


Labor's tax grab? It's the capital gains tax, stupid

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The ALP's proposed ban on negative gearing has been well publicised and debated. But its proposed changes to capital gains tax have received far less attention.

This is because investors tend to focus on short-term costs over more significant long-term outcomes. But since most of us are long-term investors, we should look a little more closely.

In 1999, the Howard government introduced a 50 per cent CGT discount if an asset was held by the investor for more than a year (to replace the previous indexation rules). This meant that only 50 per cent of the net capital gain was taxable. Individuals and trusts, but not companies, are entitled to the CGT discount.

The net capital gain (or loss) is calculated as the difference between an asset's cost (purchase price plus acquisition costs) and the net sale proceeds (sales price less direct selling costs).

The ALP has proposed to halve the CGT discount from 50 per cent to 25 per cent: this effectively increases an investor's CGT liability by 50 per cent.

For example, under current arrangements, only \$50 of a \$100 capital gain would be added to your taxable income. If you are on the highest marginal tax rate, you would pay \$23.50 in tax. However, under the ALP's proposed arrangement, \$75 would be added to your taxable income and your tax payable would increase to \$35.25 — an additional \$11.75, or 50 per cent

These CGT changes apply to investments, including property and shares, purchased after January 1 next year. All investments made prior to that date will be fully grandfathered.

Investments that provide the majority of their return in capital growth rather than income will be affected the most by these changes. This includes two major asset classes: property and international shares.

- First, investment-grade property. According to REIA data, the average annualised compounding capital growth rate of the five largest capital cities since 1980 is 7.2 per cent. Gross rental yields typically range from 2-4 per cent for houses, but that is before an investor pays for all direct expenses. Net rental yields are lower, in the range of 1-2.5 per cent. Therefore, in the long run, property provides most of its return in the form of capital growth.
- Second, capital growth underpins the majority of the return in international equities. The MSCI World Index has appreciated in value by 7.83 per cent a year between December 1987 when it began, and March this year. The average annual dividend yield of the index is only slightly above 2 per cent.

By comparison, the dividend yield of the ASX 200 is about 4.2 per cent.

Asset classes that generate more of their return in the form of capital growth (and, consequently, less income) are affected by the ALP's CGT policy to a greater extent. Crucially, it is these types of assets that suit a gearing strategy the best — because the lower income produces a higher pre-tax loss.

That's why the proposed CGT change has a greater impact on after-tax investment returns than the ban on negative gearing.

I estimate that the present value of the negative gearing benefits on a \$750,000 property investment to be worth about \$119,000 (assuming a long-term interest rate of 6 per cent).

The present value of the CGT discount (adjusted for the ALP's new rate) after 20 years of ownership is about \$122,000. But the longer you hold the asset, the more expensive the CGT will be. And it's not like losses incurred in running an investment property will no longer be useful. You will benefit from the negative gearing income losses, either by offsetting against eventual income profits or when you sell the property.

So the impact of the negative gearing ban is more about the time value of money, rather than paying higher taxes.

Investors might be excused for concluding that, if the ALP implements its proposed change to CGT, future investments should be skewed towards Australian shares. However, concentrating your investments in one asset class is never a good idea.

The best way to minimise capital gains tax is to use an entity such as a super fund. A super fund is the best entity as it has a zero tax rate in retirement (that is, pension phase assuming your account balance is less than \$1.6 million) and therefore is protected from these proposed CGT changes.

The next best entity is a family trust because, as the law stands, you can distribute a capital gain to a number of beneficiaries. This allows you to share the CGT liability among family members.

For example, a \$300,000 discounted capital gain in one person's name would create a tax liability of about \$114,000. However, if you can distribute that gain to four individuals, the tax liability reduces by more than 40 per cent to about \$65,000. The ALP has indicated it will seek to reform the taxation of trusts by implementing a minimum tax rate of 30 per cent — although various governments have canvassed this idea over the past two decades, no changes have ever been made.

Apart from using these tax structures, investors should think about sharing ownership with their spouse.

The goal should be to have relatively even asset ownership (both in and outside of super) by the time you reach retirement.

The proposed negative gearing ban by the ALP has garnished a lot of attention. But investors should be more concerned with the proposed CGT change and taking steps to minimise their impact.

Stuart Wemyss is an independent financial Adviser and author of best-selling book, Investopoly: The 8 Rules for Mastering the Game of Building Wealth.