Fact Sheet

Australian Unity

What is negative gearing?

Gearing involves borrowing money to invest in assets that produce both income and good growth potential. Negative gearing is when you borrow to invest and the income you earn from your investments is less than the interest you pay on the loan, thus giving you a cashflow shortfall. If your investment is negatively geared you need to have income from other sources to pay your loan commitments and investment costs.

Gearing involves a higher level of risk when compared to investments that are not geared, because if investments perform poorly you could also be paying interest on a debt for assets that have fallen in value.

Gearing is generally more suited to people who:

- have a high tolerance to investment risks
- want to invest for at least 7 - 10 years
- have a stable and reliable cash flow which is sufficient to meet loan repayments, and
- have insurance cover to cover loan commitments in the event of illness or death.

How does negative gearing work?

Negative gearing is when the return on an investment established with borrowed money is less than your interest repayments and outgoings.

Under the current Australian tax law, you may be able to claim the interest on the investment loan and other relevant expenses as a tax deduction. The key benefit associated with negative gearing is that any loss may be offset against other income earned, such as your salary, reducing your taxable income and therefore your tax payable.

Here's an example with a person borrowing $100,000 to invest:	
Interest cost at 7% p.a.:	$7,000
Investment income at 4% p.a.:	$4,000
Cashflow shortfall	$3,000
Tax reduction on claiming shortfall as a deduction (tax rate 39% including Medicare):	$1,170
After tax shortfall:	$1,830

Benefits and risks of gearing

Gearing to invest will provide you with the opportunity to:

- make larger investments as you have more money available
- reduce your current tax liability due to tax deductions for interest costs
- potentially achieve investment returns that are greater than the returns that could be achieved without gearing.

However, these benefits need to be considered with the following risks:

- if your investment is negatively geared you required to have income from other sources to pay your loan commitments and investment costs
- you need to ensure you have the financial ability to absorb the effect of potential falls in investment values and the ability to fund margin calls or rising interest payments
- the assets purchased with borrowed funds may fall in value, potentially to a point where you may owe more than your investments are worth, and
- as you are borrowing money, it is important to consider taking out appropriate insurance to cover repayment of the debt if you were to die, suffer a serious illness or become incapacitated.

Gearing magnifies losses and gains

When you borrow to invest, your gains are magnified because someone else's money was used to create the gain. So, using our negative gearing example on the left, if you borrow $100,000 and your investment appreciates by 10% in the first year, you would be ahead $10,000 – less the $1,830 cashflow shortfall. It's an $8,170 gain.

It works the same in reverse with a 10% fall in the first year resulting in a loss of $11,830.

The message here is you need to understand the full range of possibilities with a gearing strategy and ensure you only invest in an appropriate portfolio of growth assets with potential for solid capital growth over the long term.

It is long term capital growth which drives a gearing strategy. For a negative gearing strategy to be successful, your investments need to generate (over the long term) sufficient capital growth to more than cover the total cash flow shortfall (after tax) as well as tax on the capital gain.

Tax implications of gearing

- Income from a geared investment is added to your assessable income.
- Costs associated with borrowing to invest may be tax deductible.
- Allowable deductions are deducted from the investment income or your other taxable income if your investment is negatively geared.
- It is important to verify tax deductibility with your accountant or tax adviser.

Loan repayments

Your loan may be interest-only or principle and interest. An interest-only loan may increase your cash flow across the duration of the strategy but will eventually need to be repaid. Repayment can be from selling investments which can create a capital gains tax liability if the value of the investments had risen.

If you borrow using a principle and interest loan you will gradually pay off the loan across the duration of the strategy, but this option requires more cash flow, whilst allowing you to potentially retain the investments and deferring the capital gain to a later sale date. Principle loan repayments are generally not tax deductible.

Case study

Create wealth of $6,458,431 for $156 per week

Let's look at an historical example of a successful gearing plan.

In Chart 1 we have someone who is on the top marginal tax rate and borrowed $100,000 on 1 January 1983 and invested it in Australian shares. By 1 January 2017 they would have created wealth of $1,291,686 after repaying the $100,000 loan and paying capital gains tax on withdrawal of the investment, with an initial cashflow shortfall of just $34 a week – after taking into account investment income and their tax deduction. (Note: we've used historical interest rates, with the rate in Year 1 of 12.42% and a high of 16.35% in 1990).

If this person had borrowed $250,000 they would now have $3,229,216, for an initial cashflow shortfall of $85 per week.

And borrowing the sum of $500,000 would have enabled this person to create wealth to the tune of $6,458,431 after repaying the loan and paying tax on that withdrawal.

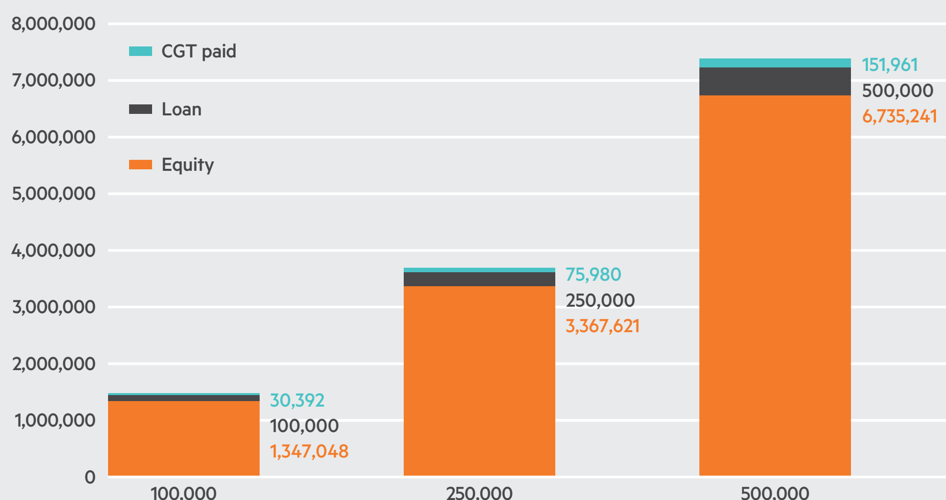
Their initial cashflow shortfall would have been just $156 a week, as shown below:

Borrow $500,000: (interest 12.42%)	$62,083
Less investment income:	$40,071
Cashflow shortfall:	$22,012
After tax shortfall: (ignoring franking credit)	$8,106 or: $156 per week

Importantly, that shortfall lasted for only 4 years – because, as the income from the share portfolio grew, the cashflow situation turned positive, as shown in Chart 2.

Chart 1: Gearing Australian shares to create wealth*

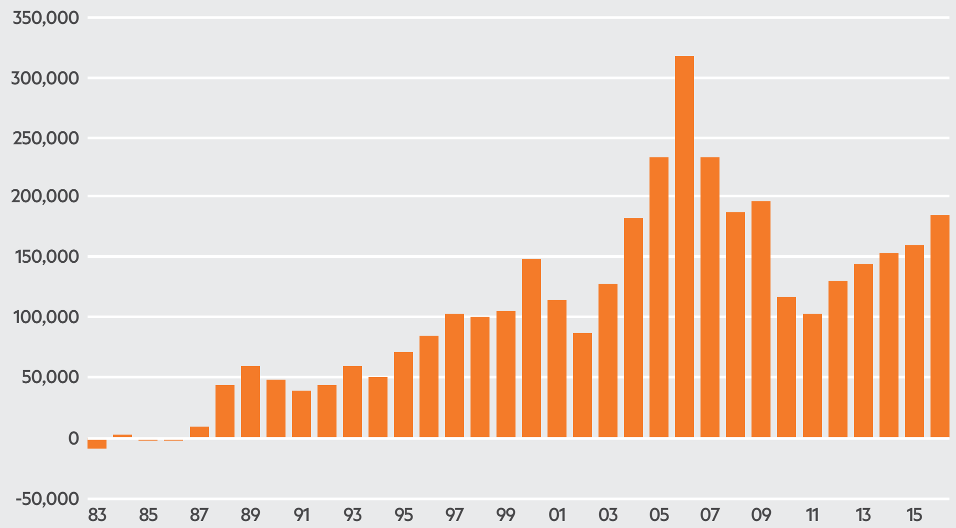
(Invested in All Industrials Accumulation Index 30 years to 1 Jan 2017)



When the cash flow situation turns positive, the strategy becomes positively geared. Positive gearing occurs when the loan expenses are less than the income generated by the investments purchased under the strategy. Neutral gearing occurs when the loan expenses are equal to the income generated. The taxation benefits may be reduced in a positive and a neutral gearing situation because there are no excess expenses to offset other assessable income. However the investment strategy may generate additional cash flow which can be used to further build your wealth.

Chart 2:
Negative gearing can turn into positive gearing

Net Annual income
All Industrials 1983-2017



*Assumptions: All Industrials Price and Accumulation Indices to 31/12/01 and the S&P/ASX XNJ and XNJAI Price and Accumulation Indices thereafter. Dividends 80% franked from the inception of franking. The top marginal tax rate at each year has been used. Interest calculated using RBA's Banks Variable Housing Loan Rates. Initial interest rate: 12.42% p.a. Past performance is not an indicator of future performance. Graphs in this document are for illustrative purposes only.

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- Dental services
- Chronic disease management
- Hospital in the home

- Investments
- Estate planning
- Trust and estate administration services
- Financial planning
- Investment, education and funeral bonds
- Banking and home loans
- General insurance

- Aged care and accommodation
- Personal and business insurance
- Aboriginal home care
- Disability services
- Retirement communities

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