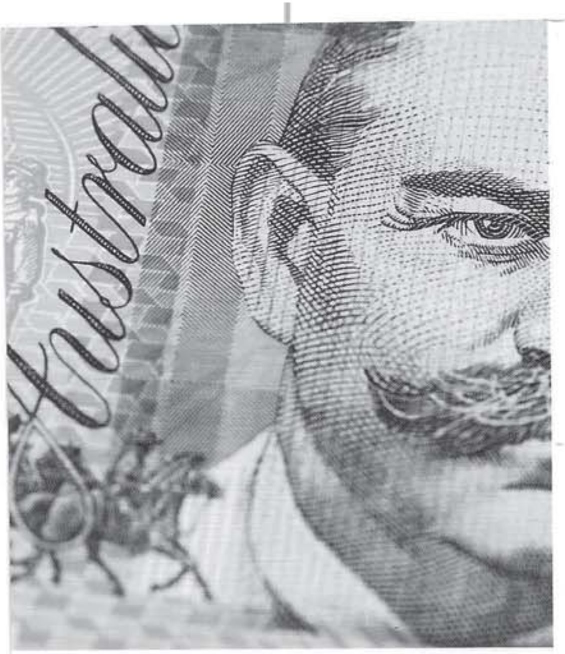

What you want to know about negative gearing... but are too afraid to ask

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Many people, especially accountants and financial advisers, tend to kick around the term 'negative gearing' and take it for granted that everyone knows what it really means.

Terminology like this sometimes makes information inaccessible to those who need to understand it the most. For those who want to understand negative gearing in plain English but are afraid to ask, this is hopefully a useful guide.

The underlying causes

Tax rates

Before we define what is meant by the term 'negative gearing', consider the current marginal tax rates applicable to an individual:

Taxable income	Tax on taxable income
0 – $18,200	Nil
$18,201 – $37,000	19c for each $1 over $18,200
$37,001 – $87,000	$3,572 plus 32.5c for each $1 over $37,000
$87,001 – $180,000	$19,822 plus 37c for each $1 over $87,000
$180,001 and over	$54,232 plus 45c for each $1 over $180,000

The above does not include the Medicare Levy of 2% of taxable income, nor does it include the Temporary Budget Repair Levy of 2% for every dollar of taxable income exceeding $180,000 (this levy will cease on 1 July 2017).

Further, if you do not have private health insurance but your income exceeds a certain threshold, you may be slugged with an additional Medicare Levy Surcharge of up to 1.5%.

In other words, if you are subject to all these surcharges and levies and your taxable income is more than $180,000, you are effectively paying half of every dollar of your taxable income exceeding $180,000 you earn in tax!

Bias in the tax system

In addition to the arguably draconian tax rates, the tax system also has an inherent bias, which generally imposes less tax on a capital gain than income.

In the context of property investment, the relevant type of income is normally rent derived from the property. The full amount of gross rent is then reduced by rental deductions and the resulting net income (or loss) is included in your taxable income.

On the other hand, if you sell your investment property and make a capital gain, that capital gain is also included in your taxable income. However, if you, as an individual, have owned the property for at least 12 months before it is sold, you will be entitled to the '50% CGT discount', which will reduce the capital gain by half before the gain is included in your taxable income.

Negative gearing

Negative gearing is really just a fancy term to describe the situation where the total tax deductions you claim on your investment property exceed the total rental income you derived from it.

For most people, the largest tax deduction by far is interest on the loan that was drawn down to buy the property. Other expenses include body corporate fees, council rates, cleaning, property management fees, repairs and maintenance costs, etc.

In addition to the tax deductions on these 'real' expenses (they are real because you have to pay for them), you are also allowed to claim tax deductions on capital works and depreciation. As the capital works deduction is essentially depreciation on buildings and improvements, it is not a cash outgoing – yes, you can claim a tax deduction for it without having to spend any money! Depreciation is similar but you would have paid for the depreciating asset (eg, stove, furniture and fittings) at some stage and the expenditure is spread over the effective life of the asset and claimed as a tax deduction over time.

If the total tax deductions you claim exceed the rental income you derive from the property, you will make a net loss, which is numerically expressed as a **negative** amount; coupled with the fact that the loss is generally and mainly attributable to the interest expense from the borrowings you took out to buy the property (borrowing is also known as **gearing**), the term 'negative gearing' was conceived.

What makes negative gearing particularly tax-attractive is that the net loss can be offset against other income that would otherwise be included in your assessable income. Therefore, if a dollar of income you earn would have been taxed at 50.5%, every dollar of negative gearing loss that offsets your assessable income will effectively save you 50.5 cents in tax!

Meanwhile, if the investment property goes up in value but you do not sell the property, no capital gains tax will be payable. Even if you do sell the property after 12 months, the capital gain will be discounted by 50%.

Accordingly, provided that the total after-tax capital gain on your property and the total tax you have saved from negative gearing exceed the total cash outgoings you incurred during your ownership of the property, you will be financially in front.

Example

To illustrate the above, consider the following example:

- You purchased a property for $500,000 (ignoring incidental costs on purchase, eg, stamp duty, legal costs, etc) by putting in $100,000 of your own money and $400,000 from the bank.
- The interest rate on the loan is 4.5% per annum. The loan is an interest-only loan, ie, none of the principal is paid down each year. Therefore, the annual interest expense on the loan is $500,000 x 4.5% = $22,500.
- The annual rent on the property in the first year is $15,000, which increases by 3% per year.
- The annual expense on the property in the first year, excluding interest expense, is $10,000, which increases by 3% per year.
- Based on a depreciation report prepared by a qualified quantity surveyor, you can also claim depreciation and capital works deductions of $4,000 per year.
- You own the property for 3 years before it is sold for $600,000.
- You pay tax at the highest marginal tax rate of 50.5% inclusive of all levies and surcharges.

Your total after-tax net cash loss over the 3 years will look like this:

	Year 1	Year 2	Year 3	Total
Rent	15,000	15,450	15,914	46,364
Less: Interest	(22,500)	(22,500)	(22,500)	(67,500)
Less: Other expenses	(10,000)	(10,300)	(10,609)	(30,909)
Less: Depreciation & capital works deductions	(4,000)	(4,000)	(4,000)	(12,000)
Net loss	(21,500)	(21,350)	(21,196)	(64,046)
Tax savings @50.5%	10,858	10,782	10,704	32,343
After-tax net loss	(10,643)	(10,568)	(10,492)	(31,703)
Add back: Depreciation & capital works deductions*	4,000	4,000	4,000	12,000
After-tax net cash loss	(6,643)	(6,568)	(6,492)	(19,703)

**Depreciation and capital works deductions are added back because they are not cash expenses*

Ignoring any incidental costs on sale, if you sell the property after 3 years, you will make a capital gain, after tax, as follows:

Capital proceeds on property sale	600,000
Less: Cost base	(500,000)
Capital gain	100,000
Less: 50% CGT discount	(50,000)
Taxable capital gain	50,000
Tax on taxable capital gain @50.5%	(25,250)
After-tax capital gain	74,750

In summary, a comparison of your return on capital from the property investment, with or without negative gearing, will be as follows:

	With negative gearing	Without negative gearing
After-tax net cash loss	(19,703)	*(52,045)
After-tax capital gain	74,750	74,750
Total after-tax return	55,047	22,705
Total capital invested	100,000	100,000
Return on capital	55%	23%

**$46,364 (total rent) - $67,500 (total interest)- $30,909 (total other expenses) = -$52,045*

As illustrated, negative gearing could potentially provide significant tax savings that may turbo-charge the return on capital on your investment property, which is why it is a hugely popular strategy especially for high income earners.

Having said that, most investments come with a degree of risk and gearing investments may have the potential of amplifying that risk. For negative gearing to work, there needs to be sufficient capital growth and/or net rental profit in the future to offset the cumulative net rental losses you incurred during your ownership of the property.

The future

Despite the usefulness of negative gearing for those who are motivated enough to have a wealth accumulation strategy to provide for their own future, it has been a hotly debated topic in the public arena for some time and is often caught up in the housing affordability debate. However, until there is a clear change in policy, negative gearing is still a legitimate and tax-effective strategy to give investors a leg up in their wealth accumulation plan.