Financial System Inquiry – Q &A

The Inquiry notes 'the tax treatment of investor housing, in particular, tends to encourage leveraged and speculative investment in housing.' P 278 **Should the government reform tax treatment in this area?**

- Tax reform is an issue for Government.
- The RBA has nonetheless noted in the past that the concessional rate of taxation of capital gains might encourage leverage speculation, particularly in combination with negative gearing provisions. (Malcolm's remarks to Senate Inquiry, 2003 PC submission)
- As we have made clear in our recent communications, the Council of Financial Regulators considers that some risk has recently been building in investor housing. It is probably not a coincidence that this is happening at a time when some other asset classes have seen modest, and in some cases quite volatile, returns.

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NEGATIVE GEARING

Negative Gearing Explained

- Geared investment – Investment purchased with debt
- Negatively geared investment – Investment purchased with debt where the return on the investment (rental income, dividends) is less than the cost of owning that investment (including the interest on the loan)
    - *So also applies to other investments such as shares* (though LVR would be smaller)
- Current tax law allows the difference (the loss on the investment) to be claimed as a 100% deduction against wage and salary income*.
- Effectively reducing the after-tax cost of holding a loss making investment
- Only makes financial sense if the investor expects to make an offsetting future capital gain
- Originally introduced to increase the supply of rental properties

Interaction with Capital Gains Tax

- The Bank has stated in the past that we are only concerned with negative gearings interaction with capital gains tax.
- Only half of any capital gains (so long as the asset is held for more than a year) are taxed at your marginal rate, however the loss on the investment initially is 100% tax deductible
    - Which may encourage chasing of capital gains - Property is especially impacted as it can be purchased using higher leverage than shares for example.

Financial Stability Concerns

- Financial System Inquiry – could encourage 'leveraged and speculative investment in housing'
- Speculation – investors bidding up housing prices
- Excess leverage – financial stability implications if prices fall
- Increased prevalence of IO loans than otherwise – which don't amortise and so don't provide as much of an equity buffer in the situation where prices fall than a P & I loan.

Potential changes

- Capping the amount of interest on investment property loans that can be claimed as a tax deduction – seems unlikely to happen, similarly to the removal of CGT exemption for OO prop over $2 million
- Henry tax review recommended a 40% savings income discount applicable to net interest income, net residential rental income and capital gains and losses. This would make negative gearing less attractive. – Also seems unlikely as it was ignored when it was first suggested in 2011.

Any change which discourages negative gearing may be a good thing from an FS perspective

Potential negatives from changes that make negative gearing less attractive?

- Potential increase in rents?
- Large-scale sale of negatively geared properties? – though only if changes were not grandfathered

* Note that this income would include rents