

## **Home Ownership Inquiry – 3<sup>rd</sup> Supplementary Submission**

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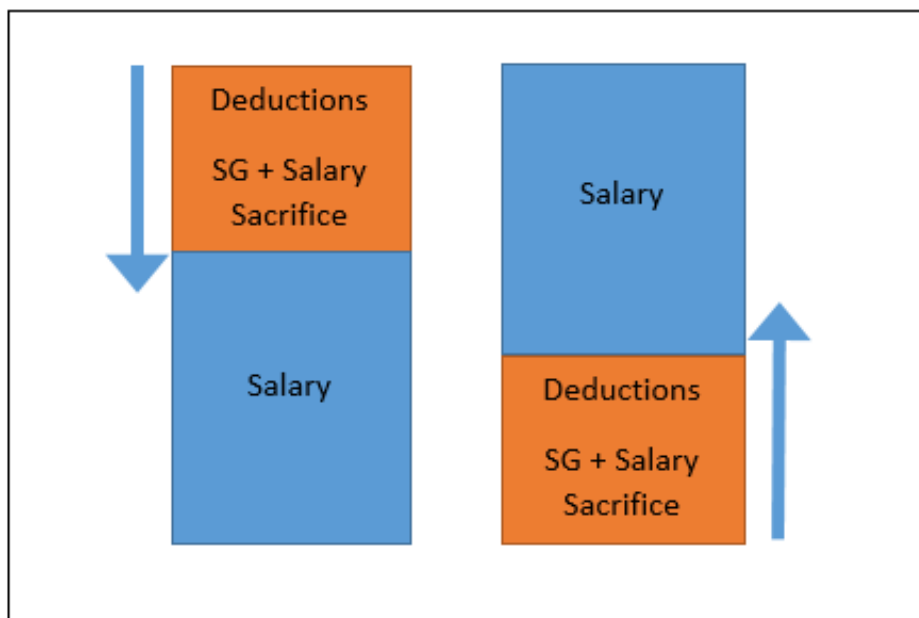
30 August 2015

### **1. Deductions for Investors (From my tax white paper).**

Deductions for investors is commonly taken from the top of the income scale, that is to say that interest and deductions are treated as Last In First Out (LIFO).

To curb investors demand, this could be changed to First In First Out (FIFO) i.e. deductions are taken from the bottom up i.e.\$0-18,200 tax bracket. The concept is shown in the figure 1.

Figure 1



As a concept, the outcomes would mean the following

- All income levels receive the same deduction rate for losses applied to income
- All income levels receive the same deduction (incentive) for super contributions.

Note that with this concept that the 15% super contributions tax could be removed. The current tax bands are shown in Table 1 as follows.

Table 1 – Current Tax Rates

<b>Tax Rate</b> <b>%</b>	<b>Bands</b> <b>\$</b>
0.0	0
19.0	18,200
32.5	37,000
37.0	80,000
45.0	180,000

### Example

For a \$1M loan and a salary earner on 37% marginal tax rate, table 2 shows a comparison of the current arrangement of LIFO versus the FIFO method.

Using FIFO removes the symmetry. This is noticeable when the cash flow turns negative and difference column increases in value.

Table 2 – Comparison of LIFO and FIFO with tax deductions

Interest Rate	Loan Value	Interest Repayment	Rental Income (3.0% Net Yield)	Gain(+) / Loss(-)	Tax Rate 37% Top Down LIFO (Tax Refund / Tax Payment)	Tax Rate 37% Bottom Up FIFO (Tax Refund/Tax Payable)	Difference	Cashflow
1%	\$1,000,000	-\$10,000	\$30,000	\$20,000	-\$7,400	-\$7,400	\$0	Positive
2%	\$1,000,000	-\$20,000	\$30,000	\$10,000	-\$3,700	-\$3,700	\$0	
3%	\$1,000,000	-\$30,000	\$30,000	\$0	\$0	\$0	\$0	Neutral
4%	\$1,000,000	-\$40,000	\$30,000	-\$10,000	\$3,700	\$0	\$3,700	Negative
5%	\$1,000,000	-\$50,000	\$30,000	-\$20,000	\$7,400	\$342	\$7,058	
6%	\$1,000,000	-\$60,000	\$30,000	-\$30,000	\$11,100	\$2,242	\$8,858	
7%	\$1,000,000	-\$70,000	\$30,000	-\$40,000	\$14,800	\$4,547	\$10,253	
8%	\$1,000,000	-\$80,000	\$30,000	-\$50,000	\$18,500	\$7,797	\$10,703	
9%	\$1,000,000	-\$90,000	\$30,000	-\$60,000	\$22,200	\$11,047	\$11,153	
10%	\$1,000,000	-\$100,000	\$30,000	-\$70,000	\$25,900	\$14,297	\$11,603	

Changes to the tax scale especially around the tax free threshold maybe needed. For example taking KPMG's tax white paper submission, they submitted that the tax rates shown in table 3. Their proposal removes the tax free threshold, replacing it with a 15% tax rate.

For the purposes of deductions and salary sacrifice into super, this would be quite appropriate.

Table 3 - KPMG Tax Scales (Tax white paper submission)

Tax Rate	Bands
15%	\$0
25%	\$27,000
35%	\$80,000
45%	>\$160,000

Using the KPMG scales, most investors would get a 15% deduction up to \$27,000 in losses. When interest rates are high, investors can claim a higher loss of 25% from \$27,000 up to \$80,000.

Table 4 - Comparison of LIFO and FIFO with KPMG tax rates for salary earner on \$100,000

KPMG Tax Rates				
	Tax Refund		Rate of Change	
Losses applied to Gross Income	Top Down (LIFO) Current	Bottom Up (FIFO)	Top Down (LIFO) Current	Bottom Up (FIFO)
\$ -	\$ -	\$ -		
\$ 10,000	\$ 3,500	\$ 1,500	\$ 3,500	\$ 1,500
\$ 20,000	\$ 7,000	\$ 3,000	\$ 3,500	\$ 1,500
\$ 30,000	\$ 9,500	\$ 4,800	\$ 2,500	\$ 1,800
\$ 40,000	\$ 12,000	\$ 7,300	\$ 2,500	\$ 2,500
\$ 50,000	\$ 14,500	\$ 9,800	\$ 2,500	\$ 2,500
\$ 60,000	\$ 17,000	\$ 12,300	\$ 2,500	\$ 2,500
\$ 70,000	\$ 19,500	\$ 14,800	\$ 2,500	\$ 2,500
\$ 80,000	\$ 21,300	\$ 17,300	\$ 1,800	\$ 2,500
\$ 90,000	\$ 22,800	\$ 20,800	\$ 1,500	\$ 3,500
\$ 100,000	\$ 24,300	\$ 24,300	\$ 1,500	\$ 3,500

Note that if losses are applied to the full \$100,000 salary, the last row shows that both columns receive the same tax refund of \$24,300.

### Summary

Changing to FIFO, means

- There is no new taxes
- There is no increased tax rates
- There is no change to negative gearing (i.e. losses applied to income)
- Net Income is added to the top of the income and taxed at the marginal rate
- Net losses are applied from the bottom of the income scale and thus deductions are significantly reduced.
- The first tax bracket is the lowest % tax rate, and thus dis-incentivises too much lending beyond the neutral level. (Neutral level explained in Supplementary Sub No2).
- In periods of high interest rates, investors may incur high losses and thus move into a higher tax deduction rate thus providing a counter balance that Mr Alexander has spoken about.

Overall this may help curb investors, more so negatively geared investors, and thus improve home ownership.

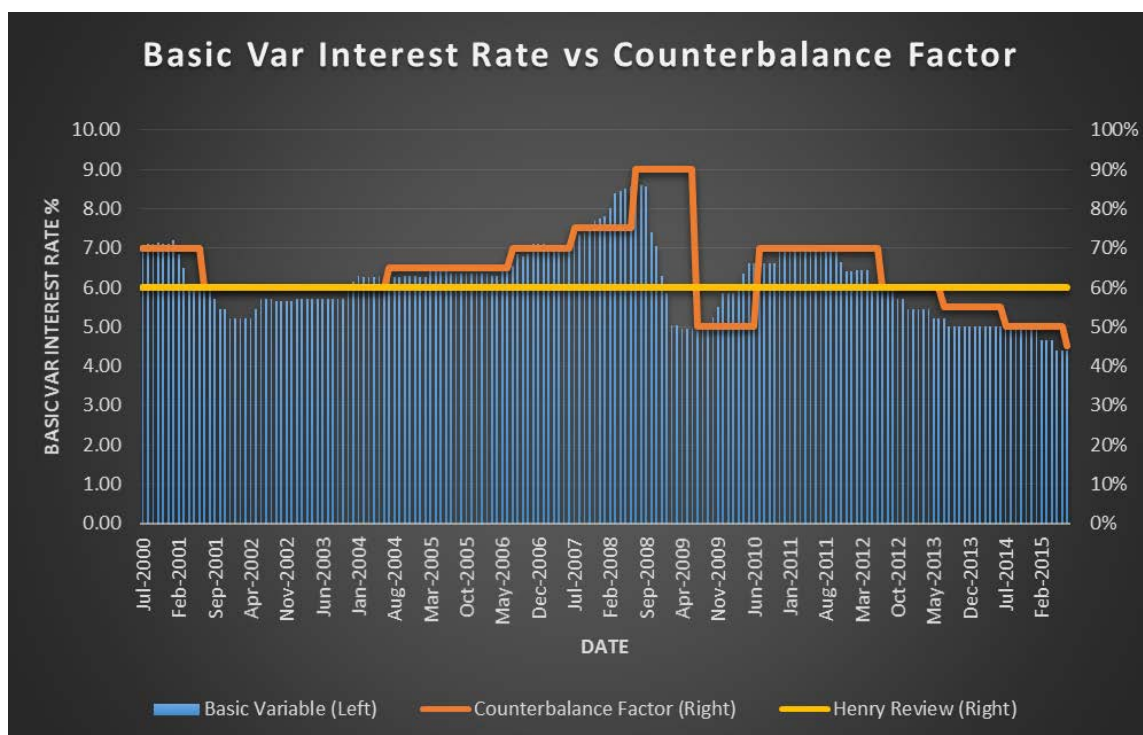
## 2. Counterbalance using Interest Rates

The following is a simple design of a counter balance for gains and losses based on interest rates. The assumption here is it includes positive gains as well.

In this example the basic variable interest rate at June each year is applied to the following year's income gains and losses. The factor applied to income uses a 0 to 100% range based on a range of 0% to 10% interest rates.

This design uses variable factors rather than fixed factors that were recommended in the Henry Review of 40% discount for losses and gains. i.e. 60% is counted towards assessable income tax.

Figure 2 – Basic variable interest rate (left) versus gains and losses counterbalance factor (right).



One of the downsides of this design, is that it plays into the hands of positively geared investors at low interest rates. This may accelerate their buying as they currently would only need to declare 45% of their investment income.

For negatively geared investors, currently 45% of losses would be applied to gross income.

When applying APRA's 7% floor, the lender would use a 70% factor. But my 1st supplementary submission I have recommended that investors should be assessed as owner occupiers, by ignoring the tax refund for sizing the loan.

Table 5 shows how the counterbalance works for positive and negatively geared investors.

The assumption is that the counterbalance factor applies to both gains and losses equally, making it symmetrical.

The middle columns show that there is a significant difference in the amount of tax refund or tax paid at low interest rates, but increases to its maximum at 10% interest rate.

The far right columns show that negatively geared investors would have a reduced loan size, but the inverse occurs to positively geared investors. This could be an unintended consequence where positively geared investors are further advantaged.

Table 5 – Breakdown of a \$10,000 gain or loss using a Counterbalance.

Interest Rate	Counter balance Factor	Gains/Losses (Current)	Applied to Gross Income (Counterbalance)	Tax Paid/Refund 37% Tax Rate		Difference (per year)	Positive Geared Loan Size increase with Counterbalance	Negative Geared Loan Size Reduction with Counterbalance
				Current	Counterbalance			
1.0%	10%	\$ 10,000	\$ 1,000	\$ 3,700	\$ 370	\$ 3,330	\$ 333,000	-\$333,000
2.0%	20%	\$ 10,000	\$ 2,000	\$ 3,700	\$ 740	\$ 2,960	\$ 148,000	-\$148,000
3.0%	30%	\$ 10,000	\$ 3,000	\$ 3,700	\$ 1,110	\$ 2,590	\$ 86,333	-\$86,333
4.0%	40%	\$ 10,000	\$ 4,000	\$ 3,700	\$ 1,480	\$ 2,220	\$ 55,500	-\$55,500
5.0%	50%	\$ 10,000	\$ 5,000	\$ 3,700	\$ 1,850	\$ 1,850	\$ 37,000	-\$37,000
6.0%	60%	\$ 10,000	\$ 6,000	\$ 3,700	\$ 2,220	\$ 1,480	\$ 24,667	-\$24,667
7.0%	70%	\$ 10,000	\$ 7,000	\$ 3,700	\$ 2,590	\$ 1,110	\$ 15,857	-\$15,857
8.0%	80%	\$ 10,000	\$ 8,000	\$ 3,700	\$ 2,960	\$ 740	\$ 9,250	-\$9,250
9.0%	90%	\$ 10,000	\$ 9,000	\$ 3,700	\$ 3,330	\$ 370	\$ 4,111	-\$4,111
10.0%	100%	\$ 10,000	\$ 10,000	\$ 3,700	\$ 3,700	\$ -	\$ -	\$0
							=Diff / int rate%	

### Summary

Although the counterbalance would be ok if it were only applicable to negative cash flow, it does have problems when it comes to the effective tax rate.

Section 4 on capital gains, table 8 highlights the problems when applying discounts.

### **3. Borrowing against the principal residence and other investments**

In the 1990's financial deregulation and lending innovation have meant that owner occupiers can borrow against their own home more so now than in the past.

Price rises are tax free on the family home, which are now used as equity to build a property portfolio. Other investors with property investments also have untaxed capital gain, which is used to borrow against.

With prices rises of 30-50% in two years, this makes it easy for existing property owners to borrow against their untaxed equity, easily making the 20% deposit.

First home buyers, do not enjoy tax free status on any of their savings. Neither can they hedge their savings to the rising tide of prices to increase equity. Unless they negatively gear a property. Which makes it a case of if you can't beat them, join them, which is not solving the problem.

First home buyers take about 7-10 years to save for a 20% deposit. Yet existing owner occupiers and investors, can reduce this timeframe by relying on rising untaxed equity. (*See section 4 on capital gains to see how savings that is taxed yearly are disadvantaged*)

#### **Recommendation**

The outcome needs to align with a first home buyer.

To achieve this, this could include the following:

- Quarantine a percentage of the family home equity from being borrowed against either for investment properties or all investments.
- Quarantine the untaxed capital gain from other investments that are used to borrow against. i.e. what is the remaining equity if the investment were sold and capital gains tax paid.

#### 4 Capital Gains Tax

Given that income is not adjusted for inflation each year, neither should capital gains.

Capital gains have the advantage of compounding the gains, because the amount from the previous year has not been taxed.

In table 6, an example of \$100,000 invested for 10 years at 7% return with 2.5% inflation and a marginal tax rate of 45%. There are four scenarios. One being the income is taxed each year, the other three are capital gains taxed at the end.

It shows that income taxed each year is still disadvantaged even when capital gains are fully taxed at the end of the 10 years. This is because of the effect of compound interest. But the current 50% discount on capital gains creates the largest gap.

Table 6 – Summary of Net Gains after 10 years

	At the end of 10 years		
Gains taxed each year as income	Fully Taxed	Inflation Adjusted	50% Discount
\$ 45,903	\$ 53,193	\$ 65,797	\$ 74,954

If the Henry review 40% discount was implemented, table 7 shows it evens the capital gains and income.

Table 7 - Summary of Net Gains after 10 years (Changes to include Henry 40% discount)

	At the end of 10 years		
Gains taxed each year as income (Henry - 40% Discount Included)	Fully Taxed	Inflation Adjusted	Henry 40% Discount
\$ 64,604	\$ 53,193	\$ 65,797	\$ 70,602

Application of a 40% discount reduces the gap between income taxed each year and capital gains taxed at the end. This would be beneficial for first home buyers who are saving. And investors would have slightly less incentive to invest.

One viewpoint though, is it would be better to fully tax capital gains and investment income because this allows a reduction in income tax rates to increase employment. Here in lies a problem with the interaction with employment. Hence fully taxing gains and losses is probably preferred.

Another consideration is that when investing, the investor wants the capital gain to exceed the income losses. So by providing discounts on capital gains and or income losses, this can create a significant distortion to the effective tax rate.

To highlight this problem, Table 8 compares fully taxing gains and income losses at the marginal rate, the Henry review 40% discount, and the current 50% discount on capital gain.

It assumes a \$500,000 capital gain, and \$200,000 of losses applied to gross income.

The results indicate that taxing to the full amount would yield a significantly higher tax take.

The effective tax rate using the current 50% discount is only 8% for an investor on a 45% tax rate. This highlights the extraordinary flaw in the current tax arrangements.

Even the 40% discount has an effective tax rate of 27% instead of 45%. I wonder whether the Henry Review considered this.

An observation is that any discount reduces the effective tax rate, even though these may be well intended to balance the system.

Hence fully taxing both capital gains and income at the marginal rate is the preferred method as it aligns closer to income taxed each year, and ensures the effective tax rate is closer to the marginal tax rate.

Table 8 – Comparing fully taxed, the 40% discount and the current arrangement

Marginal Tax Rate	Discount on capital gains	Taxes on Capital Gain of	Discount on losses	Tax Refund from losses on	Total Tax Paid on	Effective tax rate	Method
		<b>\$ 500,000</b>		<b>\$200,000</b>	<b>\$ 300,000</b>		
45%	0	\$ 225,000	0	-\$90,000	\$ 135,000	45%	Fully Taxed
45%	40%	\$ 135,000	40%	-\$54,000	\$ 81,000	27%	Henry 40% Discount
45%	50%	\$ 112,500	0%	-\$90,000	\$ 22,500	8%	Current

### Recommendation

To make it simple and fair, the full amount of capital gains should be taxed, with no adjustment for inflation or discount. Hence this would allow income tax rates to be lowered.