Risk free profit from property – the government, the risk free partner.

Associate Professor Angelo Karantonis
Head of School
Construction Property & Project Management
University of Technology Sydney

Keywords: property development, property taxation, taxation, profit.

Property is an asset that can be taxed in several ways, because it is both a capital good and consumption good. Accordingly, governments at all levels have endeavoured to impose taxes and/or fees and charges on property.

The recently introduced “exit” tax for property investors in NSW has once again highlighted the vulnerability that property as an asset suffers at the hands of government. In the NSW budget papers for the 2004-2005 financial year, total property taxation accounted for 36.7% or $5,700 million of total State Government revenue. This included Stamp Duty ($3,190 million), Vendor Transfer Duty ($690million), Mortgage Duty ($372 million) and Land Tax ($1,448 million).

In addition to state taxes, property is also taxed in several ways at the local and federal government levels. That is, the three tiers of government profit from property investors, irrespective of whether individual investors and developers make a profit or not.

This paper will examine the impact of the combined current taxation and fees of the three tiers of government associated with property investment in NSW. In addition, using case studies, the paper will derive the percentage level of the overall “risk free” profit by government instrumentalities from private property developments in NSW.

Introduction

Historically, taxation has more or less been about since the beginning of time, with the oldest known tax levied about 6,000 years ago at a place called Lagash, and with Egypt having the first systematic taxation, whose tax collectors were known as *scribes* [Avram]. In Australia, taxes were introduced in the 19th century and the first taxes were a consumption type tax [Gibson, 1999]. Indeed, the first tax included alcohol, which ultimately resulted in the *Rum Rebellion*.

Taxation can be used for many purposes; to raise revenue for government expenditure, for stabilising the economy, to reallocate resources and to redistribute income and wealth. Taxation has been defined as a "compulsory transfer of money from private individuals, institutions or groups to the government and it may be levied on wealth or income or in the form of a surcharge on prices" [Bannock et al]. Taxation can also be implemented by the various tiers of government, as is the case in Australia, where all three tiers of government endeavour to raise income predominantly through a taxation system. Total taxation in Australia has risen 31.9% to $237.5b in the five year period to 2002-3. Direct property taxes[1] have increased 30% to $21.46b over the same period and over 85% of the gain from the previous year has been as a result of the increase in stamp duty across all states [ABS, 2004].

As pointed out by Waxman [2004], all levels of government may directly or indirectly influence the decision to invest in the property market. Taxation has a direct influence on the property market. Harvey [1987] points out that a major function of the property market is to allocate land, which is a scarce resource to its most profitable use (that is its "highest and best use") relative to other land resources. On the buyer's side of the equation, Rowland [1993] points out that taxation of property investment has a major impact on buyers, as the tax system does not treat all owners or all property in the same way.

The efficiency of the market is impaired by market imperfections, one such imperfection is taxation. Theoretically, in economics, taxation is seen as a barrier to the workings of the market, as Warren [1994] points out, without government intervention (including taxation), the property market would operate as an efficient free market. However in reality, taxation exists in probably all economies, but its impact varies with the degree of taxation on the product or asset.

The NSW government recently put property under further taxing, with the introduction of a "vendor's exit tax", namely the vendor transfer duty which is similar to the stamp duty paid by the buyer. Hence on an investment property sale, the NSW government gets tax from both the buyer and the seller.

Taxes have a major impact in decision making for property investors and property developers. Whilst this paper examines taxation on property in

[1] This excludes property income, as it is assessed under the normal "income tax" category.

NSW, it should be understood that all states in Australia have similar taxes with varying rates. The one exception is the recently introduced "vendor's transfer duty", which is unique to NSW.

Taxation on Property

Writing about the history of taxation in Australia in the *Australian Marxist Review*, Gibson [1999] is critical of the government of the early nineteenth century for having "excise and customs forms of taxes" and for looking after the "land owning gentry" by not having a tax on land. Now, nearly two hundred years later, as will be discussed, there are over ten ways of taxing property in Australia.

Property is an asset that is both a consumption good and a capital good and accordingly, can be taxed as a source of income (consumption) and a form of wealth (capital). In addition, being an asset, it can also be taxed at the transfer; this tax is similar to a sales tax.

Table 1 shows the various forms of taxation applicable to an investment property from the three tiers of government in NSW.

Table 1
Taxes on Property*
For all levels of government in Australia

	State (NSW)	Local**	Federal
Income			• Rent
Consumption	• Stamp duty on mortgage • Stamp duty on commercial leases • Parking space levy	• Sect 94 contribution	• GST o Construction o Non-residential sales & leases
Wealth	• Land Tax	• Council rates	• Capital gains tax
Transfer	• Stamp duty on sales • Vendor transfer duty		

* see Appendix 1 for taxation rates and criteria
** Local government also charge for development approvals and construction certificates.

As can be seen from Table 1, there are several ways that the respective governments tax property. However it needs to also be understood, that not all property investors and/or developers are required to pay all the various taxes. Some taxes are imposed for specific property and/or purpose, for instance: "parking space levy" is only for properties within the City of Sydney, North Sydney, Milsons Point, Bondi Junction, Chatswood, Parramatta and St Leonards business districts; section 94 contributions to councils is levied on property developments; whilst the impact of GST varies between commercial and residential [see Karantonis and Antoniades, 2000 for a more detailed explanation].

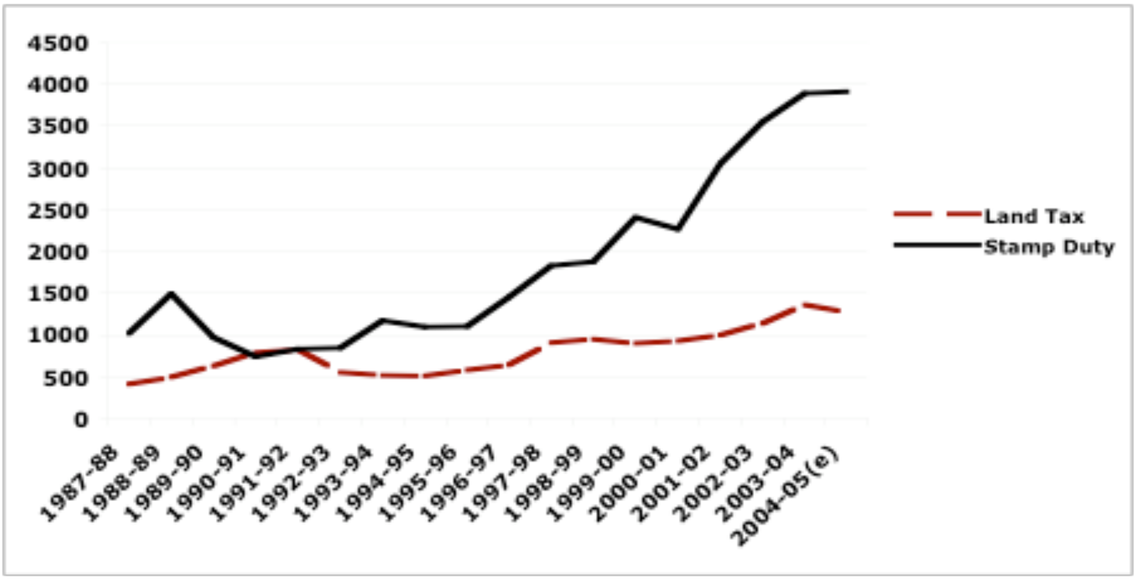
- ***State Taxes***

State taxes on property have been a major issue for some time, especially in NSW. Industry groups such as the Property Council of Australia, Real Estate Institute of NSW and the Australian Property Institute have been continuously lobbying the government for an easing of the tax burden on property.

Property taxes make up a substantial part of the NSW state government's income, reaching 15.9% for the 2003-4 revised budget (NSW Budget Papers). Figure 1 shows the level of both land tax and stamp duty in NSW from 1987-8 to the current fiscal year. As can be seen, stamp duty's huge growth is the result of the recent housing boom particularly in the Sydney market.

Furthermore, the recent NSW budget also announced changes to the land tax assessment criteria, which ultimately increases the amount of land tax to the state. As from 31 December 2004, land tax in NSW will apply to all property with a land value of more than $25,000 (other than the principal place of residence).

Figure 1
NSW State Tax revenue
1987-8 to (f) 2004-5



Source: NSW Budget Papers – 1987 to 2004

- ***Local government taxes***

The main local government taxes are the council rates which apply to all land (vacant and improved) within their jurisdiction. These taxes are levied/rated on the "land value" as assessed by the NSW Valuer General's Department and each local government has its own rating scale (¢ per $), which is applied to these values to determine the annual rate.

Other local government taxes and charges that apply to property, relate to property development. The development approval (D/A) fee is assessed according to the value of the proposed development, but the much larger local government fee in property development is the Section 94 contribution (section 94 of the NSW Environmental Planning and Assessment Act, 1979), which enables local authorities to levy contributions for public amenities and services required as a consequence of development.

- ***Federal Taxes***

The federal government taxes the property's income and its capital gain, through the entity's income tax. It also captures all property in varying ways under its 10% consumption tax (GST). For instance, commercial rental properties attract GST whist residential rent properties do not, however all property repairs have GST added to them and accordingly all property owners (including residential owner occupiers) are levied the GST for such repairs [see Karantonis and Antoniades, 2000 for more details].

On the other hand, the federal government also has some tax benefits for property investors and home buyers. There is a "first home buyers scheme" which offers first home buyers a grant of $7,000, whilst investors can receive two benefits: a depreciation allowance for construction and related costs which are "written off" against the property's rental income; and secondly, the benefit of negative gearing, where interest payments that exceed the net rental income can be "written off" other income of the entity.

Application of taxes on Property

In endeavouring to show the incidence of these taxes in property, this paper will use three methods. The first will show a typical residential unit investment to explain how the "return on the property" is taxed. The second will show the amount of tax the investor pays when a property is purchased and eventually sold. Finally, using three cases studies, the paper will ascertain the amount of tax paid by property developers in a development.

- **Tax on Investment return**

Table 2 shows a typical scenario of residential unit investment's return, which is located within the Sydney CBD. The table shows the typical outgoings and highlights the increase in taxes due to GST and the changes to the NSW land tax. In other words, the Table shows the before and after, which includes the GST and the change to the NSW Land Tax.

As can be noted from the Table, as a result of the GST and the Land Tax change, the investor's tax burden has risen from $6903 to $7399. The more interesting figure is that, "before" the government derived 53.3% of the total share, whilst the investor overall derived 46.7%. In the "after" (GST and the changes to the NSW Land Tax) the government's share increases to 57.1%, whilst the investor now only receives 42.9% of total income and yet, the investor takes all the risk!

Table 2: Before & after GST & the new NSW Land Tax

	Before		After	
Rent		$15,600		$15,600
Less				
Council Rates	800		800	
Insurance	350		385	✔
Repairs & maintenance	1000		1100	✔
Accounting fees	200		220	✔
Land Tax			240	✔
Car Park Levy	400		860	✔
Agent (7%)	1092		1201	✔
Total outgoings		3842		4806
• **Net Profit**		11758		10794
• **Tax (48.5%)**		5703		5235
• **After Tax income**		6055		5559
• **Total Taxes**		**6903**		**7399**
% share to investor		**46.7%**		**42.9%**
% share to government		**53.3%**		**57.1%**

Notes: 1. Assumes a Land value of $60,000
2. Assumes individual taxpayer on the highest marginal rate.

- **Tax on Property transactions**

Tables 3A and 3B examine the effect of the various taxes applicable to hypothetically buying (in June 2000) and selling (in June 2004), homes and home units respectively in NSW. The data used is the NSW Real Estate Institute's medium prices both at the time of purchase (June 2000) and at the time of sale (June 2004) for six randomly selected suburbs[2] together with the Sydney average.

Table 3A - Houses
The effect of taxes in buying and selling a property.

	Sold Jun-04	Bought Jun-00	Cap Gain	Stamp Duty Purchase	Stamp duty Mortgage	CGT	Vendor's Duty	Total Tax	% Profit
Ashfield	655000	438700	216300	15,232	1345	52,453	14,738	83,767	38.73%
Botany	640000	425000	215000	14,615	1301	52,138	14,400	82,454	38.35%
Fairfield	389000	217200	171800	5,264	636	41,662	8,753	56,314	32.78%
Ku-ring-gai	900000	600000	300000	22,490	1861	72,750	20,250	117,351	39.12%
Nth Sydney	893000	732500	160500	28,453	2285	38,921	20,093	89,751	55.92%
Strathfield	785000	422500	362500	14,503	1293	87,906	17,663	121,364	33.48%
Sydney Av.	**520000**	**315000**	**205000**	**9,665**	**949**	**49,713**	**11,700**	**72,027**	**35.13%**

Source: NSW REI "Property Market Focus" – June 2000 and June 2004
Table assumes individual taxpayer at the highest marginal rate.

2 The suburbs were selected by taking every 7th suburb listed, starting from the first one for homes and the second for home units.

Table 3B – Home units
The effect of taxes in buying and selling a property.

	Sold Jun-04	Bought Jun-00	Cap Gain	Stamp Duty Purchase	Stamp duty Mortgage	CGT	Vendor's Duty	Total Tax	% Profit
Bankstown	313000	193000	120000	4,175	559	29,100	7,043	40,876	34.06%
Campbelltown	342000	117000	225000	755	315	54,563	7,695	63,328	28.15%
Hornsby	395000	179000	216000	3,545	514	52,380	8,888	65,326	30.24%
Liverpool	273000	134900	138100	1,561	373	33,489	6,143	41,565	30.10%
Randwick	460000	310000	150000	9,440	933	36,375	10,350	57,098	38.07%
Warringah	400000	290000	110000	8,540	869	26,675	9,000	45,084	40.99%
Sydney Av.	**385000**	**250200**	**134800**	**6,749**	**742**	**32,689**	**8,663**	**48,842**	**36.23%**

Source: NSW REI Property facts – Various editions
Table assumes individual taxpayer at the highest marginal rate.

Data in Table 3A, shows percentage taxes on profit for homes in Sydney averaged 35.13% and range from 32.78% (Fairfield) to 55.92% (North Sydney) for the selected suburbs. Whilst, Table 3B, shows percentage taxes on profit for home units in Sydney averaged 36.23% and range from 28.15% (Campbelltown) to 40.99% (Warringah).

In other words, more than a third of the gain of the property is taken up by the government. The new “vendor’s duty”, whilst levied at 2.25%, takes 5.7% and 6.4% of the gain for the Sydney average of homes and units respectively.

- **Property development - case studies**

Three case studies will be used to demonstrate the impact of taxation on property development, one office/showroom/warehousing and two residential flat developments. For reasons of confidentiality, only the local government areas are given and these are Botany (strata offices/showroom/warehousing), Warringah (30 residential units) and Hornsby (105 residential units).

The figures of all these case studies are based on feasibilities undertaken for the respective sites that were used for their purchase and/or finance. A summary of the feasibilities and their adjustments to account for the new rates for stamp duty and land taxes are presented in Appendix 2.

Table 4 analyses the amount of tax expected to be paid for each of these developments. Explaining the analyses, the developer’s bottom line profit, is the net profit (after company tax (30%) is paid). In other words, this the amount the developer gets after all expenses, including all the taxes. The Table then identifies the various taxes paid on the respective developments. To derive the total cash surplus from the development, the total of all taxes paid is added to the developer’s net profit (shown as “profit + tax). This now allows one to derive the distribution between government and the developer of total cash flow from the development.

Table 4
Case Studies –
Taxes on Property development

	Botany	Warringah	Hornsby
Profit	**736,727**	**2,104,780**	**15,692,248**
Corp Tax on Profit	221,018	631,434	4,707,674
Net Profit	515,709	1,473,346	10,984,574
Taxes			
Stamp Duty	58,640	307,990	780,490
St/Duty (mortgage)	10,121	27,085	114,241
Council Rates	6,000	4,000	37,440
Land Tax	1,996	7,009	221,300
Sect 94	20,000	224,185	3,090,000
GST	467,272	1,161,818	8,077,379
Corp Tax on Profit	221,018	631,434	4,707,674
Total Tax	**785,047**	**2,363,521**	**17,028,524**
Profit + Tax	**1,300,756**	**3,836,867**	**28,013,098**
Govt %	**60.35%**	**61.60%**	**60.79%**
Developer %	**39.65%**	**38.40%**	**39.21%**

Notes: 1. Analysis assumes 50% funding for stamp duty on mortgage;
2. Land tax has been adjusted to reflect the new scale (NSW Budget 2004);
3. In all three developments, the developer was a corporation. Had the developer been an individual entity, the tax rate on profit would be far greater, as normal rates would apply;
4. The margin scheme has been used to assess GST on the sale of the development [see Karantonis & Antoniades, 2000 for explanation].

As can be noted from the Table, the developer derives 39.65%, 38.4% and 39.21% of the total (profit + tax) respectively for each of the developments, whilst the government, receives the balance. In simple words, the developer, with all the risk gets less than 40%, whilst the government's total for all three tiers, with no risk at all, gets around 60% as a percentage of the total (profit + tax).

In addition, the government receives; GST on the goods and services used in the development, and stamp duty from the purchasers of the development. In other words, from property, the government is in a *windfall* position.

To fully understand the impact of all the taxes in property development, if NSW had been an *absolute tax haven*, the profit would be $1,300,756, $3,836,867 and $28,013,098 for the three developments in Botany, Warringah and Hornsby respectively.

As also noted from the Table, the major impact of the taxes are the GST (margin scheme) and the company tax, both of which are only levied when the property is sold. To minimise their taxes, the practice of retaining a proportion of the development as part of the profit by developers is now becoming an option. This means fewer funds are being reinvested into future development. Should this practice continue to increase, as anecdotal evidence suggests, it will have implications for future supply.

Conclusion

As this paper has demonstrated, property being a consumption and an asset good, is vulnerable to tax from all three sectors of government in Australia. The number of taxes directly impacting on property has now risen to more than ten, with the newest one, the vendor transfer duty in NSW.

As evident in the paper, taxation has a major impact on the cash flow derived from property; in investment, in buying and selling and in property development. In all cases, the government with no capital outlay or risk whatsoever is receiving a substantial share. Indeed, in property development, the three independent case studies reveal that the three tiers of government are receiving just over 60% of total money generated form property development. The developer, who on the other hand takes all the risks, receives less than 40% and it should be noted, that the return to the developer is dependant upon the "expected" sales realisations.

Overall, this does not mean that one recommends or expects to return to the "no tax on land", as in the early period of settlement in Australia, however, the government must be careful not to tax the investors and developer out of the market altogether. In simple terms, not to *kill the goose that laid the golden egg*.

If supply of property were to fall due to the enormity of taxing property as highlighted in this paper, the result would have major consequences for government on two levels. The slowdown in supply will lead to upward pressure for rent, thus increases social benefits to ease the burden and secondly, as the development industry is labour intensive, any major cutback will have an equally major effect on employment.

References

(ABS) Australian Bureau of Statistics [2004] "Taxation Revenue, Australia" Cat 5506.0, AGPS, Canberra.

Avram K [1999] The history of taxation www.enterstageright.com/archive/articles/0899taxrel.htm

Bannock G, Baxter R E and Rees, R [1974] "A Dictionary of Economics", Penguin Books, Middlesex, UK.

Gibson S [1999], "A short history of taxation in Australia", Australian Marxist Review, No41, November.

Harvey J [1987] "Urban Land economics, The Economics of Real Property, MacMillan Education, Hong Kong.

Karantonis A & Antoniades H [2000] "GST and Property – a preliminary study", 6th PRRES Conference, Sydney

NSW Government [1987 - 2004] "Budget Papers"

(REI) Real Estate Institute of NSW [2000 & 2004] "Property Market View / Property Focus", June Quarter editions, REI, Sydney

Rowland P J [1993] "Property investments and their financing", Law Book Company, NSW.

Warren M [1994] "Economics for the Built Environment", Butterworth-Heinemann, Oxford, UK.

Waxman P [2004] "Investing in Residential Property – Understanding the Australian Property Market" 6th edition, Wrightbooks, Queensland.

Appendix 1

Income Tax

Income	Marginal Tax Rate %
0-6000	0
6000-21600	17
21601-52000	30
52000-62500	42
>62500	47
+ 1.5% Medicare Levy	
Company Tax	30

Capital Gains Tax (CGT)

- Applies to all properties *other than own residence* that was purchase from 20/9/85
- Tax levied at *normal tax rates*
- Assets acquired after 21/9/99:
  - Capital gain is *half* the nominal gain, i.e. *selling price* less *all costs (in buying, capital improvement and selling). If held for less than a year, the gain is taxed at the normal rate.*

NSW Stamp Duty on Purchase

Property Price	Duty
$0 - 14,000	1.25% (min $2)
$14,000 - 30,000	$175 + 1.5%
$30.000 - 80,000	$415 + 1.75%
$80,000 - 300,000	$1,290 + 3.5%
$300,000 - 1m	$8,990 + 3.5%
$1m - $3m	$40,490 + 5.5%
> $3m	$150,490 + 7%

NSW - other

- Stamp Duty on Mortgages
  $5 first $16,000; $4 per $1000 thereafter
- Stamp Duty on non-residential Leases
  0.35c/$100 *value of lease*
- Parking Space Levy:
  $860 per space (CBD & Nth Sydney, Milson's Pt); $430 (Bondi Jct, Chatswood, St Leonards, P/matta)

NSW Vendor Transfer Duty
New

New investor's transfer duty (1/6/04)

- Vendor stamp Duty: 2.25% on selling price
- Applies only where sale price >12% of purchase price
- Exempts *new product* (new buildings) and land sub division

NSW Land Tax

(excludes place of residence)

Land Value	Tax
0 - $400,000	0.4%
$400,000 - 500,000	$1600 + 0.6%
> $500,000	$2,200 + 1.4%

Appendix 2

Table A 1
Summary of property development feasibilities

	Botany		Warringah		Hornsby	
Gross realisation		6,470,000		18,030,000		100,851,173
Less GST (margin scheme)		467,273		1,161,818		8,077,379
Net Total Revenue		6,002,727		16,868,182		92,773,794
Less						
Land Purchase cost	1,330,000		5,250,000		12,000,000	
Land Transaction costs	59,970		336,250		795,490	
Construction Costs (+ contingency)	3,488,295		8,321,159		52,969,416	
Professional Costs	112,379		14,000		5,815,769	
Statutory Fees & Contributions	26,000		234,035		3,128,292	
Holding Costs	11,000		130,972		735,436	
Finance Costs	21,724		55,000		564,375	
Interest	411,818		856,434		2,887,301	
Selling costs	149,400		338,025		3,781,418	
GST credit reclaim	(341,582)		(803,232)		(5,682,040)	
Total Project Costs		5,269,004		14,732,643		76,995,457
Net Profit		**733,723**		**2,135,539**		**15,778,337**

Table A2
Adjusted profit after accounting for NSW government changes to Stamp Duty and Land Tax rates.

	Botany	Warringah	Hornsby
Profit	**733723**	**2135539**	**15778335**
Stamp Duty			
old	58640	274240	645490
new	58640	307990	780490
net result on profit	0	-33750	-135000
Land Tax			
old	5000	10000	270213
new	1996	7009	221300
net result on profit	3004	2991	48913
Adjusted Profit	**736727**	**2104780**	**15692248**