

# Smart strategies for using debt

2010



# Appreciating the value of debt

**William Shakespeare wrote, 'Neither a borrower nor a lender be', but the fact is debt can be a very useful tool – when used properly.**

Using debt, you could buy a house you may not be able to afford outright. You just need enough to cover the deposit and costs and you can borrow the rest, assuming you can make the repayments.

Debt can also be used to buy investments with potential to grow in value, like shares and property. This strategy, known as gearing, may help you to build an investment portfolio faster than you otherwise could have.

To help repay the loan, you'll have income generated by your investments and possibly some tax advantages. So, for many people, servicing an investment loan can be an achievable outcome.

In this booklet, we outline nine strategies proven to be highly effective in helping people make the most of debt. Individually, each strategy could significantly improve your financial position.

By using a number of them in combination, you could optimise your finances and achieve financial independence sooner.

To determine which of the strategies best suit your situation we recommend you speak to a financial adviser.

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# The two types of debt

There are two types of debt you could use:

	<b>Inefficient debt</b>	<b>Efficient debt</b>
<b>The key differences</b>	<ul style="list-style-type: none"> <li>• This is used to buy goods, services and assets that don't generate income, will depreciate in value, or have no value once they are used.</li> <li>• You can't claim the loan interest as a tax deduction.</li> <li>• You don't receive any income to help you repay the debt. To service the debt you have to rely on your own resources.</li> <li>• It's wise to reduce this kind of debt as quickly as possible.</li> </ul>	<ul style="list-style-type: none"> <li>• This is used to acquire assets that have the potential to grow in value and generate assessable income.</li> <li>• You can generally claim the loan interest as a tax deduction.</li> <li>• You can use the income generated by the asset to help repay the debt.</li> <li>• It's more easily serviceable and it can be used to accelerate the creation of wealth.</li> </ul>
<b>Examples</b>	<ul style="list-style-type: none"> <li>• A personal loan to buy a car is inefficient because the car depreciates in value, it doesn't generate any income and the interest is non-deductible.</li> <li>• Using a credit card to pay for living expenses is inefficient if it's not repaid within the interest-free period. This is because the interest on the debt isn't tax-deductible and the things you buy generally have little or no resale value after use.</li> <li>• Home loans are generally a less efficient form of debt because the home doesn't produce an income and therefore the loan interest is non-deductible.</li> </ul>	<ul style="list-style-type: none"> <li>• Using an investment loan to acquire an asset, like shares or property (either directly or via a managed investment such as a unit trust), is efficient because the asset has potential to appreciate in value, it generates income and the interest on the loan is generally tax-deductible.</li> <li>• Another way to take advantage of efficient debt is to invest in an internally geared share fund. This is a managed fund that borrows to increase its investments in Australian or global shares. As shares generate assessable income, the interest cost may be tax-deductible to the fund rather than investors directly. The share portfolio also has the potential to grow in value, over the longer term, at a greater rate than one that doesn't borrow money on behalf of investors.</li> </ul>

# Strategies at a glance

Strategy	Key benefits	Page
<b>1</b> Consolidate your debts to save money	<ul style="list-style-type: none"> <li>• Reduce the interest rate applying to your debts</li> <li>• Pay off your inefficient debts sooner</li> </ul>	<b>04</b>
<b>2</b> Use your emergency cash reserve more effectively	<ul style="list-style-type: none"> <li>• Earn a higher after-tax return than a cash account</li> <li>• Pay off your inefficient debts sooner (while retaining full access to your money)</li> </ul>	<b>06</b>
<b>3</b> Harness your cashflow to reduce inefficient debt	<ul style="list-style-type: none"> <li>• Save on interest</li> <li>• Create equity in the family home that can be re-borrowed for investment purposes</li> </ul>	<b>08</b>
<b>4</b> Use borrowed money to build wealth	<ul style="list-style-type: none"> <li>• Multiply your investment profits</li> <li>• Take advantage of a range of tax concessions</li> </ul>	<b>10</b>
<b>5</b> Transform your debt using a financial windfall	<ul style="list-style-type: none"> <li>• Replace inefficient debt with efficient debt</li> <li>• Establish an investment portfolio to build your long-term wealth</li> </ul>	<b>12</b>
<b>6</b> Build wealth via debt recycling	<ul style="list-style-type: none"> <li>• Replace inefficient debt with efficient debt on a regular basis</li> <li>• Establish an investment portfolio to build your long-term wealth</li> </ul>	<b>14</b>
<b>7</b> Offset your investment loan to retain tax efficiency	<ul style="list-style-type: none"> <li>• Earn a higher after-tax return than a cash account</li> <li>• Withdraw money for any purpose without affecting the tax-deductibility of the loan</li> </ul>	<b>16</b>
<b>8</b> Make gearing more tax-effective for a couple	<ul style="list-style-type: none"> <li>• Reduce tax on investment earnings</li> <li>• Accumulate a larger amount</li> </ul>	<b>18</b>
<b>9</b> Leverage your investment via an internally geared share fund	<ul style="list-style-type: none"> <li>• Access the power of gearing without having to arrange an investment loan yourself</li> <li>• Take advantage of potentially lower interest costs</li> </ul>	<b>20</b>

# Strategy 1

## Consolidate your debts to save money

**If you have a range of inefficient debts, you may want to consolidate them into your mortgage.**

### What are the benefits?

By using this strategy, you could:

- save on interest, and
- pay off your debts sooner.

### How does the strategy work?

With this strategy, you need to:

- increase the mortgage on your family home, and
- use the extra funds to pay off other inefficient (not tax-deductible) debts, such as a personal loan or credit card.

By doing this you could pay less interest, as the lower interest rate on your home loan will apply to all your debts.

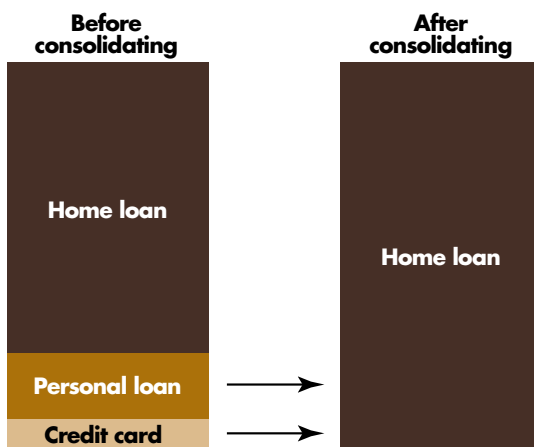
However, it's important you keep making at least the same overall loan repayments. Otherwise:

- it could take longer to pay off your combined debt, and
- you could end up paying more interest over the life of the loan, despite the lower interest rate.

Before you consolidate your debts, you should find out if your existing home loan offers features that can enable you to pay off the combined debt quickly, such as a 100% offset account or a redraw facility (see Strategies 2 and 3).

If it doesn't, you may want to consolidate your debts into a more flexible loan facility.

A financial adviser can help you determine whether this strategy suits your needs and circumstances. They could also recommend a range of other strategies that could enable you to manage your debts more effectively.



## Case study

**Carolyn and Ian** are married with a young family. Their home is worth \$500,000 and they have the following debts.

Debts	Outstanding balance	Interest rate	Current repayments (pm)
Home loan (20 year term)	\$300,000	7%	\$2,326
Personal loan (5 year term)	\$10,000	12%	\$222
Credit cards	\$5,000	17%	\$66
<b>Total</b>	<b>\$315,000</b>		<b>\$2,614</b>

They want to pay off their debts as quickly as possible and save on interest. So they speak to a financial adviser to see if they should be doing anything differently.

After assessing their goals and current debt position, their financial adviser makes a number of recommendations. The first is that they consolidate their debts by:

- increasing their home loan from \$300,000 to \$315,000, and
- use the extra \$15,000 to pay off their personal loan and credit cards.

By doing this, the home loan interest rate of 7% pa will apply to all their debts and the total minimum repayment will drop from \$2,614 to \$2,442 a month.

Their financial adviser also calculates that if they continue to pay \$2,614 into the consolidated loan each month, they will pay off their debts sooner and save \$11,499 in interest (see table below).

	Separate loans <sup>1</sup>	Consolidated loan <sup>1</sup>
Outstanding loan(s)	\$315,000	\$315,000
Monthly repayments	\$2,614	\$2,614
Remaining term	17.8 years	17.4 years
Total interest payments	\$242,055	\$230,556
<b>Interest saving</b>		<b>\$11,499</b>

Conversely, if they spend the interest savings and make the reduced repayment of \$2,442 per month, it will take them 20 years to repay their consolidated debt and the interest payments over this period will total \$271,180, which is \$29,125 more than if they hadn't consolidated their debts. This highlights why it's so important, when consolidating your debts, that you maintain the same total repayments rather than spend the interest savings.

To find out what else Carolyn and Ian's financial adviser recommended, see Strategies 2 and 3.

<sup>1</sup> In both options, we've assumed repayments of \$2,614 are made for the life of the home loan. With the separate loans, payments are redirected to the home loan once the personal loan is repaid.

## Tips and traps

- Before consolidating your debts, you should consider whether you need to pay any refinancing costs, including loan application fees, stamp duty and early termination fees.
- If you have any surplus cash, you should consider using it to reduce personal loans or credit card debt and avoid the need to consolidate your debts.
- If you're concerned about having access to your emergency cash, you could consolidate your debts and place the cash in a 100% offset account or the loan itself provided it has a redraw facility (see Strategy 2).
- Income Protection insurance can help you meet your loan repayments and day-to-day living expenses if you're unable to work due to illness or injury.
- Life insurance can provide your dependants with a lump sum payment to clear your debts in the event of your death.

# Strategy 2

## Use your emergency cash reserve more effectively

**If you hold an emergency cash reserve in a cash account, you may want to use the money to reduce your mortgage.**

### What are the benefits?

By using this strategy, you could:

- earn a higher after-tax return than a cash account, and
- reduce the term of your loan (while still being able to access the money).

### How does the strategy work?

Holding a cash reserve for emergency purposes is always wise. You might need the money for an unplanned trip, urgent repairs to your home or an unexpected illness.

Many people keep their emergency cash in a cash account because it gives them immediate access to their money. But the problems with cash accounts are that:

- the interest rate is usually much lower than what you pay on your home loan, and
- every dollar you earn is taxable at your marginal rate, which could be up to 46.5%<sup>1</sup> (see FAQs on page 24).

A potentially better option is to hold your emergency cash in an offset account<sup>2</sup> or your home loan (provided it has a redraw facility<sup>3</sup>).

By doing this, you will effectively reduce the balance on which your home loan interest is calculated. As a result, you will earn the rate of interest charged by your home loan and no tax is payable on these earnings.

If you then continue your repayments at the same level, you'll pay even more off your loan and eliminate your debt sooner. Plus, you can usually access your emergency cash via a redraw facility or 100% offset account within 24 hours.

To find out whether this strategy suits your needs and circumstances and how you should go about it, you should speak to a financial adviser.

	Higher interest rate	Tax-effective	Repay home loan sooner	Fast access to emergency funds
Cash account	x	x	x	✓
Home loan / 100% offset account	✓	✓	✓	✓

<sup>1</sup> Includes a Medicare levy of 1.5%.

<sup>2</sup> An offset account is a transaction account that is linked to a home (or investment) loan and the balance is directly offset against the loan balance before interest is calculated.

<sup>3</sup> If your home loan has a redraw facility, you can make extra payments directly into your loan and withdraw the money if necessary.

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## Case study

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**Carolyn and Ian (from Strategy 1)** have a home loan of \$315,000 after consolidating their debts and the interest rate is 7% pa. Carolyn recently received an after-tax bonus of \$12,000 and the money is sitting in their joint cash account earning 4% pa.

Although they can access these funds at any time to meet unexpected bills or expenses, the after-tax return is only 2.74% pa, when you take into account they both pay tax at a marginal rate of 31.5%<sup>4</sup>.

To use their emergency cash more effectively, their financial adviser recommends they transfer the money into a 100% offset account linked to their mortgage. This will reduce the home loan balance on which interest is calculated to \$303,000. As a result, their emergency cash will effectively earn the home loan interest rate of 7% pa and they won't pay any tax on these earnings.

Their adviser also explains that if they continue to make home loan repayments of \$2,614 per month, they will save a total of \$26,822 in interest and cut over a year off the term of their loan. Furthermore, they will be able to withdraw their emergency cash from the offset account at any time via an ATM, BPAY<sup>®</sup> and cheque book.

To find out how their financial adviser helped them use their surplus cashflow to reduce their debts even faster, see Strategy 3.

**Note:** They could gain the same benefits by transferring the money directly into their home loan, as long as it has a redraw facility.

	Before strategy	After strategy
Loan term	17.4 years	16.2 years
Total interest payments	\$230,556	\$203,734
<b>Interest saving</b>		<b>\$26,822</b>

### Tips and traps

- The interest savings will usually be the same regardless of whether you put your emergency cash in a 100% offset account or directly into your home loan. This is because both options will effectively reduce the size of your loan before interest is calculated. However, a 100% offset account may be a better option, given that fees and restrictions may apply to a redraw facility.
- Some lenders allow you to establish multiple offset accounts to help you better manage your cashflow.
- Be careful when selecting a fixed rate home loan, as an offset account can usually only be linked to a variable rate loan.
- Once you've paid off your home loan, if you have an investment loan, it can be more tax-effective if you put your emergency cash in an offset account linked to your investment loan rather than the loan itself. This is because you can withdraw the money from the offset account for non-investment purposes without reducing the amount of interest you can claim as a tax deduction (see Strategy 7).

<sup>4</sup> Includes a Medicare levy of 1.5% and assumes that Ian earns \$75,000 pa and Carolyn earns \$60,000 pa.

# Strategy 3

## Harness your cashflow to reduce inefficient debt

**If you are currently spending less than you earn, you may want to use your surplus cashflow to accelerate the repayment of your home loan.**

### What are the benefits?

By using this strategy, you could:

- save on interest, and
- create equity in your home that could be re-borrowed for investment purposes.

### How does the strategy work?

The interest on many home loans is calculated on the daily balance, even though it may be charged against the loan less frequently.

You can therefore reduce the average daily loan balance (and save a considerable amount of interest) by:

**1. Increasing the repayment frequency** (eg from monthly to fortnightly). This can reduce your average daily loan balance even though the annual repayments remain the same.

**Note:** These benefits are only available if your salary is paid more frequently than you are making loan repayments.

**2. Increasing the repayment amount.** This involves using your surplus cashflow to pay off your loan sooner.

### 3. Crediting your entire salary

automatically into your home loan or a 100% offset account (if available). By doing this:

- Your salary hits your loan account sooner, having the same effect as increasing the repayment frequency.
- Your salary is immediately used to reduce the size of the loan, having the same impact as increasing the repayment amount.
- You may achieve a higher after-tax return than if your salary is paid into a cash account (see Strategy 2).
- You can access your money (either from a 100% offset account or using the loan's redraw facility) to meet your living expenses during the month.

### 4. Paying the majority of your living expenses with a credit card.

Provided the credit card is repaid within the interest-free period, this strategy enables you to use the credit card provider's money to fund your living expenses, while applying your own funds to reduce your average daily loan balance.

To find out how you should use your surplus cashflow to pay off your home loan sooner, you should speak to a financial adviser.

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## Case study

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**Carolyn and Ian (from strategies 1 and 2)** have a home loan of \$303,000 after consolidating their debts and transferring their emergency cash of \$12,000 into a 100% offset account.

Ian receives a fortnightly salary of \$2,213 after tax and Carolyn receives \$1,823 after tax. They are making home loan repayments of \$2,614 per month and their combined living expenses are \$4,800 per month (excluding loan repayments).

Their financial adviser recognises they are spending less than they earn and outlines some ways they could use their surplus cashflow to reduce the daily loan balance and save on interest. These include:

- **Increasing the repayment frequency** from monthly to fortnightly (by paying \$1,206 each fortnight rather than \$2,614 per month).
- **Increasing the repayment amount** by \$20 per fortnight to \$1,226.
- **Crediting their salary into a 100% offset account** and withdrawing money as required to meet their living expenses.
- **Paying the majority (75%) of their living expenses with a credit card** and transferring money from the offset account to pay off the credit card within the interest-free period each month.

The incremental advantage of adopting each of these strategies is:

	<b>Loan term</b>	<b>Total interest payments</b>
Before strategy	16.2 years	\$203,734
Changing payment frequency	16.2 years	\$202,939
Increasing regular repayments	15.7 years	\$196,035
Salary crediting	7.9 years	\$94,672
Credit cards	7.7 years	\$90,935

By using these strategies, Carolyn and Ian could reduce their home loan term by up to 8.5 years and save up to \$112,799 in interest.

Also, by paying off their non-deductible home loan debt as quickly as possible, they'll build a considerable amount of equity in the family home each year. Assuming they then wish to build their wealth further, they could use this equity as security for a tax-effective investment loan (see Strategy 4).

## Tips and traps

- To accelerate the repayment of inefficient debt, it is essential that you maximise income, limit expenditure and claim all the tax deductions and offsets you are entitled to.
- Many home loan simulations show a dramatic reduction in the loan term as a result of changing the payment frequency from monthly to fortnightly. However, these simulations often divide the monthly repayment by two (eg \$500 per month to \$250 per fortnight). This results in annual repayments of \$6,500 pa compared to \$6,000 pa with monthly payments.
- If you are considering salary crediting, check your payroll provider can pay your salary either directly into your home loan or a 100% offset account.
- Your lender may not allow you to make additional repayments into the fixed rate component of the loan.
- Some lenders allow you to automatically transfer money from your offset account to repay your credit card (in full) within the interest-free period.

# Strategy 4

## Use borrowed money to build wealth

**Once you have your inefficient debt under control, you may want to borrow for investment purposes.**

### What are the benefits?

By using this strategy, you could:

- multiply your investment profits, and
- take advantage of a range of tax concessions (see FAQs on page 26).

### How does the strategy work?

This strategy, commonly known as gearing, involves borrowing money to make an investment.

Gearing can enable you to build your wealth faster than if you relied exclusively on your own capital. The downside is that it can enhance your losses if your investments fall in value.

To be successful in the long term, the investments you acquire with borrowed money must generate a total return (income and capital growth) that exceeds the after-tax costs of financing the investment (including interest on the loan).

It's therefore generally recommended the borrowed money is invested in quality share or property investments (either directly or via a unit trust).

This is because shares and property have the potential to grow in value over the longer term. They also typically produce assessable income (which means you should be able to claim the interest on the investment loan as a tax deduction).

There are a number of ways you can establish a gearing strategy:

**1. You can borrow against the equity in your home.** This approach offers the benefit of a low interest rate and there are no restrictions on what you can invest in.

**2. You can take out a margin loan.**

This type of loan typically enables you to borrow up to 75% of the value of approved shares and managed investments, such as unit trusts.

For example, if you have \$25,000 and you want to purchase an approved investment with the help of a margin loan, you may be able to borrow up to \$75,000 and make a total investment of \$100,000. It's also possible to use a margin loan to gear on a regular basis. This is known as instalment gearing.

**3. You could invest in an internally geared share fund.** These are funds where the manager borrows on behalf of investors to make a larger investment in Australian or global shares (see Strategy 9).

To work out whether gearing suits you (and which approach you should use), you should speak to a financial adviser.

**Note:** Before you use a gearing strategy, you should ensure you have a suitable timeframe (preferably five years or longer) and understand the risks (see FAQs on page 27). For example, if your investments fall in value, your financial situation could be significantly worse than if you hadn't used a gearing strategy.

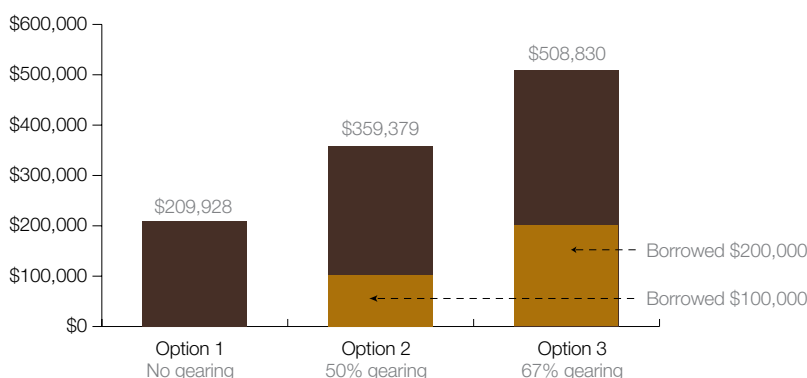
## Case study

**Jenny has \$100,000 invested** in an Australian share fund and wants to build her wealth even faster over the next 10 years. She has used some of the strategies outlined earlier in this booklet to pay off most of her home loan and her financial adviser presents three different options. These include:

- maintaining her investment at its current level of \$100,000
- doubling her investment by borrowing \$100,000 (ie a 50% gearing ratio), and
- tripling her investment by borrowing \$200,000 (ie a 67% gearing ratio).

The graph below illustrates the potential outcomes after 10 years, assuming Jenny uses an interest-only home equity loan in options 2 and 3, with an interest rate of 7% pa.

### Investment value after 10 years



**Assumptions:** Investment return is 8.5% pa (split 4% income and 4.5% growth). Investment income is franked at 75%. Interest on the loan is 7% pa. Jenny's marginal tax rate is 39.5% including a Medicare levy of 1.5%. These rates are assumed to remain constant over the investment period. With options 2 and 3, where investment income and tax advantages are insufficient to meet interest payments, a portion of the investment is sold to cover the shortfall. Otherwise the excess investment income and tax advantages are reinvested.

Clearly, the higher the gearing ratio, the greater the potential gains. But it's important to remember that Jenny still has an outstanding loan in options 2 and 3 of \$100,000 and \$200,000 respectively. If she withdrew a portion of her investment after 10 years to repay the outstanding debt and pay Capital Gains Tax (CGT) on the amount withdrawn, the value of her investment is shown in the table below.

### Investment value after repayment of loan

No gearing	50% gearing	67% gearing
\$209,928	\$251,815 <sup>1</sup>	\$293,701 <sup>1</sup>

As you can see, Jenny's financial position could improve by using a gearing strategy if the value of her investments rises sufficiently.

<sup>1</sup> After CGT on the amount withdrawn.

## Tips and traps

- Gearing should be seen primarily as a wealth creation strategy rather than a way to save tax. If you invest in assets that fail to produce enough income or capital growth over the longer term, your losses could outweigh any reduction in your tax bill.
- If you take out a margin loan, you may need to meet a margin call if your investments fall in value (see FAQs on page 27). To reduce the likelihood of a margin call, you should maintain a conservative loan-to-valuation ratio. You should also hold significant cash (or other liquid assets) to meet margin calls if required.
- If you have a partner, you may want to invest the existing funds in the name of the lower income earner and the borrowed funds in the name of the higher income earner (see Strategy 8).
- If you take out a fixed rate investment loan, you can manage interest rate risk and bring forward your tax deduction by pre-paying up to 12 months interest in advance.
- You should consider Income Protection insurance to cover the risk that you're unable to earn an income due to illness or injury.
- You should consider Life insurance if the lending institution requires the entire loan to be paid back in the event of your death.

# Strategy 5

## Transform your debt using a financial windfall

**If you receive a financial windfall, you may want to use the money to reduce your home loan and borrow an equivalent amount for investment purposes.**

### What are the benefits?

By using this strategy, you could:

- replace inefficient debt with efficient debt, and
- establish an investment portfolio to build your long-term wealth.

### How does the strategy work?

While paying off your home loan, it's possible you will receive a financial windfall such as a work performance bonus, an ex gratia payment on changing employers or an inheritance.

If that's the case, you may want to:

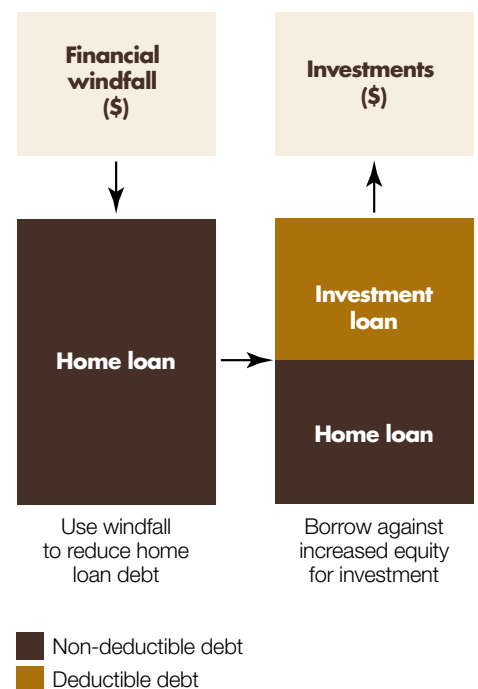
- use the windfall to reduce your home loan, by either paying the money into your loan or a 100% offset account attached to your loan
- arrange to borrow an equivalent amount through an investment loan (such as a line of credit secured by your home), and
- invest the borrowed money in assets such as shares – either directly or via a managed investment such as a unit trust.

This strategy is known as debt transformation because it enables you to convert some of your inefficient home loan debt (where the interest isn't tax-deductible) into an efficient investment loan (where the interest will generally be tax-deductible<sup>1</sup>).

As a result, you can reduce your after-tax interest cost considerably (see case study) and establish an investment portfolio to help build your long-term wealth.

The income and tax advantages from the borrowed investment could also enable you to reduce your remaining home loan faster.

To find out whether this strategy suits your needs and circumstances, you should speak to a financial adviser.



**Note:** Before you use a gearing strategy, you should ensure you have a suitable timeframe (preferably five years or longer) and understand the risks (see FAQs on page 27). For example, if your investments fall in value, your financial situation could be significantly worse than if you hadn't used a gearing strategy.

<sup>1</sup> To be eligible to claim the interest as a tax deduction, the investments you acquire with borrowed money will generally need to produce assessable income.

## Case study

**Daniel has a home loan of \$200,000**, the interest rate is 7% pa and he pays tax at a marginal rate of 39.5%<sup>2</sup>. He has just received an inheritance of \$100,000 and would like to invest this money to build his long-term wealth.

If he uses the inheritance to purchase the investments directly, his home loan will remain at \$200,000 and, because the interest payments are not tax-deductible, the after-tax interest cost will be approximately \$14,000 pa (see option 1 below).

After assessing his goals and financial situation, Daniel's financial adviser explains that a potentially better approach would be to:

- use the \$100,000 to reduce his home loan
- borrow an equivalent amount through an interest-only investment loan secured by his home, and
- purchase the investments with the borrowed money.

If Daniel follows this advice, he'll have a home and investment loan of \$100,000 each and the after-tax interest cost of the home loan will be \$7,000. However, because the investment loan interest (also \$7,000) is tax-deductible<sup>3</sup>, the after-tax cost of this loan will only be \$4,235 pa (see option 2).

In other words, if Daniel uses this debt transformation strategy, while his total debts will remain at \$200,000, his total after-tax interest bill will reduce from \$14,000 pa to \$11,235 pa and he'll still get to invest \$100,000.

Loan type	Option 1 Without debt transformation	Option 2 With debt transformation	
	Home loan only	Home loan	Investment loan
Loan amount	\$200,000	\$100,000	\$100,000
Interest payable at 7% pa	\$14,000	\$7,000	\$7,000
Less tax advantage at 39.5% <sup>2</sup>	N/A	N/A	(\$2,765)
After-tax interest cost	\$14,000	\$7,000	\$4,235
Total after-tax interest cost	\$14,000	\$11,235	

His financial adviser also suggests that:

- he use the income from the investments and the after-tax interest savings to pay off his home loan faster, and
- when his home loan is repaid, he use the investment income and tax savings to purchase more investments and build even more wealth in the future.

<sup>2</sup> Includes a Medicare levy of 1.5%.

<sup>3</sup> Assumes that the investments purchased with the borrowed money produce assessable income.

## Tips and traps

- An alternative to debt transformation is to use the financial windfall to pay down your home loan and not invest. While this strategy will reduce your non-deductible debt (and save you interest), it may not be as effective in growing your wealth.
- You could also transform your debts when selling existing investments by using the sale proceeds to reduce your home loan and borrow an equivalent amount to invest in other assets.

**Caution:** If you sell an asset, recycle the proceeds through your home loan and borrow to buy back the same asset, the Australian Taxation Office may consider this a scheme to obtain a tax benefit and seek to apply penalties and deny your interest tax deduction.

- To make it easier to calculate how much of your interest is tax-deductible when completing your tax return, you should keep your investment loan separate from your home loan. This could be done by establishing a separate investment loan or, if offered by your lender, a loan that enables you to establish separate sub-accounts within the one loan facility.

# Strategy 6

## Build wealth via debt recycling

**As you pay down your home loan, you may want to progressively redraw the equity you create for investment purposes.**

### What are the benefits?

By using this strategy, you could:

- replace inefficient debt with efficient debt on a regular basis, and
- establish an investment portfolio to build your long-term wealth.

### How does the strategy work?

While it's important to reduce inefficient home loan debt as quickly as possible, it's also important to build wealth for the long term to meet your lifestyle goals, such as retirement.

However, many people wait until their home loan is paid off before thinking about investing. Unfortunately, this means they invest later in life and don't give their investments time to grow.

One solution is to transform your debts using a financial windfall (see Strategy 5). Another approach is to use what is known as debt recycling.

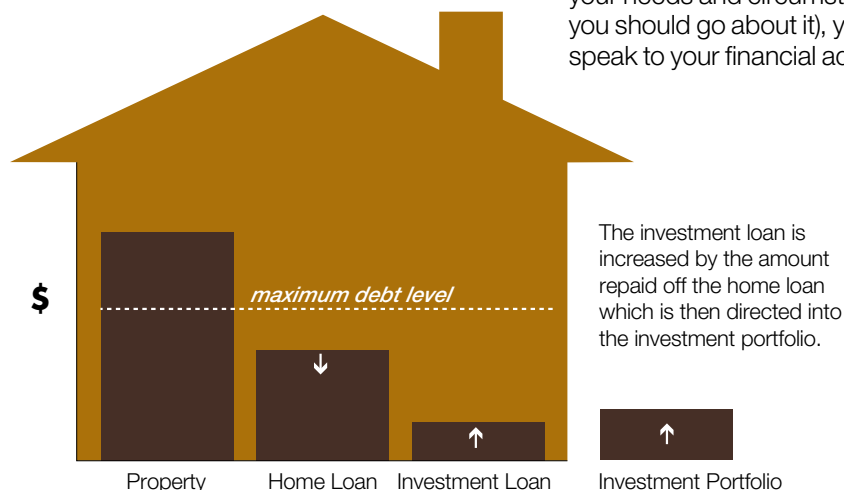
With debt recycling, you need to:

1. use the equity in your home to establish an investment loan (such as a line of credit)
2. invest the borrowed money in assets such as shares – either directly or via a managed investment such as a unit trust, and
3. use the investment income and tax advantages from the geared investment, as well as your surplus cashflow (see Strategy 3), to reduce your outstanding home loan balance.

At the end of each year, you then need to borrow an amount equivalent to what you've paid off your home loan and use this money to purchase additional investments.

This process is then continued each year until your home loan is repaid. After that, your surplus income (including investment income and tax advantages) can be used to acquire additional investments or pay down your investment loan.

To find out whether debt recycling suits your needs and circumstances (and how you should go about it), you should speak to your financial adviser.



**Note:** Before you use a gearing strategy, you should ensure you have a suitable timeframe (preferably five years or longer) and understand the risks (see FAQs on page 27). For example, if your investments fall in value, your financial situation could be significantly worse than if you hadn't used a gearing strategy.

## Case study

**Greg, aged 45, and Jackie, aged 44,** want to pay off their home loan by the time Jackie turns 50. Their home is worth \$600,000 and they still owe \$300,000 on their mortgage. Their after-tax salaries are \$3,042 and \$1,575 per fortnight and their combined living expenses are \$4,800 per month.

To achieve their goal, they have been crediting their salaries into a 100% offset account, using credit cards to pay the majority of their living expenses and paying off their credit cards at the end of the interest-free period (see Strategy 3).

However, they also want to maintain their lifestyle when they stop working. So, their financial adviser suggests they use debt recycling to complement the wealth they are accumulating in superannuation.

They're comfortable with a total debt equivalent to 67% of their home value (ie \$400,000). Given they currently owe \$300,000, they use the equity in their home to establish an interest-only investment loan of \$100,000 and invest the money in Greg's name in a managed Australian share portfolio.

They also arrange for the investment income and tax benefits to be paid into (and the investment loan interest to be deducted from) their home loan offset account.

At the end of the first year, after reducing their home loan by \$43,057, they increase their investment loan by the same amount and use the money to purchase more units in Greg's share fund.

They continue this process each year until their home loan is paid off six years from now. Then, for the next 14 years, they invest all their surplus cashflow (including the investment income and tax savings) in the share portfolio.

The table below shows the benefits of this strategy over 20 years, when compared to paying off their home loan as quickly as possible and directing their surplus cashflow into a share fund once the home loan is paid off. By using debt recycling, Greg and Jackie will have an investment portfolio worth an extra \$357,861 after Capital Gains Tax (CGT) and loans are paid (despite taking slightly longer to repay their home loan).

After 20 years	Debt recycling	Repay home loan then invest
Time taken to repay home loan	6 years	5.7 years
Value of investment portfolio (net of CGT)	\$2,633,489	\$1,875,628
Outstanding debt	(\$400,000)	Nil
Net position after 20 years (after selling all investments, paying CGT and repaying the loan)	\$2,233,489	\$1,875,628

**Assumptions:** The Australian share fund provides an investment return of 8.5% pa (split 4% income and 4.5% growth). Investment income is franked at 75%. The home and investment loan interest rate is 7% pa. These rates are assumed to remain constant over the investment period. Greg earns a salary of \$110,000 pa and Jackie earns \$50,000 pa.

## Tips and traps

- If you take out an interest-only investment loan, you can use more of your cashflow to reduce your home loan.
- Arranging a higher investment loan limit can enable you to avoid additional paperwork and fees when adjusting your loan balances each year.
- While a line of credit (which has investment and home loan sub-accounts) can make it easier to do debt recycling, these loans generally have higher interest rates than standard home loans.
- With debt recycling, because some of your surplus cashflow must be used to meet the investment loan interest, it may take you slightly longer to pay off your home loan. However, the upside is you can acquire an investment portfolio sooner and potentially accumulate greater wealth.
- When you've paid off your home loan, you could use your surplus cashflow to add to your investments or reduce your investment loan balance. Assuming the after-tax return from your investments is greater than the interest cost (which is tax-deductible), you are generally better off investing, provided you're comfortable maintaining the total debt level.

# Strategy 7

## Offset your investment loan to retain tax efficiency

**If you have already paid off your home loan, you may want to put your emergency cash reserve in a 100% offset account linked to your investment loan.**

### What are the benefits?

By using this strategy, you could:

- earn a higher after-tax return than a cash account, and
- withdraw the money for any purpose without affecting the tax-deductibility of the loan.

### How does the strategy work?

In Strategy 2 we explained why you might want to hold your emergency cash reserve in your home loan or a 100% offset account linked to your home loan.

But what should you do if your home loan has been repaid and you only have an investment loan?

Holding your emergency cash in your investment loan or 100% offset account linked to your investment loan, could enable you to earn a higher after-tax return than using a separate cash account.

But if you want to access the money for non-investment purposes, paying it into a 100% offset account linked to your investment loan is likely to be a more tax-effective alternative than paying it into the investment loan itself.

The reason is that, because an offset account is separate from your investment loan account, you can make repayments (and access them if required), without affecting the size of the investment loan or the tax deductibility of the interest.

Conversely, if you pay money into the investment loan itself, you'll reduce the size of the loan and if you redraw the money for non-investment purposes, you can't claim the interest on the redrawn amount as a tax deduction.

This means you could end up in a situation where part of your interest is tax-deductible and the rest is not (as the following case study shows).

To find out more about this strategy, you should speak to a financial adviser.

	Investment loan	100% offset account linked to an investment loan
Can you access your emergency cash for any purpose?	Yes	Yes
Do withdrawals for non-investment purposes reduce the tax deductibility of the loan?	Yes	No

## Case study

**After paying off her home loan, Laura, aged 45,** used some of the equity in her home to set up an interest-only investment loan for \$100,000, and invested in a managed share fund. The interest rate on the investment loan is 7% pa.

She recently received an after-tax bonus of \$20,000 from her employer. She plans to buy a car in 12 months and wants to know what she should do with the money in the meantime.

If she pays the bonus directly into her investment loan, the balance will drop to \$80,000. However, when she redraws the \$20,000 to buy her car, she won't be able to claim the interest on this part of the loan as a tax deduction. As a result, she'll end up with a mixture of deductible and non-deductible debts.

### After withdrawing \$20,000 from investment loan



After assessing her goals and financial situation, Laura's financial adviser suggests that she pay the bonus into a 100% offset account linked to her investment loan. By doing this, while her investment loan will stay at \$100,000, she'll save the same amount of interest. This is because interest is only payable on the difference between her loan account and the offset account (ie on \$80,000).

Also, when she withdraws the \$20,000 from her offset account to buy her car, the size of the investment loan will not be affected and the interest payments will continue to be fully tax-deductible.

### After withdrawing \$20,000 from offset account



## Tips and traps

- To use this strategy, your investment loan must have a 100% offset account. If your current loan does not have this facility, check with your lender to see if it can be added.
- In many cases, the lender will only allow an offset account for the variable rate portion of the loan.
- Line of credit facilities don't generally offer a 100% offset account. Even if a personal sub-account is in credit, the lender may not offset this against the outstanding investment loan sub-account.
- If you need to borrow money for a non-investment purpose and don't have an offset account, it's usually better to borrow using a separate loan rather than redraw from your investment loan. This way it's easier to keep track of your deductible and non-deductible interest costs.
- Once you have paid off your home loan, it can be a good idea not to cancel the mortgage. This may allow you to use the equity in your home to borrow for investment or non-investment purposes (up to your original pre-approved borrowing limit), without additional State Government mortgage duty or Land Titles Office registration fees.

# Strategy 8

## Make gearing more tax-effective for a couple

**If you have a partner, when using a gearing strategy you may want to invest your existing funds in the lower income earner's name and the borrowed funds in the higher income earner's name.**

### What are the benefits?

By using this strategy, you could:

- reduce tax on investment earnings, and
- accumulate a larger amount.

### How does the strategy work?

When using gearing, it's common to invest a combination of your own capital and borrowed money.

But if you have a partner, rather than investing the combined amount in one person's name, splitting ownership of the investments could improve the outcome considerably.

As a rule of thumb:

- holding the ungeared investments (ie your existing capital) in the name of the lower income earner could enable them to pay less tax on the investment income, and
- holding the geared investments (ie the investments purchased with borrowed money) in the higher income earner's name could enable them to benefit more when claiming the investment loan interest (and certain other costs) as a tax deduction.

If you split ownership, you also have the flexibility to decide who should sell some of their investment to pay off the loan. To minimise Capital Gains Tax (CGT), this should generally be the person who pays tax at the lower marginal rate at that time.

The amount of income generated by the investments can also make a significant difference to the results.

For example, it can be more tax-effective for the higher income earner to invest the borrowed money in lower yielding assets (ie those that generate a lower income).

Conversely, there can be an advantage in investing the money in the lower income earner's name in higher yielding assets.

To find out whether you could benefit from this strategy, you should speak to a financial adviser.

**Note:** Before you use a gearing strategy, you should ensure you have a suitable timeframe (preferably five years or longer) and understand the risks (see FAQs on page 27). For example, if your investments fall in value, your financial situation could be significantly worse than if you hadn't used a gearing strategy.

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## Case study

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**Rob pays tax at a marginal rate of 39.5%<sup>1</sup>**, while his wife Angela has a marginal tax rate of 16.5%<sup>1</sup>. They have \$40,000 in cash and want to borrow another \$60,000 so they can invest a total of \$100,000 in a managed Australian share fund.

They plan to hold the investment for 10 years and their financial adviser presents four different options, including:

1. Investing all the money (\$100,000) in a share fund in Rob's name, with Rob selling some of his investment at the end of the 10 years to repay the loan and CGT on the amount withdrawn.
2. Splitting ownership so the existing capital (\$40,000) is invested in Angela's name and the borrowed money (\$60,000) is invested in Rob's name. Rob will also sell some of his investment to pay off the loan and any associated CGT.
3. Splitting ownership (as per option 2 above), but with Angela selling some of her investment to repay the loan and CGT.
4. Splitting ownership (as per option 3 above), but with Rob investing in a share fund that pays a lower yield.

The results from each of these strategies are shown in the table below. As you can see, it is possible to add thousands of dollars to the bottom line by making the right ownership decisions when gearing as a couple.

Option	Result
1. All investments in Rob's name	\$109,103
2. Split ownership (Rob repays the loan)	\$119,078
3. Split ownership (Angela repays the loan)	\$121,801
4. As above, but Rob invests in a lower yielding fund	\$126,915

**Assumptions:** In option 4, Rob (only) invests in a share fund with a total return of 8.5% (split 1.5% income and 7% growth). In all other scenarios, Angela and/or Rob invest in a share fund with a total return of 8.5% pa (split 4% income and 4.5% capital growth). Investment income is franked at 75%. The loan interest rate is 7% pa. These rates are assumed to remain constant over the investment period. Where the investment income and tax advantages are insufficient to meet interest payments, a portion of the investment is sold to cover the shortfall. Otherwise the excess investment income and tax advantages are reinvested.

<sup>1</sup> Includes a Medicare levy of 1.5%.

### Tips and traps

- When splitting ownership, the lower income earner could invest the existing funds in their name and offer these investments as third-party security so that the higher income earner can take out a margin loan in their name. With this approach, the owner of the existing funds may be required to act as guarantor or third-party mortgage provider to the loan facility.
- You may be able to avoid the need for a guarantor by using a home equity loan. In this scenario, it's possible for one member of the couple to invest joint borrowings secured against their home in their own name and still claim a full interest tax deduction.
- Rather than selling the geared or ungeared assets to pay off the investment loan, you may be able to redeem non-CGT assets (eg cash) or pre-CGT assets. Alternatively, you may be able to manage CGT if you sell investments in a low-income year, sell investments progressively (ie over two or more financial years), crystallise losses or (if eligible) contribute the sale proceeds into super and claim a tax deduction to offset the taxable capital gain.
- When gearing in the higher income earner's name, reinvesting the income from this investment in the lower income earner's name can reduce the future tax payable on the reinvested amount.
- You should also consider factors such as the protection of assets (eg in the event of bankruptcy or litigation) when making ownership decisions.

# Strategy 9

## Leverage your investment via an internally geared share fund

**If you are looking for a simple way to gear into the sharemarket, you may want to invest in an internally geared share fund.**

### What are the benefits?

By using this strategy, you could:

- access the power of gearing without having to arrange an investment loan yourself, and
- take advantage of potentially lower interest costs.

### How does the strategy work?

In previous strategies, we explained how borrowing to invest (gearing) can be a potentially powerful way to build long-term wealth.

One option is to arrange the investment loan yourself – by either borrowing against the equity in your home or taking out a margin loan.

Another way to benefit from gearing is to invest in what is called an internally geared share fund—either within or outside superannuation.

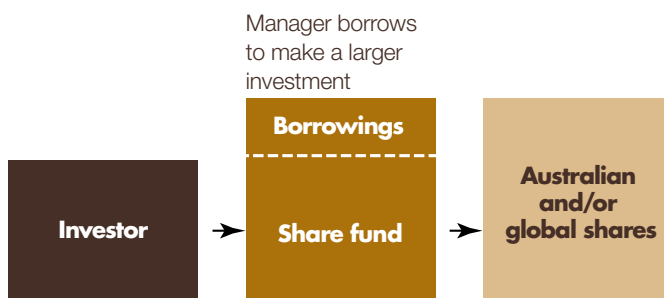
With internally geared share funds, the manager borrows on behalf of investors to make a larger investment in Australian and/or global shares (see diagram below).

The manager typically borrows at wholesale interest rates, which can be significantly lower than what you could access yourself.

The loan is generally limited recourse in nature. This means that if the investments fall in value below the level of fund borrowings, you are not required to pay back the shortfall to the lending institution.

The fund is also usually structured so that the income exceeds the loan interest, as well as any fees. In other words, the fund is usually positively geared (see FAQs on page 25).

To find out whether an internally geared share fund suits your needs and circumstances, you should speak to a financial adviser.



## Case study

**Tony, aged 40, has \$50,000** to invest for at least 10 years. He is looking for a simple way to gear into the sharemarket without having to organise his own finance.

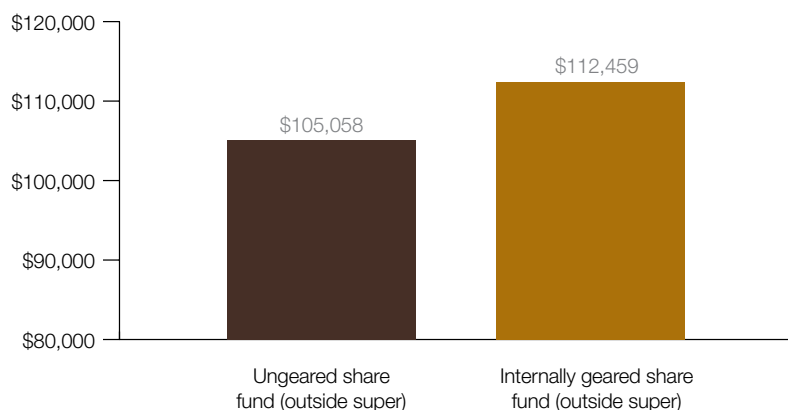
His financial adviser suggests he invest the \$50,000 in an internally geared share fund outside superannuation. This will enable him to access the money at all times and take advantage of the many benefits that an internally geared share fund can provide (see page 20).

The fund borrows an extra \$15,000 on his behalf, at a wholesale interest rate of 6% pa. As a result, his total initial investment is \$65,000 with a modest gearing ratio of 23% (ie  $\$15,000/\$65,000 \times 100 = 23\%$ ).

The graph below illustrates the potential outcome after 10 years, when compared to investing in a share portfolio with the same underlying investments that doesn't borrow on behalf of its investors.

As you can see, an internally geared share fund could improve Tony's financial position significantly.

### Value of investment after 10 years (outside super)



He could also consider investing some of his super in an internally geared share fund. If he does this with \$50,000, he could have \$121,292 after 10 years compared to \$114,111 if he invested the same amount in a non-g geared share portfolio in his super fund.

The reason the super numbers are higher than those in the graph above is because super funds pay a maximum tax rate of 15% on investment earnings. Conversely, when you invest outside super, earnings are taxed at your marginal rate, which could be up to 46.5%<sup>1</sup>.

The trade-off, however, is that you can't access your super until you reach a minimum age of 55 and permanently retire or meet another condition of release.

<sup>1</sup> Includes a Medicare levy of 1.5%.

## Tips and traps

- While internally geared share funds can magnify your investment returns, they can also magnify your losses.
- Since the borrowing is done by the manager, you can't choose the level of gearing.
- You can use borrowed money to invest in an internally geared fund, but this will significantly increase your investment risk.
- Some internally geared share funds allow you to invest fixed amounts on a regular basis, using a regular savings plan. This can take the guesswork out of trying to pick the right time to buy. It can also allow you to invest earlier as you don't necessarily need a substantial amount to get started.
- It's now possible for super funds to borrow to invest in a range of assets, provided certain conditions are met (see your financial adviser for more information).

**Assumptions:** Investment return is 8.5% pa (split 3% income and 5.5% growth). Investment income is franked at 75%. Interest on the loan is 6% pa. Tony's marginal tax rate is 39.5% including Medicare levy. These rates are assumed to remain constant over the investment period. With the internally geared investments, where investment income and tax benefits are insufficient to meet interest payments and other expenses, units may be issued to the lender or manager to cover the shortfall. Net income remaining is distributed to the investor (for unit trust investors) or credited to their account (for superannuation fund members).

# Investing with borrowed money

There are a number of ways to use efficient debt to help you build wealth tax-effectively. You can either borrow personally (eg via a home equity or margin loan) or invest in an internally geared share fund where the manager borrows on your behalf.

This table summarises the key advantages and disadvantages of each of these three popular forms of gearing. A financial adviser can help you determine the most appropriate gearing option for your circumstances.

	<b>Home equity loan</b>
<b>Description</b>	<ul style="list-style-type: none"> <li>• Allows you to use the equity in your home to borrow money to invest where you choose.</li> <li>• Can range from a standard principal and interest loan through to a line of credit (interest-only).</li> </ul>
<b>Advantages</b>	<ul style="list-style-type: none"> <li>• You have control over the gearing levels.</li> <li>• No margin calls are required if there is an investment market downturn.</li> <li>• Low interest rate (small premium for line of credit).</li> <li>• Features can include a 100% offset account, redraw facility and salary crediting.</li> <li>• Option of either a fixed, variable or split interest rate loan.</li> <li>• No investment restrictions.</li> <li>• Ability to make interest-only payments (with a line of credit).</li> <li>• Ability to pre-pay interest for up to 12 months and bring forward your tax deduction (only for fixed rate options) if deriving assessable income.</li> <li>• Line of credit allows multiple loan accounts within a facility, so you can track deductible and non-deductible interest.</li> <li>• If you are negatively geared, you may be able to offset excess deductions against other income.</li> </ul>
<b>Disadvantages</b>	<ul style="list-style-type: none"> <li>• Needs equity in a residential property.</li> <li>• Interest premium with a line of credit.</li> <li>• Where credit cards and cheque accounts are attached, you need discipline to prevent eroding of your equity.</li> </ul>
<b>Investors who may be suited to this approach</b>	<ul style="list-style-type: none"> <li>• Investors who have equity in their home and are comfortable borrowing against it.</li> <li>• Investors who have non-deductible debt, as they can take advantage of the loan features for debt reduction and recycling.</li> <li>• Investors who wish to avoid margin calls.</li> </ul>

<b>Margin loan</b>	<b>Internally geared share fund</b>
<ul style="list-style-type: none"> <li>• Allows you to borrow to invest in approved shares or managed funds, as a lump sum or in regular instalments. This is secured against the value of that investment.</li> </ul>	<ul style="list-style-type: none"> <li>• A managed investment where the fund borrows money to make a larger investment in Australian and/or global shares.</li> <li>• The fund is usually managed so that it remains positively geared (ie the fund income is sufficient to cover interest and fees).</li> </ul>
<ul style="list-style-type: none"> <li>• You have control over the gearing levels.</li> <li>• Instalment gearing reduces risk through dollar cost averaging (investments are acquired at an average market price).</li> <li>• Option of either a fixed, variable or split interest rate loan.</li> <li>• Ability to make interest-only payments.</li> <li>• Ability to pre-pay interest for up to 12 months and bring forward your tax deduction (only for fixed rate loans) if deriving assessable income.</li> <li>• If you are negatively geared, you may be able to offset excess deductions against other income.</li> <li>• You may be able to arrange for another person (or company) to provide third-party security for your margin loan.</li> </ul>	<ul style="list-style-type: none"> <li>• The fund is able to borrow at wholesale interest rates, which are generally lower than those available to individuals.</li> <li>• No margin calls are required if there is an investment market downturn.</li> <li>• The loan is limited recourse, which means your liability is limited to the value of your initial investment.</li> <li>• Investing in the fund is much simpler than establishing a borrowing facility yourself.</li> <li>• Enables you to access gearing in superannuation without having to establish your own fund.</li> </ul>
<ul style="list-style-type: none"> <li>• Higher interest rate than standard home equity loan.</li> <li>• Potential for margin calls if there is an investment market downturn.</li> <li>• Maximum gearing ratio limited to around 75% (you need to make your own initial contribution).</li> <li>• Investment options limited to investment menu of the lender (can include hundreds of direct shares or managed funds).</li> </ul>	<ul style="list-style-type: none"> <li>• Limited control over the gearing level.</li> <li>• Limited number of providers and investment options.</li> <li>• Interest on the fund borrowings is generally offset against fund income. No tax deduction for interest is available to investors unless they borrow personally to invest in these funds.</li> </ul>
<ul style="list-style-type: none"> <li>• Investors who do not own a home or do not have sufficient equity within their home.</li> <li>• Investors who do own a home but are uncomfortable with using it as security.</li> <li>• Instalment margin loans are suitable for investors with regular income but no lump sum to invest.</li> </ul>	<ul style="list-style-type: none"> <li>• Members of super funds that offer these options.</li> <li>• Investors who do not own a home or do not have sufficient equity within their home.</li> <li>• Investors looking for simplicity of a pre-packaged geared investment.</li> <li>• Investors who want to limit potential losses.</li> <li>• Investors who are uncomfortable with using their home as security.</li> </ul>

# Frequently Asked Questions

## What are the marginal tax rates?

The table below summarises the marginal tax rates in 2009/10:

Taxable income range	Tax payable (by residents)
\$0–\$6,000	Nil
\$6,001–\$35,000	15% <sup>1</sup> on amount over \$6,000
\$35,001–\$80,000	\$4,350 + 30% <sup>1</sup> on amount over \$35,000
\$80,001–\$180,000	\$17,850 + 38% <sup>1</sup> on amount over \$80,000
\$180,001 +	\$55,850 + 45% <sup>1</sup> on amount over \$180,000

## What is the Medicare levy?

A levy of 1.5% is payable on the whole of your taxable income on top of normal marginal tax rates. If you earn less than \$17,794 pa (\$30,025 pa combined for couples) you are exempt from the levy. If you earn slightly more than these limits, the levy is phased in. An additional 1% surcharge applies to singles with an income over \$73,000 pa (or couples with a combined income of \$146,000 pa) who don't have private health insurance. If applicable, this Medicare levy surcharge will be payable on top of the base Medicare levy of 1.5%.

**Note:** The Government proposed in the 2009 Federal Budget that a Medicare levy surcharge of up to 1.5% will be payable by higher income earners from 1 July 2010.

## How does dividend imputation work?

Franking or imputation credits (see Glossary) may be available when you receive dividends from Australian shares. The following example illustrates the advantages of dividend imputation, assuming shareholders on different marginal tax rates receive a fully franked dividend of \$70.

Marginal tax rate	15%	45%	This, in very simple terms, is how dividend imputation works
<b>Dividend</b>	\$70	\$70	1. A company pays a fully franked dividend <sup>2</sup> .
<b>Franking credit</b>	\$30	\$30	2. You add the franking credit <sup>3</sup> to your dividend ...
<b>Assessable income</b>	\$100	\$100	to get your assessable income.
<b>Gross tax</b>	\$15	\$45	3. Then you calculate the gross tax based on your tax rate ...
<b>Less franking credit</b>	(\$30)	(\$30)	and subtract the franking credit ...
<b>Net tax payable</b>	Nil	\$15	to get your net tax payable.
<b>Excess franking credit</b>	\$15	Nil	If your franking credit is larger than your gross tax, the Australian Taxation Office will offset (ie refund) any excess (available for certain taxpayers only).
<b>Net income received</b>	\$85	\$55	Deduct your net tax from your dividend, or add your excess franking credit to your dividend, to get your after-tax income.

**Note:** Certain investors who are unable to use all their franking credits can claim a refund of these credits in their annual tax return.

## What is Capital Gains Tax (CGT)?

CGT is a tax on the growth in the value of certain assets or investments acquired after 19 September 1985 and is generally only payable when a gain is realised.

This usually occurs when an asset is sold or where there is a change in ownership. When you invest via a unit trust, you may also receive realised capital gains via the distribution(s) if the fund manager sells underlying investments for a profit.

A capital gain will arise where the proceeds received on disposal of an asset exceed the cost base.

For assets disposed of on or after 11.45am (AEST) on 21 September 1999, CGT is usually payable by individuals and trusts on 50% of the nominal gain (ie the difference between the sale price and the cost base) where the asset has been held for more than 12 months.

As only half the gain is taxable, the effective tax rate for an individual on the highest marginal tax rate (including Medicare levy) of 46.5% is reduced to 23.25%.

For assets acquired before 21 September 1999, certain investors can choose between two methods when working out their CGT liability:

1. they can elect to be taxed on 100% of the real gain (ie the difference between the sale price and the frozen indexed cost base as at 30 September 1999), or
2. they can choose to be taxed on 50% of the nominal gain.

If an asset is held for 12 months or less, neither the 50% discount nor indexation applies (ie the investor is taxed on the full nominal gain).

## How are capital losses treated for tax purposes?

A capital loss occurs when the proceeds received on disposal of an asset are less than the reduced cost base.

A capital loss can be offset against current year capital gains, but cannot be used to reduce other sources of assessable income (eg salary).

Broadly, if there is a net capital loss for the income year, the loss can be carried forward and offset against gains in future years.

## What is gearing?

Gearing simply means borrowing money to invest. You can benefit from gearing if the growth in the value of the investment and the income you receive is greater than the after-tax cost of borrowing (including interest on the loan).

## What is positive gearing?

Positive gearing occurs when the assessable income from your investments is greater than the interest and other costs you pay on the borrowed money.

For example, if you invest \$150,000 of your own money plus \$50,000 of borrowed money (at an interest rate of 7% pa) into an asset that produces an annual income of 3%:

- your loan interest bill for the year will be \$3,500 (ie 7% of \$50,000), and
- your investment income will be \$6,000 (ie 3% of \$200,000).

In this scenario, you will be positively geared because the investment income exceeds the loan interest. This cashflow surplus of \$2,500 will need to be added to your assessable income when you complete your income tax return.

If you are on the top marginal tax rate of 46.5% (including a Medicare levy of 1.5%), you will pay \$1,163 in tax on this surplus income.

## What is negative gearing?

Negative gearing arises when the interest payments (and other costs) on your investment loan in a particular year are greater than the assessable income received from your geared investment.

In this situation, the cashflow shortfall can generally be claimed as a tax deduction to offset other sources of assessable income.

For example, if you invest \$100,000 of your own money plus \$100,000 of borrowed money (at an interest rate of 7% pa) into an asset that produces an annual income of 3%:

- your loan interest bill for the year will be \$7,000 (ie 7% of \$100,000), and
- your investment income will be \$6,000 (ie 3% of \$200,000).

In this scenario, you will be negatively geared because the loan interest exceeds the income from the investment. The cashflow shortfall of \$1,000 can be deducted from your other assessable income (eg salary) when you complete your income tax return.

If you are on the top marginal tax rate of 46.5% (including a Medicare levy of 1.5%), this strategy will save you \$465 in tax.

**Caution:** Investors who negatively gear should ensure they can meet cashflow shortfalls during the year.

<sup>1</sup> These rates do not include the Medicare levy.

<sup>2</sup> This is the after-tax income distributed by the company.

<sup>3</sup> This is the tax already paid by the company at the company tax rate of 30%.

# Frequently Asked Questions

## How can gearing help you save tax?

Gearing not only increases your potential to make money, it can also minimise your tax. The potential advantages of gearing include:

- Where the interest expense (plus costs) exceeds the assessable income in a particular year (ie the investment is negatively geared), the excess expense is generally tax-deductible and can be used to reduce the tax payable on other income such as your salary.
- If you invest the borrowed money in Australian shares directly or via a unit trust, the income you receive may have franking credits attached (see the dividend imputation explanation on page 24). These credits can be used to offset other tax payable, with any excess franking credits refunded to you.
- You may claim a tax deduction for the interest expense in the current financial year, but defer Capital Gains Tax (CGT) until you dispose of the investment. The investment may also be sold in a low-income year (eg after you retire) to minimise CGT.

- Where the investment is held for more than 12 months, only 50% of the capital gain needs to be included in assessable income.
- If you pre-pay interest costs on fixed rate loans up to 12 months in advance, you can bring forward an expense that may otherwise be tax-deductible in the following financial year.
- Negative gearing will reduce your taxable income, which could assist in minimising your CGT liability.

**Note:** You need to carefully consider in whose name the geared investment should be held. It may be better to hold the investment in the name of a higher marginal tax rate payer (to maximise the value of tax deductions in a negative gearing scenario). However, it could be equally advantageous to have the investment in the name of a low marginal tax rate payer (to reduce the amount of CGT payable at the end of the investment period).

## Is gearing right for you?

The following questions highlight some of the key issues you should consider before using a gearing strategy:

- Do you have a regular, secure income stream (eg a salary)?
- Do you intend to invest for at least five years, preferably longer?
- Can you tolerate short-term fluctuations in the value of your investment?
- Do you have sufficient surplus cashflow (eg to service all debts if the loan interest rate was to rise)?
- Do you have Income Protection insurance to protect your income in the event of injury or illness?
- For margin loans, do you have immediate access to sufficient funds to meet a margin call if the investment was to fall in value?

## What are the risks of gearing?

When borrowing money to invest, there are a range of risks you need to consider. These may include:

- A sustained fall in the value of your investments, which could result in capital losses or a margin call (if using margin lending).
- A fall in investment income, which could impact your ability to fund the investment loan interest and other relevant costs.
- A rise in interest rates, which may affect your ability to meet the interest payments or repay the loan.
- A loss of your regular income due to illness, injury or unemployment, which could affect your capacity to service the loan.

## How can you manage these risks?

You can reduce the risk of gearing by:

- Maintaining a conservative loan to valuation ratio. This allows you to access the benefits of gearing without overexposing yourself to the risks. This will also reduce the likelihood of a margin call on a margin loan.
- Using instalment gearing. This allows you to acquire investments at an average price and avoid any need to time the investment acquisition. As investment values fall, you acquire more assets for a given investment and, as they rise, so does the value of your existing holdings. Instalment gearing also allows you to defer or stop loan drawdowns if your circumstances change.
- Diversifying across a range of investments to minimise investment fluctuations. This can be achieved easily with managed funds, which can offer diversification across asset classes, countries or regions and fund manager styles.
- Having ready access to cash to meet margin calls on a margin loan. This means you are not forced to sell some of the investment if prices fall substantially.
- Ensuring the investments are liquid (ie they can easily be sold) so you can exit the investment if you need to.
- Taking out a fixed rate investment loan to manage interest rate risk.
- Taking out Life insurance if the lender requires the loan to be repaid on death. The investments can then be transferred to your beneficiaries in the event of your death.

- Taking out Income Protection insurance to cover the risk of being unable to work due to illness or injury.
- Limiting losses to the value of your investment by investing in an internally geared share fund.

## What is a margin call?

A margin call is a demand from a margin lender that you make an immediate loan repayment or deposit additional money to cover a fall in the value of your investment.

This occurs when the ratio of your loan (ie borrowed money) to security (ie your total investment) exceeds an agreed amount. The lending institution usually allows a certain buffer before demanding a margin call.

Different margin lenders and margin loans have very different terms and conditions. Some have 5% buffers, others have 10%, some require margin calls to be paid within 24 hours and others give you a few days' grace.

You should seek professional financial planning advice before you establish a margin loan.

Options when a margin call is due include:

- repaying part of the loan
- investing more money to increase the investment value
- providing additional assets as security, or
- selling assets to repay the loan.

# Glossary

## A

**Assessable income** – Income, including capital gains, on which you pay tax (ie your total income before deducting allowable deductions).

**Asset classes** – The different categories of investments (ie cash, bonds, property and shares).

## B

**Borrowing limit** – The maximum amount the lender agrees to let you borrow when your loan application is approved. This may be drawn down in a single amount or instalments, or never drawn down at all.

## C

**Capital** – Cash or assets that can be applied towards a particular purpose.

**Capital Gains Tax (CGT)** – A tax on the growth in the value of assets or investments that is payable when a gain is realised. If the assets have been held for more than one year, the capital gain may receive concessional treatment (see FAQs on page 24).

**Cashflow** – The amount of money received in a certain period. Surplus cashflow refers to the net inflow of money (ie income received net of tax and non-discretionary expenditure).

## D

**Debt** – An outstanding liability that must be repaid.

**Debt recycling** – Where you increase an investment loan (where the interest is tax-deductible) by the same amount you reduce your home loan (where the interest is not tax-deductible).

**Diversification** – Spreading your money across asset classes, sectors, markets and fund managers to reduce investment risk.

**Dividend** – Distribution of part of a company's profits to shareholders expressed as a number of cents per share. Companies typically pay dividends twice yearly – an interim dividend and a final dividend.

**Dollar cost averaging** – Where you invest fixed amounts of money at regular intervals regardless of whether the market is going up or down. Enables you to average the price you pay for your investments and not have to worry about trying to pick the right time to buy.

## E

**Efficient debt** – Debt that is used to buy assets that are income producing (making the interest tax-deductible) and are expected to grow in value over time.

**Equity** – The interest or value an owner has in an asset over and above the debt against it. For example, the equity of a homeowner is the value of the home less any outstanding loan.

## F

**Franking/Imputation credits** – Credits for company tax paid that are passed onto shareholders who have received franked dividends from Australian resident companies.

**Franked dividends** – Dividends on shares with imputation (or franking) credits attached. The tax paid at the company level is credited to shareholders. Tax is assessed on the total amount of the dividend and the franking credit, and shareholders can claim a tax offset equal to the franking credit. A company is able to declare that a percentage (up to 100%) of a dividend is franked depending on the amount of tax the company has already paid.

## G

**Gearing** – Borrowing money for investment purposes.

**Guarantor** – A party who agrees to be responsible for the payment of another party's debts in the event that they default.

## H

**Home equity loan** – A loan secured against the equity in a home. This can generally be used for investment or non-investment purposes.

**Home loan** – A loan taken out to acquire a home.

## I

**Income producing asset** – An asset that generates income for the owner (eg a share that pays a dividend). The interest on a loan taken out to acquire an income producing asset is generally tax-deductible.

**Income Protection insurance** – A policy that pays you a portion of your lost income in the event of you being unable to work due to illness or injury.

**Inefficient debt** – Debt that is used to buy assets that are not income producing (meaning the interest is not tax-deductible). The assets may also depreciate in value or have no monetary value after they are consumed.

**Instalment gearing** – A loan that allows you to increase the regular investments you make with your own money by drawing down regular amounts.

**Interest** – The amount a borrower pays to a lender for the use of borrowed money.

**Interest-only loan** – A loan where the principal is paid back at the end of the term and only interest is paid during the term.

**Internally geared share fund** – A managed investment that may be available within or outside superannuation where the manager borrows on behalf of investors to make a larger investment in Australian and/or global shares.

**Investment loan** – A loan used to buy assets such as shares or property (either directly or via a managed investment such as a unit trust) for the purpose of building wealth.

## L

**Limited recourse loan** – A gearing arrangement, such as an internally geared share fund, where the investor's liability is limited to the value of the initial investment.

**Line of credit** – An overdraft facility that is secured by a mortgage over a residential property. With a line of credit it's possible to drawdown over time to the set borrowing limit as required.

**Loan to valuation ratio (LVR)** – The loan amount divided by the value of the assets used as loan security.

# Glossary

## M

**Managed investment** – An investment which pools your money with that of other investors to form a fund invested into assets that's based on set investment objectives. A sector-specific fund invests in only one asset class (eg global shares) while a multi-sector (or diversified) fund invests in a number of asset classes.

**Margin call** – With a margin loan (see below), the lender is prepared to lend up to a maximum limit known as the loan to valuation ratio (LVR). The LVR is usually the loan amount expressed as a percentage of the assets offered as security. If you exceed your LVR, you will be required to meet a margin call, which means you must either repay part of the loan (via a cash payment or by selling assets) or provide additional assets as security.

**Margin loan** – A loan that enables you to invest in shares and/or unit trusts where these assets are used as security for the loan.

**Marginal tax rate** – The stepped rate of tax that you pay on your taxable income (see FAQs on page 24).

**Mortgage** – A loan in which you provide the lender with a certain asset as security. The security is generally released upon repayment of the loan.

## O

**Offset account (100%)** – A transaction account that is linked to a home (or investment) loan and the balance is directly offset against the loan balance before interest is calculated.

## R

**Redraw facility** – A loan facility that enables you to make additional repayments and then withdraw these extra funds if and when necessary. They will often have limitations such as a minimum redraw amount and a fee for each withdrawal.

## T

**Taxable income** – Your assessable income after allowing for tax deductions. Usually subject to tax at marginal rates plus the Medicare levy.

**Tax deduction** – An amount that is deducted from your assessable income before tax is calculated. You can claim deductions in your annual tax return or, if your deduction is significant, you can apply to the Australian Taxation Office for a variation of Pay As You Go (PAYG) tax.

**Tax offset** – An amount deducted off the actual tax you have to pay. You may be able to claim a tax offset in your end of year tax return (eg franking credits). Sometimes a tax offset may be taken into account in calculating your PAYG rates.

## U

**Unit trust** – A type of managed investment that can be purchased with ordinary (non-superannuation) money.





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