

TOP 21

INSIGHTS INTO NEGATIVE GEARING

PLUS MISTAKES TO AVOID



WealthAdviser

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Before you get started

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Before acting on any information contained herein you should consider if it is suitable for you. You should also consider consulting a suitably qualified financial, tax and/or legal adviser.

Information in this handbook is no substitute for professional financial advice.

We encourage you to seek professional financial advice before making any investment or financial decisions. We would obviously love the opportunity to have that conversation with you, and at the rear of this handbook you will find information about our authorised representative and how to go about booking an appointment.

If ultimately you decide not to meet with us we still encourage you to consult with another suitably licensed and qualified financial adviser.

In any circumstance, before investing in any financial product you should obtain and read a Product Disclosure Statement and consider whether it is appropriate for your objectives, situation and needs.

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Letter from the Wealth Adviser Library

Dear Reader

Welcome to the Wealth Adviser Library

This library was built specifically to facilitate the provision of sound financial information to everyday Australians.

Our mission is to build an accessible, comprehensively supported team of members who share our vision and commitment to providing tailored financial advice and a new foundation of financial understanding and security for everyone.

With a national network of likeminded experts, we have the potential to provide the financial building blocks for future generations.

Knowledge gives you a huge advantage

We believe that knowledge gives you a huge advantage in creating and effectively managing wealth; in planning to reach your goals; and in being prepared for whatever unexpected twists and turns life may present.

That's why our team of experts has created this series of digital handbooks and manuals that seek to inform you of not only the benefits but also the potential risks and pitfalls of various strategies and investments.

We trust you enjoy this publication and find it informative and professionally presented. Of course, your feedback is always welcome as we strive to continually offer content in a format that is relevant to you.

Take the next step

Wealth Adviser (a division of WT Financial Group Limited) supports more than 400 privately owned and operated advice practices around the country. We invite you to engage with one of our advisers to discuss what it was you were hoping to achieve when you obtained this handbook, and to establish if they can help you achieve your goals and objectives.

At the rear of this handbook you will find details on how to book an appointment.

Wealth Adviser Library

Introduction

What is gearing?

The obvious answer is, to borrow and buy an investment.

Here are some other ways to think about it:

- Gearing is borrowing to buy something that “inflates” in value. Without that inflation (or growth) gearing would be a futile exercise.
- Gearing is the process of converting income today into growth for tomorrow. You sacrifice your income from the investment as you collect it from a tenant only to give it to the bank in exchange for the “hope” of growth in the future.
- Gearing amplifies returns upwards and downwards. Gearing sharpens the knife and it certainly cuts both ways.
- Gearing increases risk and you will either be punished or rewarded for the extra risk taken.
- Gearing is about wealth creation long before it is about tax deductions.
- If you gear purely to reduce tax, then you have missed the whole point of gearing.

Gearing is not for everyone. It increases risk and that extra risk is not for everybody.

Negative gearing implies an investment results in a short-term loss with the costs exceed the rental income. This is with a view however, of achieving longer-term gain. The short term taxable loss can be used to offset income from other sources, such as salary thereby reducing overall tax payable.

On the other hand, a positively geared property is one where the direct rental income covers all of the direct costs (including the full mortgage payment) associated with it, ignoring the taxation benefits associated with the gearing. This focuses on the short term profit via the rental receipts being in excess of expenses.

This will occur when the interest rate is low relative to the rental received.

Because it can facilitate considerable tax savings, negative gearing can be an excellent wealth building strategy for high income earners.

Negative gearing can be used to invest in both shares and property, however, for the purpose of this eBook we will deal specifically with property investment.

We hope you enjoy this eBook, Top 21 Insights into Negative Gearing plus Mistakes to Avoid.

Negative gearing and property investment

For many, buying an investment property is an appealing step along the wealth creation trail. You rent or lease your property to someone to produce income. That income is assessable for income tax. You pay rates and taxes and expenses to maintain the property, and those costs are tax deductible.

If you borrow to buy your property, the interest on the loan is tax deductible.

If the total of all rates and taxes, costs of maintaining your property, and interest on the loan is greater than the income you receive from the property, the investment is negatively geared. You can claim the loss as a deduction against taxable income from other sources.

You need to buy well. To make gearing work you need to buy an asset that has a good chance to growing over time. Seek professional advice when it comes to selecting the asset, don't leave it to luck or amateur hunches.



A word of caution

In Australia, there is much hype around negative gearing. Property marketers, investment scheme promoters, and 'entrepreneurs-turned-authors' often quote historical examples of people building a property empire using negative gearing investment strategies. They assert that these people used generous tax benefits to fund their property purchases, using little or no money of their own. They tell you that you can do it too!

Be careful! Before you allow their promises and case studies to excite you, seek advice from a financial adviser, preferably with knowledge of all investment vehicles including direct property, who understands your personal financial position.

1. When quoting historical case studies, some scheme promoters might forget to advise that income tax rates in Australia are now much lower than a few years ago. Their examples may be from a time when it was common for moderate income earners to pay marginal tax rates over 45%. These rate cuts impact significantly on the profit calculations for a negatively geared investment.
2. You should also be aware that often promoters may be receiving generous commissions to sell overpriced property or property with lower returns than are achievable with otherwise careful, well-researched property selection.

Promoters of negatively geared investment strategies often suggest you should buy multiple properties, leveraging the growing equity in each to add further properties to your portfolio year after year. In theory, this sounds appealing. However, if you are losing money on properties in the short term, this might result in major cash flow shortages.

3. When is a negative a positive? Most business operators chase annual

profits. They want to ensure business receipts always exceed expenses. Applied to an investment property, this means rent receipts each year should be higher than the total of interest, all rates and taxes, agents' fees and commissions, maintenance and other expenses.

But an investment is profitable if the total rental income, plus the capital gain achieved on sale of the property, is more than the sum of all costs. Your calculations must include all costs of buying, holding, letting and selling, plus all taxes paid on the investment income and capital gain.

Income tax savings on income from other sources also contribute to the profit equation.

If you earn a salary and are negatively gearing an investment property that results in an annual income tax saving of say \$5,000 on your salary income, you should add that to the return from the property. Sometimes this tax saving can transform a losing investment into a marginally profitable investment.

As shown in the examples to follow, negatively gearing an investment can be an excellent strategy for increasing wealth and reducing income tax. The success of the strategy will depend on many factors. Your income and other deductions, for example, determine the rate of tax you pay, and therefore the value of the deduction for your investment loss. Always consider the likelihood of strong capital gain carefully when selecting a property.

Mistakes to avoid

Your financial adviser can help you consider all the risks associated with your proposed investment.

Too close to retirement

If you are too close to retirement, embarking on a gearing strategy is probably a bad idea. If you plan on retiring in the next 5-7 years, new gearing is probably not for you. If you have existing gearing, you probably need to start thinking about how you are going to pay off that

debt. A good guiding principle should be that you are aiming to be debt free by the time to get to retirement. There are few situations where it makes sense to have debt well into retirement.

You need an adequate timeline to gear. A minimum of 7 years and ideally 10. You need time so that the asset can inflate in value. You need time so that you have a chance of catching one decent market cycle in your favour. The shorter the time you have the higher the risk and the more reliant you are on luck. If you borrow to buy a property and over the next two years that market spikes upwards, you simply just got very lucky. Time reduces the reliance on luck.

Poor cash flow

You should also consider the risk of cash flow shortages, especially if you are considering multiple negatively geared investments to build a property portfolio. Can you find the cash to cover short-term losses? If you are unable to service your loan, you may suffer huge penalty interest and fees. You could even face repossession.

The risk of interest rate hikes should also be considered unless you are fixing the interest.

If you have a tight budget and not much surplus, don't worsen your situation by borrowing more money. Fix your budget either by earning more money, reducing your expense or both. Once you have a strong annual surplus you can consider gearing.

A good of thumb would be 10% of gross. If you earn \$100,000 gross you should be able to show a \$10,000 surplus. If not, you are probably spending too much.

Paying off the debt

How are you going to pay off the debt? Are you adopting an interest only strategy? If you are then your strategy is entirely dependent on asset inflation that may or may not happen. If your plan involves gradually paying off the debt, then you will be creating equity in the asset two ways.

One via growth and the other by paying off the principal of the debt.

Relying on selling the asset to pay off the debt is poor strategy. Frictional costs of getting in and out of property are considerable and an ideal strategy would be to keep the asset and never sell it, or certainly not be forced to sell it just to pay off the debt.

Do you have the right risk profile, the right temperament?

If you are after quick gains, you have the wrong temperament. If you are impatient, you have the wrong temperament. If you cannot stand losing money, you have the wrong risk profile. In summary, gearing is not for everybody. Not everyone has the right mental hard wiring to make it work.

Selling an investment too soon because of short term gains, when the idea was to hold long term potentially leaves a lot of wealth on the table. Getting out too soon at the first showing of some losses potentially crystallises losses unnecessarily when committing to the long term strategy would allow the investment to recover losses and bring in gains.

There are so many ways to mess up a good gearing strategy and often investors are their own worst enemy. Get to know yourself and come to terms with your profile. Working with an adviser can often be a good counter to one's natural tendencies and poor decision making.

Good Buffers and Contingency

What can go wrong will go wrong more often than we care to admit. You need to be ready. To have a Plan B.

Can you go into a gearing strategy with a household surplus that can absorb an interest rate rise?

Do you have a good cash buffer in case you don't have a tenant for a few months?

Have you got all your insurances in place? Life, TPD, income protection and trauma? Do you have your property and landlord insurances sorted?

Prepare for the worst!

Appropriate gearing ratios

Do not over do it! Just because a bank will lend you a lot of money doesn't mean you should take it. It needs to be part of your personal plan, not the banks plan.

Stick to reasonable gearing ratios that are appropriate for your situation. The higher your gearing ratio, especially at a household level, the faster you are driving and the more trouble you can get into. Often people focus on the gearing ratio of the asset alone but what you really need to be mindful of is the gearing ratio at a whole wealth level. What your whole balance sheet look like.

You might end up borrowing 100% to buy a \$600,000 investment property but if your total assets after the purchase is \$3,600,000 and your total debts are \$1,200,000 your overall ratio is 33% which if you have good household cash flow and an adequate timeline is very reasonable.

Don't focus on the tax benefits

Too many over emphasise the tax deduction. Don't borrow money to reduce your tax. That's a terrible reason to borrow money. Borrow money because you have a wealth creating plan and some tax benefit is a by-product of that. Tax relief is a means to an end and not an end itself.

Chasing tax deductions is a terrible wealth paradigm.

Strategic vs Tactical gearing

If the consequence of the gearing is immaterial to you, it is probably tactical. Someone worth \$3m that borrows \$30,000 to buy shares and then losses the lot is engaged in tactical gearing. The entire loss although momentarily painful will not have a material effect on their life.

Now take someone worth \$1,200,000 who bought \$500,000 property in a mining town that is now valued at \$300,000 (and prospects for selling aren't good). This person is engaged in strategic gearing and the \$200,000 loss will have a material effect on his life.

Understand what type of gearing you are engaged in and treat strategic gearing with

the respect and due diligence it deserves. Strategic gearing deserves professional help.

Negative gearing in action

Let's assume John purchases a property for \$500,000, borrowing the full amount and the purchase costs. This is on an interest only mortgage at 4.99% per annum. John pays \$25,700 per annum interest repayments and around \$5,000 in other expenses. Rental income received is \$17,500 for the year. John is on the 39% tax rate (includes Medicare). The following illustration ignores depreciation (discussed further on).

Assumptions

Purchase Price	\$500,000	\$60,000
Borrowings	\$515,000 (Purchase price plus costs)	48,000
Interest	4.99% / \$25,700 p.a.	36,000
Rent	3.5% / \$17,500 p.a.	33,000
Other Expenses (e.g. strata fees, insurance, rates)	\$5,000 p.a.	30,000

Impact on tax liability

Rental income:	-\$17,500
Less Other expenses:	\$5,000
Less Interest:	\$25,700
Net rental loss:	\$13,200

The \$13,200 tax deduction is a benefit of negative gearing and can be used to offset against John's other taxable income.



Real after tax loss

The tax deduction available based on John's marginal tax rate of 39% results in a reduction of the above after tax loss of \$13,200.

This is the net cash flow impact

$\$13,200 \times 39\% = \$5,148$ refund

Net cash flow outlay after tax: \$8,052

John is comfortable finding \$8,052 a year from his salary income to cover the short-term losses with the anticipation he will be compensated by capital growth down the track. These numbers are before any depreciation is taken into account.

This example ignores rent and expense increases. Rent increases would likely cancel the loss after a few years, further improving the profitability of that investment (though there would be no further income tax savings once the total income exceeded costs.)

Taxation considerations of Negative Gearing

Calculating depreciation benefits and tax savings and estimating rent, expenses and property value increases can be difficult. There are negative gearing calculators on some web sites, but wise investors will consult a financial adviser with expertise and experience. As you see from the examples, choosing the right investment strategy can make a huge difference to your total profits!

Effect of depreciation

The sample calculation omits consideration of another important factor. Tax law allows you to claim depreciation on rental properties built or renovated after 1985. You can claim 2.5% of the building or renovation cost each year over 40 years.

If John's investment property is new he may be able to claim \$15,000 annual depreciation (building plus fixtures & fittings). Now his annual loss is \$28,200 (depreciation plus net rental loss of \$13,200). This results in a tax savings each year of \$10,998. Because the \$15,000 is a

'notional' expense rather than an actual cost, he no longer needs to assign cash from his salary to cover losses on the investment property.

In fact, John will have an extra \$2,946 to spend each year, and will still achieve the same healthy capital gain when he sells in the future.

Rental income:	\$17,500
Less Other expenses:	\$5,000
Less Interest:	\$25,700
Net rental loss:	\$10,998
<i>Equals net cash flow</i>	\$2,946

Income tax withholding variation (ITWV)

As a negative gearing strategy may result in a considerable tax refund to be offset against other income, a request can be made to the Tax Office to reduce your rate of withholding tax deducted by your employer to better match your year-end tax liability. This means that rather than receiving a large refund at the end of the year it can be factored in each pay you receive rather than waiting until after your tax return is lodged at the end of the year.

Impact of capital gains tax (CGT)

Currently, the Australian Taxation Office calculates capital gains tax by applying your top marginal tax rate to 50% of your gain, if you have held the property for more than 12 months, after deducting buying and selling costs.

However, if you invest through a superannuation fund, different rules apply.

Use of trusts and other holding structures

An adviser may also be able to help you create structures that allow you to divide gains among family members with little or no income, so less or no tax applies. Earning income through a discretionary family trust, for example, allows the tax efficient allocation of income and capital gains between family members based on each beneficiary's personal taxation situation. Expert advice might save you tens of

thousands of tax dollars!

Impact of different marginal tax rates

When calculating the income tax benefits of a negatively geared investment, it is important to understand the effect of income tax rates. As tax rates fall, negatively geared investments may become less attractive.

With careful planning, though, even a relatively small tax saving can significantly impact on total profits.

Finally, have you considered that tax law may change?

A decade ago, if you invested in negatively geared property and your income was \$80,000 yearly, the 'tax man' might have subsidised your losses at the rate of 47c in the dollar (including Medicare Levy), leaving you to fund only 53c of each dollar lost. Today, most taxpayers will enjoy a tax saving of only 39c in the dollar (including Medicare Levy).

While you can claim investment losses as a tax deduction at the moment, government reviews of housing affordability might determine that allowing investors to claim losses against other income is inappropriate. Depreciation allowances may change. Capital gains tax might increase or the calculations methods could be altered. Rules allowing distribution of capital gains to family members on low incomes might change, or become impractical to use.

An adviser can also help you understand likely changes in tax law and how they may impact on you.

Unrealised gains and opportunity loss

Unrealised gains are those that represent an increase in value, but are not realised until the property is sold. At the end of year four, John's property may be estimated at \$750,000 in value, and so he has achieved a \$250,000 capital gain. Yet in real cash terms, he has made no actual profit as the property has not been sold. Only if the property was sold would the gain be realized and become a real return. It is

important to consider unrealised gains in situations where cash flow is critical. For example, if you are planning to live on the earnings from your investment property for a time, and have no other income, you might need to sacrifice long-term profits to preserve short-term cash flow. You could budget to borrow against unrealised gains to meet living costs, but you would then need to carefully consider the interest on that additional loan.

What if there is an unexpected downturn in the property market and the expected capital gain is not achievable? What if a government body resumes the property to build a dam or road or power line?

What if you have difficulty finding a tenant and the property is vacant for long periods? What if a tenant trashes the house? Insurance does not always cover the full cost of repair.

Negative gearing planning checklist

Before deciding that a negatively geared investment is proper for you, there are some important questions you, in consultation with your financial adviser, should consider:

- Will this investment move me closer to my long-term financial goals?
- What is my objective what do I want to achieve with this investment?
- Is this investment likely to make money, or reduce tax?
- What conditions must exist for me to make money from this investment?
- What annual cash flow or outflow will this investment generate?
- If the investment is negatively geared, can I afford the loss and manage cash flow shortages?
- What is my exit strategy if things go wrong?
- Have I checked all my calculations carefully, and sought professional

advice to verify that my plan is sound and my profit estimates are valid?

Getting the right advice

Investing in property can be highly profitable, and an excellent way to build wealth. There are, however, significant risks. Forecasting profits and estimating taxation is highly complex and requires expertise, especially if you are considering negatively geared investments.

The key considerations when considering a negative gearing investment strategy should be:

1. Does the asset promise strong capital growth over the planned investment term?
2. Is the short term tax benefit adequate to support short-term cash losses?

If the tax benefit is less than the short-term cash losses, can I comfortably afford to cover the balance of cash losses from other income or savings?

Because tax benefits can be critical to the viability of a negatively geared investment plan, negatively geared investments may be more appealing to higher income earners.

Always remember: the objective of a negatively geared investment should never be to save tax. If you are saving tax in this manner, you are, by definition, losing money! Your goal should always be to maximise after tax profits.

To maximise your profits and your enjoyment of following a successful wealth-building plan, partner long-term with a capable financial adviser who understands your personal financial situation and can guide your decision-making. The right adviser will provide valuable support as you progress on your journey to financial independence.

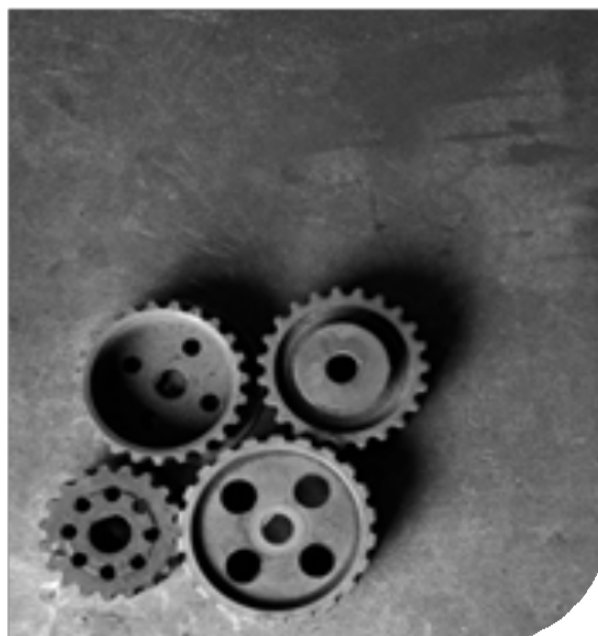
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Next you will find details on how to book an appointment with an adviser.

We look forward to meeting you soon.



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