Home loan deposit funding
Strategy Paper

It's becoming increasingly common to read headlines screaming "if you don't buy a house before turning 40 you never will".[1,2] The sad reality is that the booming property prices since the 2000s has made it more difficult to save that deposit, and now the average age for the first home buyer in Australia is rapidly approaching 40.

Never has it been more important to start saving early for a deposit, and using the power of compounding returns to do some of the heavy lifting.

However, the problem we face today is to successfully navigate through Australia's complex and continually changing taxation system in order to achieve that successful investment outcome.

The solution might just be to consider using an investment bond to build a substantial nest-egg without the burden of creating an additional tax liability. As earnings are tax paid at a maximum of 30%*, the investor does not have any tax liability while the funds remain invested inside the investment bond.

For those leaving school and entering the workforce at age 18, making regular contributions into an investment bond could ensure that by the time they are 28 years of age, significant wealth has been accumulated. The added benefit is that once the investment bond has reached its 10th anniversary, the entire balance can be withdrawn by the investor with no further tax liability.

Building up a home loan deposit utilising an investment bond makes even more sense for someone pursuing tertiary education, and perhaps won't receive full time wages/salary until their early twenties.

To appreciate this as a valid strategy though, we must change our way of thinking. In this instance, the marginal tax rate incurred by our investor is important not so much at the time of implementing the investment, but at the time of withdrawal.

Case Study

James starts a regular savings plan of $1,000 per month into an investment bond at age 22 when he leaves University to start his first job.

James' salary in that first year of work is $50,000 which gives him a marginal tax rate of 32.5% plus Medicare Levy (MCL). His effective rate of tax is just over 17% including MCL. At face value the numbers don't really appear to justify the consideration of an investment bond strategy at the time of implementation.

Fast forward 10 years and at the age of 32 James is now earning $200,000 annually, and feels he is ready to purchase his first home. If James has maintained his investment discipline, at age 32 he could withdraw over $165,000# tax free from the investment bond to use as a house deposit. He could further boost the strategy with increasing his annual contributions each year to invest pay rises or bonus payments. Refer ATO IT2346 - 125% rule.

Based upon his $200,000 annual salary income, James' marginal tax rate is now 45% plus MCL. His effective rate is 34%, and this is before we include any other investment income.

By investing within the quarantined tax environment of the investment bond, James has capped the effective rate of tax on his investment at no more than 30%*, maybe considerably less after taking into consideration imputation credits from any Australian shares. He has also benefited from:

- No personal Capital Gains Tax (CGT) liability upon withdrawal to purchase his house. A withdrawal from a traditional managed fund strategy would create a CGT event when James least needs it – when he is on the highest marginal tax rate.
- Administrative ease and simplicity; no need to record the CGT cost base of each monthly contribution, as would be required with direct shares or traditional managed funds.
- During those early years of investment he minimised his HECS/HELP repayment liability until his salary income has reached a significantly higher level and the debt repayment more affordable.
- Bankruptcy and estate planning protection.

$1,000 PV; $1,000 PMT; 0.5i; 120n; FV= $165,699

1. http://www.domain.com.au/news/how-old-is-too-old-to-get-on-the-property-ladder-20160926-groabg/
2. http://www.news.com.au/finance/real-estate/buying/if-you-dont-buy-a-house-before-turning-40-you-never-will/news-story/f3efd7e3ab6b191eb1268d7ad5a8f00c

* ato.gov.au