The Government has taken a gutsy approach to tackling the housing crisis - the days of highly leveraged property investment are likely over

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The tax reforms **the government is proposing** for residential investment properties should go to the heart of the housing crisis and tip the balance of power in the market away from speculators and more towards first home buyers and long term investors.

This will be achieved by extending the term of the Bright Line Test for taxing capital gains on housing and by removing the tax deductibility of mortgage interest payments on residential investment properties.

Extending the Bright Line Test is not a surprise, but few thought the Government would have the guts to remove mortgage interest deductibility because this won't just affect property investors, it will have a flow on affect on the sacred cows in the banking industry who have grown fat on the back of the billions of dollars of debt that has helped fuel the housing crisis.

The fact that the Government has been prepared to stick its neck on the line over this issue, which will undoubtedly rouse the ire of a multitude of self interest groups, shows how seriously it is now taking the housing crisis and its flow-on social impacts.

One of the key things the Bright Line Test has going for it is that it is relatively straight forward.

At the moment, anyone who sells a residential property apart from their family home or an inherited property that they have owned for less than five years, is liable to be taxed on the capital gain.

The government intends to extend that period to 10 years, although the test for new builds will remain at five years.

So if an investor purchases a brand new property, they will only be taxed on any capital gain if they resell within five years. If they purchase an existing property, they will be taxed on the capital gain if they resell within 10 years.

It should be noted that investors can still make and keep a capital gain on property if they sell before those time limits, the tax just takes the cream off the top.
But along with newly reintroduced measures such as loan-to-value ratio restrictions on new mortgage lending, which require investors to have more equity in their properties, the change should take much of the speculative heat out of the market.
However the removal of mortgage interest as a tax deductible expense could potentially have an even bigger impact.

At the moment investors are able to offset the interest portion of their mortgage payments, along with other expenses such as rates and insurance, against a property's rental income when calculating the taxable income it produces. This considerably reduces the investor's tax bill.
However first home buyers and other owner-occupiers receive no such tax advantage.
That gives investors a significant advantage when deciding how much they would be prepared to pay for a property, potentially making it easier for them to outbid first home buyers in particular and adding to upward price pressures in the process.
Removing that tax advantage for investors should help level the playing field between investors and owner-occupiers. It could also have more far reaching implications for the housing market.

In the past, investor-led groups have let out a familiar cry whenever changes in regulations that they didn't like have come into effect, such as recent changes to the Residential Tenancies Act. "It will force investors out of the market," they say. But of course that hasn't happened - investor interest in residential property is as high as it has ever been.
But this time, things may genuinely be different.
Removing the tax deductibility of mortgage interest could have a serious effect on some investors' cash flows, particularly those who have borrowed to the eyeballs, and that may indeed force some of them to either reduce the size of their portfolios to pay down some debt, or cash up and exit the market altogether.

This would tilt the market further in favour of first home buyers and other owner-occupiers.
But some of the details on how the change will be introduced are still to be worked out, with announcement on the change saying it would apply from October 1 this year but would be progressively phased in over four years and that new builds may potentially be exempted.
But the timing of making such a change is perfect.
Mortgage interest rates are at record lows, which means the effect of making the change now will be minimised, compared to making it later when interest rates may be much higher.
Making the change now should help ensure that those investors who remain in the market are better capitalised and more able to withstand the effects of higher interest rates and other market shocks when they start to kick in.
However one change is certain.
The days of highly leveraged property investment are numbered and we are likely to see a substantial cooling in the market as a result.