Is Negative Gearing Dead?

With some segments of the property market feeling the effects of the global financial crisis, there is a need for real estate agents to provide accurate information on negative gearing. Mark Lipson and Robert Lissauer from Sothertons discuss the importance of common-sense gearing advice for building solid property returns.

The State of Play

It was only a short time ago that maximising negative gearing was considered a safe strategy for property investors. The Global Financial Crisis has changed the expectations of many property investors to either abandon or modify their strategies to property as an asset class. There is a perception that some segments of the residential property market are attracting low levels of demand and price growth is weak. Negative gearing only compounds the poor returns. The retreat by residential property investors from negative gearing has accelerated as lending institutions reduce their exposure.

In more buoyant economic conditions, most property investors didn't question whether maximum negative gearing was appropriate, rather it was taken as a given. It was commonly held that maximising the gearing on property investment was the best way for investors to enter the property market and to create wealth. For many investors their decisions were also influenced by the favourable taxation treatment of losses generated by the strategy. The greater the gearing on a property led to a greater loss, therefore generating a larger tax refund or tax saving on other taxable income earned. This view however, is to some extent flawed, irrespective of the state of the economy.

Often when we talk to prospective clients, they are unaware of how to assess the true financial performance and status of their negatively geared investment. Most investors do not take into account the impact of the accumulated losses as part of the overall gain or loss on their property investment. Consequently, investors can make major decisions based on incomplete financial information.

Investors should see the after-tax rental losses as a black hole for their money. The only way they can recoup their losses is when the market price of the property increases more than the growing black hole.

Maximising Negative Gearing

TABLE ONE - HIGHLY GEARED

KEY DATA AND ASSUMPTIONS	
Property cost at auction	550000
Stamp Duty	28070
Variable interest rate	7.50%
Marginal tax rate	45%
Growth in median housing prices	8.0%
Rental Income yield	5.00%
Rental Income Growth per annum	1%
Mortgage	522500

RENTAL STATEMENT	Year 1	Year 2	Year 3	Year 4	Year 5	Year 6
Rental Income	27500	27775	28053	28333	28617	28903
Expenses						
Agents commission	1925	1944	1964	1983	2003	2023
Interest	39188	39188	39188	39188	39188	39188
Repairs & Maintenance	1200	1218	1236	1255	1274	1293
Land Tax	665	665	665	831	742	742
Rates & Taxes	1000	1015	1030	1046	1061	1077
Property Insurance	800	812	824	837	849	862
Other	500	508	515	523	531	539
Total Expenses	45278	45349	45422	45662	45647	45723
Profit/(Loss)	-17778	-17574	-17369	-17329	-17031	-16820
Tax Deduction	8000	7908	7816	7798	7664	7569
Loss after Tax Deduction	-9778	-9666	-9553	-9531	-9367	-9251
Accummulated Loss	-9778	-19443	-28997	-38527	-47894	-57146

SALE OF INVESTMENT PROPERTY	Year 1	Year 2	Year 3	Year 4	Year 5	Year 6
Sales	550000	594000	641520	692842	748269	808130
Less Cost of the Sale						
Purchase Cost	550000	550000	550000	550000	550000	550000
Stamp Duty	28070	28070	28070	28070	28070	28070
Agents Commission	11000	11880	12830	13857	14965	16163
Marketing & Auction Costs	10000	10200	10404	10612	10824	11041
Total Cost	599070	600150	601304	602539	603860	605273
Capital Gain	-49070	-6150	40216	90303	144409	202857
CGT at Concessional Rate			10054	22576	36102	50714
Capital Gain after CGT	-49070	-6150	30162	67727	108307	152143
Accummulated Losses	-9778	-19443	-28997	-38527	-47894	-57146
Gain or Loss on Sale	-58848	-25593	1165	29200	60413	94997

RETURN ON EQUITY	Year 1	Year 2	Year 3	Year 4	Year 5	Year 6
Investors Equity	27500	27500	27500	27500	27500	27500
Gain or loss	-58848	-25593	1165	29200	60413	94997
NPV at 6%						$57,925

Table One represents a typical maximum-negative-gearing position for a residential property investment. We have analysed the annual rental performance separately from the capital gain on sale. This allows us to measure the growing black hole in the rental performance and its effect on the true gain or loss on the sale of the property. In times of low interest rates, the maximum negatively geared model will reward the investor with a reasonable after tax capital gain in year four onwards. Currently, interest rates are at historic lows and are highly unlikely to remain at these levels in the medium-to-long term. Just as quickly as the interest rates have fallen, they will come back to previous levels as the economy picks up. The level of sensitivity to these changes in interest rates is considerable for a highly geared property. An increase in interest rates of two per cent can wipe out the economic value of the capital gain. Essentially, the investor would have created more value by investing in a high-yield savings account. At best, a maximum-negative-gearing strategy is only appropriate under limited conditions.

The same destruction of equity value can occur when property prices fall below a long-term growth trend of 8.4 to below seven per cent. Corrections in prices after property booms can have a profound effect on equity wealth of property investors. Since 2002, the long-term growth trend in median property prices has been 8.4 per cent (ABS). With the market already falling by six per cent in 2009, and with the expectation that prices will fall even further, the seven per cent threshold for Table One above looks very fragile.

So, is negative gearing dead? No. We believe that common sense in gearing needs to be the principal driver of the strategy rather than using investment property to minimise taxation.

Maximising Equity Value through Negative Gearing

A more conservatively geared property investment produces better financial outcomes at a lower risk. The lower gearing has the advantage of reducing the impact of the accumulated after-tax losses (the black hole) on the return on investor equity. Table Two profiles the same investment but at a gearing level that focuses on creating value for the investor's equity rather than maximising the taxation benefit.

On a net present-value basis, the conservatively geared investment creates significant equity value that justifies the investor's involvement. Compared to the more highly geared strategy, the return after tax and accumulated losses of the conservatively geared strategy is 43 per cent better off. The conservative approach allows the investment to coup better with sensitivity to higher interest rates and a falling long-term growth trend in the median house prices. The long-term trend would have to fall below five per cent before equity value is lost in net present-value terms.

The Role of the Real Estate Agent

For any negative gearing strategies to be successful, the investor needs to lock in and crystallise an acceptable rate of return on equity. The property must be sold to take advantage of the wealth created by the strategy. Real estate agents are perfectly placed to assist the investor to monitor real estate trends in the market and to prepare the property for sale. A successful sale outcome should be a key motivator for the investor to re-invest in another property or build the beginnings of a property investment portfolio. The benefit to the professional agent in assisting property investors is obvious. Attention to detail and the provision of information in a timely manner will be rewarded with loyalty from your clients with repeat sales business and additions to your rent roll.

Call Robert Lissauer or Mark Lipson at Sothertons on (03) 9820 6400 to discuss this issue or any other business needs.

Maximising Negative Gearing

TABLE TWO - CONSERVATIVELY GEARED

KEY DATA AND ASSUMPTIONS	
Property cost at auction	550000
Stamp Duty	28070
Variable interest rate	7.50%
Marginal tax rate	45%
Growth in median housing prices	8.0%
Rental Income yield	5.00%
Rental Income Growth per annum	1%
Mortgage	357500

RENTAL STATEMENT	Year 1	Year 2	Year 3	Year 4	Year 5	Year 6
Rental Income	27500	27775	28053	28333	28617	28903
Expenses						
Agents commission	1925	1944	1964	1983	2003	2023
Interest	26813	26813	26813	26813	26813	26813
Repairs & Maintenance	1200	1218	1236	1255	1274	1293
Land Tax	665	665	665	831	742	742
Rates & Taxes	1000	1015	1030	1046	1061	1077
Property Insurance	800	812	824	837	849	862
Other	500	508	515	523	531	539
Total Expenses	32903	32974	33047	33287	33272	33348
Profit/(Loss)	-5403	-5199	-4994	-4954	-4656	-4445
Tax Deduction	2431	2340	2247	2229	2095	2000
Loss after Tax Deduction	-2971	-2860	-2747	-2725	-2561	-2445
Accummulated Loss	-2971	-5831	-8578	-11302	-13863	-16308

SALE OF INVESTMENT PROPERTY	Year 1	Year 2	Year 3	Year 4	Year 5	Year 6
Sales	550000	594000	641520	692842	748269	808130
Less Cost of the Sale						
Purchase Cost	550000	550000	550000	550000	550000	550000
Stamp Duty	28070	28070	28070	28070	28070	28070
Agents Commission	11000	11880	12830	13857	14965	16163
Marketing & Auction Costs	10000	10200	10404	10612	10824	11041
Total Cost	599070	600150	601304	602539	603860	605273
Capital Gain	-49070	-6150	40216	90303	144409	202857
CGT at Concessional Rate			10054	22576	36102	50714
Capital Gain after CGT	-49070	-6150	40216	67727	108307	152143
Accummulated Losses	-2971	-5831	-8578	-11302	-13863	-16308
Gain or Loss on Sale	-52041	-11981	31638	56425	94444	135835

RETURN ON EQUITY	Year 1	Year 2	Year 3	Year 4	Year 5	Year 6
Investors Equity	192500	192500	192500	192500	192500	192500
Gain or loss	-52041	-11981	31638	56425	94444	135835
NPV at 6%						$177,831