STRAIGHT TALK ABOUT "NEGATIVE" AND "POSITIVE" GEARING

You may have heard of the terms "Negative Gearing" and "Positive Gearing"?

The other term in this context that is not so well known is "Neutral Gearing".

It's important to gain an understanding of these terms as you consider building your future financial security by investing in real estate.

"Gearing" is a term used in the engineering world and in it's simplest form means that various gears are used to drive machinery. The family car is a good example. To move a stationery object to a speeding object requires the use of a series of gears that get you going and then increases speed until you reach the desired driving speed.

In the world of investing, gearing is used to purchase assets using a small "gear" such as a deposit to purchase a bigger "asset" like a rental property. Obviously if your starting "gear" is the full value of the purchase, then there is no gearing as such involved. You are right up to speed from the start!

Let's have a look at some simple definitions.

First, **"Negative Gearing"** occurs where the rental income is less than the expenses. E.g. you have $1,000 coming in in rent, and $1,200 going out in expenses, you are in a negative position.

Secondly, **"Positive Gearing"** is the opposite. You have more coming in than you have going out, e.g. $1,200 coming in, $1,000 in expenses going out. You are positive by $200.

The third scenario is called **"Neutral Gearing"**, and as the term implies, you have equal income and equal expenses.

Where these scenarios get very interesting, is the nature of various expenses and the way the Australian Tax Law treats investments.

Let's have a look at an example.

Let's assume that you have purchased a brand new home for $300,000. (Yes, you can buy brand new homes in Adelaide for this amount and even less in some cases!)

For the sake of our example, we will assume that the $300,000 includes all your buying expenses such as Stamp Duty, Legals and so on, and that you have borrowed the full amount using equity in your family home as a Deposit (see my article on "Straight Talk About Financing your Rental Property" for details on how to do this).

We now rent the property for $350 per week.

This our cash income will be for twelve months, $18,200. ($350 X 52)

The Tax Department will allow a number of cash expenses to be deducted from this rental income as you have incurred the expenses in earning the income. These expenses are things like: Council Rates, Water and Sewer Charges, Other Taxes, Management fees, Insurance, Repairs, Tax Agent's fees and so on.

Let's assume in our example, that these expenses come to $6,000 per year.

We now deduct these expenses from our income of $18,200.

This leaves us with $12,200.

At this point, **if this property was completely paid for**, it would be **POSITIVE GEARED.**

However, we did say that you had in fact, borrowed all the money So we now have to account for the interest charges, which are also a tax deduction against the rental property income.

Let's say you have borrowed the $300,000 at an interest rate of 7% per annum and you have elected to pay Interest only on this loan.

This will give you an interest expense for the year of $21,000. ($300,000 X 7%)

Remember, we had $12,200 left over from the rent after paying our Cash Expenses. So, we now deduct this from the interest payable and we find that there is a shortfall of $8,800.

At this point, our positive geared property is now **NEGATIVELY GEARED. And the amount it is negative, is $8,800.**

“But wait”, as the TV salesman would say, “There is more!”

There is yet a further tax deduction and this is a **non-cash** deduction.

This deduction allows for the normal wear and tear on capital items. It is too vast a subject for this article, but all of the appliances in the house can all be deducted, not by the full cost, but at a percentage rate set by the Tax Department.

Also, if the home has been built after September 1987, you are allowed a 2.5% deduction on the building cost each year for 40 years! For more details on the precise deductions we recommend you go to a Quantity Surveyor who can work all of this out for you.

For our example, let’s say you can claim $6,000 for the appliances and $6,000 for the building in the first year against the property.

We are already $8,800 negatively geared.

We now ADD the non-cash depreciation deductions to this figure and end up with a total NEGATIVE figure of $20,800.

This is where it gets really interesting, and we get the Tax Department to actually help us fund the investment through a **TAX REFUND.**

Here’s how it works: The $20,800 LOSS, is DEDUCTED from our Taxable Income.

This will give you a Refund from the Tax Department, depending on the Tax bracket you are in.

Let’s say you are in the most common bracket of 31.5%.

This example means you would be entitled to a REFUND of $6,552.

Remember, that the cash position in this example we had a shortfall of $8,800. We now reduce this by the Tax Refund of $6,552 and we are left with a true cash shortfall of $2,248, or just $43.23 PER WEEK!

Yes, it is still Negative Geared, but only by a very small proportion.

The other good news is that you can apply to the Tax Department to receive you refund in each pay packet. It is basically an Application Form where you show the figures as per our example, and they send you a form authorizing your paymaster to take less tax out of your earnings!

Here's the Tax Department link if you would like to have a look at the form: http://www.ato.gov.au/individuals/content.aspx?doc=/content/00189056.htm

Please note that the amount of the refund is governed by the Tax bracket you are in personally. This could mean your refund could be higher or lower than my example.

I trust this has been of help to you. Before taking any action, please be sure to speak with your Tax Accountant and other Professionals.

Or to discuss your personal situation, please call me on (08) 8254 3777.

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