

Negative Gearing Explained

Making a loss to get a gain

Negative gearing is a term most people have heard about but it is not always a term that is fully understood. It may sound simple, however it is a complex strategy and you may lose money if you choose the wrong investment.

The term 'negative gearing' is given to a situation where funds are borrowed to purchase an income producing investment and the interest incurred on the borrowed funds exceeds the income generated by the asset in a given year. This creates an investment loss which may be a tax deduction. Other costs incurred in maintaining an investment may also be deductible resulting in an increased gearing effect.

There are several factors which make borrowing to purchase an investment appealing, however the most attractive aspect of a negatively geared asset is the immediate taxation benefit you may be entitled to. This is due to the fact that losses incurred on these geared investments can be offset against other assessable income, thereby creating another 'deduction' and reducing the amount of tax payable.

The most common investments negatively geared are rental properties and shares which generate rental income and dividends respectively, however other income producing instruments can also be geared.

Here is how it works:

Tom is an individual tax payer with a net salary of \$200,000 in the 2010-11 income year and owns a rental property. The rental property was purchased for \$340,000 of which he paid \$100,000 out of his own funds. The balance of the funds required (\$240,000) were borrowed, with interest being charged at a rate 7.5% p.a (\$18,000 p.a). The property is rented out at \$260 p/w (\$13,520 p.a) with other deductible rental expenses of \$1,560 resulting in his net rental income (before interest) being \$11,960.

In essence, Tom has paid out more money on the property (\$18,000) in the year than he has got back in rental income (\$11,960). This equals a net rental loss of \$6,040. This amount can now be deducted from Tom's assessable income.

Using these figures we calculate the following:

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|---|----------------------|
| <i>Taxable income</i> | <i>\$200,000.00</i> |
| <i>Less net rental loss</i> | <i>(\$ 6,040.00)</i> |
| <i>Taxable income</i> | <i>\$193,960.00</i> |
| <i>Tax payable (excluding Medicare)</i> | <i>\$ 60,832.00</i> |

Tax payable (excluding Medicare) on Tom's net salary of \$200,000, without the negatively geared property, would be \$63,550. Therefore, as a result of the negatively geared property, Tom will receive a tax benefit of \$2,718.

Even after taking into account the tax benefit the rental property still ran at a loss of \$3,322 so it may be hard to see where the benefit of negative gearing actually lies. The answer is long term capital growth. This occurs when the capital asset appreciates in value over time.

In this example, based on the property costing \$340,000, the rental property would need capital growth of 0.98% in the 2011 year to break even ($\$3,322/\$340,000$). This is before any capital gains tax (CGT) implications.

So how much growth does the investment need to make to be worthwhile?

Let's say, instead of using his \$100,000 as a deposit for the property, Tom may have invested the money in a term deposit at 6% p.a. This investment would earn him \$3,300 (after tax and before the Medicare Levy). Consequently, to determine if his negatively geared property is worth while, we must also take the above (alternative) result into consideration.

Assuming Tom is entitled to the 50% Capital Gains Tax (CGT) discount when he sells the property, as he has held it for more than 12 months, we can determine:

| | |
|---|---------------------------|
| <i>Rental Loss (after tax benefit).....</i> | <i>\$ 3,322.00</i> |
| <i>Possible alternative investment.....</i> | <i><u>\$ 3,300.00</u></i> |
| <i>Net Capital gain required (after tax).....</i> | <i>\$ 6,622.00</i> |
| <i>(To be better off than investing in the alternative)</i> | |

Therefore based on a tax rate of 45%, and taking into account the 50% CGT discount, a capital gain of \$8,545 is required before tax. This equates to an actual required growth rate of 2.51% ($\$8,545/\$340,000$).

As can be seen from the above workings, negative gearing is not as simple as it may first sound. However, if you can sustain the negative cash flow effect of maintaining an investment loan in the short-term and are quietly confident in your investment's capital growth in the long term, then negative gearing should be considered as part of your investment strategy.

If you would like any further information in relation to the above or a comprehensive analysis of your own personal circumstances, please do not hesitate to contact your McLean Delmo Partner to discuss.