

Financial Planning Insight

Reducing HECS debt strategy

Financial Planning Insight

Reducing HECS debt strategy

Objective: As part of the implementation of this strategy, the client uses the positive cashflow created in the first year to make a voluntary repayment against HECS debt which they have outstanding. This voluntary repayment attracts a 10% bonus payment from the government, which can be added to the yield produced by the forestry MIS investment.

Case study:

Internal rate of return on strategy: 15.96% pa net of fees and taxes
Equivalent 'before tax' return: 20.67% pa, net of fees
Strategy term: 21 years

Client Profile

Your client, Lisa:

- Is a single professional aged in her late 20s.
- Has begun her wealth generation strategy by investing in the equities market.
- Generates other taxable income of \$100,000 from salary.

Before commencing employment, Lisa completed a business / law degree at university, paid for by a HECS loan, of which a balance of \$42,000 is currently outstanding.

Lisa knows that she would be wise to further diversify her portfolio into assets which, historically, have not correlated with the property and equity sectors. This view has been reinforced by the volatility she has witnessed in the equities market in recent times.

It is important to Lisa that every asset within her portfolio makes a positive contribution to long term generation of wealth within her portfolio.

Lisa is able to fund additional investment costs in the next eight years in order to enhance long term wealth.

Strategy

Lisa purchases 6 units in a forestry project producing multiple revenue streams, the cost of which is tax deductible.

This tax deduction will increase Lisa's income after tax, allowing her to make an additional voluntary repayment off her outstanding HECS debt in addition to her compulsory payment. The voluntary payment will also attract a 10% bonus from the government, further reducing her outstanding HECS debt.

Any outstanding HECS balance will be indexed by the Government inline with CPI at the end of the year.

The purchase of her units is funded via a \$42,000 deductible investment loan, increased by \$250 to cover loan costs. The loan is for a period of 10 years, repayments being principle and interest in nature.

Cashflow - 2009

	Without strategy	With strategy
Salary and other investment income	\$ 100,000	\$ 100,000
Establishment fee	\$ 0	\$ 0
Tax and medicare levy	-\$ 27,500	-\$ 12,254
Compulsory HECS debt repayment	-\$ 8,000	-\$ 8,000
Voluntary HECS debt repayment	\$ 0	-\$ 15,246
Net disposable income	\$ 64,500	\$ 64,500
Cost of strategy in 2009		\$ 0

Tax - 2009

	Without strategy	With strategy
Assessable income	\$ 100,000	\$ 100,000
Establishment fee	\$ 0	-\$ 42,000
Loan application fee (1/5th deductible each year for five years)	\$ 0	-\$ 50
Taxable income	\$ 100,000	\$ 57,950
Tax and medicare levy	\$ 27,500	\$ 12,254

Outstanding HECS Debt - 2009

	Without strategy	With strategy
Opening balance	\$ 42,000	\$ 42,000
Compulsory HECS debt repayment	-\$ 8,000	-\$ 8,000
Voluntary HECS debt repayment	\$ 0	-\$ 15,246
10% bonus repayment	\$ 0	-\$ 1,525
CPI indexation of outstanding balance	\$ 850	\$ 431
Outstanding balance at year end	\$ 34,850	\$ 17,660
Reduction in outstanding debt		\$ 17,190

Change in Net Wealth - 2009

Reduction in HECS debt	\$ 17,190
Increase in investment loan	-\$ 42,250
Net present value of future income from forestry units (see assumptions)	\$ 33,264
Change in net wealth	\$ 8,204

Cashflow - Later years

Each year, Lisa will be required to make repayments on her investment loan and pay insurance costs in relation to her forestry plantation.

Both the costs of insurance and the interest/costs in relation to her investment loan are tax deductible, which will slightly reduce both her tax and medicare liability and her compulsory HECS debt repayment for the next few years.

However despite this, her net disposable income will still be reduced in some years due to the cost of interest repayments on her deductible loan.

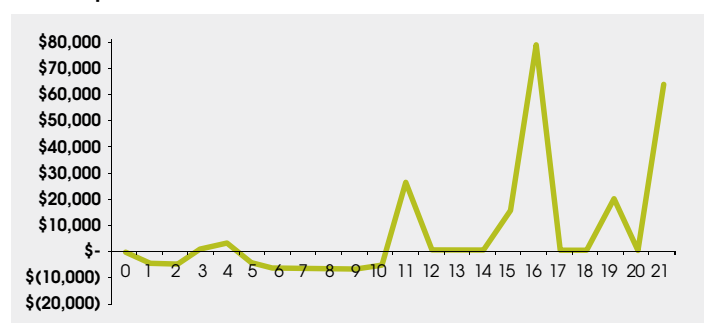
Cashflow - 2010	Without strategy	With strategy
Salary and investment income	\$ 102,500	\$ 102,500
Insurance costs	\$ 0	-\$ 258
Tax and medicare levy	-\$ 27,938	-\$ 25,740
Compulsory HECS debt repayment	-\$ 8,200	-\$ 7,755
Loan repayments	\$ 0	-\$ 7,493
Net disposable income	\$ 66,362	\$ 61,254
Cost of strategy in 2010		\$ 5,108

Results of the strategy

Net cashflow

The following graph provides a profile of changes in net income that Lisa will experience as a result of undertaking this strategy, after allowing for loan repayments, taxes and other costs.

Net cash profile



Yield

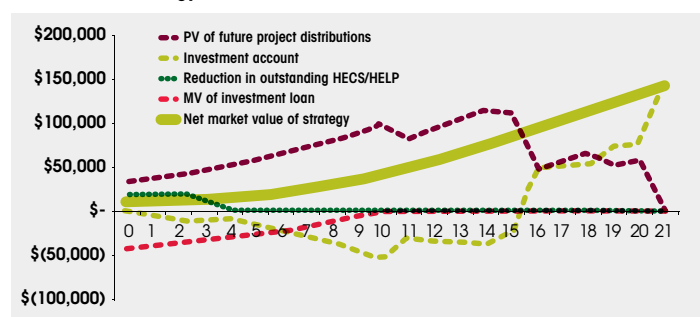
The yield (i.e. internal rate of return) that Lisa will earn as a result of her strategy will be 15.96% pa, net of fees and taxes.

To obtain the same 'after-tax' result from an alternative investment, she would need to produce a 'before-tax' return of 20.67% pa after fees (see assumptions).

Increase in net wealth

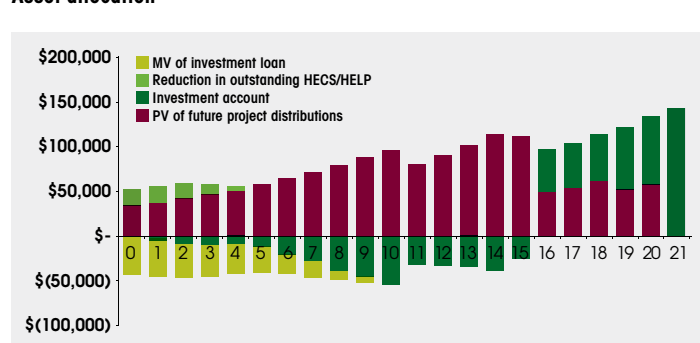
At the end of the strategy Lisa has increased her net wealth by \$142,385.

Net value of strategy



By the end of the strategy, the investment loan is paid out, all income has been paid from the forestry units, and the accumulated wealth produced by the strategy will reside in Lisa's investment account as shown in the graph below.

Asset allocation



Portfolio diversification

Lisa has potentially reduced future volatility in his portfolio by diversifying into an asset class which historically has tended to be not correlated and is less volatile than equity assets.

Portfolio risk

As this involves borrowing to purchase MIS units (i.e. gearing), the risk profile of Lisa's portfolio may increase.

Assumptions used in this case study

Salary and investment income: indexed at 2.5% pa

Establishment fee: \$7,000 per unit

Timber revenue per unit

Year	\$ per unit	Year	\$ per unit
8	\$ 317	16	\$ 35,628
10	\$ 912	19	\$ 8,651
11	\$ 11,336	21	\$ 29,886
15	\$ 6,615		

Deferred management fees: 35% of project revenue

Insurance costs per unit

Year	\$ per unit	Year	\$ per unit	Year	\$ per unit
0	\$ 0	8	\$ 129	16	\$ 307
1	\$ 43	9	\$ 149	17	\$ 122
2	\$ 46	10	\$ 175	18	\$ 144
3	\$ 58	11	\$ 199	19	\$ 171
4	\$ 70	12	\$ 175	20	\$ 145
5	\$ 81	13	\$ 209	21	\$ 175
6	\$ 95	14	\$ 250		
7	\$ 111	15	\$ 300		

Tax rate: As legislated for 2008/09 and 2009/10

Discount rate used to calculate present value of future forestry

MIS revenue: 11.07% pa

Investment account:

- Income yield – 4.8% pa
- Capital yield – 3.3% pa
- Capital turnover – 12.5% pa

Grossed up internal rate of return assumes:

- 60% of gross yield is 100% taxable
- 40% of gross yield is 50% taxable

A 50% general exemption applies to all realised capital gains.

Investment loan terms: 12.74% pa principle and interest repayments over 10 years.

All transactions, other than loan repayments, occur on 30th June.

Loan repayments are made monthly.

Investment in the forestry project complies with Division 394 of Income Tax AA 1997.

All values are shown as GST exclusive amounts.

For further information call
Adviser Services on
1300 732 822



ITC Project Management Limited ABN 55 081 643 147, AFSL No. 247019
Level One, 21-31 Goodwood Street, Richmond VIC 3121 Australia
Telephone: 1300 732 822 Facsimile: 03 9421 9900
Email: adviserservices@itclimited.com.au Website: www.itclimited.com.au

Important Information: Any financial product and taxation advice contained in this document is of a general nature only. Any such advice has been prepared without taking into account your personal objectives, financial situation or needs. Accordingly, before acting on this advice, you should consider whether it is appropriate having regard to your objectives, financial situation and needs. You may wish to consult a qualified financial planner or a taxation adviser before implementing an investment based on this advice. An investment may only be made on an application form in or accompanying a current Product Disclosure Statement (PDS). A copy of an ITC PDS may be obtained from ITC by calling 1800 999 190, or downloaded from our website at www.itclimited.com.au. ITC Project Management Limited (ABN 55 081 643 147) is the issuer of ITC PDSs and holds an Australian Financial Services Licence (No. 247019). Please note that past performance is not necessarily a guide to future performance.