PROFESSIONAL SERIES

TAX SECRETS

Negative Gearing Exposed

DYMPHNA BOHOLT

I LOVE REAL ESTATE

Negative Gearing Exposed

This may sound harsh, but it astounds me how people who are normally sound-minded, logical and intelligent will make irrational, emotional decisions when it comes to investing in property! Over the years, I have seen hundreds and hundreds of my clients make investment decisions while they are on holidays. They take a vacation and think, “Hey, I’d like to have a holiday house here!” So they go off and buy an ‘investment property’, i.e. they buy the ‘investment property’ they would like to live in. Unfortunately, quite often that investment property is going to be hugely negatively geared, and it has not been selected for its potential growth. Quite likely, it has been selected because the kitchen looks great or the colour scheme was good, or they have been persuaded by the real estate agent, or it’s around the corner from their friend’s investment property.

These properties commonly have had $40,000 – $100,000 of the investor’s equity, substituted equity, or actual savings invested in them.

Negative gearing has been part of the tax legislation for a very long time. It is the process of claiming a tax-deduction for the excess expenses relating to an income producing rental property against other taxable income.

The investor's goal is of course to have capital growth on their investment property, which outweighs any immediate negative cash flow effect.

Is buying negatively cash flowed property wrong'?

Absolutely not. It may be a desirable thing in your circumstance. Maybe your portfolio needs maximum growth, rather than income or serviceability. Maybe you are already very strong on income and are able to withstand some degree of negative cash flow in order to maximise potential growth. You simply need to give due consideration to what is right for your portfolio.

For instance, you may have a reasonable job in which you feel quite comfortable. You may have some savings as a buffer, and in five years' time you may want to be able to cut back to part-time work, or even potentially take a year off. That being the case, you may like to consider:

- Focusing on a combination of both growth and income properties.
- Avoiding placing huge financial cash flow drains on your present income.
- Focusing on growth properties that are as close to neutrally geared as possible, but still have potential for significant growth over the 5 year time span.
- Being conscious of cash flow, and not overextending yourself with growth properties.

These are the types of decision-making processes that every successful investor needs to become familiar with. You need to be able to work out your next step according to the goals in your business plan: Should you purchase a growth property? If it is going to be a growth property, how much negativity in the cash flow department can your current circumstances withstand? On the other hand, should it be a positive cash flow property? In the circumstance where you require the income from a positive cash flow property, to balance off a negatively cash flowed property, make sure you do your numbers, and that you have sufficient cash flow being generated by that property to counter the negative cash flow on your growth properties.

- You would also need to bear in mind that in focusing only on ‘cash cows’, you will eventually run out of equity to continue investing. It’s the growth properties that create the equity, but that’s a topic for another time.
- These are all financing considerations and limitations which seem to be swept under the carpet when someone’s buying an investment property. Interestingly, the successful purchasing of property comes down to being worldly or street smart, rather than who has the best (academic) education or the finance degree. Being able to assess the profitability of your property, business and/or investment is really very simple. The calculations are very straightforward and fundamentally come down to common sense:
    - How much income does my property investment generate?
    - How much do I have to spend on it?
    - Is it positively cash flowed or not?
    - Can I service it, if it is negatively cash flowed?
    - What do I believe my chances are of that property going up in value?
    - If I purchase this property, what do I think is going to happen?

Do you know what this is all essentially about? It’s about:

- you being a business manager
- you gaining sufficient knowledge and education through due diligence, studying, extra courses and seminars to increase your knowledge, so that you can determine the best thing for you to do next
- you understanding your budget
- you understanding the due diligence processes
- you understanding what your goals and aspirations are, and what strategies you can employ to achieve them.

That’s right it’s all about you! It’s about you and your objectives, ultimately. And, it’s a matter of selecting the best strategy that suits your ultimate objectives, along with your personality, to achieve your goals.

More than likely, your ideal portfolio and strategy for the future is going to incorporate a balance of both growth and income properties – manufactured or direct. Your strategy is not going to be solely one or the other. The fact is though, that you are never going to know what that ideal portfolio or strategy is, unless you start thinking about your future investments as a business.

Be worldly!

Be streetwise!

Have common sense!

Take the emotion out of investing

When I'm talking about taking the emotion out of investing, I'm realistic enough to know that this won't apply to your principal place of residence (PPR). That is usually a lifestyle decision and maybe even a potential investment decision.

Factors such as children's schooling and proximity to amenities, where you like to live, even down to the colour of the kitchen, etc., tend to be more acceptable as decision-making factors when purchasing your PPR. What I am talking about is taking the emotion out when you are purchasing an investment property - that's what it is: an investment. Therefore, the decision-making process should be more about the numbers, the analysis, the statistics behind why you are making that decision, and what you are endeavouring to achieve for your portfolio - and less about your emotions.

"Do not make an investment decision based solely on tax - it should be a good investment first - tax efficient second "

I'll put it this way - how many people would actually buy a business that lost money every year? Truly, that's what happens to thousands and thousands of property investors. They buy properties that don't cash flow. Some of them buy properties that cost them money every single week!

Now obviously they justify this decision by rationalising, "Oh, but property goes up in value." Yes, that's true, but when I have quizzed my clients on the decision-making process as to what due diligence has led to the selection of one particular property over another, or on what rationale they have calculated the potential growth of one property over another, they are left speechless.

I know clients who have five or six negatively geared properties, which means they have got to service the negative cash flow from their other income – whether it be a wage or a salary or passive income that they may have been able to achieve on other property. This type of investing behaviour only ties them to a job and keeps them in the rat race for life. If you want to have choices, have lifestyle, have early retirement (whatever that means), and have the life you want, you have to be a much more savvy investor than just buying one negatively geared investment property after another.

In most cases, the investment decision-making process has been an emotional one, not a business one. Are you getting the picture I am painting for you yet?

What do you think that same holidaying couple would do if they were presented with a business purchase which required a capital or equity investment from them of between $40,000 - $100,000? Would they do it because they liked the colour of the prospectus or the vendor's hair colour or because their friend said so? With $40,000 - $100,000 at stake, we know that couple would want to be completely informed about the investment.

In fact, far more due diligence would be done, and their rationale for assessing that business would be completely different, wouldn't it? Of course it would! They would want to know the potential return of the investment – not just now, but into the future. They would want to know the latest growth statistics of that particular market. They would want to know the likelihood of the investment not being able to return an income at any point in time, and whether or not they could service the debt. Now, compare this to purchasing 'investment property' because the kitchen looks good or your friend said so!

Can you see my point?

Create a plan

What any astute investor needs to do is put together a plan - a business plan for their personal financial future. Your financial future is a business, so treat it with the same respect you would if you were buying a business.

Without having a plan, you are inadvertently planning to fail. You need to treat the purchasing of property as a business because any individual investment purchase is a business.

Think about it - a business has income, it has expenses, it has growth, hopefully, and you have either a profit or a loss at the end of the day. A property is no different. It too, has income and expenses. It too, has the potential to go up in value.

In both, you invest considerable amounts of time, money or equity, so why wouldn't you do all the necessary due diligence and analysis regarding the purchase of property, as you would if you were buying a business? Get very clear that you are in the business of purchasing investment property, and as such, you are entitled to the tax-deductions awarded to businesses.

When you run a business, all your expenses related to that business are tax-deductible against the income of the business. This is the same when you run an investment property business. All your expenses or interest on the mortgage, council rates, insurance, body corporate, management fees etc., are all deductibles offset against the income the property earns.

The extra benefit and tax boost that you get when you are in the business of investment properties, is a tax-deduction for not spending any money!

No, I'm not going crazy.

The taxation legislation since 1985 has allowed a tax-deduction for the diminishing value of your asset; being the building and specifically the fixtures and fittings of that building.

It's called 'depreciation'. It's a tax-deduction based on a Tax Office approved formula which you get regardless of the fact that you are not actually spending money on your investment property.

The depreciation benefit is a short-term benefit, as any tax benefits you gain whilst you own the property are added back into the calculation for calculating Capital Gains Tax on the property when you sell it. However, even though this is the case, maximising your depreciation tax-deductions while they are available means that tax is ultimately deferred to when you sell the property. This could be way into the future, and even when the property is eventually sold, the tax liability would be halved due to the 50% Capital Gains Tax exemption available on sale, provided the property has been owned for more than 12 months and in a tax efficient structure or entity.

"Depreciation is the deduction you get without spending any money"

It's a crazy concept - getting something from the Tax Office for nothing. Well, almost nothing. They do give you a little sting and have the final say when you sell the property.

Some people are vehement supporters of negative gearing and others are vehemently against negative gearing. I am more on the vehemently against – but still recognise in some circumstances, negative gearing is necessary to achieve good growth on desirable properties. I believe negative gearing is something that can be very, very useful in certain circumstances, whereas in other circum-stances, particularly when overused, it can leave the investor cash-strapped and on the verge of going bankrupt.

I believe the ideal use of negative gearing is when a property fits certain criteria. That criteria is when the property is actually cash flow positive yet cash negative for tax purposes. If your investing goal is income replacement, forget the negative gearing and concentrate on cash flow positive with manufactured growth, to allow for continuity of investment.

The style of property that fits the cash flow positive but tax negative criteria is usually a property that is either new or near new or has had major renovations carried out on the property recently, and these capital improvements can be quantified with a quantity surveyor report. This way, the free tax-deductions for depreciation can be maximised, and therefore the negative gearing tax benefits are high, but the cash flow can still be positive in real terms. Let me show you an example of how this works.

Example:

Let’s assume we have an investor with a salary of $45,000, who is considering buying an investment property worth $225,000.

Let’s also assume that he will be paying an interest rate of 7% and that by using equity available in his home, he is able to borrow and claim a full tax-deduction for 100% of the purchase price plus costs.

Example:

Purchase Price	$225,000
Legal Fees	$650
Stamp Duty (estimate)	$6,400
Loan App. Fees	$2,000
	$234,050
Interest rates 7%	
Rental Income	**20,000**
Less	
Interest Payment	$16,380
Rates	$1,200
Body Corporate Fees	$765
Management Fees	$1,700
Letting Fees	$350
Insurance	$200
Maintenance	$20,980
Net Annual Cash Shortfall	**$980**
or	**$18.85 per week**

So on the face of it – this property is negatively geared - although only slightly.

However, the above calculation does not take into account any depreciation which may be able to be claimed on this property, nor does it take into account the tax-deduction which can be claimed over five years for the borrowing expenses.

Let's have a look at how these additional losses are calculated.

Example:

Depreciation:

Deprec. on fixtures and fitting $20,000 @ 20%	$4,000
Deprec. on building $104,000@ 2.5%	$2,600
Deprec. on fixtures and fittings $2,500 @ 100%	$2,500
Amortisation of borrowing costs	$9,100
Borrowing costs amortised over 5 years	$400
Total depreciation losses	**$9,500**

Paper Losses

You will notice that some fixtures and fittings have been claimed at a depreciation rate of 20% whereas a small amount of fixtures and fittings have been claimed at 100% depreciation. This is because some items can be expensed fully in the first year of purchase. Obviously, this deduction would not be available to the investor in the second or subsequent tax years.

When you take the actual cash flow shortfall and the paper losses into account on the next page, you will see how our investor's tax would be affected. On first appearances, this property appears to be cash flow negative. However, when the tax effect of the paper losses is taken into account, the property is actually positively cash flowed by $73.92 a week.

Example:

Gross salary	**$90,000**
Less Deductions	
cash shortfall	$980
- paper losses	$9,500
Adjusted Taxable Income	**$79,520**

This means that instead of paying tax on a salary of $90,000, our investor will pay tax on $79,520. Here is what the net tax saving will be to our investor for owning this property in the first year.

Tax payable on $90,000	$ 21,247
Tax payable on $79,520	$ 17,391
Tax saving	**$ 3,856**
	or $74.15/wk

*Figures exclude medicare levy

Ideally, if investors have a good, strong income from salary, business or investments, choosing this style of investment property provides them with the best of both worlds. That is, a tax-deduction to help reduce tax payable on their other income, and a positive cash flow which can be used to support living, lifestyle or further investment.

This really is, having your cake and eating it too!

Negative gearing nuances

I am often asked the question, “Why can’t I utilise the benefits of negative gearing and not hold the asset in my own name for asset protection purposes?” Well, there have been many structures set up using hybrid trusts to do exactly that. The difficulty is the Tax Office has constantly narrowed the use of such a trust with legal cases like FC of T v. Janmor Nominees Pty Ltd 87 ATC 4813; (1987) 19 ATR 254 and a more recent case Fletcher & Ors v. FC of T 91 ATC 4950 as well as other private rulings, to the point where the use of a hybrid trust for negative gearing has become dubious at best, and highly risky at worst.

This is how it works.

Negative gearing through a hybrid trust

A taxpayer with a high salary and equity in his/her own home can use the equity to get a loan for the deposit on an investment property. Instead of using the equity as a deposit directly on the new investment property, the taxpayer can subscribe to income units in a hybrid trust. The unit trust in turn uses the funds as a deposit on the desired investment property, and the hybrid trust then borrows the additional monies required to purchase the property from a bank. This way, the taxpayer can benefit from expenses as a unit holder in the hybrid trust, and claim any negative gearing against his/her taxable income.

Example:

David buys a property through a hybrid trust for $300,000. He borrows $60,000 against the equity in his home from a bank, and with the $60,000 buys 60,000 units at $1.00 each from the hybrid trust. The remaining $240,000 needed to buy the property is borrowed from the bank through the hybrid trust, using the $60,000 as the deposit. Let's assume the interest rate is 8%, and that the trust rents the house out for $300 p/w and has income and expenditure for the year as follows:

Rental Income	**$ 15,600**
Less	
Management Fees	$ 1,170
Rates	$ 1,100
Insurance	$ 500
Depreciation	$ 2,500
Interest	$ 19,200
Total Expenses	**$ 24,470**
Loss	**$ 8,870**

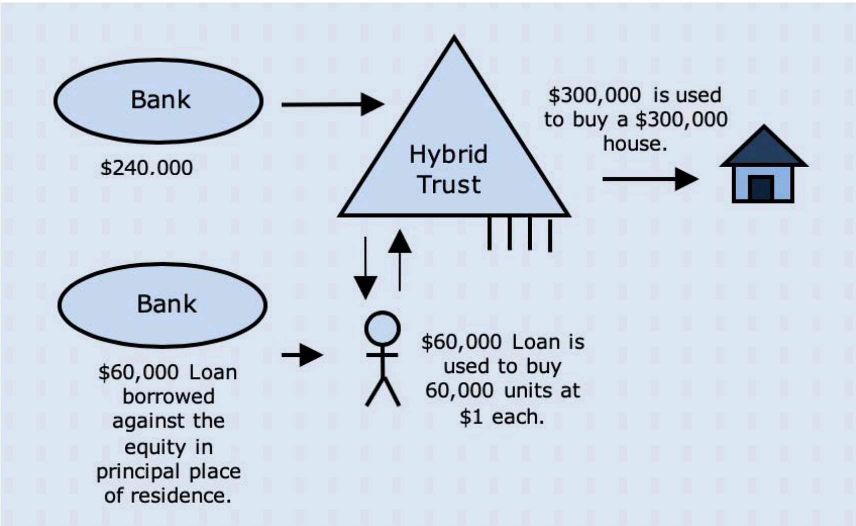
The loss from the hybrid trust cannot be distributed to unit holders, so the loss has no benefit to David's immediate tax situation. It can however, be accumulated and offset against future income earned by the hybrid trust. However, because David borrowed the $60,000 that he purchased the units with, any interest and bank fees can be negatively geared and claimed against his taxable income.

Example:

Salary	$78,000
Tax Payable	**$16,897**

With 60,000 units purchased in a hybrid trust:

Interest on $60,000 Loan @ 8%	$4,800
Salary after Deductions	$73,200
Tax Payable	**$15,337**
Tax Savings	**$1,560**



*Figures exclude medicare levy

Now let's step up the game here a little.

If David had borrowed the entire $300,000 and bought 300,000 units in the hybrid trust, the proceeds of which would then be used to purchase that same house, and he was able to structure a lending facility with his bank or financial institution such that the bank accepted the new house being purchased in the trust, as partial security for the loan, the result would have been quite different. A greater tax-deduction from his taxable income would have been able to be claimed even though the hybrid trust would have made a taxable profit which would need to be distributed.

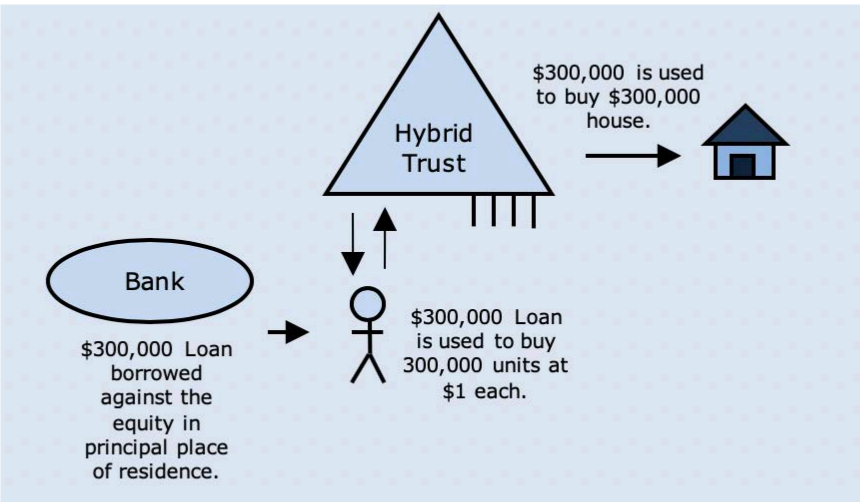
This is how the figures would work:

Example:

Salary	$ 78,000
Trust Income	$ 10,330
Total Income	$ 88,330
Tax Payable	**$ 20,629**

With 300,000 units purchased in a hybrid trust:

Interest on $300,000 Loan @ 8%	$ 24,000
Salary after Deductions	$ 64,330
Tax Payable	$ 12,454
Tax Savings	**$ 8,175**



*Figures exclude medicare levy

This is how the Hybrid Trust income with the previous arrangement would look:

Example:

Rental Income	**$15,600**
Management Fees	$1,170
Rates	$1,100
Insurance	$500
Depreciation	$2,500
Total Expenses	**$5,270**
Profit	**$10,330**

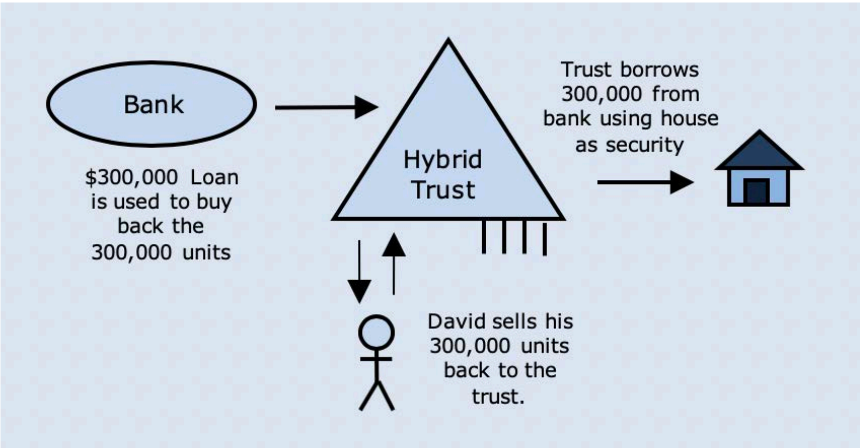
The after-expenses income of the trust is distributed to David as a return on his income units. Whilst the flexibility of a hybrid trust normally does allow distributions to be made to other lower income earners, I believe all the income should be distributed to the owner of the hybrid trust units, as this would be the situation if the property was owned directly in the taxpayer's name.

Also, whilst the income of the hybrid trust could have remained undistributed in the trust, and the trustee could have paid tax on behalf of the trust, this would have been a ridiculous decision, as the trust would have paid tax at up to 66%, which is a much higher tax rate than David, our taxpayer.

To further this scenario, after a number of years, David might decide that he would like to sell his 300,000 units back to the trust so that he can either pay back the balance of the loan or use the money to buy something else.

Example:

David sells his 300,000 units in the hybrid trust back to the trust on money that the trust has borrowed from the bank.



The bonus with this arrangement is that David gets his $300,000 back tax-free, because he is not making a profit on the units – the trust buys them back at the same price that he bought them for. Additionally, the trust can now claim the interest being paid on the loan for the purchase of the units as a tax-deduction all over again!

At some stage, as trustee for the hybrid trust or rather, as director of the corporate trustee, David might decide to sell the property. As it was bought in a growth area and over the years has been improved, it has made a capital gain, which of course means that the trust will have capital gains to distribute. At this point, rather than distribute the gain to himself and have to pay the high marginal tax rate on the capital gain, it would be more advantageous to distribute the money to low income beneficiaries such as his wife (who currently has no income), or to his children, so as to take advantage of a lower tax rate, and thus reducing the Capital Gains Tax payable.

Now all that sounds really good doesn't it?

A big fat warning!

Well, here is a HUGE WARNING! The future of such strategies is unclear, and before entering into this type of arrangement, you should seek the advice of your accountant and even apply for a private ruling on your particular set of circumstances. A private ruling is binding, so if the Tax Office says it is OK in your circumstances then go ahead, but if not, well, you have your answer.

The cost of a private ruling is really only the cost of time spent by your accountant preparing the appropriate wording of the paper, and stating the correct legal argument so that the result can be relied on when given from the Tax Office.

Other areas of concern

There is also another school of thought that says, if David wants to claim the negative gearing tax benefits from the purchase of the property in a trust – he should not only subscribe to income units but should also have some growth units attached to his initial subscription for units. This would mean that the growth/capital gain, when either his units are redeemed and/or the property is sold, would be distributed to him.

I believe that money to be made from the investment in real estate and the pro-active strategies to accumulate wealth and replace income should be the driving force behind investment decisions – not tax. Tax should be legally minimised, of course, but the fundamental rationale should be to make money.

Depending on what type of property you buy, and what the yield is on the property, the negative gearing benefits usually only last for about five years – after which the property is probably neutral or cash flow positive anyway. At this time, positive cash flow will be taxed at the taxpayer's marginal tax rate which is probably high. At least if the property is in a trust you have the flexibility to place the income anywhere the trustee sees fit.

I certainly would not be setting up a hybrid trust for negative gearing purposes, nor would I like to be the accountant that is setting one up for a client. I believe the ATO treatment of them is too shakey. I wouldn't want to be another Bamford and end up in the high court.

To find out more **call (03) 9490 8888** now or go to **www.iloverealestate.tv** to register for our next **FREE Webcast** where you'll discover the strategies, techniques, structures and support you need to successfully invest and prosper from Australian real estate.

Yours in success,

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Dymphna Boholt

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