Government Income Support

Assets test - If the investment is real estate the value of the real estate is reduced by the amount owing on the asset. For secured loans the asset value is the net value after deducting any amount still owing. For unsecured loans the outstanding balance of the loan may be deducted if evidence is provided that the loan was obtained for the purchase of that particular asset.

If the investment is a financial investment (shares, unit trusts etc) the asset value is the net value after deducting any loan amount still outstanding.

If the loan is secured against a person's principal residence, the outstanding value of the loan is not deducted from the value of the asset.

Income test - If the asset is real estate, a deduction of one third of the gross income plus the interest on the loan is allowed in the first year. If the cost is greater, evidence of expenses must be provided. Thereafter costs as shown on the owner's tax return are used with depreciation and some other costs added back. Where more than one property is involved the income from each can be reduced to zero by expenses from that property only. A loss on one property does not reduce the profit on another.

If the investment is a financial asset the full market value of the financial asset is assessed at the deeming rates to determine a person's income (no reduction is allowed for the debt). No allowance is made for loan costs, secured or unsecured.

Glossary

ATO - Australian Taxation Office

Deductions - Amount by which assessable income may be reduced for allowable expenses incurred in earning income. Can also apply to government income support

PAYG withholding payments - Tax deducted from salary and wage earners as they earn from their income (Pay as you Go)

Marginal income tax rate - Rate of tax payable on the last dollar of taxable income.

Tax offsets - Reductions in amount of tax payable as an incentive for certain actions or circumstances

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 LAST REVIEWED 09/10/08

National Information Centre on Retirement Investments Inc.

Negative Gearing

www.nicri.org.au

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INFORMATION CURRENT FROM 09/10/08

Negative Gearing

Negative gearing is the process where a person borrows money to invest and the costs of the investment are greater than the income received. Effectively, at least on paper, the investment makes a loss for a period of time. Frequently the investor may need to contribute money to the investment as the income received from the investment may not be adequate to cover the costs. Ideally however the asset would grow over time to add value to the investment.

The most common investments that are negatively geared are real estate, shares and managed investment trusts.

By gearing into an investment a profit is magnified because the gain is made not only on the investors' capital but also on the borrowed funds. Equally losses are magnified as the debt, interest and charges must be repaid.

It is important that investors have adequate income to meet their loan commitments in the event there is a shortfall in income from the geared investment. To maximise the benefits of gearing investors should be in the higher marginal tax brackets and have surplus disposable income.

These investment strategies are complex and professional advice should be sought before investing. Even the most researched and best intentioned advice may still result in a loss.

As with all strategies for investing negative gearing may not be suitable for all investors' particular circumstances, especially for some who are retired.

Features

- A tax effective means of wealth accumulation
- Enables the purchase of larger assets than if restricted to the investors' own capital
- Can reduce income tax liability (see taxation)
- Potential to achieve greater investment returns than without gearing

But Remember

- Disposable income can be reduced
- Losses magnified
- There are costs associated with borrowing
- Market values of the asset may fall causing loss in the value of the asset combined with a debt that must be repaid
- Income from the investments may vary and could even be nil or negative
- Disposal of assets at a reduced value may negate any tax advantages previously received
- Fees may be charged to buy and sell the assets
- Additional security may be called for in the event of adverse market movements
- Lender may request debt reduction in the event of adverse market conditions

Taxation

Income from the investments is fully assessable in the year that it is received. Usual *deductions*, *tax offsets* and credits apply.

The costs that may be claimed as a tax deduction include the interest charged on the loan, depreciation of the asset, rates, insurance, costs associated with inspection of property and other expenditure incurred in gaining income from the investment.

In the event of significant reduction in estimated taxable income, application may be made to the *ATO* to reduce *PAYG withholding payments*. This maintains the investor's cash flow. Otherwise a larger tax refund can be received on completion of annual tax assessment.

Financial Institution Costs and Issues

- Investigate loan options - interest only, fixed and variable interest rate loans
- Interest rates can vary with options chosen
- Fees can include commitment fees, establishment fees, loan service fees, account keeping fees and transaction fees
- Loyalty benefits may be available, though a cost may be associated with these