AFTS Secretariat
The Treasury
Langton Cres
Parkes ACT 2600

Dear Sir

SUBMISSION TO THE AUSTRALIA'S FUTURE TAX SYSTEM REVIEW

Please find attached a Submission to the Review of the Taxation system proposing that Capital Gains Tax be amened to encourage investment in the housing sector.

Yours faithfully

Philip Tuckerman

26 August 2008

SUBMISSION TO THE AUSTRALIA'S FUTURE TAX SYSTEM REVIEW PANEL

I am writing to the Taxation Review Panel to propose that Capital Gains Tax be varied to encourage more private investment in the new housing sector.

Background

Housing is one of the foundations of Australian society and over recent years with changes in demography, the wealth of the nation and changes in Commonwealth/state financial arrangements, housing has become a critical issue for many. This relates to the cost of buying a home or affordability including renting and issues about supply and demand.

One of the factors influencing these is the taxation system as it relates to investors in the housing market and specifically Capital Gains Tax (CGT).

Over the last ten years there has been unprecedented growth in the Australian economy. Much of that growth has been reflected in the rapid increase in the asset value of housing. For home owners this appears a benefit but for home buyers it has caused grief as the subsequent rise in house prices have not been met with similar increases in wage incomes.

Similarly there has been significant rises in rent as investors seek to make appropriate returns on their assets, leading to stress for people living in rental accommodation.

One issue that has affected the price of homes is the reluctance of investors to sell because of the tax they would need to pay on their capital gain.

For the majority of people who invested in housing 5-6 years ago, they have seen their asset at least double in value. This in turn has generated enormous pressure to increase rents.

Example - house purchased $250,000 5 years ago with expected return of 5%, generated through rent required a weekly rate of approx $250 – this return would be acceptable for most investors as negative gearing through loan arrangements would add to the investor's wealth. Five years later and the house is now worth $500,000 and most of the negative gearing tax deductions have gone (most investment loans are for about 5-6 years). The owner now wants at least 5% return so the rent becomes $500 per week. Net wages have not increased by 100% over the last 5 years – rental stress.

Many investors buy and sell new homes – maximising the negative gearing aspects available to them. Under normal circumstances a steady rise in the price of homes allows investors to maximise their returns without large payments of CGT. The situation that exits today is different as the rapid rise in asset value creates a problem with capital gains tax. In the simple example above for the investor to sell he would be liable for a capital gains tax on 50% of the increase in the house price i.e. $250,000 or a tax on $125,000.

One of the basic beliefs in Australian society is if you can legally avoid paying tax you do. The perverse result is that many investors are not selling and re-investing in the housing market simply because they don't want to pay the CGT.

Obviously this issue is not the only one affecting the housing sector but it has meant that a large number of potential investors are now dormant in the market with a reduction in houses for sale as well as a reduction of potential funding for new housing.

Capital gains have been part of the tax system for decades and the move to reduce assessable gains by 50% was a welcome move by the investing community. Of recent times because of the rapid increase in house prices the CGT is acting as a barrier to investment in the housing sector.

<u>Capital gains tax and housing</u>.

There is an argument that housing is no different to any other form of asset and as such CGT should apply. The argument against that is that a large proportion of investing in housing is done by individuals and involves significant amounts of capital, compared to other popular forms of investment (stocks and shares). Not many individual investors borrow 80% of a share portfolio with a value of $250,000 – in the example above investors in housing do.

Investors or people buying a second house or more fall into 3 simple categories –

1. <u>Category A</u> - an investor who buys, rents and sells homes strictly driven by market returns;
2. <u>Category B</u> - a "maybe" investor who buys and rents the property in the hope that the housing market increases and he will make a profit. He may or may not want to sell the property when the negative gearing tax aspects become minimal; and
3. <u>Category C</u> - a person who purchases a second house for social advantage – a coastal retreat, unit for possible retirement in the future, for the kids etc. He may rent the house for limited periods but does not consider himself to be an investor.

CGT is not an issue for Category C house owners. Category B investors would consider CGT at various stages of ownership – when the negative gearing benefits start to diminish, need for funds for personal reasons, other investment possibilities etc. However, CGT is a major consideration for Category A investors.

<u>The Proposal</u>

It is proposed that the CGT be amended to encourage investment in the housing sector for new houses. The proposal is that the CGT rate be reduced for new houses that have been purchased within 5-6 years. For sales after seven years the existing arrangements would or could remain unchanged. This would mean that Category C investors (above) would not be affected and Category B investors may decide to become Category A investors. It would significantly affect those Category A investors and encourage them to invest in new housing.

The principle objective of this proposal is to encourage more private investment in the new housing sector.

It is proposed that changes to the CGT be introduced to encourage investors to sell their investment properties after about 5-6 years of ownership. It is proposed that a graduated scale of CGT be introduced along the following lines (obviously could be finetuned) -

- After 12 months but less than 24 months of ownership – CGT would apply to 40% of any gain;
- After 24 months but less than 36 months of ownership – CGT would apply to 35% of any gain;
- After 36 months but less than 48 months of ownership – CGT would apply to 30% of any gain;
- After 48 months but less than 60 months of ownership – CGT would apply to 25% of any gain;
- After 60 months but less than 72 months of ownership – CGT would apply to 20% of any gain;
- After 72 months but less than 84 months of ownership – CGT would apply to 40% of any gain;
- After 84 months of ownership – CGT would apply to 50% of any gain.

Transitional arrangements would need to be determined for exiting housing investments. There are in excess of 100,000 vacant houses in Australia. As a kick start and a means of increasing the supply of homes into the market and reducing the number of vacant homes, the transitional arrangements could cover established homes and apply to Categories A, B and C investors. A possible model would be that in year one existing owner investors would attract a 35% CGT on gains and for year two CGT would be 45% on gains. After that the arrangements would only apply to new homes and the existing arrangements of 50% CGT would apply.

Problems/Issues

There may be definitional difficulties regarding “ownership” and when that commences especially where the purchase involves land and then building. It is probable that it should be completion of the building but this is something that would need to be thought through to avoid instances of buying the land and the construction taking 4 years to complete. In other words safeguards would need to be developed to ensure that windfall gains could not be made via paper transactions.

It is important to note that this proposal (apart from the transitional arrangements) is for new homes only.

There will be potential loss to government in the form of potential revenue foregone. To counter this, additional private funds flowing to the housing sector reduces the need for additional government funding for housing assistance.

There could be a reduction of rental accommodation as investors sell their properties but this should be ameliorated over time with additional housing stock being built.

A potential benefit also could be a slight reduction in existing house prices as additional housing stock is placed on the market.

The government has used the tax system to address the issue of superannuation with carrots and sticks. The use of the tax system to address partly some of the housing issues is one they should consider.

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NB I own my own home with a small mortgage. I do not have any interest in any other residential property.