All You Need to Know About Positive and Negative Gearing: The Essential Guide

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Welcome

At Horizon Property Alliance we're passionate about helping people like you, to build wealth and financial security through sound property investment strategies.

With 25 years' experience, we excel at finding the right properties to meet our clients' personal and financial goals.

We understand that property investment is not a decision taken lightly. It calls for careful consideration and arming yourself with the necessary knowledge to make well-informed decisions.

You'll find this introductory guide to property investment a really good place to start!

Michael Knights

Introduction

When considering property investment, there are many factors to take into account, like whether to enter into an investment that is positively or negatively geared.

Gearing is a term that is commonly thrown around and there are many opinions as to which strategy should be used.

In this eBook we explore the pros and cons of the debate. Let us start with the basics, what is gearing and what does it mean?

In general gearing refers to the borrowing of funds to invest in property or shares, with the intention to fast-track the development of wealth creation.

We are going to explore gearing as it relates to property investment:

Positive gearing

Positive gearing is when you borrow money to purchase an investment property and the income derived from that investment, eg rental income, is more than the expenditure required to maintain it, for example loan payments, interest, property maintenance and management fees etc.

Negative gearing

Alternatively negative gearing is when income received from the investment property does not cover the amount borrowed, interest payments and other expenses incurred. In other words, income is less than expenses.

How Gearing Works

Before purchasing a property for investment you must understand how that property fits in with your overall investment strategy - identifying whether it will be positively or negatively geared is an important way to determine suitability.

Positive Gearing

This type of gearing is also known as a "cash-flow property". This is because the investment provides ongoing additional income and literally pays for itself.

Positive gearing is generally achieved in a market when rental incomes are higher due to a greater demand by renters coupled with low interest rates.

Benefits

- Provides for ongoing additional income in your pocket.
- Rental income covers all investment expenses so there is no monthly outlay required.
- Mitigates impact of market fluctuations and other changes to your personal situation. With the right investment, potential interest rate rises could still be covered by rental income. Further, if your financial situation were to change, for example a loss of job or reduction in earnings, a positively geared investment pays for itself.
- An additional income stream is appealing to lenders if applying for additional loans.

Disadvantages

- You have to pay tax on the monthly additional income earned plus Capital Gains Tax at time of sale, if capital growth has been achieved.
- The type of investment properties that generate a positive cash flow can often be situated in rural or outer areas. This may impact a lower capital growth over the longer term.

How Gearing Works

Negative Gearing

“Capital growth properties” as they are often referred, are generally a longer term investment strategy. The anticipation of high level capital growth over time is appealing to investors who are willing to incur short term, tax deductable losses.

Negative gearing is generally achieved with investment properties situated in areas closer to capital cities, or even inner city areas, where growth is achieved typically over a longer period of time.

Benefits

- Ability to claim tax deductions on losses incurred, which in turn reduces your overall taxable income.
- Long term capital growth expectations, at time of sale, may significantly compensate for the losses incurred during ownership of the property.

Disadvantages

- Rental income won’t cover your costs, therefore you will have to come up with monthly payments to cover the shortfall in expenses.
- Profit is only achieved if the investment increases in value by more than the ongoing cash losses.
- You have to pay Capital Gains Tax on capital growth at time of selling.
- If circumstances change and you need to sell sooner than expected, capital growth levels may not cover initial outlay and monthly losses.

Case Study

The following case study demonstrates the difference between a positive and negative geared property scenario.

Source: ASIC Money Smart www.moneysmart.com.au

Rod and Karen are brother and sister and both earn around $70,000 per year. They are both thinking about buying an investment property worth $400,000. Interest on an investment loan will be 6% pa, payable on an interest-only basis. Additional property expenses are estimated at $5,000 a year. Rental income is expected to be $500 a week.

Rod will need to borrow the $400,000 needed to buy his investment apartment as he has no savings. Interest on the loan is $2,000 a month, which is tax deductible.

Karen has some money saved so she only needs to borrow $100,000 for a similar apartment. Karen's interest payment is $500 a month, which is also tax deductible.

	Rod and Karen's income before buying an investment property	Rod's negatively geared investment property	Karen's positively geared investment property
Salary	$70,000	$70,000	$70,000
Plus rental income	-	$26,000	$26,000
Less interest	-	- $24,000	- $ 6,000
Less property expenses	-	- $ 5,000	- $ 5,000
Taxable income	$70,000	$67,000	$85,000
Tax + Medicare levy	- $15,697	- $14,662	- $21,097
NET INCOME	$54,303	$52,338	$63,903

Assumptions:

- Example reflects the interest payable in the first year. Over time this will decrease but so will the tax benefits
- It does not take into account inflation, increases in rental income or changes to interest rates or income tax rates over time
- Capital growth is not taken into account as it does not affect income calculations. The same capital gain would be applicable under either scenario

Karen is positively geared so her income is considerably higher than Rod's. If Karen had left her money in a savings account earning 5% interest, her after tax income would be the same, however a savings account has no potential for capital gain.

Rod actually has less money in his pocket as most of his rental income is being paid to the bank in interest so he has to cover some of his investment expenses from employment income. He will be hoping a future capital gain will recoup his short-term income losses.

Summary

Interestingly, Australia is one of only a few countries globally that allows investors to negative gear, thus claiming tax deductions for losses incurred on property investment.

Industry commentary debates the issue, with those in favour of negative gearing, stating it keeps the market buoyant because more buyers are likely to invest in property if they can reduce tax by offsetting losses incurred.

The flip side questions the impact negative gearing has on first home buyers. This debate believes vigorous investing makes it difficult for first time purchasers to compete in the market.
Now that you know what gearing is and how it impacts on property investment, you can make an informed decision about your own investment strategy.

And remember there is "no one size fits all" investment strategy. The best strategy is tailored specifically to your own circumstance, objectives and goals.

How Horizon Property Alliance can help

The team at Horizon Property Alliance possesses an in-depth understanding of the property investment market. They bring a powerful combination of experience and professionalism to their clients.

Our mantra is about customer service.

We work with you and your financial advisors or will introduce you to highly skilled experts who will nurture you through the process. It's your choice.

We start by spending time with you to understand your financial goals and personal dreams. We choose the best property to suit your circumstances and educate you on the whole process.

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