Debt strategies

Transfer your debts using a financial windfall

If you receive a financial windfall, you may want to use the money to reduce your home loan and borrow an equivalent amount for investment purposes.

How does the strategy work?

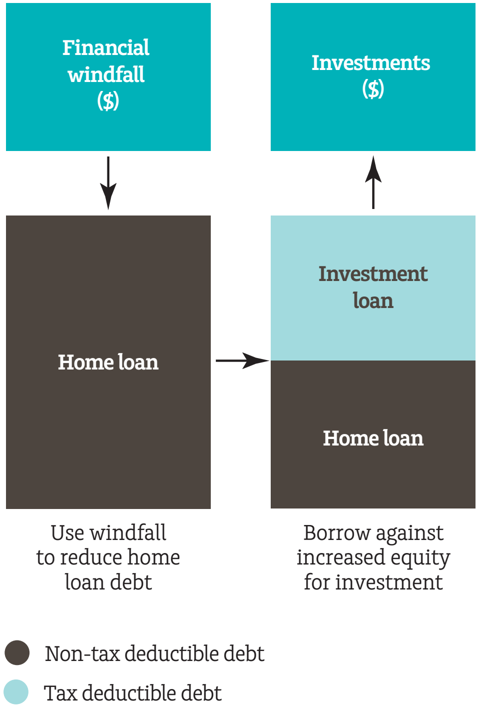
While paying off your home loan, it's possible you may receive a financial windfall such as a work performance bonus, an ex gratia payment on changing employers or an inheritance.

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 home loan debt (where the interest isn't tax deductible) into an 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 on the opposite page) and establish an investment portfolio to help build your long-term wealth.



Other key considerations

- Keeping your investment loan separate from your home loan can make it easier to calculate how much of your interest is tax deductible when completing your tax return.
- You should ensure you have enough insurance to protect your income and cover your loan repayments in the event of your death or disability.

Seek advice

A financial adviser can help you assess all the issues that need to be considered and determine whether a debt transformation strategy suits your needs and circumstances.

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Case study

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 in the opposite table).

After assessing his goals and financial situation, Daniel's financial adviser explains 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, the after-tax cost of this loan could potentially be $4,575 pa (see option 2).

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.

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.

	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 deduction 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**	

[1] Includes Medicare levy.

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