How to

max out your tax benefits through negative gearing

Negative gearing has long been used by spruikers to lure unsuspecting investors wanting to make a quick buck in property. But while the strategy can offer substantial tax relief, it can also result in massive losses. *Michael Quinn*, lawyer, accountant and director of The Quinn Group, shows how to make it work for you

While negative gearing is most commonly associated with property investment, it can also apply to the investment of other assets such as shares or bonds.

The term 'geared' refers to any investment that is purchased with the assistance of borrowed funds. Thus a 'negatively geared' investment is one that is purchased with the assistance of borrowed funds and, after deducting other expenses, the net rental income is less than the interest paid on the borrowings in any income year.

At first glance, it is understandable that you might think to yourself: "Why would anyone buy an investment that is losing money?"

But the benefit of this situation is that, where negative gearing is concerned, the entire shortfall amount can be deducted against the investor's other assessable income. The fact that, historically, property prices continue to rise over time is equally beneficial to the investor as, in the long term, it is likely that the investment will generate a capital gain.

There are two important things to note when considering whether negative gearing is appropriate for your situation.

First, you must have other forms of assessable income in order for this to work. Otherwise, you simply incur a loss as there is no income to offset it against.

And secondly, the investment is purchased with one of two possible outcomes in mind.

Either there is the expectation that current losses are going to turn into profit over time, or it is sold for a capital gain which is big enough in total to cover all past losses incurred.

A good investment is, above all, designed to create a profit.

While negative gearing initially provides tax breaks, both the ongoing profit and capital gains options eventually have to generate a profit and – as a result – a taxable income amount, to be effective.

So, you need to be confident that one of these two options is likely, based on your investment choice.

If, upon assessment, these outcomes are unlikely, negative gearing is probably not a wise option and you would need to assess whether the investment itself is, in fact, a good one.

It's also not possible to negatively gear an investment that does not produce an income.

Under sec 51 of the *Income Tax Assessment Act 1936*, you cannot claim as deductions any expenses incurred on an asset not producing income.

In addition to the tax breaks, the investment continues to make capital gains during this time.

What expenses can you claim?

In order to maximise your total tax-deductible amount at the end of the financial year for a property that's negatively geared, there's a range of expenses that can be included in the total annual cost of the property for deduction purposes.

1 Prepaid expenses

It's possible to claim any prepaid expenses that are related to your income-producing asset.

If the payment covers a period of 12 months or less and the period ends on or before 30 June, the expense can be deducted immediately for that income year. But, if the repayment is for more than a 12-month period and more than $1,000, it may need to be spread over two years or more.

Examples of expenses that can be prepaid include costs associated with preparation of leases, payment of interest, insurance, rates and body corporate fees.

2 Borrowing expenses

These are expenses directly incurred in taking out a loan for your property. They can include establishment fees, valuation fees, title search fees, costs of preparing and filing mortgage documents, stamp duty charged on registration of the mortgage and mortgage insurance (where applicable). Interest costs do not qualify as borrowing expenses.

If the total cost of these items is over $100, the deduction is spread over five years or the term of the loan, whichever is the lesser. If the total cost is $100 or less, it is fully deductible in the first year.

If you repay the loan early, and in less than five years, you can claim a deduction for the balance of the borrowing expenses, in the year of final repayment.

If you obtained the loan part-way through the income year, the deduction for the first year is apportioned according to the number of days in the year you had the loan.

> The fact that, historically, property prices continue to rise over time is equally beneficial to the investor, as it's likely that the investment will generate a capital gain

3 Mortgage discharge expenses

Provided that the mortgage was used as security for the repayment of money borrowed to produce assessable income, the costs of discharging the mortgage are deductible in the year they are incurred.

4 Legal expenses

There are a number of legal expenses which are deductible under various sections of the Income Tax Assessment Act.

The most important of these are associated with the preparation of leases, the registration of patents, designs and copyrights, and debt collection fees. This can also include the costs involved in evicting a non-paying tenant.

Most legal expenses are of a capital nature and are, therefore, not deductible. These include costs of processes such as purchasing or selling your property, resisting land resumption and defending your title to the property.

For capital gains tax purposes, however, non-deductible legal expenses may form part of the cost base or reduced cost base of your property.

5 Deduction for decline in value of depreciating assets

From 1 July 2001, the uniform capital allowance system (UCA) applies to

How does it work?

Using an investment property as an example, a simple application of negative gearing can be demonstrated as follows:

Sarah purchases a house as an investment for $400,000. She has borrowed the entire amount at 10% pa interest, making the annual interest repayments a total of $40,000.

If the house is rented out for $400 a week, this gives Sarah an annual rental income of $20,800. The cost of the rates, home maintenance, insurance, agent's fees and so on total $5,000 a year. She can also depreciate the property at a rate of $5,000 per year.

Mortgage interest	**$40,000**
Rates, maintenance, etc	**$5,000**
Depreciation	**$5,000**
Total expenses	**$50,000**
Rental income	**$20,800**
Total loss	**$29,200**

The shortfall of $29,200 ($50,000 minus $20,800) is tax deductible from Sarah's gross income at the end of the financial year when assessing her taxable income. This results in a considerable tax saving for Sarah while she holds the investment.

Sarah's tax refund

30c tax threshold – $8,760; 40c tax threshold – $11,680;
45c tax threshold – $13,140

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Assets claimable as depreciable include airconditioning units, electronic security systems, rainwater tanks, TVs, antennas, roller-door motors and washing machines

most depreciating assets, including those acquired before that date. The UCA consolidates a range of former capital allowance provisions, including those relating to plant and equipment by providing a set of general rules that applies across a variety of depreciating assets and certain other capital expenditure.

You can calculate deductions for your depreciating assets' decline in value using these new rules, and then deduct an amount equal to the decline in value for an income year of a depreciating asset that you held at any time during that year.

Examples of assets claimable as depreciable items include electronic security systems, airconditioning units, rainwater tanks, roller-door motors, television antennas, television sets and washing machines.

6 Low-value pooling

You can allocate both low-cost assets and low-value assets to a low-value pool. Low-cost assets are all those that cost less than $1,000 not inclusive of GST and low-value assets are those that have declined in value under the diminishing value method to less than $1,000. The deduction for the decline in value of depreciating assets in a low-value pool is calculated using a diminishing value rate of 37.5%. Low-cost assets that are added to the pool are depreciated at half the rate – 18.75% – for the year in which they enter the pool.

7 Capital works deduction

You may be eligible to claim a deduction for the construction expenditure related to these expenses. Known as capital works deductions, these are usually spread over a period of either 25 or 40 years.

It's necessary to point out that total capital works deductions must not be greater than the total construction expenditure, and no deduction can be claimed until the construction is complete. Also, deductions can only be claimed for as long as the property is being rented, or is available for rent.

Deductions for capital expenditure can be applied to a variety of works, for example, a building or extension – adding a pergola, a garage or another room – or alterations like demolishing or putting up an internal wall, or structural improvements such as a new fence or a retaining wall.

Costs that are admissible in the expenditure total can include fees for engineers and architects, and payments to tradespeople like bricklayers or carpenters. However, you cannot claim for expenses such as clearing land prior to the construction, landscaping or the cost of the land that the rental property is built on, as the value of the land is not depreciated over time.

Yes! Negatively gearing your home *is* possible

This is done by establishing a discretionary family trust with a shelf company to act as trustee. You and your family then rent the house at a proper market rental on a long-term lease.

Be aware, however, that if the home is owned by a trust, any capital gains exemptions may be lost and you also may be liable to pay land tax. But your lease on the house will be valued for capital gains tax and, meanwhile, you can claim any interest payable, insurance, rates, repairs and depreciation as tax deductions.

Once you have established negative gearing on the property you can, if you wish, provide your employer with a PAYG Variation Certificate. This allows your employer to give you reduced PAYG deductions, providing for the losses that are being incurred on your property.

Seek advice

Negative gearing can be a beneficial investment tool for the right person if it is applied correctly, and the necessary research and projections are carried out prior to execution. Without sound professional advice there are many hidden traps that could see a potential money-making venture turn into a financial-loss nightmare.

This is why, if you are considering negatively gearing an investment property, it's important that you seek the advice of professional accountants and financial planners as they will be able to assist you in making the right decisions for your situation. ■

Michael Quinn, director of The Quinn Group, is an experienced lawyer, accountant and educator. For further information or assistance, contact Michael and the team of legal and accounting professionals at The Quinn Group on 1300 QUINNS or visit www.quinns.com.au