Wealth Creation Through Tax Effective Debt

You have indicated one of your objectives is to implement a tax effective, wealth accumulation strategy over the long term using non-superannuation investments.

Based on our discussions about your tolerance for investment risk, we believe a gearing strategy is an appropriate means of assisting you to achieve your lifestyle goals and objectives.

Gearing (or using debt to invest) simply means using other people's money to help increase your wealth more rapidly. It allows you to acquire more assets than you could if you had only used your own funds. The expectation is that over time, the rise in capital value of the underlying investments will (after payment of Capital Gains Tax on redemption) exceed the net accumulated funding costs. However, you generally need to keep the borrowing program in place for at least five years to allow time to overcome market volatility, and for the leveraging effects to work.

To help achieve capital growth desired from a geared portfolio, you need to invest in assets that have a strong likelihood of increasing in value over time. These are known as growth assets and the most commonly used are shares and property. Managed funds can provide you with a convenient means to access these growth assets as well as the opportunity to achieve diversification of your portfolio.

When it comes to implementing a gearing strategy, there are a number of structures you can choose from:

- A standard home equity loan
- A line of credit
- An instalment margin loan
- A lump sum margin loan

Each of these structures has different features and benefits, depending on your individual requirements. One of the main advantages of implementing a gearing strategy using one of these structures is the tax savings that may be available to you.

While tax savings should never be the primary reason for choosing an investment strategy, you may be eligible for the following tax benefits associated with gearing:

- Where your tax deductible interest expense exceeds your investment income, the excess deduction can be used to reduce the tax payable on other income such as your salary. This is known as negative gearing.
- The leverage provided by gearing can increase the value of your franking credits (if you are investing in Australian shares that pay franked or partially franked dividends).
- You can claim a tax deduction for the interest expense in the financial year it is incurred, and given you can choose which year to sell the investment, you can defer Capital Gains Tax until then. The investment can be sold in a low-income year (eg post retirement) and thereby reduce Capital Gains Tax payable. You may also be able to pre-pay interest costs up to 12 months in advance giving you a greater potential tax deduction in the current financial year.
- Even though up to 100% of the interest expense is tax deductible, Capital Gains Tax is only payable on 50% of capital gains arising on the sale of investment (assuming the investment is held for at least 12 months).

It is important to note that if your investment assets increase in value, then a gearing strategy may magnify your profits significantly. However, if the assets fall in value, gearing can also magnify your capital losses. Any gearing strategy should therefore be approached with caution.

We recommend that you consult your tax adviser to ensure that this strategy is consistent with your personal tax position.