

# Negative gearing in the current market

**Margaret Lomas, founder of Destiny Financial Solutions, looks at different gearing strategies and explains whether negative gearing still makes sense in the current environment**



Before we establish if negative gearing is, in fact, still a viable option, we must establish what the term means.

### What is gearing?

Gearing is the term used to describe the process of increasing the size of your investment through borrowing. Typically, when you gear an investment, you use that investment as security to access more funds, which in turn buy more of the assets. When you gear an investment you either receive a negative outcome (negative gearing) or a positive outcome (positive gearing). It's important to note that both outcomes are based on borrowing and both outcomes are based on the amount of tax that you pay as an individual, and so the amount of tax break you can receive.

### Negative gearing

Most people believe that negative gearing is a strategy that explains how people on high incomes get back more tax. In fact, negative gearing means gearing your investment so that the costs to maintain it (loan repayments, yearly investment costs and expenses) outweigh the income produced, leading to a reduction in taxable income.

In other words, negative gearing happens where the total yearly costs of any investment outweigh the total income and you are allowed to claim a loss against income earned elsewhere.

For example, John buys a property that gives him \$10,000 a year. He pays

out \$13,000, losing \$3,000. As he pays tax at 40 cents in the dollar on his salary, he is allowed to claim this loss of \$3,000, which, for tax purposes, essentially 'reduces' the amount of salary he has earned by \$3,000. He can now ask for the tax that he paid on that \$3,000 (\$1,200) to be returned to him. Now his loss is only \$1,800 (\$3,000 less \$1,200).

Property income via rents		\$10,000 pa
Cost	\$13,000	
Loss	\$3,000	
Tax @ 40%		\$1,200
Total loss	\$1,800	

The reason why it's believed that negative gearing is used mainly by high income earners is that, obviously, the higher your income the more of the loss you can have paid by your tax refund. However, you can never get more than 45% of the loss back, as this is the top marginal rate of tax, and you will always have to pay the 55% yourself.

The pay-off for meeting this commitment is considered to be the rise in value of the asset you purchased. If it does not rise in value, then the exercise has a cost for you. If it does rise in value, then your return is considered to be the yield on your commitment. For example, if you committed \$2,000 a year after tax back and the asset went up by \$10,000, then your yield has been significant at 500%.

### Positive gearing

If negative gearing is an outcome whereby the costs exceed the expenses, then positive gearing is the opposite, and occurs when the income on an asset you invest in exceeds the expenses. For property, this would occur if you purchased a property which had a high

yield for your purchase price. With interest rates becoming lower, and so reducing the yearly costs of holding an investment property, and with rents coming under pressure in many areas and so increasing, more incidences of positive gearing are being seen and some people who initially negatively geared are seeing these properties now returning a positive income. An example is as follows.

Sandra buys a property that pays her \$15,000 a year, and her costs are \$13,000. As she makes \$2,000 profit, this amount is tacked on to her other income and so she has to pay tax at her marginal rate. If this was 40 cents in the dollar, she would pay \$800 in tax and keep the remaining \$1,200. If the \$2,000 pushed her into a higher tax bracket, she would pay the higher tax amount on the \$2,000.

Property income		\$15,000 pa
Cost	\$13,000	
Profit		\$2,000
Tax @ 40%	\$800	
Total income		\$1,200

### What about positive cash flow?

Positive cash flow is a natural result of positive gearing. The fact that the income is higher than expenses will always mean that you end up with money left over, even if some is lost in tax. However, even a negatively geared property can have a positive cash flow, if the on-paper deductions provide enough additional tax back to close the gap.

On-paper deductions are those we can make where money hasn't actually been paid out as an expense but part of the asset has lost value. In a nutshell, each dollar of lost value of the claimable part of the asset can be received as a refund against your marginal tax rate. Looking back at John, it would look as follows.

John has \$10,000 income and \$13,000 of expenses, but the building loses \$3,000 of its value in a year, and fixtures and fittings lose \$4,000. In total, he can claim \$7,000 in loss of value. He's in the 40 cents in the dollar tax bracket, so he gets a further \$2,800 of his tax back. As this is added to the \$1,200 he receives for the actual loss, he gets back \$4,000. However, he lost \$3,000, so he's now \$1,000 ahead. This is now the amount of his positive cash flow.

Property income		\$10,000 pa
Cost	\$13,000	
Loss	\$3,000	
Tax @ 40%	(\$10,000 x .40)	
Total tax deductions		\$4,000
Total Loss less deductions		\$1,000

On-paper deductions like this can also reduce the amount of tax paid in a positively geared situation. As an on-paper figure, these deductions can eliminate the gain made and also add to the cash flow.

From these examples, you can see that even when you negatively gear you may not end up with a negative cash flow, so it's very important to understand that negative gearing or positive gearing is not the issue. It's the final result, or bottom line cash flow after all your tax claims are made, which becomes most important to you as an investor.

### Should I negatively gear?

Given that we have now established that the phrase 'negative gearing' doesn't describe the final cash flow at all, the question should be rephrased as two different questions.

#### 1. Should I aim for a positive or a negative cash flow?

Where property is concerned, a school of thought has always reigned that any property that has low income and higher expenses (and so a negative result) would exist in a city and attract higher growth and an ultimately better yield and that any property with a positive result would have a higher income and a lower growth rate, and be in a regional area. With the changing property landscape this has not turned out to be a pure theory over the past 10 years, where we have seen better growth in many well-located regional areas than we have seen in the cities.

What this means is that you can no longer use the excuse that you are buying property with a negative cash flow because it will grow better, or that you are buying property with a positive cash flow because you want cash now and are prepared to forgo ultimate gain to get it. Instead, you must take more

time to establish the drivers likely to provide a property with the greatest chance of strong and growing rental yields, and the best chance of future growth. In addition, you must be aware that both of these can be delivered regardless of where the property is.

Look for areas with a growing population, developing infrastructure, economic vibrancy and a median household income that is growing faster than inflation. These will also be areas where large companies are relocating and employment opportunities continuously exist. These are the drivers that will determine how, and by how much, an area is likely to grow in the future.

#### 2. Should I gear at all?

Remembering that gearing means 'to borrow', now is the time to estimate your personal capacity to maintain a loan should you not see the cash flow outcome you hoped for. Given the state of our economy, you must consider your job stability, current commitments to personal non-tax-deductible debt, and the ability of the area you'll buy in to continuously attract tenants and so an income stream. Gearing increases the return (the higher the loan, the less of your own money you need and so the greater return on your personal contribution) but it also multiplies both the risk and the loss if you make one.

Being able to increase your exposure to growth assets can mean you reach retirement in a better financial position. The ability to select good assets, be they property or any other kind of investment, is crucial at this time. Where property is concerned, make all of the tax claims you can, but don't invest just because you want to get a reduction in the tax you pay. Choose your property carefully and determine the areas most likely to weather the storm, deliver good rental yields and retain their values in the coming few years, and consider your personal financial circumstances before beginning any investment plan. ■

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