HOW NEGATIVE GEARING WORKS

Property Investment Explained

Written by Nicole Pedersen-McKinnon for Mirvac

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What is negative gearing?

Let's start with "gearing". Gearing is the term for investments bought with borrowings. Gearing allows you to invest more money than you actually have and earn higher returns relative to the equity you put in. Investments – in shares, property or something else – can be either negatively or positively geared.

> "Negative gearing is when the assessable income you receive from your investment is lower than the tax-deductible expenses you incur from holding it."

In other words, you make a net loss. Bear in mind that tax-deductible property expenses include loan interest, management expenses, running expenses and depreciation – claiming over time the cost of some fixtures and fittings and, perhaps, the original costs of erecting the building itself (new buildings attract the full available 40 years of depreciation).

Note also that depreciation is a 'non-cash' deductible expense that can be a significant figure, especially in the case of new buildings.

Why do people use negative gearing as an investment strategy?

Negative gearing allows investors who make a loss to reduce the tax they pay on their other income.

What about cash-flow?

A negatively geared investment can have a positive, neutral or negative cash-flow result. **A positive or neutral cash-flow** occurs when the income plus the tax advantage covers your cash expenses (all allowable expenses excluding depreciation). As this approach means your investments pay for themselves, it may be possible to implement the strategy over and over.

A **negative cash-flow** leaves you out of pocket each month, even though you are getting a tax advantage. The strategy is a good one if you are confident you will eventually realise a capital gain big enough to compensate the losses. Of course, there is a limit to how many negative cash-flow investments you can hold – at some point you will exhaust the money you have available to fund them.

What is positive gearing?

Positive gearing is when the assessable income you derive from an investment is higher than your tax-deductible expenses – so the investment generates a profit. Naturally, you will incur tax on this profit.

Positive gearing is achieved through high-yielding investments – those with large income relative to their investment cost – or having a higher proportion of equity in the deal. But as property prices have risen in recent years, positively geared property (especially in cities) has become difficult to find.

How can I make gearing work for me?

Whether you favour positive or negative gearing...

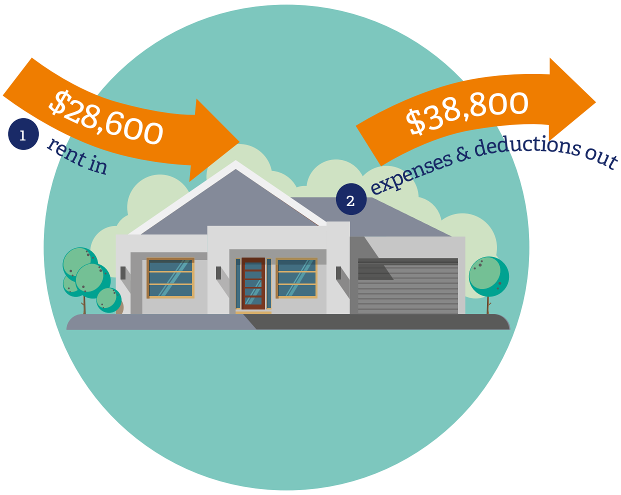
> if you have a personal debt (such as a home loan) advisers may suggest to take out an interest-only investment loan for your new investment. That way, the non-deductible personal loan (usually under a Principal-and-interest payment structure) will reduce as fast as possible, while you benefit from the maximum deductions from your interest-only investment debt (because the principal is not reducing).

It is good news if your investments generate excess income (either because they have positive cash-flow or are positively geared) as then you can use the extra money to reduce your personal debt even faster. Once you are free of this, the decision is yours whether to start channelling all your cash into your investment loans so that they will one day become 100 per cent yours, without a mortgage, and the income they earn will be clear profit (subject to tax).

* This is not intended to be financial advice. Please see independent advice.

CASE STUDY:

How Michael uses negative gearing



1 Michael earns $100,000 as a builder. He buys an investment property that earns him $28,600 a year in rent.

2 Michael's tax-deductible expenses for the investment property total $38,800. This means he is negatively geared by $10,200.

Michael's investment property numbers

Assessable income (Rent)	$28,600
–	
Expenses (Interest, management, fees, rates, pest control, strata fees)	$30,800
–	
Depreciation deduction	$8,000
Loss	$10,200

3 Michael can deduct $10,200 from his $100,000 income. He is now only taxed on $89,800.

Michael's income	$100,000
–	
Investment property loss	$10.200
Michael's taxable income	$89,800

Michael is a builder on $100,000 a year who wants to reduce his tax bill. He wants to buy an investment property in an up-and-coming area, within easy travelling distance to the city, because he believes property prices will continue to rise in the area.

He has managed to save $120,000* as a deposit on an investment property and pays $600,000 for a nice new apartment.

He quickly finds tenants willing to pay him $550 a week in rent – the property's income.

On the expenses front, Michael's $480,000 interest-only loan costs him $1900 a month (at an interest rate slightly higher than principal-and-interest rates: 4.75 per cent) and he decides to spend money to outsource management of the apartment to a property management company.

Before factoring in property management and other expenses, Michael is ever so slightly ahead each week. But management fees, landlord's insurance, building insurance, rates, pest control and strata fees add up to $8000 a year, resulting in a tax loss which Michael can deduct from his other sources of assessable income.

Then depreciation is on top of that. As Michael has bought in a new building, he can claim a capital works deduction for the initial build cost of his apartment, for the full 40 years. He can also claim for depreciation of eligible fixtures and fittings within the building. In all, there's another $8000 he can offset against his income in the first year – $7500 for the building costs spread over 40 years plus $500 for some white goods for a decade or so (the ATO lists all the items you can claim and for how long, and a quantity surveyor can compile a complete depreciation schedule for you).

This all means Michael's annual property expenses are $38,800 while his rental income is $28,600 making him negatively geared by $10,200 a year. He gets to take this off his $100,000 income – a tax advantage of $3774 (on his 37 per cent marginal tax rate). What's more, he is cash-flow positive by $1574 so he is not one cent out of pocket at the end of the financial year.

If the property price continues to grow faster than the interest rate Michael is paying, he can expect to pocket a capital gain when he sells too.

* Many lenders will take a smaller deposit which can provide a greater tax deduction however you may be required to pay for lender's mortgage insurance.

Nicole Pedersen-McKinnon is an independent finance commentator and educator on television, online, in Fairfax papers and in high schools around Australia.
Website: **https://www.themoneymentorway.com/#!/smart**.
Facebook: **Nicole Pedersen-McKinnon Money**.
https://www.facebook.com/NicolePedersenMcKinnonMoney/

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