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Negative gearing: separating fact from fiction

Tuesday, 12 November 2024
11:30am – 12:30pm (AEDT)

Webinar will commence soon

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National Tax Director

Advisory. Tax. Audit.

Nexia Australia

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Introduction
Negative gearing

- Incites strong opinions
- Public discourse often contains myths, misconceptions and mythology
- The subject is not going away
- Today's goal:
    - To inform

Today’s session
Negative gearing

- What it is; why people do it
- How do you know if you’re doing it right?
- Tax rort? Or clever tax planning?
- Three-act performance
- Various claims – fact or fiction?
- Where to from here?

Act I

- What negative gearing is

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What is negative gearing?

- Investment strategy
  - Leverage off debt
  - Bigger investment footprint

Negatively gear… what?

- Shares
- Commercial property
- Residential rental investment
  - Today's focus

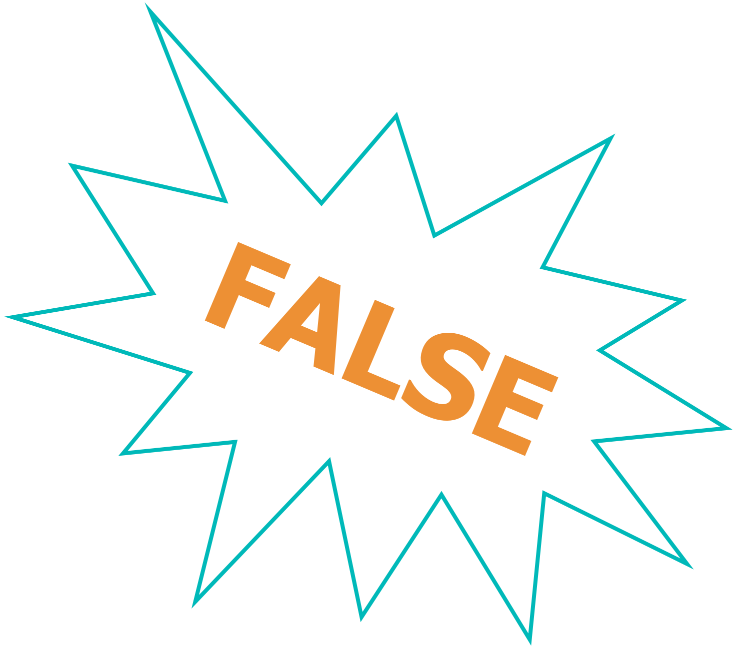
- In earlier years, at least:
  - Deductions typically exceed income

Claim #1

Negative gearing is a legislated tax concession

- A tax break, a handout, a giveaway
- Claim made by:
    - People who don’t know the law

- In reality…
    - There are no specific laws for negative gearing



Residential property investment

Example 1

- Purchase established house, rent out
- 20% deposit
- Deposit funded by:
  - Savings
  - Draw on equity in home mortgage

Investment property

	$
Cost	600,000
Stamp duty	30,000
Total	630,000
Deposit (20%)	126,000
Bank loan	504,000
Total	630,000

Residential property investment

Example 1

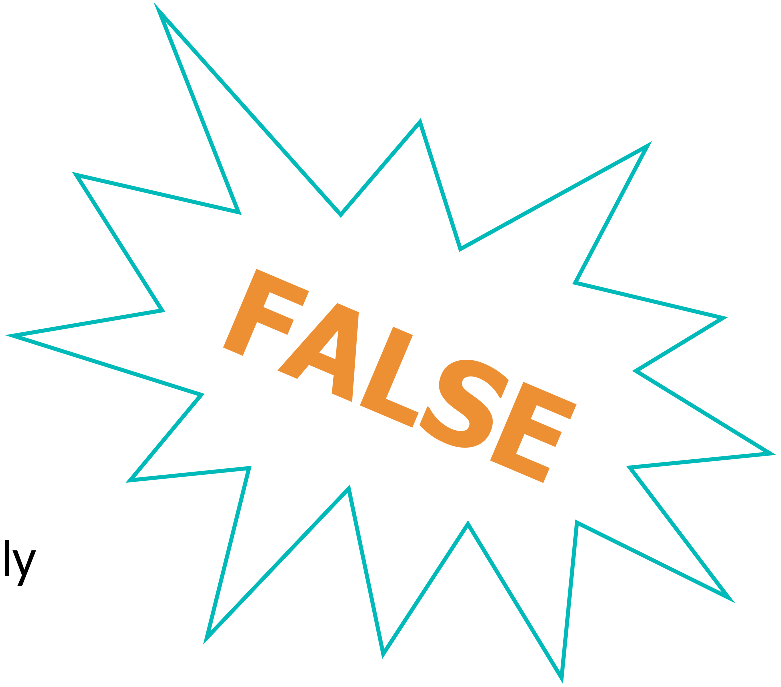
- Negatively geared loss deducted against salary income

First year's rental P&L	
	$
Rent	30,000
Building w/off	7,000
Insurance	3,000
Interest	31,000
Management fees	2,500
Rates & land tax	3,500
Repairs & maint	1,000
Total	48,000
Loss - "deduction"	(18,000)
Tax saving! (47%)	8,460

- Note: no depreciation deduction

Claim #2
Tax minimisation strategy

- Claim made by:
  - People who are bad at maths
- A little arithmetic…
  - Deliberately losing $1 solely to save 47c is… silly



Residential property investment

Example 1

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Management fees	2,500
Rates & land tax	3,500
Repairs & maint	1,000
Total	48,000
Loss - "deduction"	(18,000)
Tax saving! (47%)	8,460
After-tax loss	(9,540)

- The rest of the story…

Claim #3
Government loses revenue

MOSTLY FALSE

- Claim made by:
  - People who haven’t thought it through

- Follow the money…
  - Negative gearing losses mostly reflect income to someone else
    - Banks, insurance companies, real estate agents, etc pay tax on that
  - Plus:
    - Tax paid on properties turned positively geared
    - Tax paid on capital gains

Pre-submitted questions

Act II

- Why people do it

Why people do it

- Bigger investment footprint
  - Build greater wealth over time, and more quickly
  - Supercharges returns on equity…

    or losses

Example 2
The power of leveraging

- You have $100 to invest
  - You could invest that $100
  - Or… borrow $900, and invest $1,000
- Either way, you have $100 of equity

- What happens if your investment rises in value by, say, 10%?

Example 2

The power of leveraging

- A 10% increase can turn your $100 into:
  - $110, or
  - $200

	Investment footprint	
	$100	**$1,000**
	$	$
Investment	100	1,000
10% value increase	10	100
Value	110	1,100
Debt	-	(900)
Equity	110	200

Example 2

The power of leveraging

- However, a 10% *decrease*…

	Investment footprint	
	$100	**$1,000**
	$	$
Investment	100	1,000
10% value decrease	(10)	(100)
Value	90	900
Debt	-	(900)
Equity	90	-

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Net tax payer
Net rental income

- Accumulated after-tax rental loss
  - Net cash outflow in earlier years (slide 13)
  - Delayed gratification
- Turn positively geared?
  - Start “recouping” earlier years’ losses
  - Paying tax on rental profit

- Accumulated after-tax rental profit

Net tax payer
Capital growth

- Still in position of accumulated after-tax rental loss?
  - Capital growth make up for it?

- ie, *if* were to sell property:

After-tax capital gain > Accumulated after-tax rental loss ?

  - If yes, you're in front
  - If no, you're behind

Are you doing it right?

Do you know your break-even point?

- Still in position of accumulated after-tax rental loss
- Do you know what property's value needs to be, to offset above?
- If not, can't know whether in front or behind

Example 3
Break-even point

- Refer to Example 1
- After one year:
  - After-tax rental loss of $9,540
- To offset, what must property's value grow to?
  - $652,000

Example 3

Break-even point

	$	$
Required sale price		652,000
Cost base		
Commission	16,300	
Purchase price	600,000	
Stamp duty	30,000	
Build w/off	(7,000)	639,300
Capital gain		12,700
Less 50% discount		(6,300)
Net capital gain		6,400
Tax at 47%		3,000

Capital gain	12,700
Less tax	(3,000)
After-tax capital gain	9,700

- About matches accumulated rental loss

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Example 3

Break-even point

- One year on:

Break even	$	Reason
Pre-tax rental loss	$18,000	47c
Pre-tax capital gain	$12,700	23.5c

- Roughly equal, *after tax*

Example 3

Break-even point

- One year on:

	$
Purchase price	$600,000
Break-even market value	$652,000
Required growth	8.7%

Benchmark

- Recalculate each year, compare to sense of property's market value

Example 3

Use equity for next property

- Equity builds as property grows in value:

	Start	1 year	2 years
Growth, say		8%	9%
Value	$600,000	$648,000	$706,000
Loan (interest-only)	$504,000	$504,000	$504,000
Equity	$96,000	$144,000	$202,000

Example 3
Use equity for next property

- Equity builds as property grows in value:

	Start	1 year	2 years
Equity	$96,000	$144,000	$202,000

- Borrow against equity to fund deposit & stamp duty on next property
  - Lender's mortgage insurance
  - Service; tax refund subsidises

Tax rort?

Or clever tax planning?

- Neither

Claim #4

Allowing negative gearing deductions means an even playing field

- Claim made by:
  - People who should be careful what they wish for

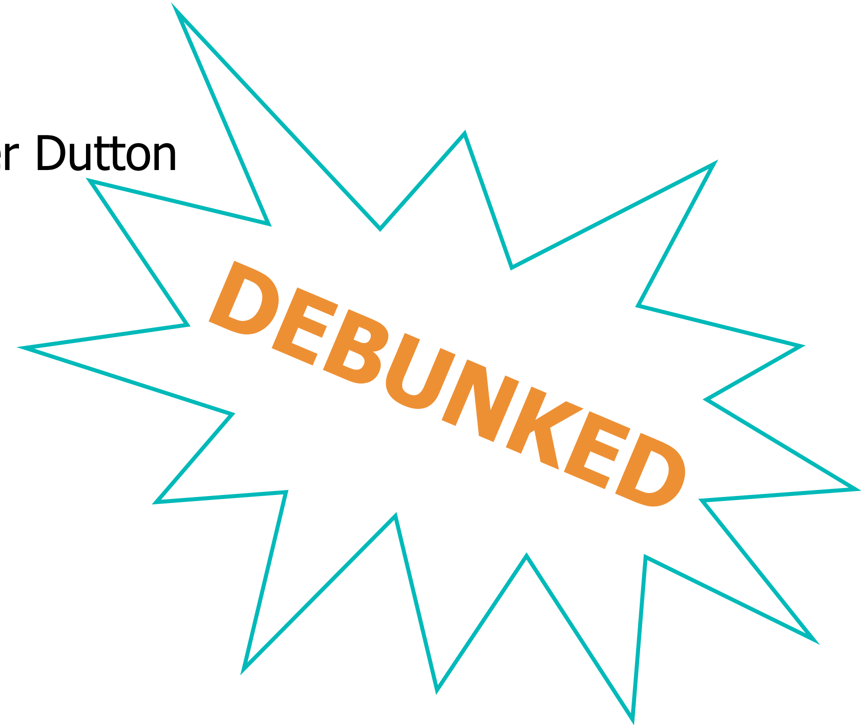
- Tax law often is *not* an even playing field
  - Discriminate for good reasons
- CGT on the family home…?

Claim #5

Restricting negative gearing deductions will crash house prices

- Claim made by:
  - Malcolm Turnbull, Scott Morrison, Josh Frydenberg, Peter Dutton

- Studies have concluded:
  - Modest, one-off, 1-2% decline



Claim #6

Restricting negative gearing deductions will push up rents

- Claim made by:
    - People steeped in mythology

- What really happened in 1985 – 1987…

Sydney	↑	Up
Perth	↑	Up
Melbourne	←→	Even
Brisbane	↓	Down
Adelaide	↓	Down

- Local cyclical factors
- Grandfathering

Claim #7

Vast majority of negative gearers on below-average income

- Claim made by:
  - The usual suspects

- Large number of teachers and nurses
  - Mostly one property each
- Smaller number of surgeons and engineers:
  - Multiple properties
  - Bigger values
  - Disproportionate share of deductions

MISLEADING

Claim #8

Negative gearing adds to housing supply

- Encourages investment in housing properties
  - Therefore, increases housing supply
    - Therefore, improves housing affordability

- Claim made by:
  - People who don’t know the stats
    - Or if they do, they haven’t thought it through

Claim #8

Negative gearing adds to housing supply

- Vast majority of investors buy established
  - Number of houses unchanged
  - No addition to supply
- Former owner displaces tenant in demand pool
  - Supply and demand unchanged

TOO LITTLE TO QUALIFY AS A MEANINGFUL CLAIM

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Summary so far

Claim	Stack up?
Defenders	
Crash house prices	✗
Push up rents	✗
Even playing field	✗
Mostly <ave income	✗
Adds to supply	✗
Detractors	
Specific concession	✗
Tax minimisation	✗
Lost revenue	✗

More pre-submitted questions

Act III

- The *twist*

One last claim

Fuels unproductive, speculative growth in house prices, reducing affordability

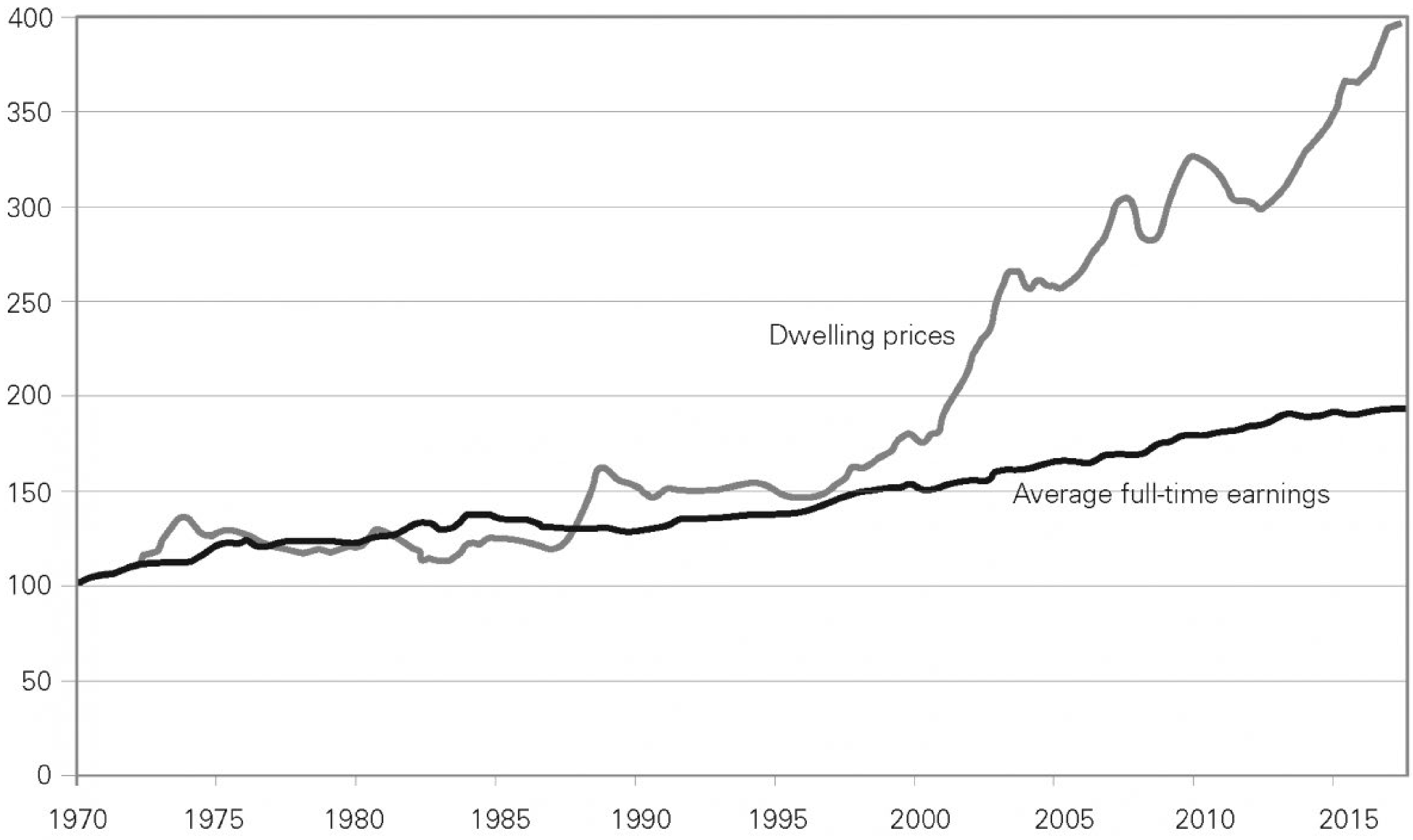
- Claim made by:
  - People with a broader understanding of what's going on

- But there's a caveat

House prices and wages

Median house price / income ratio	
Before 2000	Today
~4 : 1	~8 : 1

- What happened from 2000?



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What happened from 2000
Caveat

- 50% exemption for capital gains – September 1999
  - *Combination* with negative gearing
- Other factors, such as:
  - Interest rates
  - Migration management
  - State/Territory governments
  - Local government

What happened from 2000

Outcomes

- Fuelled demand (as investments) beyond supply
  - Prices became disconnected from incomes
- Speculative growth
  - Does not add productive value to the economy
- Houses are different to other asset classes

So then…

Restrict negative gearing deductions and reduce 50% CG exemption?

- Two questions in response:
  - And… do nothing else?
  - It's that simple, is it?
- Broader reform issue in play

Back to that final claim…

Fuels unproductive, speculative growth in house prices, reducing affordability

- If you want to fix this, need to fix wider problems in our tax system as part of a coherent set of reforms, across multiple tiers of government.

YES, BUT THERE'S A CAVEAT, AND IT'S NOT THAT SIMPLE

Conclusion

Negative gearing

- Much public discourse less than fully informed
- Almost everyone knows Act I
    - Some know Act II
    - Few aware of Act III
- Resolving Act III requires looking beyond negative gearing & capital gains
- Wider reform needed, for any chance of gaining public consent

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