Investing
What is Negative Gearing

What is negative gearing?

Negative gearing an investment occurs when the ongoing expenses incurred for holding an asset exceed the income received for that asset.

The net result of the asset's income less expenses is negative (a loss) hence the term negative gear.

Negative gearing can apply to any type of investment, not just housing but is typically used in rental property discussions.

Why is negative gearing so popular?

The benefit of negative gearing is that the net loss can be used as a **tax deduction against other income earned** reducing the amount of tax that you pay.

This helps minimise the cost of the asset holding and can help leverage larger and possibly more effective investments over and above what could be invested if the benefit weren't available.

How does gearing work in practice?

Every dollar that reduces your taxable income gives you a benefit related to your marginal tax rate as you don't pay tax on that dollar.

For example, if your marginal tax rate is 39% (including Medicare Levy) then for every $1 of net loss you claim as a deduction you receive back $0.39 through your tax return.

This is why negative gearing is more tax effective for taxpayers on higher marginal rates – as the amount these taxpayers get back per dollar of net loss is higher.

It is important to note though, for every dollar claimed there is a **loss amount** that is **not received back** through the tax system so must be accounted for in the cash flow of the investor.

In the example above although the taxpayer receives $0.39 back per dollar of net loss, they are still out of pocket by the **residual $0.61 which isn't refunded** through the tax system. The taxpayer needs to be able to fund this loss from other asset income or salary and wages.

The End Goal

Ultimately, when the asset is sold the investor is aiming to recoup all the losses from the time the asset is held and make a net profit (after capital gains tax), otherwise holding the asset would not be worthwhile.

Before commencing any investment, negative geared or otherwise, it is important to understand how the investment and the associated tax implications work and make an informed choice as to when/where to invest funds.

As a side note - Positive gearing is when the investment income exceeds the ongoing costs.