Negative Gearing

If owning an investment property is part of your long-term plan, understanding what Negative Gearing means, how it works and when it is a good thing will be important to get familiar with. This guide will help you answer some questions that are commonly asked.

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What is negative gearing?

There is much talk about the pros and cons of negative gearing. Our aim is to inform and empower our clients with easy-speak education so you fully understand how it works.

To define negative gearing, we take the following steps:

1. Define the actual words NEGATIVE and GEARING.
2. **Negative** in this context means loss – think of owing an investment property as running a business (which it is). Now think of setting up that business so that it actually makes a loss.
3. **Gearing** means borrowing.
4. Putting the two together means running an investment which makes a loss (mainly due to the interest expense involved with borrowing money).
5. If there is not a loss, and there is a profit, that is positive gearing.
6. **Negative gearing** arises when the expenses incurred in owing an investment property *exceed* the revenue you receive.
7. The loss that you incur is then deductible from your assessable income on your tax return, which means you pay less tax.
8. This reduces the cash flow impact of owning an investment property.

See case study on the next page.

Negative Gearing: Case Study

Mr and Mrs Smith have a home worth $800k upon which they owe $200k. They purchase an investment property for $600k. They borrow the full amount of the investment property PLUS the costs – they borrow $630k @ 4.5%pa with Interest Only repayments.

Item	**$/week**	
Rental income	$550	This assumes the property is occupied – all investment properties are subject to tenancy risk.
Property management	($40)	Varies from agent to agent – We have used 7%.
Maintenance fees	($30)	We have taken an estimate $1,500pa and divided by 52 – this includes minor repairs, etc.
Strata fees	($20)	Estimate – costs of maintaining the unit block and surrounds.
Council rates	($20)	Estimate – local council fees.
Depreciation	($200)	There may be an entitlement to claim depreciation on fixtures and fittings in your unit and throughout the development plus the building. Ask your accountant to investigate this potential – it is a deduction you receive without any impact on your day to day cash flow.
Interest	($545)	$630,000 @ 4.50% = $28,350pa interest only.
Total profit / (loss)	($305)	

Effectively, Mr and Mrs Smith have made a $305 loss for the week. **This loss is claimable against their taxable income.** If you are not already doing so, please ask your accountant about submitting a Tax Variation Form – this allows you to obtain the benefits of these deductions as soon as possible.

Key recommendations

The keys to any form of investment, which involves borrowing, are the following:

- Buy quality investments, preferably with a reliable and rising income stream
- Borrow conservatively so you can survive interest rate rises and possible loss of income
- Maintain reliable income from your job or other sources to cover your borrowing costs, especially in the early years