Negative Gearing

What is it and how does it work

What is it?

Negative gearing is a form of financial leverage where an investor borrows money to buy an asset, but the income generated by that asset does not cover the interest on the loan. The investor must fund the shortfall (from other sources of income or capital) until the asset is sold, at which point a profit is made if the capital gain on the asset exceeds the accumulated loss.

Tax rules for negative gearing

The tax treatment of interest expenses and future gain affects the investor's taxation return. Tax rules vary from country to country. Losses from negative-geared property investments are currently tax-deductible in Canada, Australia, and New Zealand.

Gearing in Australia

In Australia, negative gearing usually refers to borrowing for a residential investment (e.g. a house or unit) which is rented out. In most places rents are less than the interest on property value, and the investment thus results negative gearing if the investor borrows, for instance, 80% or 90% of the cost.

Tax treatment of negative gearing

Australian tax treatment of negative gearing is as follows.

- Interest on an investment loan for an income producing purpose is fully deductible, even if the income falls short of the interest. Any rental loss amount is offset against income from other sources, such as the wage and salary income of the investor.

Other rental expenses

- Ongoing maintenance and small expenses are generally fully deductible.

Fixtures and fittings

- Property fixtures and fittings are treated as plant, and a deduction for depreciation is allowed, based on effective life.

Capital works

- Capital works (buildings or major additions, constructed after 1987 or certain other dates) receive a 2.5% per annum capital works deduction (or 4% in certain circumstances). NB The investor's cost base for capital gains tax purposes is reduced by the amount claimed.

Capital gains on sale

On sale of investment property, capital gains tax is payable on proceeds less cost base. A net capital gain is taxed as income, but if the asset was held for 1 year or more than the gain is first discounted by 50% for an individual, or 33 1/3% for a superannuation fund. (This discount commenced in 1999, prior to that a cost base indexing and a stretching of marginal rates applied instead.)

Investor vs. owner-occupier

The property investor situation may be contrasted with owner-occupiers. Mortgage interest and upkeep expenses on a property used for private purposes (such as a residence) are not deductible. But any capital gain (or loss) made on disposal of one's primary residence is tax-free. (There are rules to apply when changing a property from private use to rented out, or back, and for what is considered one's main residence.)

Negative gearing example for a residential property

- Total purchase cost $420,000
- Amount borrowed $336,000 (80% LVR)
- Interest year 1 $23,520 (7.5% int only)
- Rent per week 380

Rental Income and Deductions Year 1

Rent income	$19,760
Less expenses	
Bank charges	$254
Commission	$1,976
Depreciation*	$10,500
Interest	$23,520
Insurance	$1,100
Roof repairs	$587
Water rates	$1,030
Total expenses	$38,967
Net rental loss	**($19,207)**

NB In cash terms the shortfall is only $8,707 i.e. loss of $19,207 with add-back of the non-cash expense of depreciation $10,500

Tax effect

- The whole rental loss amount of $19,207 becomes a deduction amount for Year 1 in the investor's tax return, which is off-set against other income
- Tax effect or tax savings for the investor on highest marginal tax rate of 46.5% is $8,931
- Net cash effect for the investor after tax is cash positive of $223 (i.e. cash shortfall of $8,707 – tax saving of $8,931)