NEGATIVE GEARING

How it works against you!!

Conversations about negative gearing are usually combined very closely with the words "saving tax". Quite often dentists look at their first property purchase as a necessary way to save tax rather than an investment opportunity. Time and time again, I hear the following two sentences combined together (1) "I'm paying too much tax" (2) "I think I need to do some negative gearing". This type of thinking is wrong from both a taxation and investment point of view.

Why? I hear you asking

Gearing means borrowing. The more you borrow, the more highly geared you are. The more you borrow, the more interest you pay. When the amount of interest you pay is more than the rental income you receive, then you are making a loss caused entirely by your high level of gearing (borrowing). In simple terms more money is going out (to the bank) than is coming in (from the tenant).

Your losses are about to become a lot worse (more negative) because there are further expenses to pay including, real estate agent management fees, letting fees, insurance, council rates, body corporate levies, land tax (possibly) and repairs and maintenance.

Let's look at the following simple example where you find "a bargain" being a brick house built in the 1970's in a reasonable suburb and in good condition. The purchase price is $500,000 and the bank agrees to lend you the full purchase price of $500,000 at an interest rate of 5.5%. The loan is interest only so you don't need to repay any of the principal. From your own money you only need to find around $25,000 to pay for stamp duty and legal fees. Good tenants who do not have pets, are keen to move in and pay $480 per week rent.

Financially your position for the first year is as follows:

Money in – Rent (52 x $480)	$24,960
Money out – Interest ($500,000 x 5.5%)	$27,500
Negative Gearing Loss	($ 2,540)
More money out:	
Agents fees	$ 1,500
Insurance	$ 500
Rates	$ 1,800
Repairs & Maintenance	$ 660
Depreciation	$ NIL
Total amount lost	($ 7,000)

Where your taxable income exceeds $180,000, you will be on the highest tax rate of 45% plus 1.5% medicare levy. Your tax saving on the above $7,000 loss is $3,255 ($7,000 x 46.5%) which means you are still out of pocket by $3,745 ($72 per week). Not sure about you, but I can certainly find better use for $72 per week than to give it to my bank manager. So that everyone is perfectly clear, if you want to save $3,255 tax, you do not need to buy a negatively geared investment property because you can achieve the same result with fewer headaches by donating $7,000 to your favourite charity.

So why do people negatively gear if they know they will lose money?

It's because they are hopeful that their investment will increase in value **buy more than** what they lose each year in negative gearing.

Property values around Australia have been generally flat over the past three years and it was recently reported that for the 2012 year the greatest increase in median house prices in a capital city was Perth at 6.1% while Sydney was in second place at 3.4%. Everywhere else was at 3% or less which means the value of most properties is barely keeping up with inflation. At the same time I continue to see advertisements about how you can own an investment property for less than $20 a week with the taxman and the tenant paying it off for you. In my opinion these inducements to purchase property are factually correct but it is necessary to estimate a future growth rate in the value of the property which is difficult to do and which I consider in many cases to be optimistic.

A growth rate of 6% every year for 5-10 years may seem conservative but it must grow by that amount **every** year and just one year of zero or negative growth early in the investment cycle can change the outcome significantly. Also $1 now doesn't have the same value as $1 in 10 years' time due to inflation (CPI). With inflation running at 2-3% per year, then a third to half of your 6% growth rate isn't growth at all but cost increases/reduced buying power of your money. The growth rate also needs to cover the costs of buying the property (stamp duty) which in our example was $25,000 and selling costs which are likely to be around $15,000. Finally the growth rate needs to cover that $3,745 that you are out of pocket each year.

In summary you need to ensure your property value grows by enough to cover inflation (CPI), buying and selling costs as well as your negative gearing losses before you have made any **real** gains. And don't forget, if you do make the gains you are hoping for then you will still need to pay capital gains tax.

Is there anything else I need to know?

When investing in property for gain rather than for the tax deductions there are numerous other considerations that you should discuss with your trusted advisor. These are:

a. In whose name should the property be?
b. Should I use a family (discretionary) trust to own the property?
c. Can I invest through my self managed superannuation fund (SMSF)?
d. Can I claim depreciation on chattels?
e. What properties can I claim the tax building allowance on?
f. What are the advantages of buying a NRAS property? (National Rent Affordability Scheme)
g. How should the loan/finance be structured? (Interest only, offset account etc.)
h. Can I claim repairs, maintenance, renovations?
i. What happens if my income falls, tax rates fall, interest rates go up etc.?

So why would I bother?

In a nutshell, there is nothing wrong with investing in property and borrowing to the extent that you are in a negative position, provided you have a clear understanding of how much you are losing and that you will only make a long term gain if your property goes up in value by more than your accumulated yearly losses and costs. If your priority is saving tax then consider donating to a charity, but if your priority is to invest for profit then do your research, select the right property and get advice from your accountant.

If you missed our last free seminar on "positive" gearing and would like an invitation to our next seminar in mid-April 2013 call the office of MW Partners on 03 88255400. As a member of the ADAVB, there is no charge for your first consultation so call Albert Gigl at MW Partners if you require specific taxation advice or merely a second opinion on any dental related tax matter. For your convenience MW Partners is located on the same floor as the ADAVB at 10 Yarra Street, South Yarra.