

# Negative Gearing

1. **What** is negative gearing – negative gearing is where the interest expense on the finance to acquire an investment exceeds the income generated by the investment, and the surplus interest is available to be offset against other income, thereby reducing the overall tax liability of the person or entity
2. **Where** would you find assets that are negatively geared? Many types of investment assets can be negatively geared – managed funds, shares and property are common examples, because lenders are prepared to lend against these assets. Not all assets have to be geared directly – you may have a line of credit which is separate from your home loan that you use for investment purposes – interest on this loan can be offset against the investment and your other income.
3. **Why** on earth would someone throw their money away by negative gearing? After all, even with the tax concessions, you only get a percentage of your loss back on tax. The only way that negative gearing works is where the capital growth in the asset exceeds the loss suffered from the excess interest and other costs. While the asset is growing in value, you are not paying tax as the gain is unrealised, but you are able to offset your loss against your other income, which helps to fund the cash shortfall on the loan interest repayments.
4. **When** is it advantageous to negatively gear? Probably in two main scenarios – where the capital growth is expected to be so significant that your short term losses will be well and truly recovered on the sale of the asset, and the other is where you can obtain a significant tax advantage, because your taxable income is at or close to the top marginal rate of tax.
5. **How** do you negatively gear an investment? It is not something that you generally intentionally set out to do, but for some investments, such as property, there are a number of other costs that increase the negative cash flow position of the asset, such as paying the rates and insurance etc. Also, with property, there may be non cash expenses, such as capital allowance and depreciation claims, that create a greater negative result for the asset, but provide a greater tax refund at the end of the year.
6. **Who** is best suited to negative gearing? Investors with an appetite for risk and another source of income, so that they can make up the cash flow shortfall, as well as take advantage of the income tax concessions that are available for negatively geared assets. The key to successful negative gearing is to have enough surplus cash available to be able to meet the shortfall and hold the asset over the required time frame. For some assets, such as property, the up front costs and selling costs (such as stamp duty, legals and agent commission) make it prohibitive in most cases to hold the asset for a very short period of time, so if you plan to gear such ‘lumpy’ assets, you need to have a strong cash flow from other sources. One point to note, where you have a family trust and you would like to negatively gear an asset, make sure the trust receives sufficient other income to ensure the losses are utilised, as a family trust can’t distribute losses on an annual basis.

Remember, Robert Kiyosaki said that you can have as many positively geared assets as you like – you are restricted with the negatively geared assets by the cash flow required to continually top them up.

Now to an example. You purchase a rental property for \$400,000 and you borrow 100% of this amount (you have secured 20% of the loan on an existing property that has 'spare equity'). The property rents for \$400 per week and the loan that you have taken out is an interest only, variable rate and it is starting at 6% interest:

Rent for 52 weeks	\$20,800
Interest on loan – 6% x \$400,000	<u>\$24,000</u>
Negative cash flow before other costs	\$ 3,200 – \$61.54 per week

What happens if the interest rate increases to 8%

Rent for 52 weeks	\$20,800
Interest on loan – 8% x \$400,000	<u>\$32,000</u>
Negative cash flow before other costs	\$11,200 - \$215.38 per week

What happens when you put the rent up to \$500 per week?

Rent for 52 weeks	\$26,000
Interest on loan – 8% x \$400,000	<u>\$32,000</u>
Negative cash flow before other costs	\$ 6,000 - \$115.38 per week

Now, while interest rates can and will fluctuate as the Reserve Bank requires them to, you can't always put the rent up (tenant may have a long lease, your property may become vacant at a time of high availability of properties etc), so before you take the leap with a large investment, make sure you have your bases covered.

You can apply to reduce your weekly tax liability based on your expected loss from your negatively geared investments by completing a section 15-15 variation and lodging it with the tax office – these form can be downloaded from the ATO website [www.ato.gov.au](http://www.ato.gov.au) – Find a form, sort by forms, all topics, Pay as You Go (PAYG) and select the PAYG Withholding Variation Application form.