If you owe tax, it might be cheaper just to pay it

David Huggins

A large part of my work is about things that happen at the end of June. That's because this is when people start thinking about how much tax they are going to have to pay.

They then speak to their financial planner or accountant and, under pressure to beat the June 30 deadline, act on poor advice they later bitterly regret.

These nearly always involve taking out a loan to make an investment. Remember always that loans are separate from the investment. No matter how your investment performs, you will have to repay the loan in full with interest.

This fact alone exposes you to at least two major risks.

First, you will have to pay the interest. Often clients are told that they will be able to meet this obligation through a combination of their own income and income from the investment. This advice is often based on assumptions about future events that inevitably turn out to be wrong. If your income drops or the investment does not perform you may not be able to pay the interest. For a tax deduction today, you have locked yourself into interest payments for many years to come.

Second, you have to repay the entire loan. If your investment performs poorly, you will have to sell other assets or use other income. What this can mean for some clients is that in trying to get a tax deduction they end up losing most assets including their home.

Poor advice is usually in two steps. First, the client is told that they have a tax problem. This can be because of a windfall gain or not putting aside enough during the year to pay tax. Or maybe the client has a large income and has to pay a lot of tax. The starting point should be whether the client should just pay the tax. Instead, the adviser proceeds on the basis that the client has a problem and needs to take action.

The second step is that the client is shown a document that compares their position if they do nothing and just pay their tax with a prediction about what their position will be if they borrow money to make an investment.

The upshot of the prediction will be that the client can simultaneously get a substantial tax deduction, generate additional income and make a capital profit in the future.

The problem with these predictions is that the obligation to pay back the loan with interest is fixed but the return from the investment will vary and is very unlikely to be what has been predicted. Usually clients are warned about this fact only in a general way and they are not given information about what their position will actually be should the investment not perform as well as their adviser predicts.

The driver for this type of advice is that advisers are paid commissions rather than charging a client a fee for service.

Advisers make money only when a client invests and the amount they receive increases depending on how much the client borrows.

This creates a powerful incentive for advisers to tell clients that they should borrow as much as possible to reduce their tax.

When clients see their financial adviser they expect that they will receive unbiased advice and that the adviser is acting in their best interests.

Instead, feeding off a desire to pay less tax, some advisers are selling products and strategies that can have a disastrous consequences for their clients in the future.

In my view, the first question that a client should ask when they are told about these types of strategies is why don't I just pay my tax.

Picture: Getty Images

David Huggins is a lawyer who specialises in resolving disputes about poor financial advice