. These obligations require expenditures not required by owners of single dwelling.

Pointing out these facts is not to criticise these obligations, but rather, to identify why the market value of units may appear high relative to a single dwelling. These obligations also mean that unit owners incur administration and sinking fund costs which are not borne by owners of single dwellings.

In an extreme example the owner of a single dwelling can ignore modernising their property and even some maintenance and the impact on the market value of the property would be small. If a multi-unit complex adopted a similar approach market values could be affected significantly. (Some investors might be less concerned thought their tenants might not be happy.)

To assert that residential unit holders should pay a general rate established on a different basis to that of single residences because of a one-off comparison of the relative market values city units and suburban dwellings represents a failure by Treasury to properly inform the decision-making process.

How did we get to this mess?

In part, the explanation of the change to the rating structure provided in Budget Paper 3 was glib. While it was not impossible to establish what was proposed, the documentation did not provide the actual amendment to the rating formula (as shown at page 2). Nonetheless, the documentation released at the time did indicate the magnitude of the rating impact.

Second, the rationale for the change, that is to improve equity, was accepted at face value. The Public Accounts Committee commissioned Pegasus Economics to review the ACT for 2016-17. Pegasus considered the measure and noted at page 17:

> 'This change seems justified on the basis of horizontal equity that requires people with the same means to pay the same amount of tax in the event of house prices and unit dwellings have similar prices.'

Was the Public Accounts Committee properly informed? Is there any evidence that residences with similar market values have an equivalent capacity to pay? Horizontal and vertical equity are more easily understood when expressed in terms of income. However, in circumstances where taxpayers can be asset rich but income poor the distinction is more problematic.

At the more practical level did Pegasus consider if the tax base is unimproved land value what is the relevance of market value for assessing equity? Did they seek to establish how single dwellings and multi-unit dwellings are taxed in other jurisdictions?

The failure of the Pegasus Report to raise the most basis questions is surprising. Immediately proceeding its consideration of the change to the rating of multi-unit dwelling Pegasus spent a page addressing the Government's failure to remove stamp duties on cars while zero rating new vehicles emitting less that 130 grams of CO_2 per kilometre.

With this eye for detail Pegasus should have been quick to understand unit owners are just like owners of Tesla cars – that is rich people who were not paying the full amount of fuel excise.

My assessment is that the Assembly, on this occasion, failed to provide effective oversight of executive government. That is, it failed to ask the most basic of questions about the merits and consequences of the change to the general rate for multi-unit dwellings.

Is there a way out?

In the absence of sensitivity analysis supporting the development of the measure it is very difficult to see how the equity concerns – to the extent that there are any – can be addressed.

The structural problem with the tax can be readily addressed. It is possible to overcome the problem of taxing unit owners on the basis of an asset they don't own by separately rating the Owners Corporation. This approach would mean that the Owners Corporation would have to make a payment to the Revenue Office and to raise the funds for the payment through the levies it imposes on owners.

There are a couple of practical problems with the option. First, an Owners Corporations might not have the funds to pay the obligation until a new administrative fund budget is approved. This is only a timing issue which would mean a one-year lag in the receipt of the higher tax obligation. More significantly, the Owners Corporation would be responsible where owners don't meet their levy obligations. This could affect the solvency of an Owners Corporation which is not well managed.

While these problems would need to be addressed, raising a separate general rate on the Owners Corporation could provide an opportunity to better target the measure by excluding Owners Corporations with an AUV below a threshold level. Before you could set the threshold, sensitivity analysis would be needed to better understand the equity concerns in relation to multi-unit dwellings.