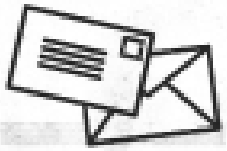
Diversifying funds makes for happy returns

Money penny



This week's answers provided by Brad Hodge CFP of BDH & Co in Epping, an Authorised Representative of Hillross Financial Services (AFSL no. 232705), a Principal Member of the Financial Planning Association. Answers should be used as a general guide only. Professional advice should be sought before making investment decisions. For a referral to a financial planner, or for more information on the FPA, call 1800 626 393 or visit www.fpa.asn.au.

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Q I am single, have full-time employment, and a mortgage outstanding of $200,000 which is being paid off at $1500 per month at an interest rate of 6.5 per cent pa. I have a spare $500 per month and I am on the highest marginal rate of tax. Am I better off using surplus funds to pay off the home mortgage or to make an investment?

A The interest expense associated with a residential mortgage is non-deductible therefore the after-tax rate of return on reducing the mortgage is equivalent to the effective interest rate on the loan.

For example, if the effective interest rate on the loan was 6.5 per cent pa, the after-tax return would be 6.5 per cent.

A top marginal rate taxpayer would need to get a gross return of 12.6 per cent to equal this after-tax return.

If you continue paying the loan at this rate you will pay the loan off in about 19.75 years.

You have a spare $500 (after tax) per month to spend. You can either use this extra money to reduce the mortgage quicker, or to contribute this to an investment fund where the proceeds will be reinvested.

The principal of diversification advises us not to place all our eggs in one basket or in investment terms not in the same asset class. Through paying off a mortgage, the investor is effectively exposed to only one asset class — residential property. Property like all other asset classes such as shares and bonds will vary in value according to movements in their respective markets.

Let's say you continue to pay the loan at $1500 per month and invest the extra $500 per month into a diversified Australian share fund generating an after-tax return of 5.8 per cent pa, switching to $2000 per month after the loan is discharged.

On these assumptions, after 25 years the investment will be worth about $209,287 in today's dollars (assuming a 3 per cent discount rate).

Alternatively, if you reduce your loan by $2000 per month, then the loan will be discharged in about 12 years. If you then contribute the $2000 per month into the same fund for the remainder of the 25 years, your investment will be worth approximately $219,300 in today's dollars.

Broadly, the excess amount that is invested in diversified shares will be invested sub-optimally if the after-tax return of that investment is less than the effective loan rate. In this situation, the gap between the two scenarios increases as the additional amount increases.

Another strategy to consider is to establish a regular gearing (borrowing) strategy. You will need to have an aggressive risk profile to follow this strategy. The long term effect of the strategy is to substitute non-deductible debt with deductible debt. The idea is to regularly borrow to invest while still paying your regular mortgage payments. Over time your mortgage will be repaid, you will have a deductible investment loan with the interest payments available to offset against other taxable income and your asset base will be larger as you have regularly invested.

Q We are married and have operated a successful small business through our company for the past 13 years. We are now both in our early 60s, and have decided to retire. The company's active assets were sold generating a $1 million capital gain. We also have superannuation, both of us having funded up to our standard lump sum RBL of $588,000 (at that time). How can we minimise company tax and prepare for retirement?

S mall business owners who satisfy the relevant rules can potentially access a number of concessions to reduce or eliminate tax payable on capital gains when they sell their active business assets. Active business assets are those the business entity uses in carrying on the business and extends to include intangible assets such as goodwill.

While many conditions need to be satisfied, the Small Business Capital Gains Tax (CGT) concessions are potentially very generous. Furthermore, additional benefits can be obtained if these CGT concessions are combined with the concessions given to superannuation savings.

One of the Small Business CGT concessions available is the retirement relief which exempts up to $500,000 per individual of capital gains and converts the exempt CGT amount into the CGT exempt component of an ETP. This is relevant for your situation given you have already funded up to your RBL as this component will receive concessional treatment when rolled over to start a tax efficient income stream in retirement. The payment of the ETP will also release funds from your company.

The CGT exempt component of the rolled over ETP will form the undeducted purchase price of an income stream. This will be the case even where this component exceeds the individual's Reasonable Benefit Limit. An excessive CGT exempt component can accordingly be returned tax free over the term of an income stream (or life expectancy for allocated or lifetime income streams).

If the company claimed the 50 per cent active asset reduction, the following situation arises:

While the company has reduced its assessable capital gain to nil, only $500,000 has been used to create a CGT exempt ETP component. Another $500,000 of the gain is still kept inside the company with potential taxation issues if you require access to it in order to add to the funds they will need to create tax efficient income streams in retirement.