ipac explains

gearing

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what is gearing?

Borrowing to invest, also known as gearing can help you accumulate wealth faster by investing someone else's money in addition to your own. This is because you benefit from the greater growth of a larger investment.

Although there is a cost to investing borrowed money, if the investment produces a better return than the interest payable on the loan, then you benefit from the difference.

Although gearing has the potential to build wealth faster, it isn't for everyone because of the risks. It is for this reason you must seek professional advice.

when is gearing effective?

When the interest on the loan is greater than the income you receive from your investment, negative gearing occurs. This interest can be claimed as a tax deduction that may be used to reduce your tax on other income, such as your salary.

Many people are attracted to gearing, and in particular negative gearing, because of this potential tax benefit. However, no investment strategy should be entered into purely for the potential tax benefits. No amount of tax benefits can make up for a poor investment. In considering gearing you must look at the underlying investment and be aware that negative gearing only becomes effective if the investment grows sufficiently in value to make up for the after tax losses you are incurring every year. You should also be mindful that if you sell the investment capital gains tax would need to be paid.

example

Mark invests $200,000 in a managed fund with exposure to Australian and International shares. He invests $100,000 of his own money as well as borrowing $100,000 at an interest rate of 9%. As the managed fund is orientated towards long term capital growth, it pays income of only about 3% per year.

In the first year of the investment, the investment pays $6,000 in income, and the interest on the loan is $9,000. Mark is able to claim a tax deduction of $3,000. If he is on the highest marginal tax rate, he will get back about $1,395 of this loss through his tax. Importantly, he has still "lost" $1,605.

Will the investment be worthwhile? Well that depends on the growth of the investment. If his portfolio grows sufficiently to make up for this income loss, after capital gains tax is paid, then it could prove to a worthwhile investment. If however, interest rate on the loan increases, or the investment experiences negative returns, then the outcome can be quite different.

what are the benefits?

~ If your investment includes Australian shares, income from your investment is likely to be partly "franked", in other words, tax has already been paid on that income.

~ Capital gains tax payments are deferred until you sell the investments, enabling you to pay the tax when your marginal tax rate may be lower, such as when you retire.

~ You also have the option to pre-pay interest on the loan in order to obtain a tax deduction a year earlier.

~ Investing through your own company or trust may also be a tax effective strategy

what are the risks?

- Gearing increases the returns of an investment, whether they be losses or gains.
- At times when investment returns are negative, the value of your investment will fall. If this occurs you may be required to pay back part of the loan or provide extra security by investing more money. This is referred to as a margin call and you are generally required to respond to it generally within 24 hours.
- Sharemarket returns during the 1990s have been higher than historical averages. If returns are lower during the time you invest then the performance of the non-geared investment and the geared investment would also be lower. Other risks include rising interest rates or changing taxation regulations.

is gearing suitable for you?

- Taking into account what your financial and lifestyle situation will be over the next seven years, are you able to commit to the geared investment throughout that time?
- Do you have the resolve to ride out falls in investment markets?
- Do you have a reliable income and expect this to continue for the term of the investment and loan?
- Do you have an emergency fund to meet potential margin calls?
- As you can't rely on the returns from your investment to pay the interest on the loan, are you prepared to use some of your income to pay the interest?
- Do you have income protection insurance in place in the event of not being able to return to work for an extended period of time?

If the answer is yes to all of these questions, then gearing may be appropriate for you

how a financial planner can assist you

Your financial planner can meet with you, discuss your financial capacity and tax situation and what you want to achieve. Based on this your planner can recommend if gearing is appropriate in your circumstances.

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