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The secret's out - Labor's negative gearing restrictions will apply to ALL INVESTMENTS and not just residential property

Recent clarification of Labor's proposed changes to negative gearing recently undertaken by the Tax Institute of Australia has revealed that if Labor wins the next Federal election in 2019, its proposed changes to negative gearing would apply not just to residential real estate, but to all investments in all asset classes acquired after the commencement date of amending legislation.

Subject to the technical definition of what constitutes an investment, the negative gearing restrictions will apply to any share investment in a private or public company, any investment in a business, any loan investment, any investment in a private or managed trust, any investment in treasury bonds, commodities, derivative contracts, private equity hedge funds and the list goes on. Furthermore, because Australian resident taxpayers pay tax on overseas income, Labor's proposed negative gearing restrictions applies to geared world-wide investments owned by Australian resident taxpayers.

After listening to and reading the various press reports about Labor's proposed negative gearing changes, many of you may have thought that this new Labor tax policy would only apply to residential property. Labor's new negative gearing restrictions will be very far reaching because it applies to all asset classes.

Labor's justification

It is also worth pondering whether the reasons espoused by Labor for this massive change is justified, namely that such changes are part of a "Positive plan to help housing affordability" (link www.alp.org.au/negativegearing)

Labor's negative gearing proposals are based on Labor's view of what is a fair tax system and what is an unfair tax system. Labor's position is predicated on the proposition that it is unfair for the tax law to allow "the wealthy end of town" to deduct negative gearing deductions from their personal exertion income because this reduces the average rate of tax being paid by that taxpayer.

Labor laments that many Australian working families cannot afford to have negatively geared investments and because of this, Australian working families can end up paying a higher rate of tax (but still a substantially lesser amount of tax) than their wealthier or more financially successful fellow Australians.

If there is a change of Federal Government next year, it will be very interesting to see whether such changes will be passed by the Senate.

Investment income and negative gearing

Most Australian taxpayers derive 2 types of income, namely

- income from personal exertion (i.e. salary and wages or other personal exertion income), and
- income from property (i.e. investments regardless of their asset class).

Depending on the tax profile of a taxpayer (including whether an investor is carrying on an investment business), most investment income derived from an investment is treated as ordinary income whereas any capital gain arising on say the realisation of a residential investment property, may be treated as a capital gain .

At the present time, it appears that Labor's proposed policy will allow negative gearing deductions to be offset **only against a taxpayer's other investment income** (and only to the extent of that investment income) and not against the personal exertion income of the taxpayer (such as salary and wages).

At a practical level, this will mean that the acquisition of future investments will need to be carefully examined and planned from for both cash flow and tax flow purposes. There is no legislation at the present time and it is too early to contemplate appropriate strategies, however it seems likely that taxpayers who have various investment income streams will be in a more favoured position then lower income investors whose investment income stream is essentially limited to the investment asset that is being geared.

There are many unanswered issues and no doubt, these negative gearing proposals if legislated, would introduce considerable further complications and uncertainties when making investments – which are not very conducive to a growing economy.

Some of the unknowns include how improvements to an investment asset will be treated. For example, will the installation of a new kitchen into an existing residential property or the construction of an additional bedroom after the commencement date of the legislation, be treated as part of the existing investment (in which case the improvement can be negatively geared) or as a separate investment asset which for tax purposes only, is to be treated and accounted for as a separate and distinct investment asset from the existing investment asset a residential investment asset.

Likewise, will a capital gains tax rollover of an existing negatively geared investment asset after the commencement date of the legislation by an individual to a company (that is wholly owned by that individual), result in the company being able to also negatively gear the asset or will it be treated as a post commencement date investment asset for negative gearing purposes.

Currently non-deductible interest increases the cost base of the asset

Under the current law, non-deductible interest on loans borrowed to finance the acquisition of an investment can be treated as a third element cost base for the asset. This means that any non-deductible interest can be added to the cost base of the asset so that the cost base of the asset is increased. This treatment of non-deductible interest does not provide to an investor an immediate tax benefit (which a tax deduction does provide), however it does reduce the ultimate net capital gain for tax purposes when the asset is realised.

It is not clear at this stage whether Labor's proposed negative gearing changes will allow this to happen in the future.

Because a net capital gain is the difference between CGT proceeds attributable to the arms-length sale of an investment asset less the asset's CGT cost base, an increase in the cost base reduces the net capital gain. At the present time, if a CGT asset is held for more than 12 months, then any net capital gains is reduced by the 50% GST discount. As such a net capital gain of $200,000 is reduced to $100,000 and the taxpayer's marginal tax rates apply to the $100,000 (and not the $200,000).

Note however that it is also Labor's policy to reduce the CGT discount on the sale of an asset from 50% to 25% in respect of new CGT assets acquired after the change in CGT law. Once the CGT discount is reduced from 50% to 25%, then a net capital gain of $200,000 will only be reduced to $150,000 and the taxpayer's marginal tax rates apply to the $150,000. If the net capital gain pushes a taxpayer into the highest marginal tax rate of 45% plus medicare levy, this would result in an addition $23,500 capital gains tax being paid under Labor's new CGT policy.

Finally and in cases where a taxpayer's investment income may fluctuate from year to year, it is unclear whether unused negative gearing deductions that arise in a low investment income year can be carried forward by a taxpayer to be used against excess investment income in a subsequent year.

Worked examples

For those readers who are interested in the "tax math" involved, we set out below a couple of examples which you may find interesting.

Example 1 – Larry

Larry receives a small inheritance of $200,000 from Uncle Ernie. Because Larry wants to get ahead, he decides to buy a strata residential property. Larry borrows a P & I loan of $600,000 from his bank and his current interest rate is 6%. Larry buys an existing stand-alone residential property for $800,000 which is funded by his equity of $200,000 and bank debt of $600,000. Larry is an employed architect working for a family business and his current taxable income (after very limited work deductions) is $165,000 per annum.

Larry receives gross rental income of $650 per week (being $33,800 p.a.) and Larry's total direct property expenses before interest (but including leasing commission, strata levies, rates, taxes and insurance) are $7,800 per annum. After expenses, Larry's net rental income is $26,000. The current interest payable on his loan is $36,000 p.a. Larry's current negative gearing deduction per annum would be $10,000.

Under the current law Larry would receive a modest tax benefit of $3,900 pa based on Larry's 2019 marginal tax rate of 37% plus 2% medicare levy (being 39% x Larry current negative gearing deduction of $10,000).

Under Labor's proposed changes to negative gearing, Larry would receive no negative gearing tax deduction and is $3,600 worse off.

Example 2 – Curly

Curly is Larry's cousin and he also receives a small inheritance of $200,000. He is also somewhat wealthier than Larry and owns non geared ASX shares worth $200,000. He is not a share trader and is more interested in receiving fully franked dividend income which averages 7% per annum. Curly is an employed management accountant/financial controller in the same family business as Larry. Curly's current taxable income (after very limited work deductions) is $125,000 per annum. Curly decides to buy an $800,000 strata unit next door to Larry's unit. He also borrows $600,000 from the bank at 6% and like Larry, his annual negative gearing deduction would be $10,000

Curly's cashflow is his net salary plus his fully franked dividend of $14,000. Curly's gross income is $178,000 p.a. comprising his salary of $125,000 and total investment income of $53,800 (comprising $33,800 gross rental income and a $20,000 grossed up fully franked dividend).

Because Curly's assessable investment income is $53,800 and because Curly's residential property expenses are $43,800 (comprising general property expenses of $7,800 and interest of $36,000), Curly can deduct all of his property expenses and this will reduce his net investment income to $10,000.

Labor's proposed changes to negative gearing would not affect Curly because Curly had gross investment income of $53,800 p.a. whereas Larry's gross investment income was $33,800 p.a. Curly's taxable income (after all deductions will be $135,000 (comprising $125,000 salary and net investment income of $10,000.). Curly also benefits from the $6,000 imputation credits attributable to the company tax paid by the ASX companies as he can apply this $6,000 credit against any tax paid or payable by him on his taxable income of $135,000.

Clearly, investors will have to take informed tax and legal advice before gearing any assets if Labor's proposed changes become law. If you have any queries, please contact Peter McCrohon of CharterLaw Legal.

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