Australian Unity

Bonds & Gearing
Strategy Paper

While the advantages of leveraged, or geared, investing are generally well known, a common concern is what to do with any surplus income that arises on an annual basis – particularly with record low interest rates at present already diluting the interest cost tax deduction associated with investing borrowed funds.

There are a number of strategies to be considered for this surplus income:

- **Making additional repayments to the gearing loan.** Investors are typically reluctant to implement this strategy as the resultant reduction to the deducible interest cost each year will significantly dilute the tax effectiveness of the strategy.
- **Taking out an additional loan to gear into a second investment property.** The main concerns in pursuing this strategy are:
  - taking on significant debt to re-enter the property market
  - media warnings of a property "bubble"
  - having too much overall exposure to direct property
  - future interest rate rises.
- **Invest surplus income annually into direct shares or a managed fund.** While this maintains liquidity and flexibility, the additional taxable income it would produce also lowers the effectiveness of the strategy by increasing taxable income each year. Also, how will the gearing loan ultimately be extinguished at or after retirement – will there be additional Capital Gains Tax (CGT) consequences upon selling the shares or withdrawing the managed funds at a later date? Will there be CGT consequences of selling the investment property?
- **Non concessional contributions to super.** May be appropriate but subject to eligability criteria, caps, preservation age and condition of release.
- **Make annual contributions into a Lifeplan Investment Bond.** Doing so could offer the following benefits:
  - maintain liquidity and flexibility as the funds are not preserved within the investment bond
  - while invested in the investment bond there is no additional taxable income to reduce the effectiveness of the gearing strategy
  - the accumulated benefit within the bond may even be sufficient to clear the gearing debt at future retirement, or whenever the investor's Adjusted Tax Income (ATI) makes gearing less appropriate. Withdrawing these funds from the investment bond beyond its 10^{th} anniversary would incur no negative tax consequence as withdrawals are not taxable to the investor
  - investment property can be retained rather than sold in order to extinguish gearing debt.

Case Study

Let's look at the case of a married couple, Luke and Elise. They are both aged 45 with two teenage children nearing the completion of their schooling years, and have just repaid the home loan on their principle residence.

Luke is a plumber receiving wages of $90,000 p.a. while Elise is employed in the public service sector with a salary of $120,000 p.a.

For the last two years they have jointly owned an investment property valued at $500,000 and returning $400 per week in rent (gross). The property is secured against an investment loan of $460,000. Repayments at present are interest only at 5.0% ($23,000 p.a.).

After all livings costs and investment expenses have been accounted for, they have a surplus income of approximately $20,000 p.a. Their immediate concern is what to do with these funds. They currently have healthy superannuation balances, and are reluctant to contribute anything further to super.

How does an investment bond strategy help with this scenario?

- Funds held within an investment bond are not preserved, unlike superannuation where a preservation age and condition of release must be met prior to withdrawal
- Up until the policy's 10th anniversary, investment bond withdrawals consist of a "non-assessable" amount which is not taxable, and the earnings component which is taxable, but qualifies for a 30%* tax investment bond rebate. Once an investment bond reaches its 10th anniversary, any income streams or withdrawals are non-taxable in the hands of the policy owner
- There are no contribution caps, nor any personal CGT consequences for withdrawing funds or switching fund options, as would occur with traditional unitised managed funds
- Investment bonds can nominate beneficiaries, and in most cases can be structured as a "non-estate" asset, bypassing future Probate delays or the risk of an estate challenge upon the subsequent death of Luke or Elise
- Investment bonds have existed in an environment where very little regulatory or legislative change has occurred over the last 30 years, unlike superannuation which is tinkered with on a regular basis.

In the case of Luke and Elise, by investing the surplus income of $20,000 in an investment bond, they will receive:

PV=0; N=15; I=6.0%; PMT=$20,000

FV=$465,520

Assumptions: starting balance nil, annual contributions $20,000, net earnings 6% p.a., time frame 15 years, future value $465,520.

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