WBN Vol 18. Issue 2

dmc
Design Management Consultants
Limited

TAXES AND PROPERTY

As the saying goes the only certain things in life are Death and Taxes.
Some commentators are predicting the proposed tax reforms will be the death of residential property, with one Canterbury University economist predicting house price falls of 34% - but will this be the case?

The Tax changes are themselves not yet certain. The Tax Working Group (TWG) only makes recommendations which the Government does not have to follow. The earlier Brash Report was largely rejected as being politically untenable (even though technically sound), but in being rejected it actually did its job – to make the next round of proposals look more palatable by comparison…unless you are a property investor or a tenant.

The political process saw many of the TWG ideas strategically leaked to the media long before the formal announcement. This gave the politicians a chance to gauge public reaction and take up their positions on whichever side of the fence is safest. The release was stage-managed, emotional, and narrow. Thus we had NZX Chief Mark Weldon describing property depreciation as 'crazy', particularly when there was no depreciation on shares.

The reality is that company accounts include depreciation and it is therefore already built into the share price. And this is usually via reduced book value accounting – a 10 year-old desk still functions as a perfectly good desk even after having been completely written off.
But, if you cut building depreciation then you are going to have huge problems replacing components that only have a short life span. There are a large number of components that need to be replaced over the term life of a building in order to keep the building functional.
Far from crazy, building depreciation is very real and a valid business expense.

It looks almost certain that residential property depreciation claims will be stopped and Government will move to haul in LAQCs and close loop holes in trusts. Other recommendations include a land tax (very likely at around 0.5%), through to a Risk Free Rate (very unlikely) – so property Tax change is just a matter of time.

So what will happen?

Many residential investment properties are highly geared so simply don't produce positive returns with rent income being less than the mortgage and OPEX payments. Socially this is a good thing as it helps house poorer tenants who cannot afford a mortgage. Building depreciation helped Landlords offset costs, leaving capital gains required to generate profits. Unless house prices rise strongly, losing the ability to depreciate buildings will create higher financial losses on rental property. If these losses can then not be 'balanced' via LAQC transactions owning highly geared rental property will quickly become unpalatable.

If all Landlords dumped loss attributing property at the same time, there would be a catastrophic crash, however this simply is not going to happen. To offset the financial losses, the vast majority of Landlords will be able to justifiably hike rents and pass on the entirety of their tax loss.
Because there is already a housing shortage due to a growing population driving demand and a slow-down in construction restricting supply, tenants will not have anywhere cheaper to go.
The losers will be working tenants who will see the entirety of their PAYE tax cuts 'returned' to the Government via the Landlord, while beneficiaries will get increased accommodation supplements.

Overall, the tax changes are likely to be *good* for property. PAYE tax cuts, higher GST, higher rents, and a housing shortage are all inflationary. And the best hedge against inflation is Property.