Gearing

Gearing involves borrowing money to invest in assets that produce both income and good growth potential. This can help to build your wealth.

Gearing involves a higher level of risk because it places not only your investments at risk but 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 higher risk tolerance
- Want to invest for at least five to seven years
- Have a stable and reliable cash flow sufficient to meet loan repayments
- Have insurance to cover loan commitments in the event of illness or death

How the Strategy Works

Money is borrowed and added to your own savings to purchase an investment. The investment should produce assessable income (if you want to claim tax deductions for interest) but should also be a growth investment such as shares or property (including through a managed fund).

The borrowing expenses reduce the earnings rate so investments that offer the potential to deliver higher growth are most effective.

By borrowing, you have a larger amount to invest. This may provide greater potential to diversify and build wealth. However, gearing increases the risk of a portfolio. While investing more money can provide the opportunity to increase potential gains when markets are rising, gearing can also increase losses in falling markets.

Interest and related borrowing costs are usually tax-deductible if used to purchase income-producing assets. If your loan is a principal and interest loan, only the interest component is tax deductible. You should consult your tax adviser to determine your specific taxation situation and what is appropriate for your circumstances.

Levels of Gearing

Your gearing arrangement could fall into one of the following categories depending on the costs of borrowing relative to the income generated from the investment.

- Positive gearing – the loan expenses are less than the income generated
- Neutral gearing – the loan expenses are approximately the same as the income generated
- Negative gearing – the loan expenses are greater than the income generated.

If your investment is negatively geared you need to have income from other sources to pay your loan commitments and investment costs.

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 greater than the returns that could be achieved without gearing

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

- Gearing will increase the risk attached to your portfolio
- 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, even to a point where you may owe more than your investments are worth.

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.

Tax Implications of Gearing

The taxable income from a geared investment is added to your assessable income. Generally, costs associated with borrowing such as interest and expenses are tax deductible. If the cost is an allowable tax deduction, it will be deducted from:

- Income received from the investment
- Other income if your investment is negatively geared.

Tax minimisation should not be the reason for negative gearing. Any tax benefits that might accrue have secondary importance in this process.

Loan Repayments

If you borrow using an interest-only loan the amount borrowed will eventually still need to be repaid. Your financial planning strategy should make provision for this repayment. One option is for the loan to be repaid by selling investments. This may create a capital gains tax liability if the value of your investments has risen.

Alternatively, you could choose to borrow using a principal and interest loan so you gradually pay off the loan amount and are able to keep the asset longer term. Or you may set up another savings strategy to accumulate money towards the loan repayment at a future date. For example, you could accumulate the savings using an insurance bond or managed fund.