Guide for Buying a Negatively Geared Property

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Introduction

As the small percentage of Australia's population who have achieved real wealth and financial independence will tell you, it's not always about how much you earn but what you do with your money that really counts.

Creating wealth through negatively gearing an investment property is a well established practice in this country with approximately 30% of residential properties owned by investors. If you were to believe some people it would all seem very simple. Buy the right property in the right location and then courtesy of the Government's tax concessions have the tenant and the Tax Office partially fund your running costs while you sit back and profit from the appreciating value of the property.

But can using property to make money be that simple?

The truth is, it only works when you have a combination of the right property in the right location, the correct tax advice and ownership structure plus the most suitable loan. Over the years many of our clients have grown their wealth by negatively gearing property but we have also seen some financial disasters. This country now has a 'property investment industry' with many self proclaimed property gurus but there is no substitute for independent, unbiased professional advice.

The purchase of your principal place of residence is often described as an emotional decision from the 'heart' but buying an investment property is a business decision that needs to be made from the 'head'. In business, 'failing to prepare is preparing to fail' which is why your property purchase needs to be thoroughly researched, carefully planned and most importantly, financially sound.

This booklet specifically relates to the negative gearing of a residential property. We assume you intend buying the property in your personal name or owning it jointly with your spouse or partner. We also assume that you are not a property developer, overseas resident or carrying on the business of rental property investment because there are additional, more complex rules that would apply.

Clearly, negative gearing isn't suitable for all investors. Your financial planner will tell you that in any financial planning or wealth creation strategy you need to match an investor's risk profile to the investment type, gearing strategy and time frame. The attraction of borrowing or gearing is that you can invest in a property that might otherwise have been unaffordable and take advantage of the tax concessions. Make no mistake, it can be a risky business because while gearing can amplify your gains, it can also magnify your losses.

This booklet is designed to give you an understanding of the key principles of buying a negatively geared property that you can then discuss with your accountant, solicitor, mortgage broker or buyer's advocate. It is general in nature and covers a broad range of topics including how negative gearing works, where to buy, the risks and the record keeping requirements. It offers you a 13 step checklist to getting started and you can read all about the tax treatment of expenses incurred when purchasing, maintaining and selling a property. It briefly addresses the complex mine field of capital gains tax and provides some tax tips and warnings along the way.

To illustrate the likely costs and tax treatment of the expenditure we have built in a case study that flows through the entire booklet from purchase to sale. The booklet also has worksheets so you can prepare some financial projections and 'what if' scenarios for the property. Finally, based on a number of assumptions we can prepare a 10 year cashflow forecast for a property and also project the profit and loss statement.

As your accountants we are here to guide you through the process and help evaluate the financial soundness of the strategy taking into account your objectives and taxation position. We are not your average accounting firm that just keeps the score. Rather, we want to work with you in conjunction with your financial planner to develop tax effective strategies that will help secure your financial future.

Regards

The History of Negative Gearing

The Australian Government introduced negative gearing in the early 1980's to encourage taxpayers to purchase investment properties to increase the availability of rental properties. By supplying housing for people who were not in a position to purchase their own home it would save millions of dollars in funding plus huge administration and infrastructure costs. With a growing number of the population renting, an under supply of rental properties would not only push rents up (giving rise to inflationary pressure and unhappy electorates), it would also put further pressure on the government housing supply. The initiative was also designed to stimulate the economy because so many industries in this country heavily rely on building, construction and development.

A quarter of a century later the landscape has changed.

Statistically speaking, Australians are living longer and having fewer children. The Australian Bureau of Statistics suggests that currently 84% of retirees have a family income of less than $21,000. At the same time, the 'baby boomer' generation is approaching retirement age and most of them will lean on the social security system. Unfortunately compulsory employer funded superannuation didn't start until 1991 when the first wave of baby boomers were mid-way through their working lives. Initially contributions were only 3% of their wage, growing to the current level of 9% by 1998. Courtesy of this planning initiative and some prosperous years in the new millennium, the outlook was positive until the 2008 share market 'crash' wiped out around 25-50% of their superannuation fund balances.

The global credit crisis and rising unemployment will mean we can expect to have many under-funded retirees and as a consequence, the Government continues to encourage self-funded retirement strategies including superannuation and negative gearing. However, history tells us that Governments (and change of Governments) can also mean policy changes and the tax concessions are not set in stone.

Negative Gearing Overview

Negative Gearing describes the situation where you borrow to buy an investment (most commonly property or shares) and the interest and other costs you incur to maintain the investment exceed the annual income you receive from the investment. This booklet specifically relates to the negative gearing of *residential property*.

A negatively geared property is where the interest and expenses to maintain the property (including depreciation, building construction write off etc.) exceed the rental income. The ultimate aim for most property investors is to build a portfolio of positively geared properties (where the rental income exceeds any running costs) that grow in value at a much higher rate than inflation. It is through negative gearing and the associated tax benefits that investors are able to purchase and accumulate real estate.

When buying a negatively geared property you need to understand some key principles including:

- A Tax Deduction is available because you are making a 'loss' on your investment. This implies a net cash outflow that you will need to fund from other sources
- Negative Gearing is attractive because of its tax advantages, however, the taxation benefits should not be the primary consideration behind the investment decision
- Capital Growth is the most important ingredient in successful property investing. You accept the losses in the belief that the future capital gain on sale will more than compensate you for those financial losses
- Promises of high rental returns are attractive but remember, the rent helps fund the loss but the capital growth is what builds equity
- Buying the right type of property in the right location is the key to long term capital growth
- When is the best time to buy? Property experts suggest you buy the best possible quality property you can afford, when you can afford it. 'Time in the market' not 'timing the market' is what really matters

The net result of a negatively geared property is a tax deductible loss. The tax benefit of the loss will then depend on the ownership structure and if an individual, the owner's marginal tax rate. Theoretically, the tax