From: david.tonuri@ubscapital.com
Sent: 29 August 2003 9:55
To: housing@pc.gov.au
Subject: Submission to Inquiry on First Home Ownership

I am 33 years of age, hold a Bachelor of Economics (First Class Honours) and am a home owner in Sydney.

I have a particular private interest in the impact of personal income taxes on the housing market in two areas, namely:

A) The impact of the exemption from capital gains tax (CGT) on the principal place of residence.

B) The impact of using a CGT-free asset as security for borrowings for the purchase of an investment property.

I will briefly discuss my perspectives on each of these two matters.

A) CGT EXEMPTION ON THE PRINCIPAL PLACE OF RESIDENCE

1. As a general principle, capital will be encouraged to flow from higher-taxed assets to lower-taxed assets in the pursuit of superior after-tax returns.

2. It is therefore hardly surprising that we have seen significant flows of capital into the housing sector where gains for owner occupiers are free of tax.

3. As a numerical example, consider the after-tax returns for an individual who has $100,000 to invest either by (a) borrowing to buy a principal place of residence, or (b) borrowing to buy a portfolio of shares. In both instances, transaction costs and transaction taxes are ignored.

> Borrow to buy principal place of residence

The individual is able to borrow $400,000 at an interest cost of 6.56% pa (being the current home lending base rate for the National Australia Bank) to buy a property for $500,000, at a loan-to-valuation ratio of 80%. The annual interest cost is $26,240. However, with a rental yield of say 4%, the individual would have otherwise paid $20,000 in rent for the year, so the incremental net cost of borrowings is $6,240. Over the course of one year, and based on empirical data for the past decade, the house has probably increased in value by 8%, so it is now worth $540,000. After allowing for the net cost of borrowings of $6,240, the individual has made a tax-free gain of $33,760, or otherwise a 33.76% after-tax gain on his $100,000 equity contribution to the house.

> Borrow to buy portfolio of shares

The individual would only be able to borrow to a loan-to-valuation ratio of 65% for a portfolio of shares. Accordingly, the $100,000 of equity could be used to assemble a portfolio of shares of value of $285,714. The interest cost would be $13,557 at 7.30% pa (being the current margin lending rate for the National Australia Bank), although with a 4% dividend yield on the portfolio giving $11,428 in dividends, the net pre-tax cost is $2,128 or $1,096 after tax at the highest marginal rate. To get the same one-year after-tax return as the individual who borrowed to buy a principal place of residence, the share portfolio must have appreciated at 16.1% or more than twice the rate of the house price inflation assumed. The likelihood of a 16.1% share price rise appears much lower than the likelihood of a 8% house price rise in the current economic environment.

4. The leverage affect of being able to borrow at higher loan-to-valuation ratios for a house relative to a portfolio of shares is acknowledged.

5. A solution to this taxation distortion would be to remove the CGT exemption on the principal place of residence, although it should be noted that (a) such a solution would be politically unacceptable to any government of the day, and (b) removal of the exemption would, in fairness, also permit deductibility of interest and other expenses (such as depreciation) related to the principal place of residence, which in turn may cause further overheating of the housing market as after-tax interest rates would effectively be reduced by up to 48.5%.

6. The taxation of housing in the United States, where gains on the principal place of residence are taxable and interest expenses are deductible up to a level, should be further investigated.

B) USE OF PRINCIPAL PLACE OF RESIDENCE AS SECURITY FOR AN INVESTMENT PROPERTY

1. I believe that it is common practice for home owners with substantial equity in the principal place of residence to use the principal place of residence as security for purchasing an investment property.

2. Typically, a lender will advance a loan of up to 80% of the purchase price of a property without further security required or lenders mortgage insurance.

3. Where additional security, such as the principal place of residence, is pledged, a lender will be comfortable in advancing 100% of the purchase price plus stamp duty and other transaction costs (say another 5% of the purchase price) to fund the purchase of the investment property.

4. The investor is then able to claim interest expenses on (say) 105% of the purchase price of the property which materially assists his cashflows and ultimately enables him to pay a much higher price than he would have otherwise, and arguably more than an intending owner-occupier (such as a first home owner) would have.

5. The CGT exemption on a principal place of residence is normally lost where part or all of the residence has been used for income-generating purposes. An example is where part of a house may have been rented out for a period. The exemption is lost based on the proportion of the property used for income-generating purposes and the period over which this took place. This issue is well established in taxation practice as it is applied today.

6. It therefore seems wrong from a taxation policy perspective that a principal place of residence can retain its CGT-free status where it has been used in a direct way to guarantee loans for an investment property.

7. There are several ways to rectify this. One way would be to have a complicated calculation which would assess the proportionate use of the CGT-free asset in providing additional security. The other and much simpler way would be to restrict interest deductions on an investment property to 80% of the purchase price where a CGT-free asset had been used as security. Clearly, if a taxable asset such as shares had been pledged as additional security, then there would be no such restriction.

8. As a policy matter, such action should reduce the overheating of the housing market by eliminating the tax-based advantage that established owner-occupiers have in buying properties over a first home owner.

I am happy to provide further views on these issues and can be contacted on the numbers listed below.

David Tonuri

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