

FEBRUARY 2019

TAX ALERT:

**LABOR'S PROPOSED CHANGES TO NEGATIVE GEARING &
THE CAPITAL GAINS TAX DISCOUNT**

Introduction

Federal Labor leader Bill Shorten has announced the Labor party's (ALP) plan to introduce changes to both negative gearing and the Capital Gains Tax (CGT) discount to all investment assets. If introduced, these changes will have potentially far reaching implications for the Australian property market. The proposed changes are summarised below:

- **Negative gearing** - Labor has proposed to limit negative gearing to *newly constructed* property investments from a yet-to-be-determined date following the next election. All investments made before this date will be fully 'grandfathered', ensuring that taxpayers will continue to be able to deduct the full net rental losses against their taxable income.

Losses from *new investments* in existing properties can still be used to offset other investment income tax liabilities. These losses can also continue to be carried forward to offset future investment income and any capital gains on the investments.

- **Capital gains tax** - Labor has also proposed to halve the capital gains discount for all assets purchased after a yet-to-be-determined date following the next election. This will reduce the capital gains tax discount for assets that are held longer than 12 months from the current 50% to 25%.

All investments made before this date will not be affected by this change and will be fully 'grandfathered'. This policy change will also not affect investments made by superannuation funds. The CGT discount will not change for small business assets.

Potential Impact

There is a lot of debate and disagreement about the potential impact of these proposed changes on property prices. Noting that these proposed changes were first announced when the Australian property market was booming and it has since slowed down considerably.

Industry experts have contended, however, that the proposed changes appear to favour mature investors who have a combination of positively geared and negatively geared properties under mostly 'grandfathered' investments. Conversely, most smaller investors (ie. with a single negative geared property) will appear to be worse off. Further, in all likelihood it may increase demand for newly constructed properties, in preference to existing properties.

Essentially the ALP's proposed changes will result in the addition of a new category of tax loss – the investment loss. This may result in a whole new layer of complexity when preparing individual tax returns with taxpayers impacted having to appropriately calculate, apply and carry forward investment losses in addition to dealing with capital losses.

We have provided an example below to help explain the potential impact of these proposed changes.



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Example: Impact of proposed negative gearing restrictions on three different investors.

Investors	Alice	Bill	Charlie
Investment details for each Investor	<p>Alice borrows \$600,000 to buy an investment property in Melbourne.</p> <p>The interest rate is 5% pa and the net return (after all deductions other than interest) will be 3.5% pa.</p> <p>Alice also earns \$250,000 pa (ie. 45% marginal tax bracket) but has no other investments.</p>	<p>Bill borrows \$600,000 at 7% pa to buy shares in a Australian listed public companies.</p> <p>The net return (after all deductions other than interest) will be 2.5% pa.</p> <p>Bill already has a positively geared investment property, worth \$700,000, with a net return (after all deductions) of 3% pa.</p> <p>He also earns \$400,000 pa (ie. 45% marginal tax bracket).</p>	<p>Charlie borrows \$1,200,000 at 5% pa to:</p> <ul style="list-style-type: none"> buy a property for \$600,000 which will return a net rent (before interest) of 3%; and buy \$600,000 of shares in an Australian listed public company which will pay a grossed-up dividend yield of 5%. <p>In addition, Charlie uses \$500,000 of his own funds to purchase five-year treasury bonds, paying him an interest rate of 2.4% pa. (<i>assuming that treasury bonds covered by the negative gearing restrictions</i>)</p>
Interest expense?	$=\$600,000 \times 5\% \text{pa}$ $=\$30,000$	$=\$600,000 \times 7\% \text{pa}$ $=\$42,000$	$=\$1,200,000 \times 5\% \text{pa}$ $=\$60,000$
Investment income earned?	$=\$600,000 \times 3.5\% \text{pa}$ $=\$21,000$	$=(\$600,000 \times 2.5\%) +$ $(\$700,000 \times 3\%)$ $=\$15,000 + \$21,000$ $=\$36,000$	$=(\$600,000 \times 3\%) + (\$600,000 \times 5\%)$ $+ (\$500,000 \times 2.4\%)$ $=\$18,000 + \$30,000 + \$12,000$ $=\$60,000$
Are the Investors better or worse off under proposed changes?	<p>WORSE OFF - Alice will be adversely impacted by the proposed negative gearing changes, as her interest expense exceeds her net rental income by \$9,000.</p> <p>Under the current rules, that excess could have offset against Alice's taxable income, which would currently give her a tax saving of \$4,050.</p>	<p>WORSE OFF - Bill will be adversely impacted by the proposed negative gearing changes, as his interest expense exceeds the total investment income by \$6,000.</p> <p>Under the current rules, that excess could have been offset against Bill's other taxable income, which would currently give him a tax saving of \$2,700.</p>	<p>NEUTRAL - Charlie will not be impacted by the proposed negative gearing changes.</p> <p>Charlie's total interest expense is \$60,000, while his total investment income from the three sources is also \$60,000.</p> <p>His position will remain neutral.</p>
	<p>Under Labor's proposed rule changes, the excess of the investment expenses cannot be offset against other taxable income, but must be carried forward for offset in future years against future investment income or capital gains from the disposal of the investment assets.</p>	<p>Charlie can fully utilise the losses he makes from the negative gearing of his property & share portfolio, offsetting against the positive gearing of the treasury bonds.</p>	
Issues to consider in later years?	<p>All taxpayers with investments will need to review their position every year, as their circumstances may change. If, for example, the interest rate for the investment falls and rental returns rise; a previously negatively geared property may become positively geared. Also, taxpayers may buy new investment assets with better gearing ratios, in which a shortfall problem may be reduced, or even eliminated.</p>		



Conclusion

Industry experts consider that all taxpayers with investments will need to closely manage their investment portfolios, particularly where circumstances may change going forward, such as a change in interest rates.

Also, it has been identified that families purchasing properties should carefully consider in the name of which family member/entity is best able to manage any negative gearing restrictions.

We note that this Tax Alert has been prepared based on the information which has been released by the ALP to date, however it will be critical to see the final detail of any legislation (if Labor was to win the next election) before any investment decisions are made.

Please do not hesitate to contact your Lowe Lippmann Relationship Partner if you wish to discuss any of these matters further.



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