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What is Negative Gearing?

By Wayne Staal CA

Negative gearing is a phrase circulated around a lot, sometimes positively, sometimes negatively … so what is it? Is it your solution to building wealth and saving tax? After reading this article, you should know whether it is for you. Of course, you should seek advice from your Accountant.

What is it and a worked example!

In a nutshell, “negative gearing” is a fancy word for making a loss. That is, your expenses are more than your income, normally because of a loan (gearing) and the interest component on that loan.

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Let's look at an investment property example ($525,000 House, 4% interest, 90% Lend) as that is a very common negative gearing situation:

Investment property example ($525,000 House, 4% interest, 90% Lend)	
Rental Income	24,960
Landlord Insurance	(600)
Council Rates	(2,200)
Water Rates	(1,900)
Property Agent Management Fees	(3,295)
Other Repairs & Gardening	(1,000)
Net Income Before Interest & Depreciation	15,965
Interest on Mortgage	(18,900)
Negative Gearing/NET LOSS	($2,935)

The tax benefit you derive from the loss will depend on your marginal tax rate, so each taxpayer is different.

Your highest Tax Rate (Excluding M/Care)	0%	19%	32.5%	37%	45%
Tax Benefit	$Nil	$557.65	$953.88	$1,085.95	$1,320.75
Net Cash Outflow (Loss minus tax benefit)	($2,935.00)	($2,377.35)	($1,981.13)	($1,849.05)	($1,615.24)
Per Week Estimated Holding Cost	$56.44	$45.72	$38.10	$35.56	$31.04

The above example excludes building depreciation for simplicity purposes. However, it should be noted, that building write-off claims can help the negative gearing/tax benefit reducing the cash outflow for the owner. However, any building write-off claims make the capital gain larger at the end.

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As you can see, even after the tax benefit, you still go backwards from a cashflow point of view. So why would anyone do it?

The answer lies in the gamble on future profits/capital gain. If you think the holding cost is worth the chance of the investment going up over time…. at least by your combined losses each year….. Then it is worth holding the investment.

Common misconceptions:

- You get back the loss as a tax refund – You will only ever get back a proportion (your tax rate) of the loss each year. The rest is a genuine cash outflow. Every deduction works this way, not just negative gearing.

- Loan repayment vs interest – Some people think the loan repayments are deductible. It is actually only the interest component of the repayments, not the whole repayment, which are deductible. If you have "Principal and Interest" repayments on the investment, your cash outflows will be even greater than the example above.

- Helps reduce Child Maintenance Payments – This is no longer the case. Child Maintenance and Government Benefits are all assessed on "Adjusted Taxable Income", which essentially addback rental property losses, salary sacrificing and voluntary superannuation contributions.

So when is it suitable?

It can be suitable in lots of situations, but where we have seen it work best is when the taxpayers have some or all of the following traits:

1. Surplus cashflow – earnings are above and beyond what they need each week to live, so the clients are looking to use some of that to build investments.

2. When you are disciplined and manage cash, family budgets and tax/GST payments well.

3. Having the investment loan on "Interest Only" and using any surplus cash to aggressively pay down private/non-deductible debt like your home loan.

4. You are particularly good at picking growth investments (shares or property for example).

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So when it is not suitable?

Essentially the opposite to the above, but also:

1. When there is uncertainty over your long term income (babies, change jobs, launch business, so-on). Remember, negative gearing is making a loss each year, with the goal to sell the asset for a profit in the future. To sell a property (for example) for enough to cover transfer duty on purchase and commission on sale, plus make a profit to cover your negative gearing each year, you need to be thinking long term (normally min of 5 to 7 years) to be safe. Income should be reasonably predictable/secure over that time period.

2. You are making the investment purely for the tax deduction – not the investment/asset in its own right. Selecting assets based on tax characteristics almost always ends badly.

3. The investment is made in a high risk area, like a mining or army town for example, which better suit situations where you are less reliant on gearing.

4. The taxpayers are on low tax rates, so don't really need the tax benefit of negative gearing.

5. The negative gearing is way in excess of what they need – that is, the property is making significant cashflow losses each year, meaning the property must grow rather aggressively over time to make their money back and funding that loss day to day can cause budget stress.

6. An old property is selected which requires large repairs each year, meaning the loss each year grows faster than expected.

7. Can only just fund it on the current interest rates, and haven't factored in an increase in interest rates.

8. Failed to get advice at the beginning.

Other things to consider:

- Recently The Australian Labor Party planned cap or remove the tax benefits associated with Negative Gearing. While they missed out on winning government, it could again appear on the agenda of any of the major parties if they are looking to clawback tax. In the UK for example (which we often copy their reforms) have progressively phased out the interest deduction on investments.

Conclusion

Negative Gearing is neither good, nor bad. It is definitely suitable for the right person looking to build their investments.

Of course, should you have any queries, please contact our office to discuss your options.

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