

Guide To...

Transform your debt using a financial windfall

While paying off your home loan, it's possible you will receive a financial windfall of some sort. For example, you might receive a work performance bonus, or an ex gratia payment on changing employers, or perhaps an inheritance.

Should you use this money to pay off some of your home loan or should you invest it to help build your wealth?

The answer may be to do both by using a strategy known as 'debt transformation'. This is the process of using a financial windfall to reduce inefficient debt and replace it with efficient debt.

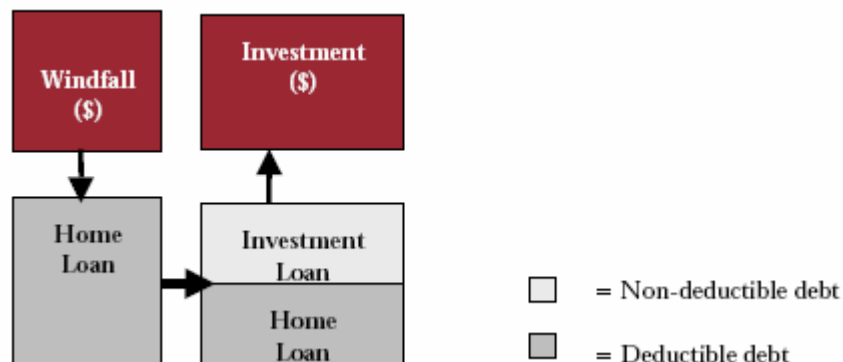
How does the strategy work?

When you receive a cash lump sum, pay it into your home loan account to reduce the outstanding balance. This then provides you with some additional equity that you can redraw (via an investment loan) to purchase an investment. The benefit is that although your overall debt level remains constant, the interest on the investment loan should be tax deductible – provided the investment produces an assessable income.

This means that you may be able to reduce the amount of tax you pay each year as well as have an investment portfolio helping you to build wealth in the future. Also, the income and tax savings from your geared investment can be used to reduce your home loan debt more quickly.

The benefits

- Create wealth in a tax-effective way sooner, by using a financial windfall to replace non-deductible debt with deductible debt.
- Use the income and tax benefits from your geared investment to further reduce inefficient debt.



Tips and Traps

- An alternative to debt transformation is to use a financial windfall to pay down the home loan and not invest at all. While this has the advantage of reducing non-deductible debt (thereby saving you interest) it does nothing to accelerate the creation of wealth to meet your future lifestyle goals.
- The concept of debt transformation can also be applied to your existing investments that you want to sell. For example, if you sell an investment, you could use the proceeds to pay down your home loan, and then borrow an equivalent amount to invest in other investments. This strategy will reduce your non-deductible debt, and replace it with deductible debt.

Caution: If you sell an asset, recycle the proceeds through your home loan and then borrow to buy the same asset back, the ATO may consider this a scheme to obtain a tax benefit and therefore seek to apply penalties and deny the interest deduction.

- To avoid problems in determining which portion of an interest cost is deductible, keep your investment loan (which is tax deductible) separate from your non-deductible home loan. In this regard, you should take out a separate loan unless your existing loan allows for separate sub-accounts within the loan (e.g. a line of credit facility).

If you have any queries in relation to the content of this material, please do not hesitate to contact Kate Kimmorley the Principal Financial Adviser at Kimmorley Financial Management on (07) 5591 1725.

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