Aspects of Negative Gearing Australian Real Estate

Negative gearing will again be a political issue during the lead-up to the next Federal election.

What is Financial Gearing

A combination of debt and equity is commonly used to fund investment in assets, such as rental properties, shares or business assets.

A leveraged investment refers to the method of using borrowings plus an investor's own funds to purchase an asset; the higher the leverage, the greater the debt. Gauging the mix of an investor's debt to equity is referred to as the gearing ratio.

Leveraged investment is often expressed in terms of being positively or negatively geared. Positive gearing occurs when net income derived from an asset exceeds borrowing costs (mainly interest). Conversely, negative gearing arises when the net investment income derived is exceeded by interest outgoings (and other funding costs).

Negative Gearing Real Estate

Negatively geared residential or commercial property occurs when rental (or lease) income, less the costs of owning and managing the investment (such as depreciation, insurances, repairs and maintenance, council rates, land tax, travel costs and agent management fees) is exceeded by mortgage interest costs.

For tax purposes, the resulting rental tax loss can be deducted from an investor's income derived from other sources, including salary and wages, other net rental income, dividends, interest and/or business income. Other deductions and considerations come into play where property is located outside Australia.

Is it feasible to Negatively Gear?

Investments in real estate that generate an annual rental loss will be a tax deduction against other income. A tax refund to an individual investor generally arises at the individual's marginal tax rate(s). The higher the marginal rate, the greater the refund. The tax refund reduces an investor's net cash outflows from an investment. Notwithstanding the tax refund position, unless the value of the real estate out paces an investment's cumulative after-tax losses, the investor will not be ahead financially. That is, an investor will lose money over the real estate ownership period. Of course, if the investment does increase at a rate greater than the after-tax loss position, then an investor will make money.

Key Incentives

(i) Cash flow: For individuals, tax refunds are generated at the relevant marginal tax rates which assists cash flow. For example:

(a) If the top marginal tax rate applies to a salary and wage earner, 47% of the tax rental loss can be refunded by the Australian Taxation Office. Lower marginal tax rates apply if an individual's taxable income is less than $180,000.

(b) Rather than wait to lodge an annual income tax return, an individual can apply, to the ATO, to permit their employer to deduct less PAYG throughout the year which boosts monthly after-tax cash flow to better align with loan repayments.

(ii) CGT Discount – Currently, any capital gain on disposal will attract a 50% general discount for resident individuals and trusts (with resident individual beneficiaries) provided the asset is held for more than 12 months.

(iii) Rent Increases – Initially, a negatively geared investment may be justified if the net rental stream is expected to rise or interest costs are expected to reduce.

(iv) The potential ability to claim depreciation on plant and equipment and 2.5% of the construction cost of the building (including alterations and improvements) provide a cash free deduction against rental income each year.

(v) New Opportunities – The use of internet-based booking platforms such as Airbnb and Stayz has significantly increased an investor's ability to generate greater financial returns from residential property investments. In these situations, a question arises as to whether the investment is more of a business operation, especially where there are several rental properties and staff are employed to attend to bookings, cleaning, etc. If a business does exist, it will be important to consider whether the small business CGT concessions and GST applies.

Key After Tax Outflow Considerations

An important consideration before embarking on a negative geared property investment is to consider the impact that after-tax cash outflows will have on after-tax income. The after-tax cash flow position differs from the rental loss result. This is due to non-deductible principal loan repayments and deductions being funded on initial purchase, such as capital works and capital allowance deductions as detailed below.

(i) Deductions for capital costs

A capital allowance deduction may be available on items of plant and equipment that have formed part of the purchase price of a property. However, since 9 May 2017, this deduction has been restricted on items of plant and equipment forming part of old residential properties (refer below).

Additionally, the construction cost (not purchase price) of the property including any improvements can generally be claimed at 2.5% over a maximum 40-year period. Therefore, it is important to obtain that information from the vendor, or alternately you can engage a quantity surveyor to provide an estimate of those costs.

(ii) Principal repayments

Importantly, it is necessary to consider the cash flow impact of loan principal repayments to a financier. Generally, the interest rate associated with principal and interest loan facilities is lower than interest only, as financial institutions perceive the risks of lending to be lower. However, if an investor is using a principal and interest loan facility, it is necessary to also take into consideration the cash flow impact of principal repayments each year. Any cash flow shortfalls would need to be met from other funding sources such as after-tax salary. Currently, there is a definite move away from the provision of interest only loans by Australian banks.

Before embarking on a negatively geared investment, a realistic cash flow analysis should be prepared.

Developments in the Past

Prior to 1985 the Courts provided certain boundaries on acceptable negative gearing scenarios, especially in situations displaying an underlying private or domestic motivation. For instance, in *Ure v. FCT* 81 ATC 4101 (FCA), the taxpayer borrowed monies at commercial interest rates of up to 12.5% and on-lent the borrowed money to his wife and family company at 1% interest. The funds were eventually used to discharge a home mortgage, to purchase a house (that was let to the taxpayer and his wife by a private company) whilst the balance of funds was invested. The Commissioner of Taxation only allowed an interest deduction to the taxpayer equal to the 1% interest income and the Court confirmed the Commissioner's stance.

In *FCT v. Groser* 82 ATC 4478 (S.C.V.) the taxpayer was denied a deduction for part of a rental loss as the rental income charged to his brother was not being levied at a market rate. Similarly, in *FCT v. Kowal* 84 ATC 4001 SCG the taxpayer rented a house to his mother at less than a market rate. He was denied a deduction for part of his rental loss, which reflected the undercharging.

1985 Tax Summit

Following the tax summit in June 1985, the Hawke government introduced anti-negative gearing legislation effective from 17 July 1985. The law applied to new investments in real estate by individual, company, partnership or trustee investors. Under these rules, negative gearing interest expenses were quarantined to the extent that they would otherwise create a rental loss (apart from a carve-out for 4% building depreciation deductions). Rental losses were quarantined so they could not be offset against other income. Instead, losses were carried forward to future tax years to be offset against property income. Negatively geared real estate acquired prior to 20 September 1985 continued to fall outside the CGT tax net on disposal but not for property purchased after that date.

After extensive lobbying by the property industry, and possibly for other macro economic reasons, the Hawke government revoked the negative gearing rules during July 1987. At the same time, the building depreciation rate was dropped from 4% to 2.5% to minimise the impact on revenue collections.

Post Repeal of the 1985 Negative Gearing Legislation

Since the repeal of the negative gearing legislation in 1987, tax cases impacting on negative gearing scenarios have involved split loans. The use of split loan facilities was the subject of a general anti-avoidance High Court decision in *FCT v. Hart* (2004) HCA. The case centred on the level of tax deductible interest that was capitalising on an investment loan at a relatively high rate of interest.

The taxpayers had a debt wrap platform which allowed them to maintain a home loan (non-deductible interest) and an investment account balance (deductible interest). Security for both loans was the two properties. All loan repayments were directed towards the home loan. The tax-deductible interest therefore compounded on the investment loan, which ended up having a balance more than the value of the investment property. The taxpayer claimed 100% of the investment loan interest as a tax deduction. The High Court's order required principal payments to be applied in a pro-rata manner to both loan accounts, whereby reducing the amount of tax deductible interest.

The use of a line of credit facility by an investor is handy for separating borrowings relating to non-income and income producing assets and it is easier to calculate deductible interest. It also provides flexibility to an investor. However, care needs to be exercised when using split loan funding platforms.

The ATO has issued several tax determinations and rulings concerning the use of these types of financial facilities. The takeaway message is that deductible compounded interest is fine, provided there is a genuine commercial reason for the compounding.

2017 Legislation Changes

For second-hand residential properties purchased after 9 May 2017, a depreciation deduction is not available for second-hand plant and equipment acquired with such properties. However, any investor who purchases a brand-new property can claim depreciation on plant and equipment forming part of the investment property. Non-residential properties are unaffected by the changes.

From 1 July 2017, new legislation provides that travel expenses relating to residential property investment are no longer deductible and cannot be included in a property's cost base for CGT purposes. This restriction does not apply to taxpayers carrying on a business of letting rental properties or to certain taxpayers, including companies.

Future Developments

As mentioned, negative gearing will be a leading issue during the lead up to this year's Federal election.

The coalition's platform is to leave negative gearing in place, whilst Labor's position is to apply changes to negative gearing across all new investment asset acquisitions, not just real estate. Labor is proposing that existing properties are fully grandfathered and therefore unaffected. That is, tax concessions for negative gearing will cease to be available from a date yet to be determined, although it is proposed that losses from new investments can be used to offset net income from other asset investments and against certain capital gains.

Labor plans to halve the CGT discount rate from 50% to 25% from a date to be determined. The CGT discount will not, however, change for small business assets.

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Geared investments in a balanced investment plan pre-retirement may be worthwhile pursuing. However, it must be remembered that there are potential pitfalls and the strategy can end up costing an investor money.

Given the extent of the tax and financial planning issues associated with geared investment strategies, we recommend that you discuss your specific circumstances with your Crowe Horwath tax adviser or financial planner.

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