

Tech Q&A

Replacing non-deductible debt with deductible debt (Debt Recycling)

Question: George and Elaine are married. George is aged 40 and earns \$60,000 p.a., while Elaine is aged 35 and earns \$50,000 p.a. The couple jointly owns a managed fund worth \$100,000 of which \$50,000 is borrowed (Loan to value ratio of 50%). They currently pay \$1,000 per month off their margin loan (principal and interest). Distributions are currently being reinvested into the managed fund. The current value of their family home is \$500,000 with a mortgage of \$200,000. George and Elaine are making minimum home loan repayments of \$1,681 per month. The couple has determined that excluding the home loan repayments, they require \$55,000 net income to cover expenses. Is the couple’s current debt strategy the most effective way to accumulate wealth?

Answer: No. George and Elaine’s current debt strategy does not consider the impact of tax on debt being repaid. By replacing bad debt (non-deductible debt) with good debt (deductible debt), George and Elaine are able to further enhance wealth at retirement whilst satisfying their net income requirement.

Table 1 below highlights George and Elaine’s current situation to a more tax-effective alternative solution. If George and Elaine reduce their margin loan repayments to interest only and redirect distributions to as additional home loan repayments, could and commence a margin lending installment gearing strategy where they invest \$7,500 p.a. and borrow a further \$7,500 (maintaining their current 50% LVR) the couple will be effectively reducing the non-deductible home loan debt with deductible margin loan debt.

Projecting over ten year period George and Elaine will reduce their average tax liability from \$38,631 to \$34,777 improving their tax position by \$3,584 on average. Managed fund will grow from \$100,000 to \$372,058 (income rate of 4.5%, and growth rate of 5.2%) with a total margin loan (interest rate 11%) liability of \$104,479, whilst reducing the bad debt (home loan) to Nil. The value of residential property is \$762,216 assuming a growth rate of 4%, total assets including residential property is \$1,029,795 (net gain of \$62,359) from the existing situation.

	Current Situation	Alternative Situation
Average Income Tax Paid	\$38,631	\$34,777
Total Non-Super Investments	\$1,127,993	\$1,134,274
Total Liabilities (Loans)	\$160,557	\$104,479
Net Position	\$967,436	\$1,029,795