This information is provided to the Business Tax Working Group in response to the discussion paper released on Monday, 13 August 2012.

BMT Tax Depreciation seek to comment on and respond to points made under the heading *Depreciating Assets and Capital Expenditure* starting on page 27 of the discussion paper especially relating to point 4: Building Depreciation, starting at paragraph 148.

Building depreciation

We are quite concerned with the points made in reference to removing building depreciation. Without building depreciation, Australian businesses as well as private investors will have a reduced capacity to invest in new capital expenditure and infrastructure. This extends from -

1. small, medium and large businesses operating in an owned or rented building where continual investment, of a capital nature, needs to take place to ensure a facility is fit for operation and can compete on a national and international level; to
2. private individuals, mostly 'mum and dad property investors' who privately fund rental housing in Australia.

There is a current rental crisis, housing supply crisis and government housing crisis in most regions of Australia. Although there are various stimulus packages being offered by governments at various levels to stimulate home building, some have recently been withdrawn making the situation worse. Given the above, we are surprised that the Business Tax Working Group has suggested the removal of a housing supply incentive like building depreciation.

Outside the terms of reference

This discussion paper states that it will not be considering aspects of our tax system which fall outside of the business tax system as noted below:

> *"80. It should also be noted that that the Working Group is not considering changes to Australia's dividend imputation system, as it operates outside of the business tax system and is therefore outside the scope of the Working Group's terms of reference"*

The Working Group claims they are not considering changes to systems which operate outside the business tax system (e.g. Australia's dividend imputation system), as they do not fall within the Group's terms of reference. However, 'building write off' or Division 43 also falls outside of the business tax system, as we have noted it affects mum and dad investors involved in negative gearing property investment.

The paper also mentions that suggested changes will have a negative effect on some sectors that will not benefit from a company tax cut as can be seen below -

> *"129. The removal of statutory effective life caps for certain assets would also reduce after tax returns to investments by unincorporated taxpayers, such as primary producers, who would not benefit from a cut to the company tax rate"*

However it seems that there is a considerable oversight in that the removal of building depreciation will have a significant impact on mum and dad property investors who make up 2.5 million individual non business tax paying Australians. These people will gain no direct benefit from a company tax rate cut.

Negative gearing

Building depreciation is an element of Australia's negative gearing facility and is designed to support the supply of housing in Australia. From a property perspective, negative gearing is used when a property investor borrows money to buy an investment property and the income generated from the property is less than the deductable expenses/write-offs (related to the property), with the difference (i.e. the loss) being tax deductable. Deductable expenses/write-offs include building depreciation, interest costs, maintenance expenses and holding costs (e.g. building insurance and rates). **Both sides of government have ruled out any changes to negative gearing legislation – consequently this should rule out changes to building depreciation legislation.**

It is well known to all Australians that in July 1985 the Hawke/Keating government changed negative gearing so that losses or expenses could not be claimed against rental or other income. The immediate result was a dampening of investment in rental accommodation and significant increases

in average rents. The Hawke/Keating government quickly restored the negative gearing rules in September 1987.

According to the Australian Bureau of statistics between 1985 and 1988 the number of private sector dwellings completed dropped from 129,100 per year to 107,700. At the same time the waiting list for public housing had a dramatic increase from 144,600 to 198,100 which was a 37% increase.

Source:http://www.abs.gov.au/ausstats/abs@.nsf/2f762f95845417aeca25706c00834efa/f93a40ff13f209dfca2570ec007877a1!OpenDocument

Impact on the property and construction sector

Changes to the corporate tax system proposed by the Working Group aim to increase investment, productivity and wages. However the property and construction sectors will suffer with the removal of any tax incentive available to income producing property owners or purchasers. As demonstrated earlier when negative gearing legislation was restricted between 1985 and 1988 new dwelling completions per year fell substantially.

A building depreciation claim is not just available for *"expenditure incurred in constructing capital works"* as outlined in paragraph 148 of this discussion paper. It is also available to those who purchase existing properties which commenced construction within qualifying dates (residential after 18th of July 1985, non residential after 20th of July 1982 and traveller accommodation after 21st of August 1979). Therefore any reduction in building depreciation will have a negative impact on mum and dad property investors who fund the majority of rental housing in Australia and purchase both new and existing dwellings.

A large portion of the construction sector is made up of residential housing. Private property investors are needed to fund this housing. Building depreciation is a considerable incentive for property investors. Without it, developers will struggle to sell and therefore fund residential construction projects. The second hand property market will also be negatively affected. The vast majority of rental properties are existing second hand buildings. Tampering with tax incentives to property investors will see this sector decline, resulting in fewer transactions, fewer rental properties available and less redevelopment of existing properties. This will ultimately lead to a lower level of housing quality for all but the wealthiest Australians.

Impact on financial institutions

The ensuing credit problems must also be acknowledged. Our financial institutions are heavily geared in property and need to be able to fund new construction in Australia. The Working Group must consider the impact of removing building depreciation on our financial institutions' ability to continue to fund housing in Australia. Since the start of the global financial crisis, our financial institutions have been forced to tighten funding requirements; especially relating to medium risk endeavours like construction. Taking a concession away from building owners adds to the cost of ownership. This will damage the fragile construction industry and the delicate funding arrangements our banks currently have with the construction and property sectors.

Indeed, changing the tax system that supports price stability in Australia would have severe repercussions for Australian financial institutions. Our banks' vulnerability to the property sector is large enough to cause an unprecedented funding crisis in Australia with the ability to damage every facet of our economy. Compounding this is the fact that if banks cannot lend to our future home owners, the rental market will be put under more pressure, pressure that it cannot handle – rental vacancy rates are already at record low levels.

Impact on Australians not linked to business

The Working Group suggests that depreciation is recognised in other ways as outlined below.

> *"150. There is a case for scaling back existing building allowances because the tax system recognises depreciation in other ways, for example, by providing a deduction for costs of insurance, maintenance and repairs and reflects the actual depreciation (or appreciation) as a capital loss (or gain) on disposal. The United Kingdom has significantly scaled back the availability of building depreciation.45 In 2010, New Zealand changed the depreciation rate of buildings with long estimated useful lives to zero per cent. This change is intended to make New Zealand's tax rules more neutral and non-distortionary.46"*

This is a shallow observation; while other tax deductions may compensate for a fraction of depreciation available on a building, the medium to long term implications of removing the capital allowance deduction must be considered.

We are surprised that the Working Group is looking at a smaller subdued economy like New Zealand as a case study. It is also concerning that the Group is suggesting Australia adopt similar tax strategies. It will be interesting to note the likely decline in residential investment and general quality of property, particularly rental properties in New Zealand, in the coming years.

The Working Group has not acknowledged the impact of changing depreciation benefits for the average Australian property investor, for whom depreciation deductions are a significant incentive to purchase property. Building depreciation on average results in a deduction of between $5,000 to $7,000 per year for a typical residential property investor. The removal of such deductions would greatly reduce the yearly cash flow for these investors and undoubtedly reduce the rate of property investing Australia wide.

> *"The Working Group supports the principle of a business tax system characterised by a low rate and broad base, subject to other considerations. However, the Group notes that while there may be some scope to examine base broadening options, this needs to be done cautiously. It is vital that the net effects — especially on particular sectors and on investment decisions — of removing existing concessions are examined carefully."*

The impact of this loss of cash flow for private investors as well as the impact on the housing industry and affordability of rental housing would be very significant. Not only would rents rise, but the rate of investment would decrease, potentially bringing the property market to a halt or decline, worsening the current housing crisis in Australia.

To compound the situation, the reduction in building depreciation claims will increase the effective marginal tax rate (EMTR) for all Australians.

> *"151. Any move to a less generous building depreciation regime can be expected to raise EMTRs on investments by a range of businesses. To the extent that residential construction is brought within scope, investment in this area may be adversely affected with implications for housing affordability. However, any such*

impact could be expected to be marginal as the impact of the additional tax would be widely distributed."

While this point is addressed in the excerpt above, the impact will most certainly not be marginal for those in the housing, property and construction industries and investors who always work building depreciation into their long-term budgets.

Effective life regime

Applying an effective life regime to various buildings would be a long, expensive process with a painful transition. As discussed below there are a few options:

> *"152. The adoption of an effective life regime for buildings would also raise policy design and implementation challenges. The ATO would have to determine the effective lives, but in practice these vary depending on the type of construction, the nature of the building itself and the use to which it is put. The value of a purchased building would have to be established separately from the land — this process may be difficult, costly and open to manipulation. By contrast, deductions under the building depreciation regime are based on the original cost of construction."*

The type of construction, the nature of the building and the buildings use would vary widely, and one building could easily fit into more than one category.

Conclusion

When attempting to provide relief to struggling businesses, The Business Tax Working Group needs to consider the ramifications of the process changes and consider the industries important to each Australian, including the housing and construction sectors.

Taking a concession away from a struggling industry that provides housing to every day Australians, in order to give to business should not be an option. There are currently tens of thousands of Australians waiting for public housing; the waiting times have been reported to extend for many years. We have a shortage of housing in most regions of Australia driving up house prices and creating an affordability problem. Renters are struggling to find accommodation, vacancy rates across Australia currently sit at 2% - vacancy

rate balance is achieved between 3 and 4%. Governments are trying to stimulate new housing construction with stamp duty concessions and new home construction bonuses. However, the Business Tax Working Group is suggesting that a concession be taken from a sector that provides housing for Australians and this concession be transferred to corporate organisations via a company tax cut. **A link will be easily drawn between giving a concession to business by taking it from Australian mum and dad investors and Australian renters of whom a large proportion are underprivileged.**

In conclusion, BMT Tax Depreciation urge the Business Tax Working Group to reconsider the suggested changes to building depreciation. Removing the concession will have a dire effect on the economy especially the construction, financial and property sectors. Further, the two million families currently renting private homes in Australia will be worse off. Unprecedented pressure will be placed on public housing, adding to an existing crisis. The 2.5 million property investors who privately fund housing will be negatively affected, and at the same time, will generally not benefit from a business tax cut. The removal of building depreciation will ultimately result in losses being passed onto everyday Australians renting properties and will destabilise our housing sector.

BMT Tax Depreciation

BMT Tax Depreciation is a national firm of eleven offices. We employ approximately 160 staff and assist property investors by providing property depreciation reporting and advice. The organisation is run by Bradley Beer who is the Managing Director, Thomas Plenty (Director) and Brendan Farrugia (Director). For further comments or if you have any questions relating to this submission please contact Mr Thomas Plenty on 0408 448 072 or Associate Director Nol Petrohelos on 0408 448 059 or via email – nolp@bmtqs.com.au.