Negative gearing

What is Negative Gearing?

The term gearing refers to the process of borrowing money to invest. Negative gearing for tax purposes, occurs when the deductible expenses associated with an investment, including interest on the money borrowed, are greater than the assessable income earned from the investment.

This means that you are making an income loss on the investment. Because this loss is generally tax deductible, your tax liability on other assessable income may be reduced, thus reducing the effect of the overall loss on your cash flow.

In the long-term it is expected that the total returns from the investment, including capital growth, will be greater than the short-term income losses. However, if sufficient capital growth does not occur you may be worse off overall.

Investors should understand that while negative gearing can be an effective means of increasing returns, it also carries with it the risk of increasing your losses. Careful consideration and planning should be undertaken before you borrow to negatively gear.

How does it work?

Most private investors think of negative gearing in relation to residential property. They may fail to realise that other income producing assets, particularly shares and unit trusts, can be negatively geared with favourable results over the long term.

The following example illustrates the way negative gearing works. In this example the investor has $100,000 to invest. However, it is possible for the investor to borrow $200,000 thus giving a total of $300,000 to invest.

Assume

Investment Income	3.3% p.a.	Loan Interest Rate	6.0%
Capital Growth	5.4% p.a.	Investor's Marginal Tax Rate	48.5%

	No Gearing	Negative Gearing
Total Investment	$100,000	$300,000
Investment Income	$3,300	$9,900
Less Interest Paid on Borrowing	$0	($12,000)
Taxable Income/ (Loss)	$3,300	($2,100)

For the investment without gearing, the after tax income will be $1,700. The negatively geared investment has a loss of $2,100. This will provide a tax saving of $1,019 (provided the investor has sufficient other assessable income) so the after tax loss is only $1,081.

Guide to…

Although negative gearing may produce a loss on a year to year basis, it is necessary to look at the long term view to show the overall effects that a negative gearing strategy may have on an investment.

	No Gearing	Negative Gearing
After 10 years the investments are sold for	$169,201	$507,607

After taking into consideration the costs of the exercise, including tax, the results are:

	No Gearing	Negative Gearing
Net Capital Value (after CGT and repayment of debt)	$152,421	$257,262
Return on Original $100,000	$74,609	$143,153
(Including Net Income/loss)		
Annual Return on Investment	5.73%	9.29%

In this situation, negative gearing has significantly improved this investor's financial situation.

What are some guidelines?

Investors considering negative gearing should keep in mind the following:

- Negative gearing produces maximum benefits for investors on the highest marginal tax rate.
- Make sure that you can continue to make the loan repayments if interest rates rise substantially.
- Ensure that you can service the loan if you are unable to earn a living - income protection insurance may be necessary in this situation.
- Take a long-term view in order to get the most out of a negative gearing arrangement.
- Organise your cash flow so that you can comfortably make your loan repayments - a variation to your PAYG tax may assist in this regard. The Australian Taxation Office can provide a form for decreasing the PAYG withholding amounts deducted by your employer from your salary or wages.
- As cash flow from your investment builds up and tax deductions decrease over time, consider increasing your gearing.
- It is not advisable to borrow money to invest in assets that are already geared.
- Seek professional advice so that you develop a strategy which can reduce the pitfalls and maximise the benefits of negative gearing.

Assumptions for example.

- Investment income is fully taxable
- All capital gains are subject to the discount method of calculating taxable capital gains
- No capital gains are made, and thus no CGT payable, until the end of the investment period
- The lending rate remains constant for 10 years
- All assets are sold after 10 years and all debt repaid
- Income returns, in dollars, are constant for 10 years (note this is for simplicity, it would be reasonable to assume that income would rise over time, such an outcome would improve the returns in both cases shown in the example)
- In the ungeared case income is re-invested at the same after tax return as the investment.
- In the geared case the after tax losses, increased by earnings foregone, are deducted from the end benefit.