28 February 2019

Committee Secretariat
Committee Secretariat
Finance and Expenditure Committee
Parliament Buildings
Wellington

By email: fe@parliament.govt.nz

RING-FENCING RENTAL LOSSES

Please find attached the written response of the New Zealand Property Investors' Federation Inc on the Taxation (Annual Rates for 2019–20, GST Offshore Supplier Registration, and Remedial Matters) Bill, specifically around the proposal to ring-fence losses on rental properties.

The Federation is is happy to provide the Committee with any further information it may require and wishes to be heard in person should this opportunity be available.

Yours sincerely

Andrew King
Executive Officer

Submission to the

Finance and Expenditure Select Committee

examining

Taxation (Annual Rates for 2019–20, GST Offshore Supplier Registration, and Remedial Matters) Bill

Ring-fencing Rental Losses

28 February 2019

Andrew King
Executive Officer
New Zealand Property Investors' Federation Inc
PO Box 5014, Springlands, Blenheim
Email: Andrew@nzpif.org.nz
Mobile: 021 216 1299

New Zealand Property Investors' Federation

This submission has been prepared by the New Zealand Property Investors' Federation Inc (the Federation) in response to the select committee invitation to provide feedback on the Residential Tenancies Amendment Bill.

Established in 1983, the Federation has twenty affiliated local associations situated throughout New Zealand. It is the national body representing the interests of over 7,000 property investors on all matters affecting rental-housing.

The Federation welcomes this opportunity to participate on the draft legislation.

Industry Background

To assist readers understand the extent of the economic and social importance of the private rental industry in New Zealand and the implications of residential tenancies legislation the following background points are offered.

What is the extent of the private rental industry?

There are approximately 350,000 private residential landlords in New Zealand, owning on average 1.5 rentals each. There are no corporate or institutional residential landlords.

There are over 464,000 residential rental properties[1], housing over 600,000 tenants, and worth around $150 billion[2].

Private landlords are the largest providers of rental accommodation in New Zealand. 86% of tenants rent from a private landlord or trust.

Median weekly rent for all accommodation is $430[3]. The amount spent on rent each week is $199 million and annually this is $10.4 billion.

The rental industry pays tax on a combined annual net income of $1.44 billion[5].

Most property investors (57%) have been engaged in the business for 10 or more years[4]. Property investors are using their rental income business as a mechanism for saving for retirement.

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[1] "Landlord group's code sets high standards" 5/9/08 NZ Herald

[2] NZ Herald 10/1/07

[3] Tenancy Bond Centre statistics

[4] ANZ NZPIF Annual Survey 2006

[5] Inland Revenue Department

SUMMARY

The New Zealand Property Investors' Federation welcomes the opportunity to submit on ring-fencing rental property losses.

The stated aim in ring-fencing rental losses is to level the playing field between property speculators/investors and home buyers. It is believed that there is unfairness in the system because investors (particularly highly-geared investors) have part of the cost of servicing their mortgages benefitted by the reduced tax on their other income sources, helping them to outbid owner-occupiers for properties. Rules that ring-fence residential property losses, so they cannot be used to reduce tax on other income, are intended to help reduce this perceived advantage and perceived unfairness.

1. There is a fundamental error in the assumption that tax deductibility for rental property allows investors to outbid owner-occupiers. If an investor increases their offer for a property by, say, $1,000, many people believe this $1,000 is tax deductible. It is not. Only the interest on any borrowings would be tax deductible.

2. When purchasing a property, owner occupiers get the benefit of accommodation, while rental property owners get the benefit of rental income. Owner occupiers have no income from the property from which to deduct costs while rental providers have rental income from which they deduct expenses from and either pay or are refunded tax depending on whether they make a profit or loss.

3. A report by independent economic consultants, Morgan Wallace, states that "our analysis does not establish any bias in the after-tax returns available to an individual entering the property market either as an investor, homeowner or tenant. To that end the housing market can be considered a "level playing field".

4. Ring-fencing does not provide any additional tax revenue to the country, it merely defers it into future tax years. Rental property providers don't get the benefit of the tax loss when cashflow is poor, making it impossible for many to provide a rental. However, they do get the benefit in later years when it isn't required because they are by then profitable.

5. Ring-fencing will have a dramatic effect on large and costly repairs, such as reroofing or painting the property. These large and one off costs can put a

cashflow positive rental property into a loss making situation during one financial year without the ability to use the loss in the same year. This would encourage ad hoc and piecemeal repairs and maintenance.

6. The proposed tax change will not affect all rental property providers. Many rental property providers make taxable profits, so only those that currently make loses will be affected. This may reduce the immediate impact of the proposal as a relative minority of investors' will be forced to sell their rentals.

7. The main effect will be on the future supply of rental property which will be required to meet growing demand. There are already financial difficulties in buying and providing a rental property. These difficulties are most pronounced in the early years of ownership. Being able to use these early losses to reduce an owner's other income helps to smooth out these early year cashflow difficulties. This helps investors to increase the supply of rental property.

8. Ring-fencing will encourage higher rental prices in order to make providing rental property feasible. If rental prices do not increase, many people will no longer be in a position to provide rental property and supply will fall behind tenant demand. Ultimately this will lead to higher rental prices, so either way, higher rental prices are inevitable.

9. Ring-fencing will have a larger effect in areas where rental yields are low, such as Auckland, Tauranga, Wellington and Queenstown, which are areas that already have housing cost and rental affordability issues.

10. The NZPIF offers an alternative option. In order to maintain rental property supply, minimise rental price increases and provide a disincentive to highly geared rental property, the NZPIF recommends a cap on claiming rental losses.

DISCUSSION

Leveling the playing field between investors and homeowners

As the IRD Background Paper states, "rental property is not formally tax advantaged". Using losses from one investment to offset income in another is currently available for any investment income. The reason it has been proposed to remove this feature from rental property losses is due to the belief that investors (particularly highly-geared investors) have part of the cost of servicing their mortgages subsidised by the reduced tax on their other income sources. It is believed that this helps them to outbid owner-occupiers for properties. Rules that ring-fence residential property losses, so they cannot be used to reduce tax on other income, is intended to help reduce this perceived advantage and perceived unfairness.

However, there is a fundamental flaw in this belief, due to the different benefits that homeowners and investors receive from buying a property.

The homeowner receives accommodation while the rental owner receives taxable income through rent.

As there is no income received or tax payable for the accommodation that the homeowner receives, there is no ability to apply a tax deduction for any expenses. Alternatively, a rental property owner must pay tax on their net rental income. This is calculated by taking revenue expenses away from gross rental income and paying tax on the net profit or claiming a tax refund on the net loss.

The rental property owner does not receive a purchasing advantage over the homeowner by being able to deduct expenses from their rental income.

A report by economic consultants, Morgan Wallace, states that the housing market can be considered a "level playing field" between investors' and first home buyers.

Morgan Wallace have produced a model to demonstrate that the ability for investors to deduct expenses such as mortgage interest from the gross rental income they receive does not provide them with an advantage over homeowners. Contrary to this believe, homeowners actually have an advantage over investors.

This was demonstrated by considering two people who each had $200,000 as a deposit with the ability to obtain a $300,000 mortgage to buy a $500,000 property.

They assumed a 5.5% gross rental for the property which the investor received as rental income and the homeowner received as the imputed value of the accommodation they received.

While the accommodation value that the homeowner receives isn't taxed, the rental income that the investor receives is taxed. This means that the after-tax return on the $200,000 investment is $2,500 for the homeowner, but only $1,675 for the investor.

Through their analysis, Morgan Wallace determine that the housing market can be considered a “level playing field” which if anything is tilted to benefit the homeowner.

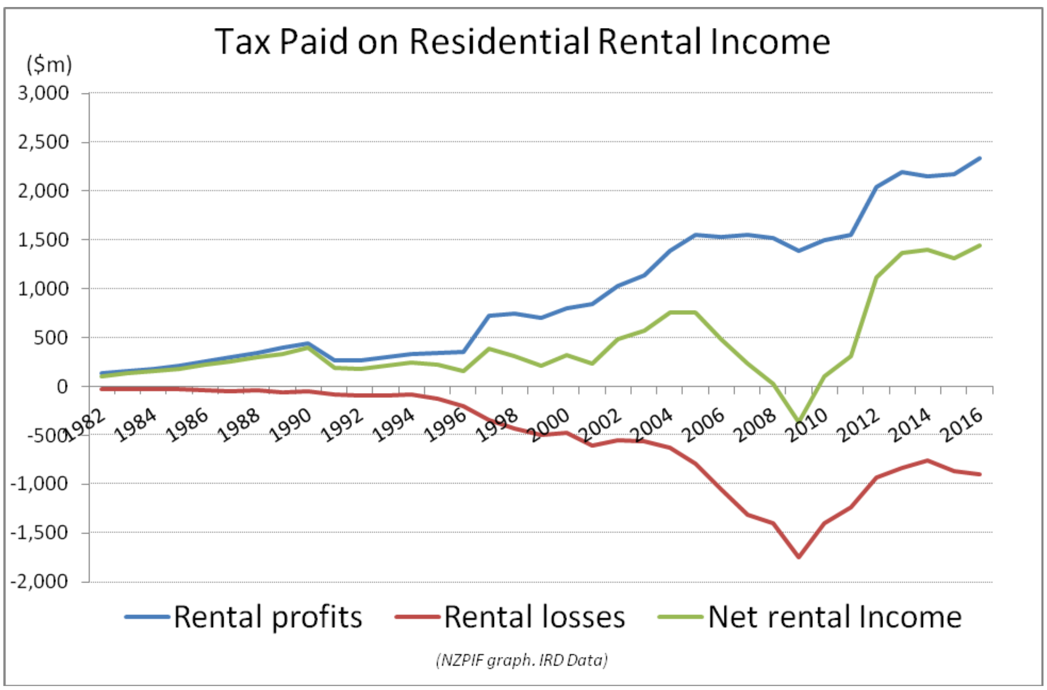
Ring fencing puts the interest of first home buyers above renters

The only realistic aim for ring-fence rental losses is to dissuade people from providing rental property in order to reduce competition for first home buyers. This is a poor use of tax policy, which should not be used to influence people’s investment decisions. In doing this, the policy change is putting the needs of first home buyers above those of renters.

While there may be less competition from rental property buyers, this will be countered through higher rental prices for renters, making it harder for those aspiring to be first home buyers to save a deposit.

Not all rental property owners will be affected

Graph one shows rental property income from 1982. As can be seen, net tax paid rental income over the last few years has been approximately $1.4b per year. This was made up of $2.2b of income less $0.8b of losses. As can be seen, the majority of rental property pays tax on the rental income earned.



Graph 1

The $0.8b of losses is likely to be from recently purchased rental property, which is due to the high price of housing and the high costs involved in providing a rental property. As rental prices tend to increase over time, rental properties eventually become profitable and start to pay tax on their profitable income.

As an aside, the graph also demonstrates that rental property owners take on the risk of mortgage interest rates increasing. The only time that rental property made a net loss was when mortgage interest rates peaked in 2008.

Table One below provides the cost of buying the average NZ property and providing it as a rental to tenants.

Table 1. Cost of providing the average NZ home as a rental plus cost comparison between renting and owning the average NZ home

NZPIF Study, September 2018

		Rental Owner			Home Owner
Property Value (REINZ NZ Median house price)		**$556,000**			$556,000
Chattels value	4%	$22,240			
Deposit / Investment	10.00%	$55,600		15.00%	$83,400
Mortgage		$500,400			$472,600
Mortgage Interest rate (Average of the four main banks floating rates)		5.86%			5.86%
Weekly Rent (national upper quartile rental price)		**$550**			
Annual rent		$28,600			
Annual Expenses				Term of mortgage	
Mortgage	Interest only	$29,323		25	$36,056
Insurance		$1,000			$1,000
Rates		$3,000			$3,000
Property Manager (incl gst)	8.0%	$2,288			
Other		$500			$500
Maintenance as % of rent	8.0%	$2,288			$2,288
2 week vacancy provision		$1,100			
Total expenses		$39,449			$42,844
Chattels depreciation claim at	10.0%	$2,224			
Tax Refund/Payable	33.0%	-$4,331			
Landlords cost before Ring Fencing		-$6,569			
Landlords cost post Ring Fencing		-$10,899			
Homeowners cost above renting				Annual	$14,244
				Weekly	$274
Homeowners cost above renting with no principle repayments				Annual	$5,882
				Weekly	$113

This example allows for a 10% cash deposit of $55,600, meaning the other 25% must come from equity in other assets. While the REINZ median house price is used, the rent is the higher upper quartile figure which is a more realistic rental price to use. Despite using the higher rental figure and realistic expenses, the rent does not cover outgoings.

The current and realistic cost of providing the average NZ property as a rental would cost the owner $5,569 in the first year. This includes being able to use the loss to offset other income. If ring-fencing is introduced, the cost in the first year to provide this property as a rental would increase to $10,899.

It is currently difficult enough to provide a new rental property in New Zealand, however it will be extremely difficult to provide one if ring-fencing of losses is introduced.

This example is not a low yielding property and it involves a considerable amount of capital to keep borrowings lower. In its current form, ring-fencing will make it impossible for many people to be able to buy the average NZ home and provide it to tenants as a rental home.

In order to return to the pre-ring-fenced situation, the weekly rent would need to be increased by $90 to $650pw or the cash deposit would need to more than double. The higher rent is likely to be unachievable for tenants while the higher deposit is likely to be unachievable for rental property providers.

This example shows how, if introduced as currently proposed, ring-fencing would have a dramatic affect on the industry. It would make it extremely difficult for rental property owners to provide new rentals and it would make it extremely difficult for tenants to afford higher rental prices.

The example also shows that even without a first home owner paying off any mortgage principle, it is still $113 per week cheaper to rent than own the average NZ home. This indicates that rental property is good value but also that there is room for rental prices to increase.

Increased difficulty to provide rental property

As shown in the figures above, it is currently quite a hurdle to buy and provide a property as a rental. This difficulty is reduced by the current ability to claim rental property tax loses against other income.

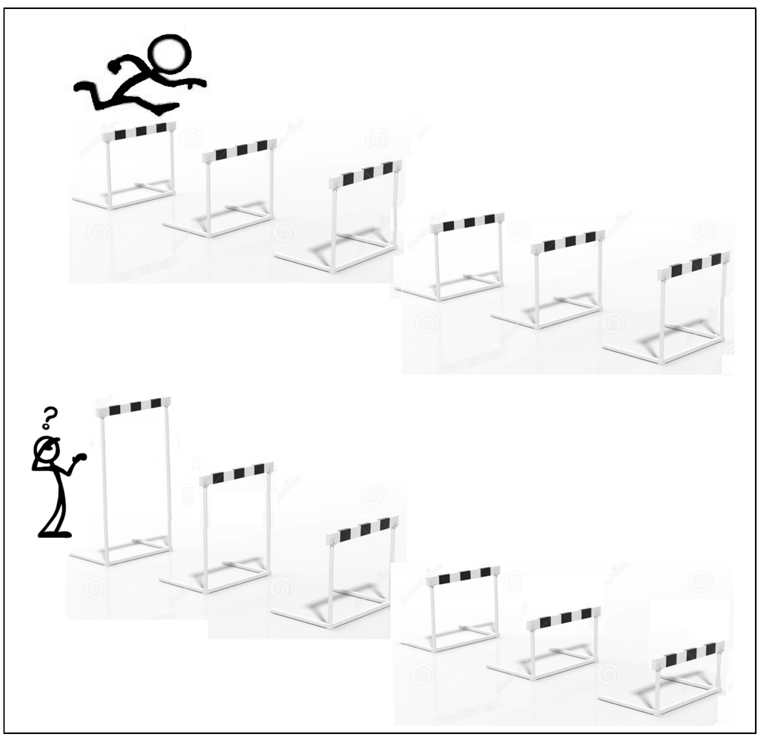
Over subsequent years it becomes easier to fund a rental property as rental prices rise and potentially the level of debt is reduced. As this happens, the losses reduce and the amount of rental property tax loses against other income also reduces. When the property starts to make profits, the rental property owner starts to pay income tax.

The current system uses tax law available to any other investment to reduce the negative cashflow in the early years of ownership, then pay tax once the property has a positive cashflow. By doing this, the rental property providers cashflow is evened out over the years.

If ring-fencing of rental property loses is introduced, tax losses will be pushed into the future. So tax losses will not be available in the first year when losses are high and cashflow is poor, but they will be available in future years when the property becomes profitable and tax losses are not actually needed.

Rather than smoothing out cashflow and making it less of a hurdle to provide a rental property, ringfencing will make it much harder, impossible for many, to buy a rental.

The following cartoon reflects the situation as it is now, with the cashflow hurdles being evened out over the years at the top and how it will be if ringfencing is introduced. Many potential rental property providers simply won't be able to get over that first hurdle.



Reduction in supply of rental property

As the figures in Table One above show, it is very difficult to buy and provide a new rental property for a tenant. It takes a large cash deposit and it requires regular capital injections to cover costs.

A rental home provider has very little control of market forces that determine the price of a property or the expenses to operate it. They are mostly price takers rather than price setters, meaning that if factors become difficult, an increasing number simply cannot provide the rental accommodation.

The capital injections tend to reduce over time as rental prices rise, meaning that owning a rental property becomes easier over time. This is accelerated if the owner uses the higher rental prices to pay off debt.

The ability for an owner to use rental losses to reduce tax paid on other income improves cashflow in the early years when low income and high expenses are most pronounced. This means that the current system enables a higher number of rental properties to be provided by improving cashflow when it is most needed.

Ring-fencing rental property losses will not increase the amount of tax revenue the Government receives, it merely changes the timing of when it receives it. Owners will, quite rightly, not lose the ability to claim the losses, but they will only be able to do this when they have a lower need for the improved cashflow.

Ring-fencing will therefore make it extremely difficult to provide rental property while making it impossible for many. The NZPIF believe it would be irresponsible to introduce such a measure at a time when New Zealand has a shortage of rental properties.

Higher rental prices

As the measure will not affect all rental property providers equally, it is difficult to estimate the effect on rental prices.

There is no doubt that the policy will put pressure on rental prices to increase, but when the increase will occur is more difficult to estimate.

Rental property owners who cannot afford the cost will be most likely to increase their rental prices, but this may not be achievable to a sufficient degree. It is likely that some owners will be forced to sell, but we have not seen any estimates from Government on how many are likely to do so.

The degree of rental price rises will be affected by how many owners will need to sell their rentals, how many unaffected landlords will use the policy to increase their rental prices and therefore their return and the reaction of tenants.

Even with higher rental prices, the cost of renting a property is likely to be considerably lower than owning, meaning that home ownership will not be an attractive alternative for some tenants. The only other alternatives are accepting the rent increases, seeking lower value accommodation or taking in extra people to share the cost increases. Younger people may also stay at home for longer than they otherwise would.

While there will be pressure on rental prices to rise, these factors will put a limit on the level of these price rises. If rental prices do not increase sufficiently then there will be a real barrier to increasing the supply of rental property. This ongoing lack of supply will continue to place pressure on rental prices over a period of time, meaning that rental price increases will be higher for a number of years than they would have been without the ring-fencing policy.

The NZPIF would like to see independent economic modelling undertaken to examine and calculate the likely effect ring-fencing will have on the rental market.

Uneven application across New Zealand

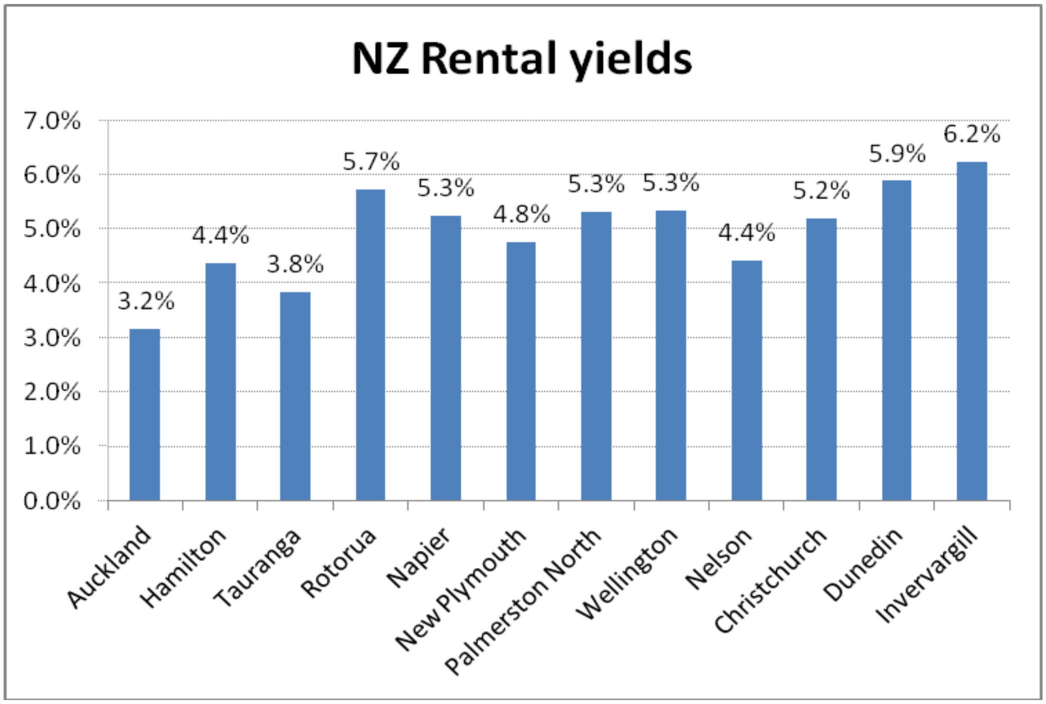
New Zealand has a variety of housing and rental markets which are not homogenous.

According to REINZ march statistics, house price range from a low of $215,000 on West Coast of the South Island to $880,000 in Auckland. Rental prices range from $300pw in Invercargill to $646pw in Wellington.

Graph 2 below shows the range of average rental yields from around New Zealand, ranging from 3.2% in Auckland to 6.2% in Invercargill.

It is clear that ring-fencing is going to have its greatest impact in low yielding areas of the country, as these are the areas it is most difficult to provide rental property.

With the fastest growing population in the country, Auckland has the greatest requirement for more rental properties yet it is going to be the hardest hit area if ring-fencing is introduced.



Graph 2

Using ring-fenced losses

Under the proposal, losses could only be offset against residential rental income from future years or taxable income if a property is sold. As there isn't a capital gains tax in New Zealand, there is no tax payable when a rental property is sold. This means that losses could only be offset against residential rental income from future years.

This introduces risk for rental property owners. If they have to sell the property before it becomes income producing, they completely lose the benefit of the loses. This fact is pointed out in the Morgan Wallace report and is completely unfair given that the rule will not apply to any other asset class.

The risk of losses not being used at all further reduces the incentive to buy and provide rental property.

Interest allocation

Poorly conceived new taxes, such as ring-fencing, inevitably lead to a complex and unfair sets of rules to stop people getting around them.

We agree with the decision not to introduce interest allocation rules in order to prevent some rental property owners from reorganising their debt around differently owned assets.

Portfolio basis

The suggestion that ring-fencing rules should apply on a portfolio basis is very sensible as it would go some ways towards minimising the reduction in supply of rental property.

On its own, this suggestion would not make the proposal workable as it would just mean that some owners would be less affected than others.

While the vast majority of rental property owners have just one property, it would be highly complex for multiple property owners to report properties on an individual basis.

Property the rules will apply to

The rules will only apply to residential rental property. It will not apply to baches that are sometimes rented out, farmland or business premises.

As ring-fencing is an unjust proposal which will have highly negative consequences on the rental industry, the NZPIF would not like to see it implemented in other property related industries.

We therefore agree that, notwithstanding our objection to the proposal as currently suggested, it should not apply to other property related industries.

Timing for introduction

If ring-fencing was to be introduced it should be phased in gradually over a period of at least five years.

This could be achieved by ring-fencing 20% of available losses in the first year after introduction and increasing by 20% in each subsequent year until fully implemented.

This would allow people time to make decisions on how they can handle the new law as well as implementing their decisions.

A gradual introduction would be fair to tenants as well as owners, as it could mean that rental prices could increase more gradually.

An alternative approach

The NZPIF suggests an alternative option to ring-fencing that would be less likely to discourage spending on repairs and maintenance and reduce the impact on rental property supply.

Ring-fencing all rental property loses as proposed will have a large and negative effect on the rental property industry through reduced rental property supply, increased rental prices, reduced choice for tenants and overcrowding.

Rental property providers do not control the housing market or the cost of buying rental property. They only have a limited effect on rental prices and a very limited effect the costs associated with providing a rental property.

Ring-fencing will make many properties unviable as rentals and reduce supply.

If the decision is made to introduce ring-fencing, the NZPIF believe it should be targeted rather than introduce a tax law that affects all rental property owners.

In order to maintain rental property supply, minimise rental price increases and provide a disincentive to highly geared rental property, the NZPIF recommends a cap on claiming rental losses.

We believe that if ring-fencing is going to be introduced, then it should not prevent the average NZ property from being provided as a rental.

Our research shows that currently, the average NZ property makes a loss of approximately $9,000 in the first year of ownership. If ring-fencing was applied to losses greater than 20% above this level, then this would allow the average NZ property to continue being provided as a rental.

Recommendations

The NZPIF recommends that:

1. Ring-fencing in its proposed form is not introduced as the playing field between investors and home buyers is not unequal.

2. Before any decision is made, Government produces and makes public an impact statement on the likely effects of ring-fencing on rental prices and the supply of rental accommodation.

3. If ring-fencing is introduced, it should be at a level of losses over $10,000 so that rental supply and rentals prices are not too adversely affected.

4. If ring-fencing is introduced, losses should be offset against residential rental income from future years or on any of the owner’s taxable income if and when a property is sold.

5. If ring-fencing is introduced it should be phased in gradually over a period of at least five years.