Should I negatively gear into an investment property?

One of the most common questions I am asked is, "should I negatively gear into an investment property?"

Like many questions, the answer is, "It depends."

So rather than preparing an article that is of no use to anybody, I thought I would prepare a few articles that will hopefully share some constructive insights that can help answer what it depends on…

The first common misconception is that of negative gearing. The correct terminology is "Gearing."

Types of Gearing	Brief Explanation
Negative Gearing	- Total expenses associated with the asset are larger than the income received - Therefore you make a net income loss - This loss can offset other personal income you receive which helps reduce your tax
Neutral Gearing	- The expenses of the asset equal the income of the asset. - No net gain or loss - No advantage or disadvantage to your tax position
Positive Gearing	- Expenses are less than income received - You make a net income gain - This gain increases your personal income and increases tax payable

Let's identify the common expenses:

- Interest on the loan – note principle loan repayments are not deductible,
- Ongoing property repairs & maintenance (not improvements),
- Body Corp fees,
- Agent management fees,
- Utility expenses: Service charges on gas, electricity, water,
- Rates, and
- Insurance – Building & Landlord's Insurance (ie to cover loss of rent or tenant damage).

So why gear?

Most people consider gearing primarily to help reduce their tax with a secondary thought to it assisting in growing their wealth. Some build a portfolio of properties whist others are happy to just own one. A number of people dip their toe in the water and find it not to their liking and sell within a few years.

Gearing is best thought of as borrowing money to invest – generally from a bank. Using the bank's money to help buy an asset you couldn't otherwise afford to fully pay for yourself is a pretty common strategy - we all buy our homes this way, so why not an investment? The attractiveness is even greater if the property value increases significantly – your gain is magnified (however losses are also magnified), and generally being able to claim a tax deduction for the interest paid on the loan.

Example of a magnified gain on a neutrally geared property sold after 10 years:

Purchase Value	$600,000
Loan amount (70%)	$420,000
Personal funds invested/Deposit (30%)	$180,000
Sale Value in 10 years	$800,000
Rent Received	$210,000
Interest Paid	($210,000)
Gain	$200,000
Return on initial $180,000 investment (deposit)	111%

Assumptions: Interest rate of 5.0% and rental return of 3.5%

However, as mentioned, the property may not increase in value, it may actually decrease in which case the losses are magnified to the same extent. If the property decreased in value by $200,000, you would lose all of your personal money invested as well as have a debt to the bank for a further $20,000.

Generally it is attractive to higher income earners who are impacted by the higher Marginal Tax Rates:

Tax Rate	Applies to income from	Tax Saving per $1,000 of deduction
32.50%	$37,000 to	$325
37%	$80,000 (proposed to be $87,000) to	$370
47%	$180,000+	$470

However, as outlined above, in order to claim this deduction you actually have to make an income loss on the property – this has a direct impact on your personal cash flow. However many people are comfortable wearing this in exchange for a (hopeful) future capital gain when they sell the property.

Wearing these losses by negatively gearing can be impacted further if:

- The property is vacant for some time
- The tenant fails to pay rent and you are uninsured, or the loss is beyond insurer limits
- The tenant damages the property
- Additional funding voted for capital works from a Body Corporate meeting.
- Unforeseen expenses such as stove, carpet or hot water service replacement.

The important consideration here is to gear within your means. You don't have to be negatively geared. Being as closer to neutrally geared prevents many issues if your personal cash flow is otherwise affected.

Pay a larger deposit and have a smaller loan!

Reducing the LVR (Loan to Value Ratio) can prevent many of the disaster we come across. All this means is instead of only "putting down" a 20% deposit – maybe consider a 30-40% deposit.

Let's look at how that works assuming a Property Value of $500,000:

Deposit	Loan Amount	Interest Payable	Rent Received	Gearing Status
$50,000 (10%)	$450,000 (90%)	$22,500	$17,500	Negative
$100,000 (20%)	$400,000 (80%)	$20,000	$17,500	Negative
$150,000 (30%)	$350,000 (70%)	$17,500	$17,500	Neutral
$200,000 (40%)	$300,000 (60%)	$15,000	$17,500	Positive

Assumptions: Interest rate of 5.0% and rental return of 3.5%. Whilst we are currently in a low interest rate environment, that will not always be the case – it was less than 10 years ago rates were over 7%. The effect of other expenses may also reduce the overall net rent received.

Saving up that little bit longer and paying that little bit extra provides beneficial breathing space that protects you from those uncertainties in life – this can be the difference of keeping the property for the long term and maximising your profits, or being forced to sell it under duress for less than you invested.

Consideration should also be given to the impact of Capital Gains Tax when you sell.

Assets held for greater than 12 months qualify for only 50% of the gain to be included in your assessable income. If you make a gain of $100,000, only $50,000 is assessed.

The tax impact of this $100,000 gain is as shown:

Marginal Tax Rate	Tax on gain	Net profit after tax
32.50%	$16,250	$83,750
37%	$18.500	$81,500
47%	$23,500	$76,500

So while there is a better annual tax saving, if negatively geared, with a higher marginal tax bracket, the tax upon sale is larger.

There are a couple of strategies to assist in reducing tax upon sale, such as waiting until retirement, or selling in a year where you earn less and fall into a lower tax bracket. There are also some superannuation strategies that may be appropriate.

This leads onto the second misconception; property always goes up in value!

Given time, the indeed many properties increase in value creating a nice gain. We have all heard the stories of people that bought a property for $40,000, 30 years ago which is now worth $500-600,000 or even $1 million!

There are many, many success stories. We all probably know of someone that has done well out of property.

However, not all properties sell for more than they were purchased for. Especially those that are not held for the long term.

Some people are forced to sell for various reasons:

- Relationship breakdown
- Loss of job, change of job
- Birth of a child
- Change of business conditions for those running their own businesses.
- Difficulty servicing the loan and other outgoing costs
- Interest rate increases – especially when coming off a "honeymoon" fixed interest period onto a much higher variable rate loan.
- Issues with tenants, property managers or body corporates
- Council and Government re-zoning.

In fact we come across people going through these issues quite frequently. We currently have clients that cannot sell a property they purchased in Gladstone during the mining boom – even at 1/3 their purchase price.

Be careful of property spruikers – we often come across people that have been stung from buying an apartment in QLD with rent guarantees. Often these rent guarantees are just built into the purchase price. Unfortunately, most people are more attracted by the idea of a tax deductible trip to QLD each year to "check on their investment property" despite the losses they are signing up to!

Other tips and traps:

- Use a reputable real estate agent for the property purchase and management.
- A property less than 40 years old should allow you to claim depreciation to help reduce tax.
- Try to remove the emotion and excitement of buying a property from the equation. Remember, it is a rental property, not your home. Look for something that will be easily rentable and provide steady income for many years.
- Buy in suburbs experiencing population growth. This may mean looking at suburbs you would never consider living in.
- Location (location, Location!!) – Proximity to quality schools & public transport are attractive
- Price:
  - $1m property attracts a certain tenant that is not always available. May be higher quality than someone that rents a $300,000 property, but it could be vacant for many months.
  - Is it better to have 3x $330,000 properties than 1x $1million property?
    - Spreads the risk of being dependant on 1 property
    - Reduced likelihood of all 3 properties being vacant at same time
    - $1m property is potentially subject to gain value at a faster rate
    - However $1m property may not always have a buyer
    - $330,000 property will always have a buyer, a 1st home owner or investor as well as tenants.
- Agent will take a sign-up fee on the lease. If tenant leaves after 1 year, or even breaks the contract and you are unable to recover monies, there is a new fee for leasing to a new tenant.

In summary….

Like all investment decisions, choosing to buy a property should be a well thought out process. Do your research and speak with professionals that can guide you in the right direction.

There are profits to be made. Obtaining the right advice can help prevent you falling into traps that impact on making a gain.

Importantly, if it seems too good to be true, walk away.

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