FACT SHEET
Negative Gearing

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Negative Gearing

Gearing is the process where money is borrowed for investment. It can be positive, neutral or negative. With negative gearing the costs associated with the investment are greater than the income received, creating a loss (on paper at least) and reducing the investor's income tax liability. Ideally the asset value would grow over time, enabling the costs to be recovered and deliver a profit.

The most common investments that are negatively geared are real estate, shares and managed investment trusts.

By gearing into an investment a profit is magnified because the gain is made not only on the investors' capital but also on the borrowed funds. Equally losses are magnified as the debt, interest and charges must be repaid.

It is important that investors have adequate income to meet their loan commitments in the event there is a shortfall in income from the geared investment. To maximise the benefits of gearing, investors should be in the higher *marginal tax rates* and have surplus disposable income.

These investment strategies are complex and professional advice should be sought before investing. Even the most researched and best intentioned advice may still result in a loss. As with all strategies for investing negative gearing may not be suitable for the particular circumstances of all investors, especially for some retirees with modest savings who require investment security.

Features

- A tax effective means of wealth accumulation
- Enables the purchase of larger assets than if restricted to the investor's own capital
- Can reduce income tax liability (see taxation)
- Potential to achieve greater investment returns than without gearing

But Remember...

- Disposable income can be reduced
- Losses can be magnified
- There are costs associated with borrowing
- Additional security may be called for in the event of adverse market movements
- Market values of the asset may fall causing lender to request debt be reduced (margin call) or repaid and forcing asset to be sold at a loss
- Income from the investments may vary and could even be nil
- Disposal of assets at a reduced value may negate any tax advantages previously received
- Fees may be charged to buy and sell the assets

Taxation

Income from the investments is fully assessable in the year that it is received. Usual *deductions*, *tax offsets* and credits apply.

Costs that may be claimed as a tax deduction include loan interest, depreciation, rates, insurance, maintenance, property management and other costs incurred in gaining income.

In the event of significant reduction in estimated taxable income, application may be made to the Australian Taxation Office

Glossary

Deductions - *Amount by which assessable income may be reduced for allowable expenses incurred in earning income. Can also apply to government income support.*

PAYG withholding payments - *Tax deducted from an income source (e.g. salary, wages, investments) or the regular tax instalment that must be remitted to the ATO.*

Marginal Tax Rate – *The rate of tax that is payable on the last dollar of an individual's taxable income.*

Tax offsets - *Reductions in amount of tax payable as an incentive for certain actions or circumstances.*

(ATO) to reduce *PAYG withholding payments*. This maintains the investor's cash flow. Otherwise a larger tax refund can be received on completion of annual tax assessment.

Depending on the owner's assessable income and their circumstances, completing an income tax return may not be required.

Financial Institution Costs and Issues

- Investigate loan options - interest only, principal and interest, fixed and variable interest rate loans
- Interest rates can vary with options chosen
- Fees can include commitment fees, establishment fees, loan service fees, account keeping fees and transaction fees
- Loyalty benefits may be available, though a cost may be associated with these

Government Income Support

Assets test - If the investment is real estate the value of the real estate is reduced by the amount owing on the asset provided the loan is not also secured by the GIS recipient's primary residence – either in part or in full. For unsecured loans the outstanding balance of the loan may be deducted if evidence is provided that the loan was obtained for the purchase of that particular asset.

If the investment is a financial investment (shares, unit trusts etc.) the asset value is the net value after deducting any loan amount still outstanding.

If encumbered against a person's principal residence, all or part of the debt may not reduce the asset value.

Income test - If the asset is real estate, one third of the gross income is allowed as a discount in the first year and in subsequent years if tax returns are not required. If the costs are greater, evidence must be provided. Where tax returns are required, expenses adjusted for depreciation and some other costs are used.

If more than one property is owned, the income is assessed on each property and a profit on one cannot be reduced by the loss on another.

If the investment is a financial asset the full market value of the financial asset is assessed at the deeming rates to determine a person's income (no reduction is allowed for the debt). No allowance is made for loan costs, whether it is secured or unsecured.