Tax Working Group Public Submissions Information Release

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Deemed Rate of Return on Income from Rental Property

This submission is a suggestion for taxing rental property which at present enjoys a preferred status compared to other investments, and produces an advantage to rental property owners over owner occupiers.

The preferred status and advantage comes about through

a. the use of leverage (driven by RBNZ Bank capital adequacy rules) at a higher level than alternative investments
b. returns being mainly through untaxed capital gains and not taxable income. This provides an advantage over shares, bonds and other traditional investment classes
c. A rental property owner being able to offset the costs of ownership against income, and in particular being able to deduct interest payments from the rental income. This provides a pricing advantage to a rental property owner over an owner-occupier, and could be a factor in increasing house prices.

While house price inflation is justifiably a hot topic, given the potential impact on the wider economy, the. right solution in the long term is to increase housing supply, but it is a slow process. On the other hand, measures to reduce demand could be introduced much more quickly. One focus of any new measure would be to reduce the incentives of investing in rental properties vs other investment alternatives.

The measure most commentators focus on is the introduction of a Capital Gains Tax (CGT) to help mute demand and level the playing field between asset classes. This tax is seen as complex, administratively inefficient and politically difficult for those who introduce it. In addition, given that it is generally levied at the time gains are realised, it may not do much to curb investor behavior in the short term.

An alternative that I have not seen discussed is to change the way income on rental properties is assessed, which I've called a deemed rate of return for rental properties. In concept, it is identical to the Deemed Dividend regime (Fair Dividend Rate) applying to overseas shares, which was introduced because such shares often have low dividend returns and the majority of their value lies in capital appreciation.

It would seek to address both the issue of over-investment in residential real estate(driven at least in part by tax free capital gains), and create a level playing field between property investors who can deduct interest (and other property costs) and home owners who cannot.

A Deemed Rate of return solution offers

- Expected capital gains taxed on an ongoing (annual) basis

- Impact on investment behavior occurs in the short term
- A simple and easily administered calculation and collection of tax
- A tax revenue stream that occurs immediately, and does not require the sale of a property to ascertain taxation liability and payment
- The creation of a level playing field between property investors and home owners (neither can deduct interest or other property related expenses)

How does it would work?

A deemed rate of return would be set annually for residential property investment – this could be done by reference to an observed market return (eg the gross dividend yield return from listed property shares) or by adding an amount to the govt bond rate (eg 5 year Govt bond rate plus x%). It would reflect the expected net return from property investment before tax (made up of both expected capital gains, and a net return from renting)

This rate would be applied to the property value (which would be the higher of latest Council valuation or last sale price) to obtain a deemed income for the property. For example, assuming a 5% deemed return rate, the deemed income on a $600,000 investment property would be $30,000 p.a. The deemed income would be adjusted to take into account occupancy – eg if a property was only rented for 48 weeks of the year, the deemed income would be 48/52nds of the annual deemed income.

This deemed income would be added to the income of the entity owning the property. Tax would be collected on this deemed income at the marginal tax rate of the owning entity. So if a property was owned by a Trust, that rate would be 33%, a company 28% or by an individual, that individuals marginal tax rate. For a trust owning the property in the example above, the method would result in tax payable of $30,000 x 0.33 = $9,900 annually on the deemed rental income.

The actual income from the property would be tax exempt – ie there would be no requirement to declare the actual rental income. However, no expenses relating to the property (interest, rates, repairs, etc) would be able to be claimed as the deemed income is set on the basis of a net return.

The combination of removing deductibility of interest, and paying tax on expected gains on an annual basis would be expected to act as a significant curb on investment in residential property. It would also mean that aggressive gearing of property would have a lesser financial advantage as the interest costs of doing so would no longer be deductible.

What would this deemed return apply to

This method of determining income would only apply to residential rental property. It would not apply to owner occupied houses, commercial property, apartments leased to hotel chains, employer supplied housing, etc. A test of whether it would apply could be whether there is an obligation to pay a bond under the Residential Tenancy Act. The bond database held by MBIE would also provide a check that tax was being paid on a rental property.

I would suggest that there be a number of exemptions from the regime. In particular, providers of social housing (such as HNZC and Community Housing Associations) could qualify for an exemption

Summary

A deemed rental income would be relatively easy to legislate for (it is not a new tax, just a method of calculating income), very simple to administer for both investors and the IRD, and could be implemented quickly. As an alternative to a CGT, it is specifically targeted at residential property investment, and would have a more immediate impact on investor behavior.