What your annual tax refund is really costing you

Talking point

Alison Kahler

Why is it that people just don't get negative gearing? It's not really that hard to grasp the fact that a loss-making investment isn't ideal if it could, in fact, make money.

One of the mysteries of this time of year is how normally right-minded people will do anything – absolutely anything – to get a tax refund after June 30, even if the cost of doing so is greater than the actual refund.

It's as if a red haze comes down over their eyes, blinding them to basic arithmetic as they contemplate just how much they can screw the tax office and boast about it around the barbecue. They will spend hundreds if not thousands of dollars consulting accountants and financial planners, when a good dose of common sense would leave them better off than a bodgy tax-minimisation strategy.

It's this kind of flawed logic that got so many people into trouble with all those agricultural schemes that promised so much to investors but delivered oh so very little.

For sure, they got to claim a juicy tax deduction but last time I checked it was unclear if any agricultural scheme had ever generated a return. Not a single expert could tell me if all those olives, almonds, trees and countless other products grown with the hard-earned money of average punters had ever made a gain, despite all the glossy sales material which, oddly, appeared to cut and paste the same message: "within xx years, international demand for Australian-produced [insert name of product] will be really big and [insert name of producer] will capitalise on this."

I once found a tree scheme that claimed a gain but good financial planners disputed this was the case, insisting that the purported return was merely a return of capital to investors.

Investing in property obviously can, and often does, produce gains, but if you can charge sufficient rent to positively gear a property then it's worth considering because you'll be ahead – even without a tax refund – and that is the whole point of any business.

The maths is pretty simple: an investor on the highest marginal tax rate gets only 45¢ back for every $1 they spend on a negatively geared property. And an investor on the 30 per cent tax rate who negatively gears for the sake of it is effectively giving away $1 to get just 30¢ back as a tax refund.

Don't they value the other 70¢?

The cult of the flaky deduction is disturbing and seems to often suck in those who also demand a national broadband network, universal public health system, upgraded roads or schools and other services that are paid for by taxes.

I have no idea how they think we will get those things if they aren't prepared to cough up their fair share of tax to pay for it.

There's nothing wrong with legitimate tax deductions and you should claim every single one you can.

The followers of the tax deduction religion are often members of the cult of wealth creation – an equally disturbing phrase.

But the demonic zeal with which people will buy an investment without a sound underlying proposition or structure an investment in the name of tax often ends up costing them money that would have generated its own return if invested properly.

The followers of the tax deduction religion are also often members of the cult of wealth creation, a phrase I find equally disturbing due to its misleading implication that investing is a way to get rich – no matter who you are.

This simply isn't true.

Investing is an activity that will generate compound interest at a higher rate than a bank account and might also produce some capital gain along the way.

The extra compound interest might be 1 percentage points to 2 percentage points over the long term. So if you don't have a large amount to invest in the first place, that compound interest will not be sufficient to make you anywhere near wealthy, but could well leave you better off than might otherwise have been the case.

The term wealth creation is a highly emotive one invented by the financial services industry to draw in customers.

It should be banned, as it preys on the fact that people can't accept that the amount of money to be made from investing is directly linked to the amount you have to put in.

Tax deductions have little to do with it.

Alison Kahler is a former AFR Smart Money Editor
akahler@fairfaxmedia.com.au
Twitter @alkahlerAFR