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What is
Negative Gearing?

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Negative gearing is a way that many ordinary Australians, like you and me, use the tenant and the taxman to create wealth. It has become a popular investment strategy that many Australian's utilize because it speaks to the heart of every investor who wants to make money and save tax, and that's just about everyone!

Why is Negative Gearing So Popular?

The most compelling reason why negative gearing is so popular is because history suggests that negative gearing works very well. Many have utilised the property price growth over the years along with the banks money to change their financial lives.

With the benefit of hindsight, how many properties do you wish you bought back in 1980, 1990 or even 2000? How many times have you heard the saying "I wish I bought the whole street 20 years ago".

Before you beat yourself up too much, there is a compelling reason why you didn't buy more property in years past. That's because you couldn't afford to. You probably also convinced yourself that property prices had gone as high as they could go, maybe you were worried about interest rate rises or perhaps job security or maybe you were just comfortable with your current financial position.

The lesson here is that you can't change history, but the bigger question to ask yourself is whether you should use history as an indicator to help you get Financially Sorted in the future.

Many of our clients at Financially Sorted have done this.

We all hear a lot about negative gearing in the press or from our family and friends, or maybe even from your accountant or professional advisor. Do you really know what negative gearing is and how it works?

Property and Taxation

Under Australian Income Tax Law, property investors must include on their annual income tax returns, all income earned from their property investments, including rental receipts, along with any realised capital gains.

The timing of when property income must be declared varies.

Generally, for rental income, it is usually when the amount is received. However, for capital gains they are generally not taxed until the property has been sold or otherwise disposed of. Properties can be refinanced without any capital gains tax (CGT) impact, as long as ownership doesn't change.

Chan & Naylor Tip

When you separate the facts from the hype, the truth that negative gearing can't hide from is that it is a strategy created to make a certain loss on your tax return today, and maybe a profit tomorrow (via future capital appreciation). Any property investor banks on the idea that the capital appreciation over time is far greater than the loss we incur each financial year.

Property investors are also allowed to claim tax deductions for expenses incurred in earning their real estate incomes. Common deductions would include interest, rental management costs, insurance, council rates, utilities, minor repairs and depreciation.

See our separate brochure for the types of rental property expenses available to be claimed as tax deductions.

It is normal for an investment property, especially, if it has been bought for capital appreciation (which will not be taxed until the investment is sold, potentially many years in the future), to have more expenses than income. This loss can then offset any other income (including salary or wages, dividends, etc.) the taxpayer may have, to reduce the amount of tax paid.

This is exactly what **Negative Gearing** is.

Let's have a look at a worked example and the taxation effects thereon:

	Rental Income	Property Related Deductions	Positive or (Negative) Gearing	Salary & Wages	Taxable Income
Scenario A	$10,000	$15,000	($5,000)	$55,000	$50,000
Scenario B	$10,000	$7,500	$2,500	$55,000	$57,500

Scenario A

This is the usual position in a **negatively geared** transaction.

While rental income of $10,000 must be included in the taxpayer's income tax return, the property deductions of $15,000 are higher than the rental income of $10,000, resulting in a loss $5,000, which can be used to reduce the tax payable on other income. This will be offset against their normal salary and wages of $55,000, resulting in a taxable income of $50,000.

Scenario B

This is the usual position in a **positively geared** transaction.

While rental income of $10,000 must be included in the taxpayer's income tax return, the property deductions of $7,500 are lower than the rental income of $10,000, resulting in a profit of $2,500, which must be included in the taxpayer's income tax return. This will get added to their normal salary and wages of $55,000, resulting in a taxable income of $57,500.

How Does a Property Loss Save Taxes?

Here's a case study revealing how the property loss (negative gearing) can be used to offset a taxpayer's other income.

Taxpayer A is a physiotherapist on a salary of $130,000 per annum, plus superannuation. Two years ago, she bought a property which has since appreciated in value by $85,000. Her property attracts rental income of $20,800 andshe has a total property related expenses of $15,000 (including depreciation). Her overall tax position for the 2017/18 financial year is as follows: -

	With No Property	With Property
Salary & Wages	$130,000	$130,000
Property Losses	—	($5,800)
Taxable Income	$130,000	$124,200
Income Tax + Medicare Levy	$38,332	$36,070

Although Taxpayer A has succeeded in reducing her tax bill by $2,262 ($38,332 - $36,070), she is $3,538 worse off overall ($5,800 - $2,262). This is because only 39 per cent (incl. Medicare Levy) of the $5,800 property loss was recovered by the tax she saved. The other 61 per cent had to be paid from her own pocket, and this reduced her after-tax spending power.

Chan & Naylor Tip
However, before you rush off and buy a new growth-focused investment property, you need to know that real estate values do not necessarily increase in a steady or predictable manner. They are also not guaranteed to increase in value as they have done so previously.

Provided Taxpayer A's property keeps increasing in value greater than this amount, she will be ahead.

Can You Rely on Capital Gains?

Investment for growth is about timing the market, not time in the market. Capital gains are a form of investing profit that occurs when your property appreciates in value, or to put it more simply, when an asset is worth more than the cost of acquiring and holding that asset. Capital appreciation is by far the most popular reason why investors buy real estate and why they are happy to utilise the benefits of negative gearing.

Property appreciates in value because there are more people than there are houses, and when demand exceeds supply, prices generally increase.

Being Financially Sorted.

Negative gearing is a wealth strategy that many have used over the years to get Financially Sorted. There are different investment options available to us all and a negative geared investment is just one of those.

Being financially sorted is important for us all and hopefully this article goes some way towards helping you.

We hope that this summary gives you guidance on negative gearing.

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