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How property investments face falls under Labor government

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Property prices continue to fall. Last week we heard how house values just fell nationwide for the eleventh month in a row.

For investors, it is a difficult market. Perhaps one of the most difficult issues is trying to assess the potential impact of an ALP election win. On my numbers, you can expect the after-tax returns from property to fall more than a quarter if that happens. Here's why.

Labor is proposing to scrap negative gearing on any investments in established property that are made after a yet-to-be-determined date. Existing property investments will be grandfathered. Negative gearing on new-build properties will still be permitted. If you do invest in established property after the yet-to-be-determined date, you will be able to carry forward the income losses and offset them against future property income or capital gain.

The ALP is also proposing to increase the rate of capital gains tax. Currently, if you own an investment for more than 12 months and make a capital gain on sale, you only pay tax (at marginal rates) on 50 per cent of the net gain. The ALP is proposing to reduce the discount such that the CGT liability will be on 75 per cent of the net capital gain. Again, existing investments will be grandfathered.

The impact of these taxation changes on the internal rate of return will be material. Internal rate of return is an estimate of the profitability of a potential investment. Real estate professionals like myself will work on an internal rate of return under the current tax laws on a $750,000 investment in property of 12.6 per cent a year.

Now, if you adjust those numbers for the proposed ALP changes, the internal rate of return falls to 9.3 per cent per annum. That is, the proposed tax changes wipe out 26 per cent of the after-tax investment return!

The reason is that the carrying cost is higher (because there's no negative gearing benefit) and the investor pays a higher rate of CGT when they sell.

You don't have to be a Rhodes scholar to work out that demand for property investment is almost certain to fall materially if the ALP changes are implemented.

The chart below compares the volume of owner-occupier and investment dwelling - finance commitments with the median house price (average of Melbourne and Sydney) since 2000. It demonstrates that housing prices are heavily affected by both investment and owner-occupier housing finance commitments.

If the demand for investment housing finance was to fall, it is likely that it would have a negative impact on property price growth.

Effect on markets

Property prices in locations where the majority of dwellings are owner-occupied will be somewhat insulated from the risk of price falls. Conversely, investor-owned dense locations are likely to be affected more severely.

It is likely that some of the additional cost to hold a property investment will be passed on to renters — so it is reasonable to expect that rents will rise as a result of these proposed changes.

The fact that new-build properties only will still receive negative gearing benefits will mean developers and property spruikers will heavily market these types of properties to unsuspecting investors.

The fact is that new-build properties rarely make good investments as they tend to be - located in areas where land supply is not scarce, and scarcity of land supply is the main driver of price appreciation. I fear that the ALP's policies will encourage people to invest in the wrong assets because they are chasing tax benefits.

Property is a long-term investment. The average capital growth rate since 1980 has been 8.1 per cent a year.

Adding a net rental income (after expenses) of say 2 per cent per annum results in a total return of more than 10 per cent per annum. Over this time (since 1980), the property market has endured many challenges, including double-digit interest rates, the attempted and brief abolition of negative gearing in 1985, the introduction of GST in 2000, wars, sharemarket crashes and many different governments and prime ministers. Despite this, returns have been very healthy and comparable to the sharemarket. Ultimately, I doubt these proposed tax changes by the ALP will have any material impact on pre-tax investment returns in the long run.

However, if you are concerned about these changes coming into force and would like to invest in property, it might be wise to do so over the next year so that your investment will be grandfathered (and you will still enjoy negative gearing and lower CGT).

I doubt that the ALP will be able to get these changes enacted into law as proposed — unless they win with a strong majority. Instead, I think the changes will be watered down. I suspect that instead of abolishing negative gearing on established property in totality they will probably limit it.

If the negative gearing rules are implemented as proposed, there might be merit in investing using an un-geared unit trust or company. Astute structuring may help you mitigate some of the impact of the proposed ALP changes.

It is also worth remembering that about 89 per cent of the Australian voting public do not invest in property and therefore will not be affected by this proposed policy.

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