Reconsidering the claw back of interest deductions

PROPOSAL:

I propose implementing a claw back of interest deductions upon the sale of capital assets ("the Proposal").

INTRODUCTION

New Zealand taxpayers claim large amounts of tax deductions for interest expenditure incurred in deriving income from investment properties. However, while investors are allowed to deduct the full cost of their borrowing for tax purposes, the rental income they are required to return represents only one part of the overall economic benefit obtained from investing in property. In 2003, the National Landlord Survey identified the benefits of capital gains as the primary benefit of investing in property.[1] By allowing property investors to claim deductions for interest expenditure in full while only requiring them to return part of the economic benefit they derive from their borrowing the tax system, in effect, provides incentives to borrow heavily to invest in assets with a high chance of capital gain. This practice is known as 'negative gearing'.

In 2008, a study conducted by the Department of Prime Minister and Cabinet ("DPMC") estimated that the tax benefits provided to property investors relative to owner-occupiers with similar levels of debt could range from $700m to $1,000m.[2] If legislation was introduced to disallow a percentage of these tax deductions then a significant amount of additional revenue could be raised. This would meet the fundamental purpose of any tax regime, namely to raise revenue to finance publicly-provided services and meet the Government's commitments. It would also increase economic efficiency by increasing investment in more productive sectors of the economy.

BACKGROUND

Historically, the New Zealand Government has tried to stop property investors engaging in negative gearing by introducing legislative provisions restricting the deductibility of expenditure relating to land transactions. One attempt at this can be seen in section 129 of the Income Tax Act 1976 ("the ITA 1976") which required taxpayers to be reassessed on interest previously allowed as a deduction on money borrowed to acquire rental land if the taxpayer sold the land for a profit within 10 years of the date of acquisition. Section 188A of the ITA 1976 also operated to restrict losses on such land to $10,000 per annum per person. However, these provisions were repealed by section 8 of the Income Tax Amendment Act (No. 3) 1990. The repeal of these provisions was recommended by the Valabh Committee as part of a wider proposal to widen the income tax base to include capital income.[3]

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1 National Landlord Survey, Centre for Research, Evaluation and Social Assessment, 2003.

2 Department of Prime Minister and Cabinet's House Prices Unit Final Report March 2008.

3 Caygill, David, Consultative Document on the Taxation of Income from Capital, Wellington, Government Printer, 1989.

During the 1980s, the Commissioner of Inland Revenue also unsuccessfully challenged the taxpayer's ability to claim deductions for interest expenditure incurred in acquiring an asset primarily for the purpose of making untaxed capital gains. See for example the *Pacific Rendezvous Ltd*, *Eggers*, and *Brierley* cases. The courts held that our income tax law does not even recognise the concept of capital gains and as a result there is no requirement to apportion interest expenses between expenses that relate to the derivation of taxed income and expenses relating to capital gains. [4] These failed challenges have led the Commissioner to accept such practices.

Such practices have helped to fuel rapid house price inflation. With housing looking to be a hot topic in the upcoming election, it is time to reconsider the practice of negative gearing.

APPLICATION

The clawback would be achieved when a capital asset was sold by disallowing a ratio of the interest expenses claimed as deductions in previous income tax years. The ratio would be determined by comparing the profit on sale against the income (or losses) received from that asset.

ANALYSIS

Criteria

There are four commonly identified criteria for the evaluation of any proposed tax reform:

- neutrality or economic efficiency;
- ease of administration and compliance;
- fairness or equity; and
- international compatibility.

Neutrality or economic efficiency

The proposal would reduce bias in favour of investment in assets expected to create capital gains, in particular: rental properties. Tax incentives for investing in housing are one among many factors that are driving house price inflation. Institutions such as the Reserve Bank of New Zealand[5] ("RBNZ"), the International Monetary Fund[6] ("IMF") and Fitch Ratings[7] have all voiced their concerns that house price inflation in

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A Robin Oliver, Capital Gains Tax – The New Zealand Case, A Paper Prepared for the Fraser Institute 2000 Symposium, on Capital Gains Taxation, September 15-17 2000, Vancouver, BC, Canada.

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Bennett, David, Monetary Policy Statement, Reserve Bank of New Zealand, June 2016.

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See Staff Report on New Zealand, International Monetary Fund, IMF Country Report No. 16/39, 5 February 2016

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Auckland and other regions is creating risks for New Zealand's financial stability and economic development. Studies in other parts of the world have linked high rates of investment activity with housing booms and busts.[8]

By reducing the tax incentives for investors to take on large mortgages, the Proposal would help to lower house prices and promote fairness between investments. This would have a positive economic impact as it would encourage investment in New Zealand's shallow capital markets which would increase financial options for New Zealand businesses and lower overseas borrowing.

Ease of administration and compliance

The Valabh Committee noted a common criticism of the old sections 129 and 188A was the ease with which taxpayers could avoid them, for example, through the use of land rich companys or trusts. However, the rules have changed since 1990 and there are mechanisms in place to prevent such practices.

The Proposal would admittedly add to the complexity of the tax system, however, this would be mitigated by the increasing ease with which taxpayers can determine their liabilities using new software. Inland Revenue would be more able to effectively enforce the Proposal due to more widespread gathering of property transaction data for tax purposes than was present during the 1980s.

Fairness or equity

Negative gearing is inequitable because it allows taxpayers to claim deductions for expenses that are directly used to produce non-taxable capital gains. It also puts investors at a relative advantage to first home buyers. DPMC's report in 2008 estimated the ability to deduct losses from rental properties increases the value of a median-priced house to the investor by $25,000, relative to a potential home owner who needs a large mortgage to buy the same house.

The Proposal is fair because it treats all investments alike by law but realises that it will in fact have an overwhelmingly targeted effect on property investors. This is because of the practice of negative gearing to invest in property is so prevalent whereas negative gearing to invest in shares through margin lending is extremely uncommon.[9]

It would also have a progressive effect because it is generally taxpayers in higher income tax brackets who engage in negative gearing.

International compatibility

As reported in the NBR, see: Gibson, Nevil, Editor's Insight: Fitch blames housing bubble for declining credit upgrade, National Business Review, 21 February 2017.

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Andrew Haughwout, Donghoon Lee, Joseph Tracy, and Wilbert van der Klaauw, Real Estate Investors, the Leverage Cycle, and the Housing Market Crisis, Federal Reserve Bank of New York Staff Reports, no. 514, September 2011

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The Australia Reserve Bank found that borrowing to buy shares amounted to 2% of its net debt before the global financial crisis in 2007.

The Proposal would help to address the 'equity bias' that international institutions such as the OECD, IMF and European Commission are currently targeting.[10]

Advantages to alternative policy proposals

The Proposal would be both more neutral and fair than ring-fencing of tax losses from rental properties ("Ring-fencing"). Ringfencing risks taxing landlords on "fictional income" in years where they have suffered real economic losses. Targeting 'landlords' in particular is also politically unsavvy as it creates fear that there will be corresponding rises in rents.

The Proposal is more straightforward than a comprehensive capital gains tax and could be pitched as a way of "closing loopholes" rather than the introduction of a new tax. Both the McLeod Committee[11] and the RBNZ[12] recommended against a comprehensive capital gains tax because of the practical difficulties and the risks of high compliance costs. Such a tax was also met with little fanfare when proposed by the Labour party during the 2014 election.

Political acceptance

Housing looks to be a central issue in the upcoming election. Investors in particular have faced the blame for house price inflation. While tax incentives are just one factor in the supply and demand equation, they are a factor that both the RBNZ and IMF have urged the Government to address.

There is also a more general concern about the growing levels of inequality and a belief that the wealthy are not paying their "fair share" of tax. As mentioned, the Proposal could be pitched as "closing a loophole" that the wealthy abuse.

Lastly, there is a growing concern about sustainability of current levels of Government spending in the face of an ageing population. As Brian Fallow writes:[13]

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See for example: Tax Policy, Leverage and Macroeconomic Stability, International Monetary Fund, Washing DC, 7 October 2016;

Serena Fatica, Thomas Hemmelgarn, Gaëtan Nicodème, The Debt-Equity Bias: consequences and solutions, European Commission, Working Paper N.33, July 2012

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McCleod, Robert, Tax Review: Final Report, 2001.

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See Hargreaves, David, The Tax System and Housing in New Zealand, Reserve Bank of New Zealand, DP2008/06, February 2008.

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Fallow, Brian, Why the young should be angry about superannuation, NZ Herald, Mar 10, 2017

"So long as the tax system tells people the best way to provide for their old age is not to save money but to borrow money and bid up the price of housing, we will be left with sterile and generationally divisive debates about super."

This comment aptly demonstrates how a range of different issues such as tax, housing, government spending and the age of retirement are all interlinked and fast becoming hot topics of political debate.

CONCLUSION

This Proposal is a good starting point to address the economic distortions created by the current tax incentives for housing investment. It has the potential to bring in a large amount of additional revenue through a small change. It is less complex and more politically viable than alternative options. At the end of the day, such a move will be necessary to address the future challenges for the tax system like budget pressures, an aging population, and an incre