Corelogic's Kelvin Davidson takes a look at what a National-led government would mean for property investors

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By Kelvin Davidson*

♦ A shorter Brightline Test may entice investment buyers, but probably also some sellers who would be off the hook for capital gains tax earlier than expected

♦ Softer foreign buyer rules is a lesser known entity given uncertainty around how many would buy in NZ, and the limited stock at the 'top end'

♦ Reinstatement of 100% interest deductibility would benefit existing investors and maybe boost investor sentiment – but low yields and high mortgage rates would still mean running losses for the 'average' investment purchase

♦ There are bigger picture restraints still in play, regardless of election result – such as stretched affordability and 'higher for longer' mortgage rates

Many existing and would-be property investors will be keeping a close watch on the polls and whether or not National can form/lead the next government – which we now know would mean a reinstatement of mortgage interest deductibility for all properties, a Brightline Test back at two years (rather than the five or 10 system at present), and a softening of the foreign buyer ban. But what will the overall impact of these changes be? This Pulse takes a look at some of the issues surrounding potential housing/tax policy changes.

1. Brightline

There's been a lot of focus on the possible buying implications of a shorter Brightline test from July 2024. Some investors would no doubt be tempted to make their first purchase or expand their existing portfolio by the reduced risk of having to pay capital gains tax if they needed to then sell within a short horizon. But what about the selling side? There are likely to be some existing investors struggling a bit with cashflow at present given higher mortgage rates, but who don't want to sell because a large capital gains tax bill would be even worse. If they suddenly found themselves off the hook for that bill, some extra listings and sales could follow soon after.

2. Foreign buyers

There's the potential new ability for foreign buyers to purchase NZ properties with a price of $2m or greater, albeit with a 15% tax attached. On one hand, there's no real way of knowing how many of them might actually target NZ, and for context we estimate that only about 3% of our housing stock has a value of $2m or more. Then again, the shorter Brightline Test would add some appeal, and there may also be greater effects in areas that we already know are popular with foreign buyers, such as Queenstown where about 10% of properties are valued at $2m+.The extra demand could just exacerbate the shortages of stock at 'affordable' prices that already exist.

On a side note, National's estimated annual tax take from foreign buyers is $740m. But that seems pretty ambitious. For example, there have been around 2,600 sales at $2m+ in the past year, and if you assume 5% of those went to foreign buyers at an average price of $3m, the tax would only raise roughly $60m. In some ways, to make National's figures 'work', you have to assume that the large majority of sales above $2m would go to foreign buyers – which seems unlikely.

3. Interest deductibility

There's the possible reinstatement of full mortgage interest deductibility over a phased period, with 50% this tax year and 2024/25, 75% in 2025/26, and back to 100% in 2026/27. On this particular change, we think the idea that it would open the floodgates for investors to purchase again is probably wide of the mark. To illustrate this, we've run some simple investment return numbers in the table below (which assumes either 0% or 100% deductibility).

Illustrative example of investment property returns	
Price paid	$790,000
Mortgage (65% LVR)	$513,500
Mortgage rate	7.0%
Rental yield	3.5%
Rental income per year	$27,650
Costs:	
Mortgage payments interest-only	$35,945
Rates	$4,000
Maintenance	$2,500
Insurance	$2,000
Management fees	$2,500
Annual net rental income	-$19,295
Net rental income excl. mortgage	+$16,650 (A)
Tax with deductibility	$0
Tax without deductibility (33% x A)	$5,495
Overall cashflow with deductibility	-$19,295
Overall cashflow without deductibility	-$24,790
Weekly top-up with deductibility	$371
Weekly top-up without deductibility	$477

As you can see, there's a before-tax cashflow loss each year of around $19,300 in this scenario. Then there's tax. Given those interest costs aren't deductible for an existing property in the current system, that actual loss now turns into a taxable profit, which results in an extra bill of around $5,500 (at a 33% tax rate). All told, the required top-up out of other income to keep the property going in this scenario is $477 every week.

At this stage, let's factor in 100% deductibility again. Holding everything else the same, the weekly top-up drops to $371. Now, that saving is not to be sniffed at, and of course property investors have always tended to be willing to accept cashflow losses in the early stages of their horizon, with the pay-off being rental growth and capital gains later.

It also needs to be acknowledged that these calculations are fairly simple (e.g. excluding depreciation allowances), and in reality some investors might be able to achieve a rental yield higher than 3.5% for example (or get a bargain price, or save on maintenance, etc). Certainly, some investors are still making it work right now, with the CoreLogic Buyer Classification data showing that mortgaged Multiple Property Owners still account for about 21% of purchases.

But even with all of that in mind, a $371 top-up every week is still substantial, even with deductibility added back in. The sums get even trickier if the would-be investor is factoring in lower potential capital gains in future than we've seen in the past.

Now, let's be clear that there'll still be property investors making purchases and getting the sums to work (as they are now) – and that's necessary, given we'll always need more rental stock to cater for a growing population. Indeed, rising rents at the moment highlight potential shortages of available stock might already be emerging, and that in turn could help entice some investors back. And even just the 'mindset effect' of a change in tax rules could have a similar effect – especially if investors are also concerned that they might not be able to buy at all if/when caps on debt to income ratios for mortgage lending are imposed next year.

However, the key point is that the biggest challenge for making the sums work on purchasing an existing property as an investment at present isn't the lack of mortgage interest deductibility; it's actually the large negative gap between rental yields and mortgage rates (and significant top-ups).

As such, although some investors would enjoy a mood/sentiment shift, and may be tempted into a purchase by a National victory, we doubt it'll be a game-changer.

Of course, the reinstatement of full mortgage interest deductions would certainly be welcomed by existing property investors, given it's a direct boost to their profits. It's certainly worth noting that those that have been in the game for a longer period haven't really been as affected by the phased removal of deductibility anyway, and haven't been selling to any great degree. But some extra cash would obviously be a solid boost for them anyway.

What it all means

Overall, if National won the election and made these policy changes, the reduced incentives to buy new-builds (although the LVR system would still tend to favour them because of lower deposit requirements) would tend to see demand rise for existing properties relative to new stock – with associated price effects. Indeed, there is some evidence to suggest that a new-build premium has opened up a bit in recent years, which could then go into reverse.

More generally, the combined effect of the changes could result in higher house prices than otherwise would have been the case, but perhaps not to a significant degree in aggregate. After all, affordability is still stretched, rental yields low, and mortgage rates high. Caps on debt to income ratios remain on the cards for 2024 too.

All that said, however, there's always the risk of adverse consequences, and a stronger price effect couldn't be totally ruled out, especially if foreign buyers targeted a market such as Queenstown. ***Kelvin Davidson is CoreLogic NZ's Chief Property Economist.***