Gearing – Costs and risks of gearing into superannuation

It's not normally beneficial to borrow to invest in superannuation, as superannuation is not an income-producing asset. Even though it effectively increases your retirement investment, the income it produces is assessable income to the fund trustee, not to you personally. This means that you can't claim a tax deduction for any borrowing expenses associated with borrowing to make a contribution.

However, for some individuals, there may be a benefit in short-term borrowing to fund a one-off contribution, if the alternative is that their future contributions will be constrained by the non-concessional cap and/or eligibility rules.

Although gearing can deliver benefits, the risks associated with gearing may mean it is unsuitable for you. It is essential to carefully consider these risks before proceeding with a gearing strategy.

Risks, consequences and other important things to consider

These include:

- **Reduction in capital value**. Although there are potential wealth creation benefits to be gained from gearing, these benefits are achieved at the expense of higher risk.
  It is important to note that although gearing has the potential to increase capital gains in a rising market, it can also compound a capital loss in a falling market. The following table provides an example*.

Starting Values	Geared	Non-Geared
Investor Equity	$40,000	$40,000
Amount borrowed	$60,000	$0
Total Investment	$100,000	$40,000
Market Rises 10%		
Value of Portfolio	$110,000	$44,000
Loan outstanding	-$60,000	$0
Investor's Equity	$50,000	$44,000
***GAIN* in Investor's Equity**	**25%**	**10%**
Market Falls 10%		
Value of Portfolio	$90,000	$36,000
Loan outstanding	-$60,000	$0
Investor's Equity	$30,000	$36,000
***LOSS* in Investor's Equity**	**-25%**	**-10%**

***In addition, if the income return from the geared part of the investment (together with tax benefit) is less than the interest cost from the loan and any other associated costs, then this cash flow shortfall will reduce your overall return.**

- **Interest mismatch**. The success of the strategy depends on total investment returns in your superannuation account being greater than the net borrowing costs (which you will meet

outside superannuation). There is a risk that investment earnings are lower than interest costs. You should consider this carefully before borrowing to contribute into superannuation.

- **Non-deductibility of interest costs**. As the investment is held by the superannuation fund trustee, it does not provide you with assessable income. This means that the interest costs on the loan are non-deductible to you.
- **Loss of immediate access to your funds**. As your cash flow will be directed to meet interest repayments on the loan, this may affect the attainment of some of your goals and objectives.
- **Capital gains tax (CGT)**. CGT may be payable when you sell assets used to secure the loan. At that time you should consult a tax agent in regard to this. You should consider the potential impact of this prior to proceeding with this recommendation.
- **Liquidity risk**. The nature of the asset used to secure the loan may be illiquid, meaning that it takes a longer time to effect the sale in order to repay the loan.
- **Market timing risk**. The assets used to secure the loan may need to be sold at a time when the sale price is at a low-point.
- **Fluctuations in interest rates**. If interest rates on borrowed funds increase, then you will incur additional costs that will need to be covered. This may affect the attainment of some of your goals and objectives.
- **Shortened time frame.** You are likely to be advised to limit your borrowing for super contributions to a maximum of 5 years and that you should satisfy a ‘condition of release’ within 5 years, such as retirement after reaching your preservation age or attaining age 65. There must also be a reasonable expectation that asset proceeds or other funds will become available to repay the borrowing within 5 years for this strategy to be effective.
- **Insurance**. It is strongly recommended that insurance is acquired by all parties involved in the gearing strategy as death, disablement or critical illness may require the investments to be liquidated, leading to potential portfolio losses.
- **Investment restrictions**. If at any time there is a reasonable expectation that you will need to access your superannuation funds to repay the debt in whole or part, consideration should be given to acquiring cash and short-dated fixed interest investments offered by the fund trustee.
- **Defaulting on your loan**. If you default on your loan (i.e. do not pay your loan or interest repayments when they are due), the lender may compel you to make payments, impose a penalty for late payment, or ask for the loan to be repaid in full immediately. The lender may even sell assets that are being held as security for the loan. The preserved nature of superannuation means that some individuals are not able to access their benefits to repay the loan unless a ‘condition of release’ is met.
- **Loan costs**. An application fee may apply when you apply for the loan, the details of which can be found in the Loan Application. Other bank fees may include a monthly service fee and, if applicable a facility fee. In addition, government fees may also apply. These may include stamp duty on the loan and State Government charges which differs from state to state.
- **Ending your loan**. If you decide to end or terminate the loan facility, it may be necessary to sell the investments or security held by the lender in order to do so. This means you could be selling investments at a lower price than what you paid for them, or too early for the gearing strategy to have provided significant benefits.

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