eBook

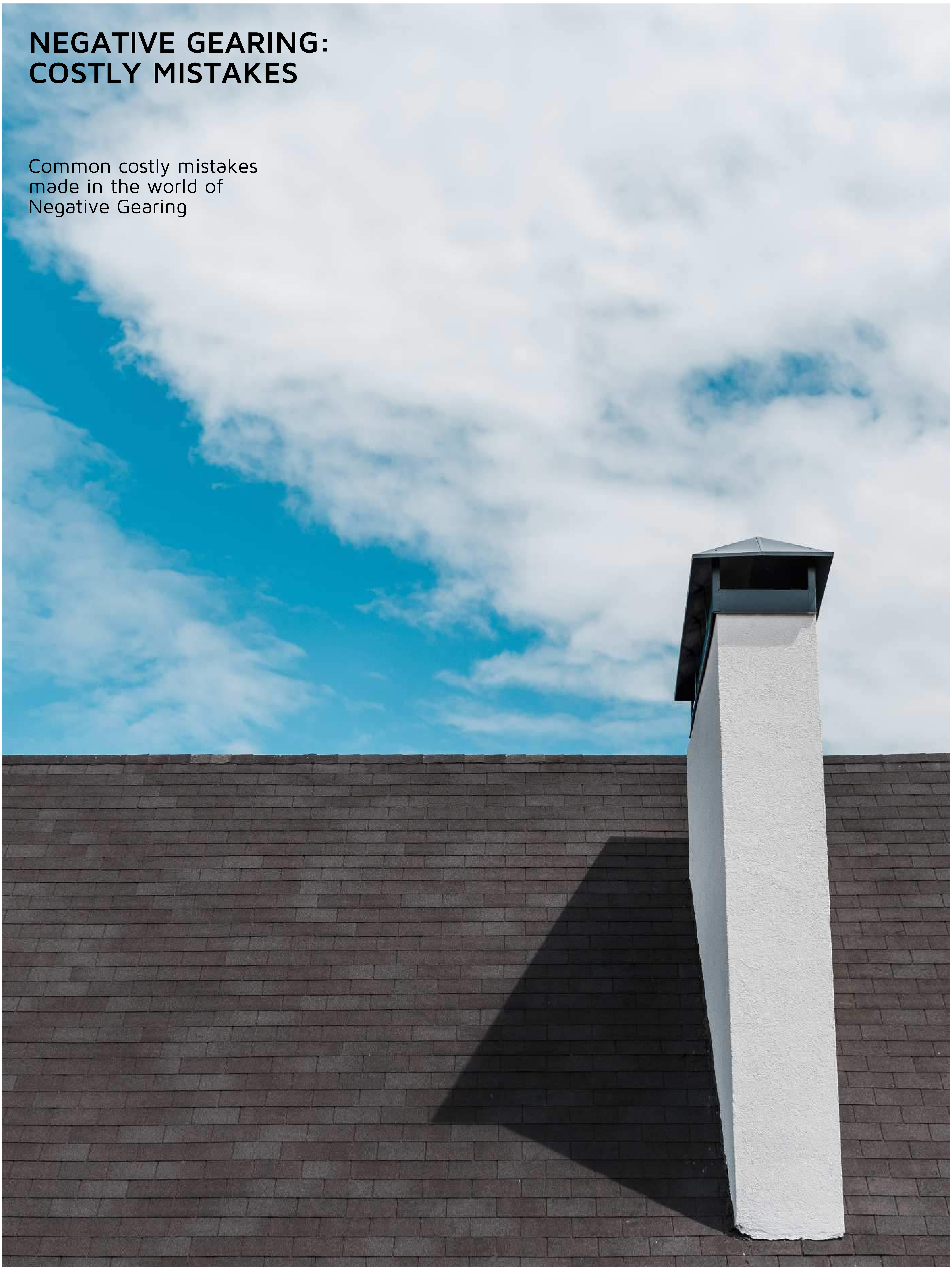
BUILDING ASSISTANCE AUSTRALIA

NO.001

PROPERTY PULSE

NEGATIVE GEARING: COSTLY MISTAKES

Common costly mistakes made in the world of Negative Gearing



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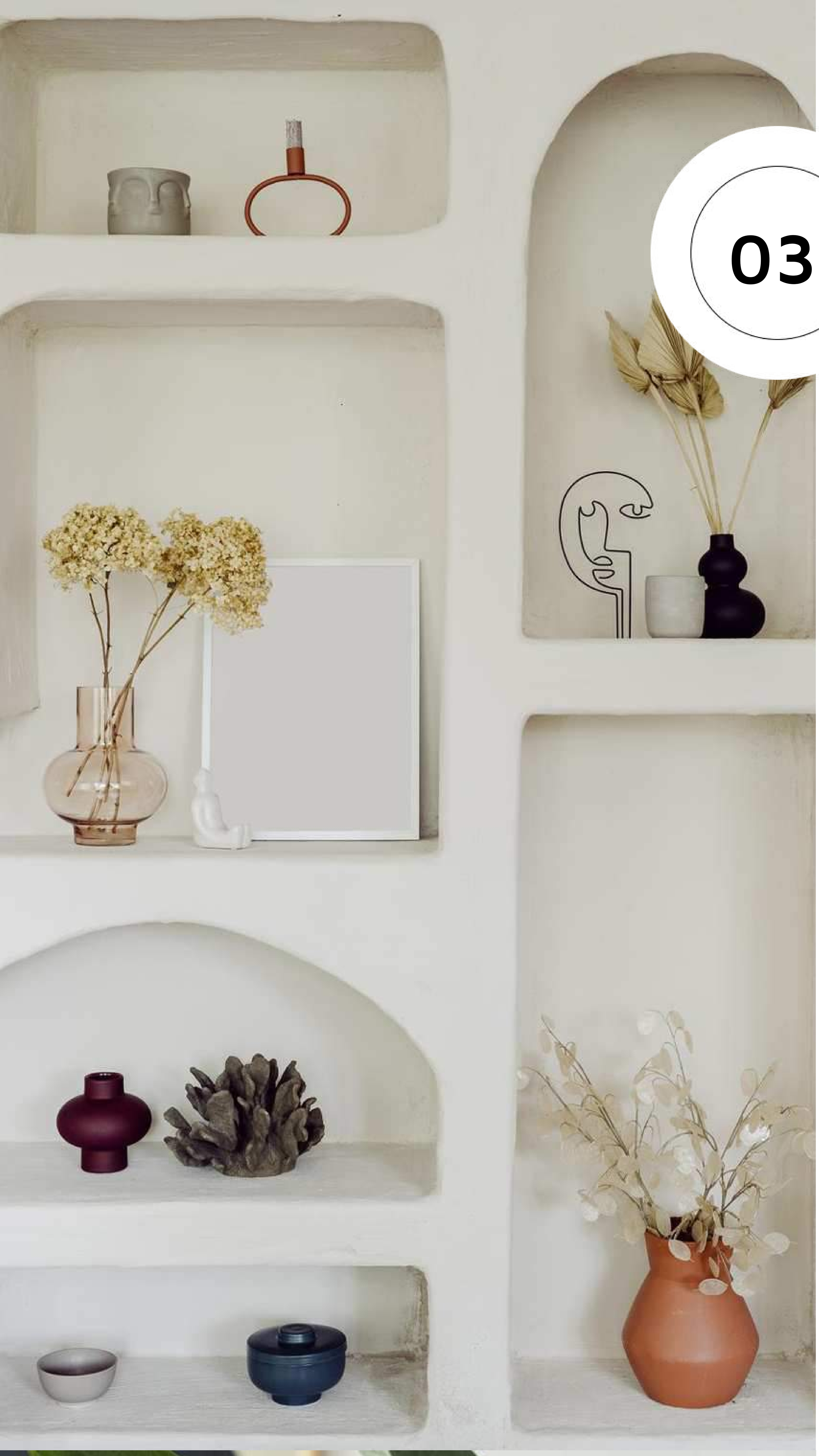

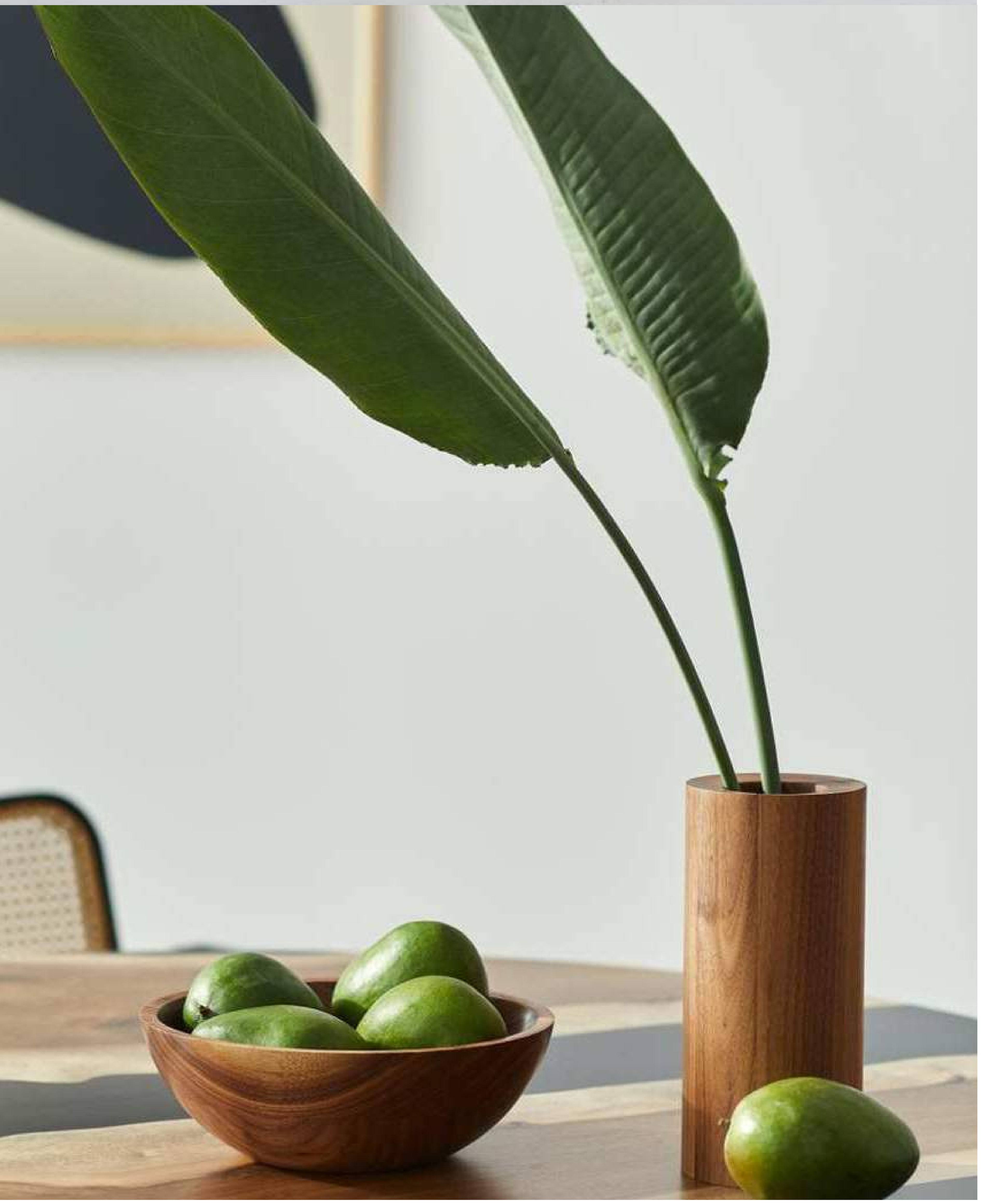

03 INTRODUCTION

A negatively geared investment is said to be one where interest on the amount borrowed is greater than the net income received from rental income through investment. Negative gearing can benefit many people by providing tax benefits.

Still, it is recommended to consult a professional tax advisor or accountant, as they can help you decide whether negative gearing is suitable for you according to your circumstances.

The investors can claim a tax deduction on the difference between the interest paid and the net income gained from the property.

The term negative gearing is getting popular as a wealth-generating strategy for building a portfolio with no money of your own and cutting down your income tax on income from other sources.

Negative gearing is an excellent way of wealth building for high-income earners. It can be used to invest in both shares and property.

This eBook will help you understand the concept of negative gearing concerning property investment.

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Property Investing and Negative Gearing as a Strategy.

Many consider property an alternative to other investments, especially regarding capital growth, tax benefits and future retirement income. As mentioned earlier, a large number of investment properties that have been purchased to create rental income are financed through the method of negative gearing.

For many, an investment property is like a business. You tend to rent or lease your property to someone to generate earnings. That earning is assessable for income tax. Moreover, you pay rates and taxes to maintain the property, and these costs are tax deductible. Only some people depend upon their own money to start up a business. Banks are happy to lend money for investment because they know the loan is secured. The interest on the loan is tax deductible if you borrow to buy your property.

The investment would be negatively geared if all costs incurred to maintain your property and interest on the borrowed amount are more significant than the income you obtain from the property. The loss can be claimed against taxable income from other sources as a deduction.

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Things to Bear in Mind.

Negative gearing has become popular in Australia. Property marketers and authors with experience regarding property and investment quote examples of people building wealth through a negative gearing strategy. They emphasize that these people avail tax benefits to finance their property purchases using no money. They will ask you to do the same thing. But you have to be careful in trusting them. Look for a property advisor who possesses knowledge of all the investment methods and can guide you according to your financial position. While quoting the examples, The lower income tax rates significantly affect the profit calculation for a negatively geared investment. The calculation methods of capital gains tax have changed as well.

You also must be aware of promoters because they may be getting attractive commissions to sell high-priced property or property with lower returns that are attainable with watchful and well-researched property selection.

As mentioned above, the negative gearing approach can be a brilliant strategy for growing wealth and reducing income tax, but many will contribute to this strategy's success. For instance, your earnings and other deductions decide the rate of tax you pay and the deduction's value for your investment loss. Always keep the possibility of solid capital gain in mind when deciding on a property.

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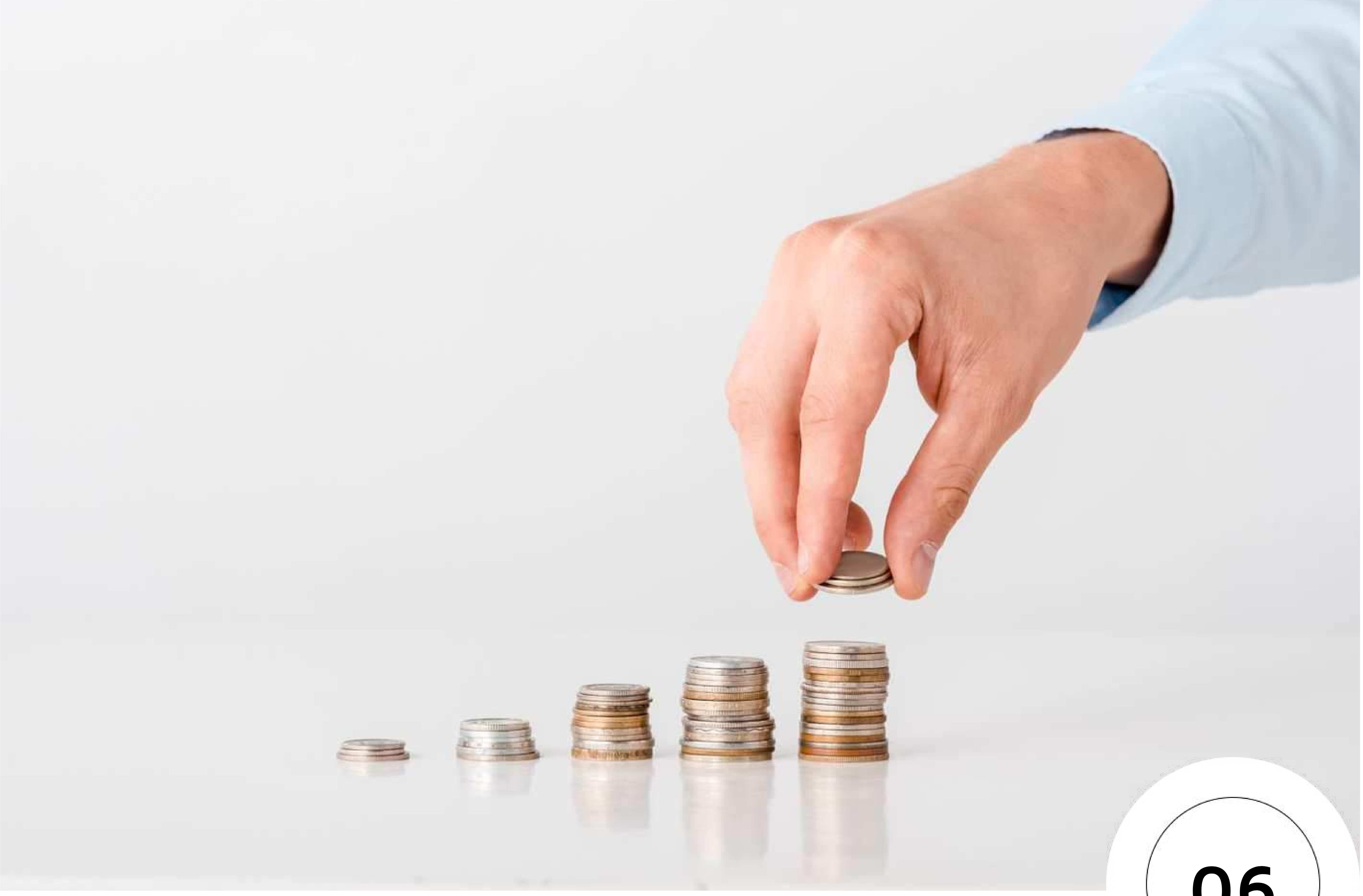

What, a Negative can be a Positive Outcome?

Most business operators want to ensure that their receipts always go above expenses. They approach the annual profits. The total interest, agents' fees and commissions, all rates and taxes, maintenance and other costs are less than rent receipts each year. If the total rental income, including the capital gain realized on the asset's sale, is greater than the sum of all costs, then the investment is said to be profitable. All costs of purchasing, retaining, selling, and taxes paid on the investment income and capital gain must be included in your calculations.

Income tax savings on income from other sources also add to the profits. Let's say you receive the salary and negatively gearing an investment property. Moreover, by making an income tax saving of $3000 annually on your salary earnings, you can add that amount to the income from your investment property. Sometimes, this tax saving can make up for losing investments and turn them into a profitable investment.

Example of Negative Gearing: John earns $85,000 annually, and 30% is his marginal tax rate. The amount of $200,000 has to invest, and his problem is whether to purchase a property worth $200,000 or buy a property of $600,000 with the help of borrowed funds.

The table next page represents the comparison of these different situations assumption of 4% capital growth and 6% interest rates. Tax rates as of 2023.

Property Investing and Negative Gearing as a Strategy.
Some Examples:

Property A: Invest $ 200,000 in a property without the use of borrowed funds.

Before Purchase		Holding the Property		Upon sale (after 5 yrs.)	
Earned Income	$85,000	Earned Income	$85,000	Earned Income	$85,000
		Rental Income	$8,680	Capital Gain	$55,555
		Less Expenses	$2,300	Taxable @ 50%	
Assessable Income	$85,000	Assessable Income	$91,380	Assessable Income	$112,777
Tax Payable	$18,092	Tax payable	$20,164	Tax Payable	$27,119
Net Income	$66,908	Net Income	$71,215	Net Income	$77,090
				Net Profit	$70,135

Property B: Invest $500,000 in property using Borrowed Funds

Before Purchase		Holding the Property		Upon sale (after 5 yrs.)	
Earned Income	$85,000	Earned Income	$85,000	Earned Income	$85,000
		Rental Income	$24,000	Capital Gain	$166,666
		Less Expenses	$9,000	Taxable @50%	
		Less Interest	$24,000		
Assessable Income	$85,000	Assessable Income	$76,000	Assessable Income	$168,333
Tax Payable	$18,092	Tax Payable	$15,166	Tax Payable	$47,349
Net Income	$66,908	Net Income + tax	$60,834	Net Income	$166,666
				Net Profit	$134,483

*For Simplicity, annual rent and cost increases are ignored in these examples.

Suppose John is comfortable covering the short-term losses on his investment property with $6,000 a year from his wage and salary income. In that case, his profits will be much more significant by using the negative gearing strategy with a possibility of solid capital growth.

You should purchase several properties, controlling the equity growth to bring more properties to your portfolio each year, as suggested by the promoters of negatively geared investment strategies. It seems attractive in theory. But if your money is being lost on properties in the short term, it can cause significant cash flow complications. One more thing you need to think about is your taxable income will get minimized to the extent that tax savings won't be possible if you are financing your losses with your tax savings.

Considerations To understand Negative Gearing

The following are the primary considerations when considering a negative gearing investment strategy.

1. Does the property guarantee strong capital growth over the aimed investment term?
2. Are the tax benefits sufficient to make up for any short-term cash losses?
3. Can the balance of cash losses from other income or savings be conveniently afforded if the tax benefit is less than the short-term cash losses?

Benefits can be crucial to the practicality of a negatively geared investment plan. Also, negatively geared investments seem to be more attractive to higher-income earners. Annual rent and expense increases are ignored in the examples mentioned above.

The increase in rent for property B would possibly compensate for the losses after a few years by improving the profitability of that investment, even though there would be no additional income tax savings when the total income surpassed the costs.

Another significant factor in the sample calculation has been left out. The Tax law permits you to claim depreciation on rental properties constructed or renovated later than 1985. 2.5% of the building or renovation costs can be claimed annually for over 40 years.

If property B is a recently built home, John might claim $12,500 depreciation, then $15,500 would be his annual loss, and $4,650 would be the income tax savings each year. Since the $12,500 is an estimated cost instead of an actual cost, he no more requires allocating cash from his salary to make up for losses on the investment property.

He has an extra $4,650 to spend every year and will yet be able to achieve the same substantial capital gain when he sells off in five years.

The Strategy of Negative Gearing to Invest.

Calculating depreciation benefits, tax savings, estimated rent, expense, and property value increases can be complicated. There are so many calculators available on some websites to calculate negative gearing, but it would be wise to consult a professional financial advisor having knowledge and expertise.
As it is clear from the examples, selecting the correct investment strategy can create a significant impact on your total profits. You can get the help of an advisor in understanding the possible changes in tax law and their impact on your investment.

The capital gains tax is calculated by applying your top marginal tax rate to 50% of your gain by the Australian Taxation Office if you have owned that property for more than 12 months, after subtracting buying and selling costs. However, different rules will be applied if you invest in a superannuation fund; capital gains tax might not impose.

A financial advisor may also help you generate ways to distribute gains among family members with no or little income; hence, no tax or less tax implies. If you get your earnings through a family trust, for instance, you may be able to schedule your sale to match the year your wife leaves off work for a baby, and you share out the gain between her and your children. The advice of an expert can save you thousands of tax dollars. It is essential to determine the impact of income tax rates while determining the income tax benefits of a negatively geared investment.

However, careful planning can prominently influence your total profits, even if it is a small tax saving. You have to keep in mind always that tax saving should never be the objective of a negatively geared investment. If you think you are saving tax this way, you are losing your money. Your purpose should always be to generate the most after-tax profits.

Cost of Loss and not Taking Gains

A professional advisor will also guide you about unrealized gains while considering your investment choice. An increase in the value of property results in creating these gains, but they remain unrealized until the property is sold.

John's property might have risen to $766,000 is worth, and he has attained a $166,000 capital gain at the end of the fourth year. However, in real cash terms, he has generated little or no profit, and there is no increase in his spending power.

It is also essential to consider unrealized gains in cases where cash flow is critical. For instance, if you are setting up to live on the revenues from your investment property for a time while having no other income, you might require to give up long-term profits to protect short-term cash flow.

You can have a loan against unrealized gains to satisfy living costs, but you would then have to consider the interest on that added loan cautiously.

John should also bear in mind that interest on his $200,000 would be earned if he merely left it in the bank and might discover other appealing investment opportunities, such as shares.

On the contrary, if he considers his profit on property A, he should reduce at least $10,000 yearly as the after-tax interest income he would have earned on his money. This is the "opportunity cost" of the investment.

You will realize that property A is no longer an attractive investment venture; besides, he carefully characterizes annual rent increases and depreciation allowance.

Investment Risks

After correctly calculating all costs, John might decide that property B gives a higher profit than the cash investment. At this time, he has to assess the risks associated with this investment. He has to consider the conditions, such as if he is having difficulty finding a renter and his property stays vacant for a long time or if a renter damages the house since insurance doesn't cover the entire repair cost.

Also, there can be an unpredicted decline in the property market, and the expected capital gain is not attainable. The factor of cash flow shortages is also there, particularly when considering multiple negatively geared investments to create a portfolio.

You have to be able to find the cash to cover your short- term losses. You may also suffer to pay a heavy amount of penalty interest and fees if you cannot service your loan. You could even encounter repossession.

The risk of the interest rate rise should also be considered. It would help if you showed flexibility while making your plan. Another thing you need to consider is that there might be some changes in tax law. When you plan to claim your investment losses as a tax deduction, the government's assessment of housing affordability might conclude that letting investors claim against other income is inappropriate.

There can be a change in depreciation allowances. Capital gains tax can be increased, or the method of its calculations could be revised. The rules regarding the distribution of capital gains to family members on low incomes may alter or become impractical..

Questions raised from Negative Gearing

There are some essential queries you have to keep in mind while consulting with your financial advisor before determining that the negatively geared investment is suitable for you. These queries are as follows:

- What are your goals? What do you want to accomplish with this investment?
- Will this investment help you make money or tax reduction?
- Can you bear the loss and maintain the cash flow shortages if the investment is negatively geared?
- Can you achieve your long-term financial goals with this investment?
- What annual cash flow or outflow will this investment produce?
- What conditions are mandatory for me to generate money from this investment?
- What is your exit strategy if things don't work correctly?

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Conclusion.

Property investments can be immensely profitable and an excellent way to create wealth. However, there are some associated risks. Predicting profits and guessing taxation is highly complicated, and it requires expertise when you are planning for negatively geared investments

It would be best if you relied on a professional financial advisor who can understand your financial position and guide you according to them to maximize your profits and make a successful wealth-generating plan. You will make progress on your road to financial independence with the support of the right advisor.

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These use historical data. Of course, past performance is not necessarily indicative of near- future results. We use this data to highlight long-term trends.

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The steps include:
Step one. Relationship.
Step two. Knowing the numbers.
Step three. The choices.
Step four. Recommendations.
Step five. Plan into action.
Step six. Working together as a team.

CONTACT US TO START YOUR RELATIONSHIP WITH OUR LICENSED TEAM MEMBERS