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Budget Tax Changes Have Chilled Negative Gearing

Even before the most recent interest rate rise, negative gearing into residential rental property was dying a rapid death. The 2006 Federal Budget hammered a few more nails into the coffin. Naturally, an army of real estate agents, property developers and associated hangers on will say differently. Since the real estate industry buys so much advertising in the main stream press, it's hard to get the truth from reading the finance pages.

Successive tax changes mean that investment strategies based on owning one or more rental units or rental houses now rates so low on the priority scale of dentists seeking to create wealth that such propositions should be rejected out of hand. I regard them as a wealth hazard.

Regrettably, many of the financial writers in the popular press actually write their daily columns with the assistance of press statements put out by banks, insurance companies and real estate interests. Hardly any it seems actually understand the workings of our tax system. Consequently myth and fallacies abound.

Myth Number One

"The Government halved capital gains tax as a result of the Ralph Review"

This is not true. What actually occurred is far more complex, but most persons who sell "passive" assets such as rental units in the future will pay more capital gains tax under the new systems than they would have had the old system continued.

This occurs because the Government cunningly abolished the indexation of the base cost as well as abolishing the 5 year averaging provisions. This greatly increased the amount subject to taxation and they then, generously, it seems, indicated that only half of the resulting much greater amount would be added to taxable income.

If under the old capital gains tax systems a rental property was sold after a long period of ownership of, say, 25 years and its sale value net of selling costs equalled the indexation of its base cost at CPI over that long period; then the vendor would have had no tax to pay even though the compounding effect of 25 years growth at CPI may have tripled its value!

However, under the new system which ignores indexation of the purchase cost and dispenses with 5 year averaging, provides that half of the nominal gain is added to the vendor's personal taxable income for the year and taxed at their marginal rate. Readers can play with the numbers of a few examples and they will see that the change in capital gains tax drove a spear at the heart of negative gearing.

Who Gains?

The reality is that the Government's tax take from the sale of passive investment assets is now much greater under the new system than the old. However, the total revenue under the Ralph Review changes was projected to be neutral. Since those who sell passive assets (other than superannuation funds) pay more tax, it raises the question as to who got the benefit.

The benefit went to small business owners, including dentists whose practices and practice premises are classified as "active business assets". There are a series of capital gains tax concessions which apply to the sale of these active business assets.

Hence, it is now far more tax effective to own your own dental premises rather than passive rental property. Since most dentists sell their premises to the dentist who purchased their practice without going through a real estate agent, it is unlikely that any agent is going to advise them to purchase premises ahead of rental properties. Inevitably, most real estate agents will have lots of rental properties to sell.

Myth Number Two

"If it is tax deductible, it must be good"

Nothing could be further from the truth. The reality is that an investment which was sound at a high marginal tax rate, and hence a high rate of tax benefit, may be quite dumb at a lower tax rate and a much lower tax offset.

Marginal Tax Rate Impact

Not too many years ago the tax and Medicare levy combined totalled 61 cents of a marginal dollar. Furthermore, we paid that marginal tax rate at a very low level of income. Several years ago, the highest marginal tax and Medicare rate of 48.5 percent was still sound on taxable income above $50,000. Currently, the highest marginal rate of tax has fallen to 46.5 percent including Medicare levy and is only payable on income above $150,000. Income above $75,000 is taxed at 41.5 percent including Medicare levy. These changes mean that where a couple are able to split their income they can have $150,000 of jointly taxed income and pay tax at a rate of 31.5 cents per marginal dollar up to that amount. On the amount up to $300,000 they pay a marginal tax rate at no more than 41.5 cents per dollar.

Negative Gearing Benefit is the Reverse of Tax Rate

An investor with the highest marginal tax rate gets the greatest concession for claiming negative gearing costs. However, because of the changes in both tax rates and tax thresholds, the vast majority of persons now gearing residential properties being mainly average income earners, are only able to achieve a 31.5 cents per dollar saving. In the recent past it may have been a 48.5 cents per dollar saving. Furthermore since the superannuation surcharge has been abolished and given the forthcoming simplification of superannuation rules, many people will choose to lower their income by funding superannuation.

Rental Property Collapse

Even the white shoe spivs who sell dreams on the Gold Coast are having difficulty in convincing people that it makes economic sense to negatively gear into a rental unit or two in tall towers. Consequently, many of those who did invest need to cut their losses by selling as the market is dying.

The market appears to be at its worst in Sydney where celebrated developer, Harry Triguboff, the owner of Meriton, has been unable to sell his recent developments and is reported in the press as owning $1 billion of rental apartments, numbering about 3,000. It is most unlikely that he set out to own thousands of the units. Rather, he had developments in the pipeline and funded them through to fruition hoping that any drop in the market would be of short duration and he would be able to quickly sell down his stock and recover his working capital. It is most unlikely that he set out with the aim of being Australia's biggest rental unit property owner. Large developers strive to turn over their stock in order to get their working capital into further projects.

In a market where even the most wealthy and astute businessman gets caught, there are many thousands of small investors who bought rental properties based on slick presentations which overstated the rent, understated the property owners costs and which did not take account of interest rate rises for tax changes. Their hopes for positive gearing and capital growth have both turned negative. For many people, the results are an enduring nightmare.

For example, I know of a couple with modest income who were persuaded to buy and develop two blocks in South East Queensland. The promoters showed them cash flows which provided positive outcomes. The result has been that right now they are losing $3,000 per month and must sell urgently as increasing debt and high interest rates will accelerate their monthly loss. They simply cannot afford to hang on, because if they do all of their equity in their property, and progressively their equity in their own home will be swallowed up.

Loose Lending Practices

In recent years, insurance bonds were used as collateral to enable moderate income earners to gear up to several units instead of one. There are also opportunistic mobile lenders who smooched up to friendly valuers in order to get the valuations boosted significantly so that they could lend their customer sufficient money to buy value inflated property at the height of the market. Recently, much lending occurred on so called "low doc" loans. Many of these relied upon persons with insufficient capital or income falsifying their income to get the loan. As loan defaults rise, the mortgage insurers will examine the loan documentation and refuse to pay up where it can be demonstrated that false statements were made. Unfortunately every few years the bankers throw money at persons who wouldn't pass normal credit checks. The tightening of interest rates together with other events such as high oil prices causes the market to correct itself and purge the poor deals. The greedy and the gullible both get hurt.

When Did it Start to go Wrong?

The evidence from place to place will vary, but we noticed that in areas surrounding our offices in Doncaster Melbourne, four major intended high rise development projects were cancelled in about March 2003. That is a point at which we could see physical evidence of the real estate market for these types of properties dying in Melbourne.

Negative Gearing of Plantations

Regrettably there are still greedy and overly optimistic accountants who flog eucalypt plantations, olive groves, tropical timber etc to their clients. The Synstrat Group has, since its inception, had a policy of not recommending these types of schemes. However, over the years, we have had many approaches to sell them. We note that the commissions applicable usually lie between 8 and 10 percent. A typical sale for tax purposes can be in the hundreds of thousands of dollars.

Our observation is that any class of investment which has to rely upon paying such high levels of commissions to get sales must have something fundamentally wrong with it. Dentists should immediately walk away from accountants who propose these investments.

Our continuing advice is to avoid these investments. With the lowering of marginal tax rates, the perceived tax benefit in these schemes is falling in a similar manner to that of gearing into property.

Owner Occupier versus Non Owner Occupier

Human beings behave in a self interested way. Inevitably, people look after their own homes which they live in and care for. Dental practice owners have a similar attitude to their premises.

With respect to rental property, it is a case of an extension of the old question *"Did you ever check the oil in a rented car?"* Most people agree it is unlikely that they would.

Rental property simply doesn't get looked after as well as owner occupied property. Nor does its capital appreciation match that of the houses that we live in and look after personally.

However, the way in which median price statistics are gathered and promoted is quite dishonest because it incorporates new capital spending in such a way that it is presented as a growth in property values. We tend to spend a lot more in renovating and improving the houses we own and live in to that which is spent on rental properties. The result is that in areas where a lot of owner occupier houses are sold, median price statistics invariably show an impressive gain over a long period of time. What the figures don't tell us is how much capital the owners put into their houses to improve them during their period of ownership. The actual data is drawn from sales recovered at state stamp duty offices.

The Overall Verdict

As a class of investment, negative gearing into residential rental properties rates extremely poorly. Forestry, and plantation type schemes, should be avoided.

Is Buying a Dental Practice Still a Sound Financial Decision?

The questions as to tax treatment on other forms of negative gearing beg this question. However, it is clear that subject to sensible decision concerning price, location, premises and a proper budget and business plan for the buyer, buying a dental practice is usually a sound proposition. There are key issues involved.

The Unsaleable Practice versus the Saleable Practice

An example of a practice which can be difficult to sell is a high end cosmetic dental practice run by a very energetic dentist who is a super salesman. The practice is advertised for sale at around 100 percent of its fees. The reality is that no sane younger dentist is going to pay the price, having recognised that:

1. It is a silly price to pay after allowing for normal dental opportunity costs, and

2. The only dentist's who can takeover that type of practice and run at similar fee levels as the existing proprietor, are almost certainly the type of dentists who are already running their own successful practices. Therefore, the potential buyer market for such a practice may in fact be close to zero.

At the other extreme there is the older dentist who offers the traditional type of practice for sale. There is a high probability that almost all potential buyers could step into the practice and not only takeover the existing treatment plans, but in all probability, improve them and increase practice fees. Naturally they need to be careful of the price they pay, and factor in the probability of significant renovation and replacement of equipment.

The Accountant and Real Estate Agent Trap

Some real estate agents try and set themselves up as practice brokers. Often they rely upon the valuation by the practice owner's accountant. Where the practice owner's accountant has only one or two dental practices, they often produce ridiculous valuations relative to the market, possibly taken from comparisons with non professional businesses. This is often attached to a lengthy list of equipment with values attached; some of the equipment being quite aged. Buyers need to be aware that there are only a handful of accountancy practices with sufficient dental practices on their books to see a constant flow of buy and sell contracts, and hence have a real understanding of the actual market for solo dental practices. Often real estate agents seem reluctant to produce the real figures, producing only summaries of figures with some costs excluded. Valuation requires experienced analysis of the actual figures prepared by the practice accountant for the practice, not some shortcut. Nor do businesses which provide listing services of practices for sale see the final negotiated contract for sale. At Synstrat we have been privileged to see many contracts of sale or purchase of dental practices which end up in the accounting records of our clients.

Why Aren't Dental Practices Worth More?

The simple answer is that there is a restricted pool of buyers. You need to be a dentist to actually operate a practice. It would be very rare for a non dentist to own a practice and employ a dentist to run it; that is a very risky proposition. Therefore, the potential pool of buyers for dental practices will be limited to qualified dentists within a particular experience group. Conversely, the types of businesses which don't require qualifications to run them such as newsagents and postal agencies have a vast market of potential buyers. As a result, they often sell for ridiculously high prices relative to income as the owners are in fact buying themselves a job. Invariably, the owners personal opportunity cost is much lower than that of a dentist.

Summary

1. Active business assets such as dental practice and premises are usually superior assets to purchase compared to passive assets such as rental property.

2. Capital gains tax on most passive investments has been made higher rather than lower by the changes to capital gains tax. Capital gains tax was not halved.

3. The combination of changes to both capital gains tax and marginal tax rates has effectively killed negative gearing into "passive investment residential property assets" as a sensible wealth creation strategy.

4. Low documentation (low doc) loans are dangerous.

5. Forestry and plantation schemes flogged by some accountants as tax deferral mechanisms should be avoided. Tax changes have made them even less effective.

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