HOUSING TAX INTEGRITY – DISALLOWING TRAVEL DEDUCTIONS AND LIMITING DEPRECIATION DEDUCTIONS

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Background

I am a Property Investment expert, Skynews Business resident property commentator, author of 8 Property Investing books and I have been helping property investors for almost 25 years.

In addition, I am the Founder and inaugural Chair of the Property Investment Professionals of Australia (PIPA), a not-for-profit industry association aiming to provide standards and accreditation to an industry which is presently unregulated.

To distinguish myself from the spruikers, my company provides advocacy services for property investors for a low fee. We do not make commissions from property sales in any way, nor do we become involved in the transaction. We provide pure education and support services only and act on behalf of the investor, not the developer.

Therefore I have considerable experience in the Property Investment Industry and could be considered a key stakeholder.

The Industry

While property investment has not been considered an industry in the past, the level to which it has grown now most definitely constitutes an industry.

Contrary to the misconception that property investors are wealthy, we have found that, resoundingly, the typical property investor is a mum and dad in their early forties with teenaged children. They have recognised that they do not have enough in superannuation to be able to sustain a suitable lifestyle in retirement and they believe that an aged pension will either be considerably harder to obtain or well below the amount they will require.

They do not have cash to invest, as they still have dependents and the usual bills, and do not see themselves as capable of having a share portfolio or investing in managed funds.
They do have considerable property equity having most likely owned their own home for a period of around 15 years.

They do not feel a comfort borrowing against this home to invest in shares or managed funds, as they perceive these to be volatile and risky. They do feel comfortable borrowing against the family home to buy more property as they feel more confident with this asset and also like the fact they can see and touch it.

How it works, in a nutshell.

As they have no cash to invest, property investors will usually borrow 100% of the purchase price of an additional property, and also borrow the costs such as stamp duty and conveyancing. To do this they will offer the equity they have in their own home as additional collateral security.

Depending upon the interest rate of the day, the rental income will be less than the combined expenses of interest and running costs of the property. This shortfall then becomes the 'amount invested' each week by the investor, who hopes that eventual capital gain will be greater than the total of funds invested.

Until May 9, 2017

Under previous legislation the property investor could receive a deduction as follows:

1. The actual loss (the difference between rent and expenses) saw a deduction at their marginal rate of tax – meaning up to 45% of the shortfall was covered by a return of tax.
2. The building was able to be depreciated. With an average yearly depreciation amount of, say $6,500, a further tax refund (in that example) of up to $3,375 per year might be obtained – and this further reduces the yearly loss
3. The plant and equipment was able to be claimed at varying rates. Each time a new investor purchased a property, any plant and equipment was provided a new effective life and deductions were based on a second- hand value at this new life. In many cases, and especially when interest rates were low, reducing holding costs of property, this last deduction resulted in enough tax returned to cover the rest of the loss and sometimes result in the cash flow on the property becoming positive.
4. Any travel associated with inspecting the property could be claimed.

Because of this outcome, **many people who otherwise had no cash to invest, and could not afford to contribute any funds on a weekly basis,** could still invest to create a retirement income and work toward becoming self- funded in retirement.

Benefits

The long- term benefits of allowing these tax advantages are that many ordinary Australians who otherwise would *not* have been able to plan effectively for their retirement years now can, and the long- term outcome is that more people will retire in a position to either self- fund, or only require a part pension.

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The shorter- term benefit is that many of these investors are in a position to begin to pay off investment debt using the cash flow created by the tax advantages, and many properties quickly become **positively geared.** In short this means that within a few years (in our experience around 5 years) property investors find themselves in a 'tax payable' position – their income increasing, their deductions reducing as they paid down debt and reduce the interest expense, and their plant and equipment deductions depleting.

NOTE: Most property investors keep, or intend to keep, their investment properties for a term of at least 15 years. This means that most property investors receive tax advantages for 5 years on average, and then pay additional tax for the remaining 10 years.

What investigation has been done into what will be lost in future tax collected when Australians no longer invest in property due to the lack of tax advantages and because they cannot afford to do so without these advantages?

Post May 9, 2017

The proposed situation post May 9 means the typical investor can make claims as follows:

1. The actual loss (the difference between rent and expenses) sees a deduction at their marginal rate of tax – meaning up to 45% of the shortfall is covered by a return of tax.
2. The building is able to be depreciated. With an average yearly depreciation amount of, say $6,500, a further tax refund (in that example) of up to $3,375 per year might be obtained – and this further reduces the yearly loss.
3. Only brand- new properties can have plant and equipment deductions, or plant and equipment bought by the owner for an established property. Existing properties will have no allowable deduction on existing plant and equipment items purchased as part of the transaction.

Issues

1. This represents inequity. While I agree that the existing method of applying a new effective life is unworkable and provides a benefit over and above the spirit of the present legislation, I feel that removing the capacity to claim any balance depreciation remaining on plant and equipment is unfair. Just because the item changes hands does not change the fact that it still has some remaining effective life and to make that not allowed for future owners is unfair, when in other forms of investment (such as in a business), balance depreciation is passed onto new owners.

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2. The removal of this benefit has already had a marked effect on the participation of investors in the market place. The short- term benefit of cooling house prices is more than offset by the long- term disadvantage of having less people self- funded in retirement. Remember, most property investors have no cash to invest elsewhere and so they are unlikely to adopt an alternate investing plan – they simply won't invest at all.

3. If a property investor buys, say a second- hand air conditioner for their established property, how is this treated? Are they the original owner of that piece of plant for the purpose of using it in an income producing activity?

4. If this purchase of the second- hand item *is* considered to fall under the allowable deduction rule, since the property investor bought the item and put it into their property, what will stop property investors going one step further and buying established property under two contracts? One for the house and land and one for the plant and equipment? Under those circumstances, they bought the plant and equipment, second hand.

5. Removing the attractiveness of property investing may save some dollars in the short term but will come at a hefty cost over the 5 – 15- year term where many property investors typically fall into a tax- payable position, as their properties became positively geared.

6. On another front, the announcement has also had a negative impact in the many, many markets which did not need to be cooled. Sydney and Melbourne are the only over heated markets yet all of the integrity measures being applied are impacting markets which need a boost.

7. The removal of travel expense deductions is a fair action. This was an abused benefit and only made it easier for the spruikers to market overpriced property in sunny locations.

Suggestions

It is critical to overhaul the legislation which presently allows a new effective life to be obtained over, and over again by subsequent owners of the plant and equipment inside a property. However, a simpler solution would be to apply an effective life and value to an item once only, when it is new. Then, when a subsequent owner buys the property, they claim only the balance of what is left at the original purchase price. This is essentially how building depreciation currently works and it is a fair and equitable solution which acknowledges that, just because an item changes hands, the remaining value of it does not suddenly reduce to NIL. This solution also then treats investors of all assets, including businesses, equally.

This would be a palatable solution to property investors, keep the property investment industry robust without it becoming too hot, and solve the longer- term issue of assisting Australians to be less of a burden to the welfare system by continuing to encourage them to have in place strong wealth creation plans.

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