EQUILIBRIA FINANCE

Finance that fits.

Strategy 5 Transform your debt using a financial windfall

If you receive a financial windfall, you may want to consider using it to reduce your home loan and borrow an equivalent amount for investment purposes.

What are the benefits?

By using this strategy, you could:

- replace inefficient debt with efficient debt, and
- establish an investment portfolio to build your long-term wealth.

How does the strategy work?

While paying off your home loan, it's possible you will receive a financial windfall such as a work performance bonus, an ex gratia payment on changing employers or an inheritance.

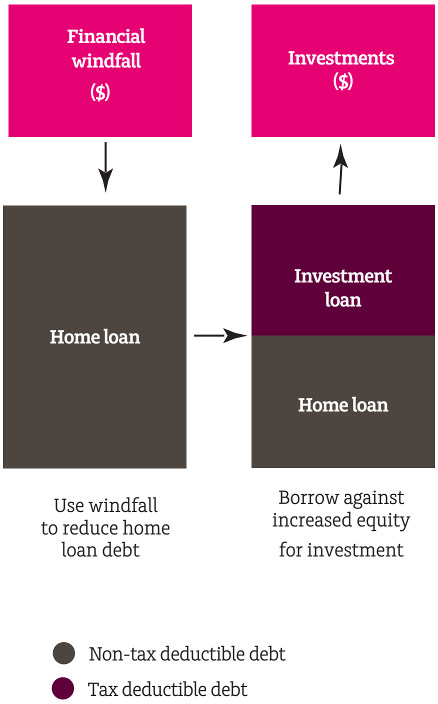
If that's the case, you may want to:

- use the windfall to reduce your home loan, by either paying the money into your loan or a 100% offset account attached to your loan
- arrange to borrow through an investment loan, and
- invest the borrowed money in assets such as shares or property—either directly or via a managed fund.

This strategy is known as debt transformation because it enables you to convert some of your inefficient home loan debt (where the interest isn't tax-deductible) into an efficient investment loan (where the interest may be tax deductible).

As a result, you could potentially reduce your after-tax interest cost considerably (see case study) and establish an investment portfolio to help build your long-term wealth.

The cash-flow efficiency generated from the borrowed investment could also enable you to reduce your remaining home loan faster.



Note: Before you use a gearing strategy, you should ensure you have a suitable time frame (preferably five years or longer) and understand the risks.

For example, if your investments fall in value, your financial situation could be significantly worse than if you hadn't used a gearing strategy.

For more information contact;
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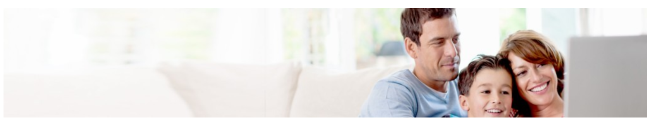

Case Study 5 | Transform your debt using a financial windfall

Daniel has a home loan of $200,000, the interest rate is 7.5% pa and he pays tax at a marginal rate of 39%[1]. He has just received an inheritance of $100,000 and would like to invest this money to build his long-term wealth.

If he uses the inheritance to purchase the investments directly, his home loan will remain at $200,000 and, because the interest payments are not tax deductible, the after-tax interest cost will be approximately $15,000 pa (see option 1 below).

After assessing his goals and financial situation, Daniel's financial adviser and mortgage broker in consultation explain that a potentially better approach would be to:

- use the $100,000 to reduce his home loan
- borrow an equivalent amount through an interest-only investment loan secured by his home, and
- purchase the investments with the borrowed money.

If Daniel follows this advice, he'll have a home and investment loan of $100,000 each and the after-tax interest cost of the home loan will be $7,500. However, because the investment loan interest (also $7,500) may be tax deductible[2], the after-tax cost of this loan could potentially be $4,575 pa (see option 2 in the table below).

In other words, if Daniel uses this debt transformation strategy, while his total debts will remain at $200,000, his total after-tax interest bill could reduce from $15,000 pa to $12,075 pa and he'll still get to invest $100,000.

	Option 1 Without debt transformation	**Option 2 With debt transformation**	
Loan type	Home loan only	Home loan	Investment loan
Loan amount	$200,000	$100,000	$100,000
Interest payable at 7.5% pa	$15,000	$7,500	$7,500
Less tax advantage at 39%[1]	N/A	N/A	($2,925)
After-tax interest cost	$15,000	$7,500	$4,575
Total after-tax interest cost	$15,000	$12,075	

His financial adviser also suggests that:

- he use the income from the investments and the after-tax interest savings to pay off his home loan faster, and
- when his home loan is repaid, he use the investment income to purchase more investments and build even more wealth in the future.

Note: This case study illustrates the importance of speaking to a financial adviser and mortgage broker about how you may best use a windfall to achieve your wealth goals. They can also address a range of potential issues and identify other suitable strategies – see Tips and Traps.

Tips and traps

- An alternative to debt transformation is to use the financial windfall to pay down your home loan and not invest. While this strategy will reduce your inefficient (non-deductible) debt and save you interest, it may not be as effective in growing your wealth.
- You could also transform your debts when selling existing investments by using the sale proceeds to reduce your home loan and borrow an equivalent amount to invest in other assets. Caution: If you sell an asset, recycle the proceeds through your home loan and borrow to buy back the same asset, the Australian Taxation Office may consider this a scheme to obtain a tax benefit and seek to apply penalties and deny your interest tax deduction. You should therefore consider seeking specialist taxation advice from a registered tax agent before using this strategy.
- To make it easier to calculate how much of your interest is tax-deductible when completing your tax return, you should keep your investment loan separate from your home loan. This could be done by establishing a separate investment loan or, if offered by your lender, a loan that enables you to establish separate sub-accounts within the one loan facility. We recommend you speak to a registered tax agent
- If you have debt, you should ensure you have enough insurance to protect your income and enable the loan to be repaid in the event of your death or disability.

1 Includes Medicare levy.

2 Assumes that the investments purchased with the borrowed money produces assessable income.

For more information contact;
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