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# NEGATIVE GEARING EXPLAINED

Negative gearing is a popular investment strategy that can assist you to reduce your investment property holding costs. In this edition of Property Insight, we explore the concept of negative gearing and explain how this strategy can be used effectively to meet your financial goals.

**So what exactly is negative gearing?**

The term 'gearing' basically relates to how you manage the expenses and income of an investment. Gearing applies not only to property, but also to stocks and shares. When it comes to property, gearing is commonly thought of in terms of negative and positive.

Positive gearing is where the property generates a positive income stream. Negative gearing is where the investment generates a negative income stream or a loss, which can then be claimed as a tax offset. Your property investment can also be neutrally geared, with the income and expenses breaking even.

**How is losing money considered a wise investment strategy?**

Buying an investment property is an important financial decision that is part of an overall strategy designed to meet both your short- and long-term goals. This strategy should be based on your current financial position and personal circumstances.

With this in mind, the main reason investors use negative gearing as a strategy is to reduce taxable income, while building wealth through potential capital growth. Put simply, if you make a loss on an investment property, you can claim a tax reduction on your income (known as a tax offset). You can then use the tax offset to lower your tax bracket, meaning you pay less tax. Negative gearing is a particularly popular strategy with high-income earners who are looking for ways to build wealth and have the tax department help fund the investment.

So is your property working for you in the long-term if you do not have positive cash flow? Yes! With a well-chosen investment property, rental returns should increase over a period of time, changing the property from negatively geared to neutrally geared, and finally to positively geared. This means you should be able to recover any losses through rental increases and reduced tax payments. Furthermore, when you sell a property, the capital growth should cover any losses and, if executed correctly, put cash in your pocket!

**Why would I choose a negatively geared property when I could purchase something that is cash flow positive?**

Generally speaking, positively geared properties are not located in the most highly desirable locations or close to core infrastructure.Ttherefore they don't achieve the same strong rate of capital growth. Additionally, a positively geared property may not reduce your taxable income. In fact, you may be required to pay additional tax on any income derived from a positively geared investment.

This is where your financial goals are integral to the type of property you purchase. For example, if you have a short-term goal of reducing your taxable income, with a long-term goal of selling for maximum capital growth, a negatively geared property can allow you to achieve this, whereas a positively geared property usually will not.

**Why do we have negative gearing in Australia?**

Without such stimulus in the real estate market, the government would be required to supply more affordable housing. To put things into context, population projections by the National Supply Council show that over the five years to 2014, the gap between housing supply and demand will grow to 308,000 dwellings in Australia. Over the next 20 years, the biggest undersupply is predicted to be in and around the four major cities – Melbourne (19 per cent), Sydney (16 per cent), Perth (10 per cent) and Brisbane and surrounding areas in south-east Queensland (21 per cent).

The tax benefits available for negative gearing are intended to help people buy investment properties by minimising potential short-term cash flow issues. In other words, negative gearing makes the property market more accessible to everyday investors.

**The pitfalls of negative gearing**

As with any investment scenario, there are drawbacks to negative gearing. It is a long-term property strategy that should only be adopted if you can sustain a shortfall, and with this in mind you should consider how you would cope in a range of worst-case scenarios. All types of investments experience cycles triggered by factors such as rising and falling interest rates and property values, changing government policies, population demographics and unforeseen events.

Specific property-investment risks can include short- and long-term tenant vacancies or unreliable tenants, resulting in the loss of income from rent. These risks can be minimised by following the market and choosing a property in a highly desirable rental location with strong prospects for capital growth.

There are, of course, other ways to reduce the risks. Many investors opt to balance their property portfolio with negative and positively geared properties. Depending on your goals, you may choose a combination of both, with negatively geared properties positioned for stronger capital growth, and positively geared properties that offset any losses. It all comes down to what you hope to achieve in the short- and long-term.

**Claiming further tax offsets (depreciation and deductions)**

On top of the tax offsets we have already discussed for negatively geared properties, you can also claim depreciation and deductions, further reducing your costs. Depreciation and deductions are also available to positively geared properties.

There are essentially two depreciation types: 'building' and 'fixture and fittings'. Building depreciation is where the value of the building is reduced yearly for up to 40 years. This is different to fixture and fitting depreciation where a deduction is taken over the life of a fixture or fitting. You can also claim any purchasing costs that were incurred to set up the property, such as lenders mortgage insurance (LMI), over the first five years, and also ongoing costs such as bank-loan interest.

**Possible Tax Deductions**

- Building Depreciation
- The cost of a building is determined by a Quantity Surveyor
- Calculated over a period of 40 years, depreciated at 2.5% pa
- Fixture and Fitting Depreciation
- Deductions depreciated over the life of the fixture or fitting (7-10 years)
- Including: hot water systems, carpet, ovens, air conditioners
- Purchasing Costs
- Expenses from the purchase
- Including: bank fees, solicitor fees, lenders mortgage insurance

**Expenses**

- Ongoing costs for the property
- Including: maintenance and repair costs, council fees, water, insurance, interest on the loan, body corporate fees
- This is a specialised area of tax and to claim your depreciation costs the Australian Tax Office requires a depreciation schedule by a registered Quantity Surveyor. It is also beneficial to engage a tax agent who specialises in property tax to get the most out of your tax benefits.

**Negative gearing: a long-term strategy**

At the end of the day, your long-term goals should dictate the investment strategy that best suits your circumstances. A good strategy will help you choose an investment that creates the balance between returns and security that suits you. Negative gearing is a long-term strategy that, if successfully executed, should pay excellent dividends through capital growth.

## NEGATIVE GEARING: CASE STUDY EXAMPLE

David is interested in investing in a property; he has done his background research and found a property he thinks best suits his investment strategy. Let's look at the breakdown:

Property-2 Bedrooms, 2 Bathrooms, Unfurnished

- Purchase price-$ 440,000
- Deposit (20%)-$ 88,000
- Bank loan (80%)-$ 352,000
- Interest rate-7.3% pa

Rented permanently at:- $470 per week
(Scenario based on 3% vacancy rate)

**David's income and expenses for this investment would be:**

Income (pa)

- Rental-(3% vacancy rate)-$23,660

Expenses (pa)

- Body corporate-$5,700
- Council rates-$2,600
- Management fees-$1,849
- Insurance-$300
- Interest – bank loan-$25,696

Total Expenses-$36,145

**INCOME LESS EXPENSES** = Loss of $12,485

**Without negative gearing, David is looking at a loss of $12,485 per year on this investment. However, there are additional deductions David is eligible for:**

Allowable Deductions (pa)

- Building depreciation (approximately)-$9,000
- Fixtures/fittings depreciation (approximately)-$6,000
- Travel expenses-$1,000
- Accountancy fees-$500

Total Allowable Deductions--$16,500

**If David is on a wage of $100,000 per year:**

**Income**

- Personal Income-$100,000
- Rental Income-$23,660

**Total Taxable Income-$123,660**

- Expenses**-**$36,145
- Deductions-$16,500

**Total Allowable Deductions** -$52,645

**New Taxable Income-$71,015**

The benefit of offsetting deductions means that David's tax bracket has changed:

**New Taxable Income-$71,015**

Tax applicable on personal income of  $100,000-$24,950 (before purchase of property and other deductions)

Tax applicable on taxable income $71,015-$14,855 (after purchase of property)

**Possible tax refund-$10,095 ($24950-$14855)**

So if we take David's total loss on this property ($12,485) and apply the potential tax refund of $10,095, he is now operating on a loss (holding cost) of $2,390 per annum. However, as the property's rent increases over time, this shortfall will decrease and the property should

eventually become positively geared. If David has chosen wisely, he should also reap the benefits in the long-term when he sells the property.

When it comes down to it, there are risks and benefits of most investment strategies and the key is to ensure the strategy that you choose is right for your risk level and financial circumstances.

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