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Advanced Debt Management Strategies



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Introduction

Most of us carry some form of debt whether it's our mortgage, credit cards, store cards, or even investment debt. And the reason we take on debt is because we're prepared to pay a premium to have the item sooner rather than later.

When it comes to borrowing money for personal items like clothes, cars, and holidays, we just accept that we're going to pay more to have it now, and sometimes this is justified. But when it comes to buying a home we generally accept the need to borrow because we know it's unlikely that we can save money quicker than the pace of rising property prices.

The same principle is true of course for investment assets. The reason we borrow to invest is because we expect that, over time, our total returns will be much higher than the cost of borrowing. Debt can be an effective tool in the creation of wealth but mistakes in this area are common and can be very costly.

In this guide we're going to explore 10 strategies that can help reduce the amount of time it takes to repay debt, reduce the amount of interest payable, and reduce the amount of tax payable.

John & Mary - Financials, Goals & Assumptions

Throughout this guide we're going to follow the case study of John and Mary who are both 40 years of age and married. This is their current financial position and the assumptions we'll use for all of our examples:

Salaries (gross pa)	\$90,000 + \$30,000 bonus (John) and \$60,000 (Mary)
Family Home	\$800,000 with \$450,000 still owing
Car Lease	\$30,000 still owing over 4 years
Credit Card Limits	\$20,000 fully drawn
Personal Loan	\$20,000 still owing over 3 years
Super Balances	\$350,000 (John) and \$200,000 (Mary)
Savings Account	\$20,000
Share Portfolio	\$60,000
Living Expenses	\$55,635 per annum
Surplus Income/Savings	\$1,000 per month
Upgrade Car	\$40,000 every 5 years
Retirement Target	Age 60 on \$100,000 pa net (in today's dollars)
Returns on all Shares/M Funds	4.00% Dividend Yield, 4.00% Growth, 50% of income being fully-franked dividends
Returns on all Property	3% Net Yield & 5% Growth
Interest Rates	4% on Home Loan, 5% on Investment loans & 6% on SMSF Investment Loan
Wages Growth	3.5% per annum

Chapter 1 – Debt Consolidation

John and Mary have four personal debts, a car lease of \$30,000, credit card balances of \$20,000, a personal loan of \$20,000, and a home loan of \$450,000 with 25 years still remaining. In total, their combined debt is \$520,000 and their combined monthly repayments are \$4,017.

Debt	Owing	Interest Rate	Loan Term	Monthly Repayments
Car Lease	\$30,000	7.5%	4 years	\$720
Credit Cards	\$20,000	18%	N/A	\$300
Personal Loan	\$20,000	10.5%	3 years	\$643
Home Loan	\$450,000	4%	25 years	\$2,354
Total	\$520,000			\$4,017
Consolidation @ 4%	\$520,000	4%	25 years	\$4,017



As their home is worth \$800,000 most banks will lend them up to \$640,000, being 80% of the value of their property, without paying any Lenders Mortgage Insurance. This 80% is referred to as the loan to value ratio, or LVR. The difference between what they currently owe and their maximum LVR, is referred to as available equity. We'll use this term a number of times throughout this guide.

By refinancing their home loan and consolidating their debts together, using their available equity, John and Mary can reduce the interest rate on all of their debt to just 4%. If they maintain the same monthly repayments as they're making now, for just four years, then revert back to the new minimum monthly repayment of \$2,412, they'll cut **14 months** off their home loan term and save **\$19,096** in interest costs, just by consolidating their loans.

Chapter 2 – Debt Reduction

John and Mary now have their debts consolidated but still have their incomes paid directly into a bank savings account. They use this savings account as their main operating account, and have all of their loan repayments, credit card repayments, their monthly bills, and their spending money, come out of this account. They also allow any savings to accumulate in this account which only pays them 0.5% interest per annum. Meanwhile they're paying 4% interest on their home loan.

100% off-set accounts can benefit borrowers by crediting their loan balance, and therefore their interest expense, by the amount sitting in their off-set account. If John & Mary where to open a 100% off-set account that was linked to their home loan and have all of their income directed into it and have all of their loan repayments and expenses come out of it, they'd be saving themselves 4% annual interest on their daily mortgage balance.



Because interest is charged monthly, but calculated on daily balances, it's important to try and keep money in the off-set account for as long as possible. So, John and Mary use a 55 day interest free credit card for all their bills and have a direct debit set up to pay the entire credit card balance from the off-set account at the end of each month, so that they never get charged any credit card interest. By doing this they're able to leave money in their off-set account for longer, and build up **rewards points** on their credit card.

John & Mary establish a second off-set account that's also linked to their home loan, just to keep money separated for their holidays. Many banks will allow multiple off-sets so that you can separate money for budgeting purposes. Because you can draw money out of your off-set accounts at any time, there's no need to keep any money in a traditional savings account.

The premise of this strategy is that for every day, every dollar is sitting in the off-set account, it's saving John & Mary an annualised rate of 4% off their home loan. In addition, because they're saving money and not making money they're not paying tax as they would if it was sitting in a normal savings account. On John's marginal tax rate, the net effect of having their money off-set against their mortgage would be equivalent to earning 6.56% per annum on a traditional savings account. Not a bad return for cash. This would be higher of course if John was in a higher tax bracket.

Over the life of John & Mary's home loan, by having all of their income paid directly into the off-set, paying all expenses with a credit card, paying their bills at the 11th hour, and keeping savings, for any reason, in an off-set linked to their home mortgage, John and Mary will cut **18 years** off the term of their home loan and save approximately **\$181,914** in interest repayments.

If they had have maintained their previous system of using a regular savings account then after 7 years (by comparison) they would still owe \$364,627 on the home loan but have a savings account balance of \$310,823 – meaning the offset strategy would have saved them **\$53,804** in interest over the first 7 years.



Chapter 3 – Debt Wash

Before we get into our next strategy it's important to understand the difference between **personal debt** and **investment debt**. Interest payable on money used to purchase personal items such as cars, boats, or your home, is not tax deductible and is often referred to as **bad debt**. Whereas interest payable on money borrowed to purchase investments is tax deductible, and is referred to as **good debt**.

If you're on the top marginal tax rate you would need to earn \$1.89 gross just to repay \$1 of interest on your personal debt, whereas you only need to earn \$1 gross to repay \$1 of interest on investment debt, as it's 100% tax deductible. You can see why they refer to it as good debt and bad debt.



In our case study, John earns \$30,000 gross each year as a bonus and as he and Mary are managing their mortgage repayments quite easily, they think it might be wise to start investing. So they take John's after tax bonus amount of \$18,300 net from their off-set or savings account and invest it into a well-diversified share portfolio.

As their off-set account is still technically a savings account, they're not purchasing the investments with debt, and therefore there's no tax deductions claimable on interest.

If instead they had transferred, or washed the bonus, into their home loan, then re-drew it again to purchase the shares, then they've effectively used debt to fund the investment and the interest on that \$18,300 becomes tax deductible. Washing debt in this way results in John and Mary having the same amount of overall debt except they'll have less **bad debt** against their home and more **good debt** against their investments. The tax savings over ten years, assuming the shares were held in John's name, would be **\$3,490** by using the Debt Wash strategy.

Not bad for simply paying down the home loan before purchasing the shares. If John continued to do this each year for 10 years with his annual bonus – making the additional home loan repayments and then drawing the same amount out as investment debt – the tax savings would be **\$19,632** at the end of the ten years. Again this amount would be higher if John was in a higher tax bracket.

Chapter 4 – Debt Transfer

John's existing share portfolio he received as part of an Employee share plan 5 years ago has now vested and is worth \$60,000. Unfortunately, the shares have taken a tumble recently and are currently only worth their original value.

As there's no realisable capital gains, John decides this would be a good time to replace them with a well-diversified portfolio of managed funds. But instead of simply swapping his shares for managed funds, he sells them and uses the sale proceeds to pay down his home loan.

Using the newly created equity he establishes a separate interest only investment loan of \$60,000 and uses that to purchase the new managed funds. Much like the Debt Wash strategy, John has transferred \$60,000 of bad debt into good debt and will save himself approximately **\$11,861** in tax over the next ten years. This is a great strategy to implement when replacing investment assets.

When it's time to upgrade the family home, many people choose to turn the old home into an investment property and borrow more to purchase their dream home. After several years of paying down the mortgage on the old home, which now becomes tax deductible, it usually has a relatively small amount of good debt still attached to it. And the new home of course will have a large amount of bad debt attached. This is the exact opposite of what it should be. The old home will also have very little, if any depreciation to claim as a tax deduction.

When upgrading the family home, it's often just better to sell the old home, use the proceeds to reduce the bad debt on the new home, and use the equity created, as a deposit on a new investment property. This will save most people an enormous amount of tax over the long-term. A brand new investment property is also likely to have less maintenance costs and a higher rental yield, and should of course be purchased in a suburb that has superior growth prospects than that of their first home.

The decision to rent out the family home could cost you hundreds of thousands of dollars in tax, property maintenance costs, and investment returns over the long-term. Replacing the old home for a new investment property is an excellent example of a Debt Transfer strategy.



Chapter 5 – Debt Structuring for Investments

John and Mary are thinking about buying an investment property, and after discussions with a mortgage broker, discover they're able to borrow another \$520,000 to purchase a \$500,000 property, using both their home and the new investment property as security. As they are both required to be on the loan to service it, they're under the impression that they need to purchase the investment property in joint names.

After receiving some good advice, they realise that this is not the case and they can both be on the loan but hold title in just one name. So they decide to purchase the investment property 100% in John's name as he's in a higher tax bracket. Having title held in John's name and not in Joint names will save them **\$2,479** in tax over the first ten years of holding the investment.

That might not seem like a lot, but if John was in the highest tax bracket, and Mary was a non-working spouse, then the tax saving could be over **\$40,000**.



In addition, instead of using savings as the deposit, John and Mary transfer most of their savings from the off-set account into the home loan first. They then access the available equity created in their home loan to establish a \$120,000 loan for the deposit, stamp duty and other purchase costs of the new investment property.

This ensures that their bad debt, their home mortgage, is lower, and their good debt on the investment is higher. If John and Mary had of used money straight from their off-set account, it would have cost them \$60,000 in lost tax deductions over the first ten years of owning the investment. With John's marginal tax rate the lost deductions would have cost him **\$23,400** in extra tax.

So John and Mary will effectively have two loans against their investment property – one for the deposit and costs of \$120,000 which is secured by their home, and one for the balance of purchase being \$400,000 which is secured by the new investment property. This means that in total 104% of the value of the new investment property is borrowed for and can be claimed as a tax deduction.

The other benefit of this structure is that the two properties are not cross-collateralised and the \$400,000 loan against the investment property can be moved to another bank if necessary. When you have multiple properties in your portfolio, this structure allows you to isolate the gains and access additional equity from the properties that have gone up in value, without the poorer performing properties dragging down the overall equity position. It also makes it easier to sell or re-finance your properties in the future.

Chapter 6 – Negative Gearing

Negative gearing is a term that's widely used but often misunderstood. The term suggests that you must run at a negative return or cash-flow in order to receive tax deductions. This is not the case. Under Australian tax law, you're able to claim the ongoing costs of owning your investments as a reduction or off-set to your personal income when calculating how much personal tax you pay.

These costs include the property management fees, rates, body corporate, insurance, maintenance etc, as well as the interest expense, and the depreciation. Of course depreciation is not usually an out of pocket expense, it's just a nominal amount the ATO allows you to claim due to the ageing of the building. Therefore, it is possible to be negatively geared and still have a positive cash-flow, particularly if you're on a high income, as the more tax you pay, means the more you'll get back. You can also have a positive or a neutral cash-flow and still receive tax benefits for owning investments.



Some people decide to gear more aggressively on the property in their portfolio and less aggressively on the shares in their portfolio, giving them an overall neutral cash-flow position with lots of tax benefits.

Negative gearing into property means that you can increase your exposure to growth assets and have the holding costs met mostly by the rent and the income tax rebates. However, if you were running a neutral or negative cash-flow model, the entire exercise would be pointless unless you can achieve capital growth. Refer to our video entitled '[The Ultimate Guide to Successful Property Investing](#)' for more information on what drives both yield and growth in property.



THE ULTIMATE GUIDE TO SUCCESSFUL PROPERTY INVESTING

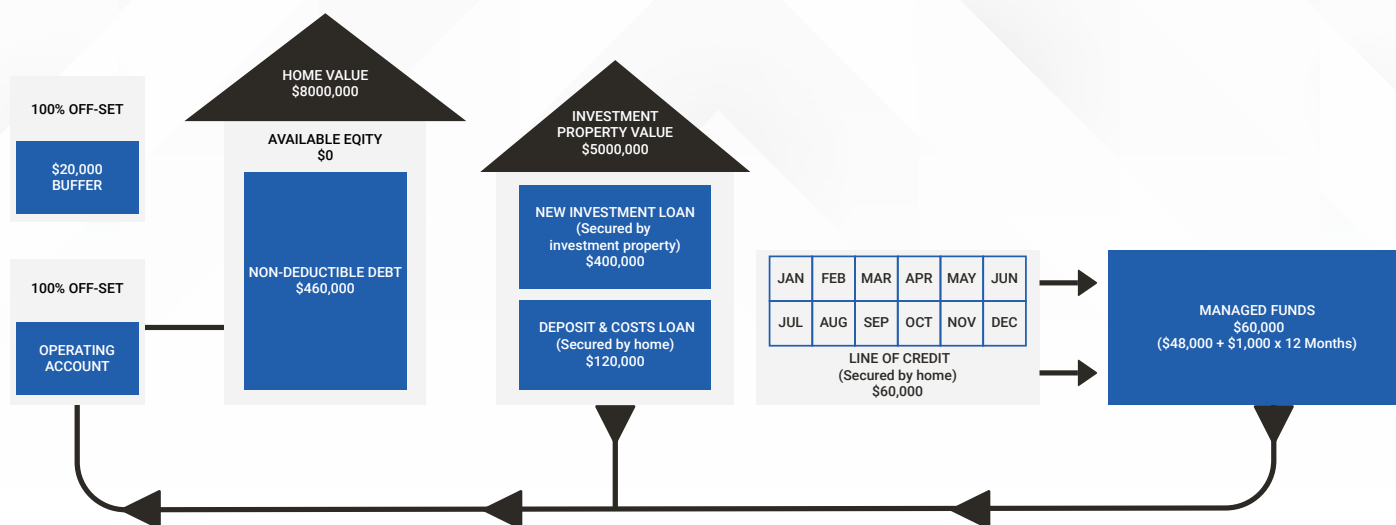
Chapter 7 – Debt Recycling

Debt recycling is the most efficient way of reducing bad debt whilst accumulating investments. If you recall, John and Mary had consolidated all their debts into their home mortgage at an interest rate of 4% pa which reduced their interest expense and brought their balance up to \$520,000.

They're also running a debt reduction strategy using two 100% off-set accounts. They also move their \$20,000 of savings into the off-set account as a starting balance to act as a buffer. As their total credit limit on their home is \$640,000 they have available equity of \$120,000 in addition to the \$20,000 cash sitting in the off-set. They also agree to sell John's \$60,000 share portfolio and pay the proceeds into their home loan, reducing their total personal debt down to \$460,000. This increases their available equity to \$180,000.

With this equity, they purchase a negatively geared investment property by establishing a new investment loan facility of \$120,000 to cover the deposit and costs, and a further \$400,000 secured by the new property, giving them a total debt of \$520,000 against the new \$500,000 investment property.

With the remaining \$60,000 of equity in their home loan, they establish a third investment loan facility for \$60,000 drawing \$48,000 out initially and \$1,000 per month for 12 months to purchase shares. Purchasing regular amounts of shares at regular intervals like this is known as Dollar-Cost-Averaging and is a strategy designed to turn the volatility of stock markets into a positive outcome for the investor.



John and Mary make sure they pay all of the rent and the tax rebates from the property and all of the dividends and franking credits from the shares, back into the off-set account. They also pay their monthly interest repayments on the investment loans and all of their property expenses from their off-set account.

This is essentially recycling their debt, reducing their bad debt and increasing good debt, as well as building their investment portfolio. John also requests a PAYG tax variation from his employer so that his new-found tax rebates can be paid to him weekly rather than waiting until the end of the tax year to claim them as a lump sum. He rightly figures that the money is better off sitting in the family off-set account saving them interest rather than sitting in the ATO's account all year.

With a neutral cash-flow position on their new investments, John and Mary should still be saving at least \$1,000 per month, so their off-set should grow by at least \$12,000 per annum. At the end of each year, they can transfer another \$12,000 from their off-set into their home loan and re-draw another \$12,000 of investment debt from the home loan to continue the monthly purchase of shares.

With more funds invested, higher investment incomes are earned and the strategy snow-balls. Over time, this transfers their bad debt into good debt at an ever-increasing rate. Debt recycling also allows John and Mary to build their investment portfolio and participate in growth markets over the years, without having to wait until they've paid down their home loan. A lot of people wait a long time before they start investing, unaware that they might be missing out on years of potential investment growth.



Chapter 8 – Eliminating Investment Debt

Many Australians will try to reduce their investment debt position when approaching retirement. This is because they're either trying to increase their income position, or trying to get as much wealth into the Superannuation system, where all income and capital gains usually become tax free in pension phase.

If this is part of your strategy, then it's best to sell down the assets and reduce the debt in years where your income is low or in the financial year after you retire. This way you will significantly reduce the amount of capital gains tax payable.

If John and Mary were to sell their investment assets the year before John retires, they would pay \$300,734 in capital gains tax, but if they sold them the year after he retires, they would only pay \$274,374. A savings of **\$26,360** in capital gains tax.

The investment property, of course, needs to be sold 'all at once'. However, further strategic tax savings could be made if John were to gradually sell down his managed investment portfolio over the first few years of his retirement, effectively spreading any capital gains over a number of years, when his taxable income will be low.

Chapter 9 – Limited Recourse Borrowing Arrangements

John and Mary were considering investing their superannuation savings into property using a Self-Managed Super Fund or SMSF, and although they have enough Super to buy a property outright within the fund they decide to use a limited recourse borrowing arrangement offered by their bank's commercial lending division. A limited recourse loan simply means that the bank only takes security, or recourse, over the **property** they've lent the funds against, as under current superannuation legislation, a mortgage can't be taken over the balance of cash or shares left in the SMSF.

So instead of buying a property worth \$500,000 and having only \$30,000 left in cash and shares, after the stamp duty and costs, John and Mary decide to borrow \$400,000 to go towards the purchase of property. This means they only use \$120,000 of their super to go towards the deposit and costs of the property, and have \$430,000 remaining that can still be invested into cash and shares.



There are a few benefits of this strategy being:

- They can diversify into an additional asset class within super
- They will have exposure to \$930,000 of growth assets instead of \$530,000 of growth assets
- They will unlikely ever pay capital gains tax on the growth of the property
- Claiming the interest on the loan, as well as the property's expenses and depreciation, against the total income of the fund, reduces the tax within the fund from \$41,267 to \$3,259 over the first 10 years – a saving of **\$38,008** in super tax
- Instead of paying the usual 15% tax on contributions and earnings the effective tax rate of the Fund is closer to 2%

For John and Mary, the difference between using the Limited Recourse Loan versus not using a loan to purchase the property, is a staggering **\$526,275** net at retirement, in favour of using the debt strategy.

Chapter 10 – Margin Lending

Margin lending is simply borrowing money to buy shares or managed funds using those assets as security for the loan, just like when we use property to secure home mortgages. Many margin loan providers will lend up to 75% of the value of the shares (75% LVR). However, these loans can be 'called in' once a 5% or 10% buffer has been breached. This is known as a **margin call**.

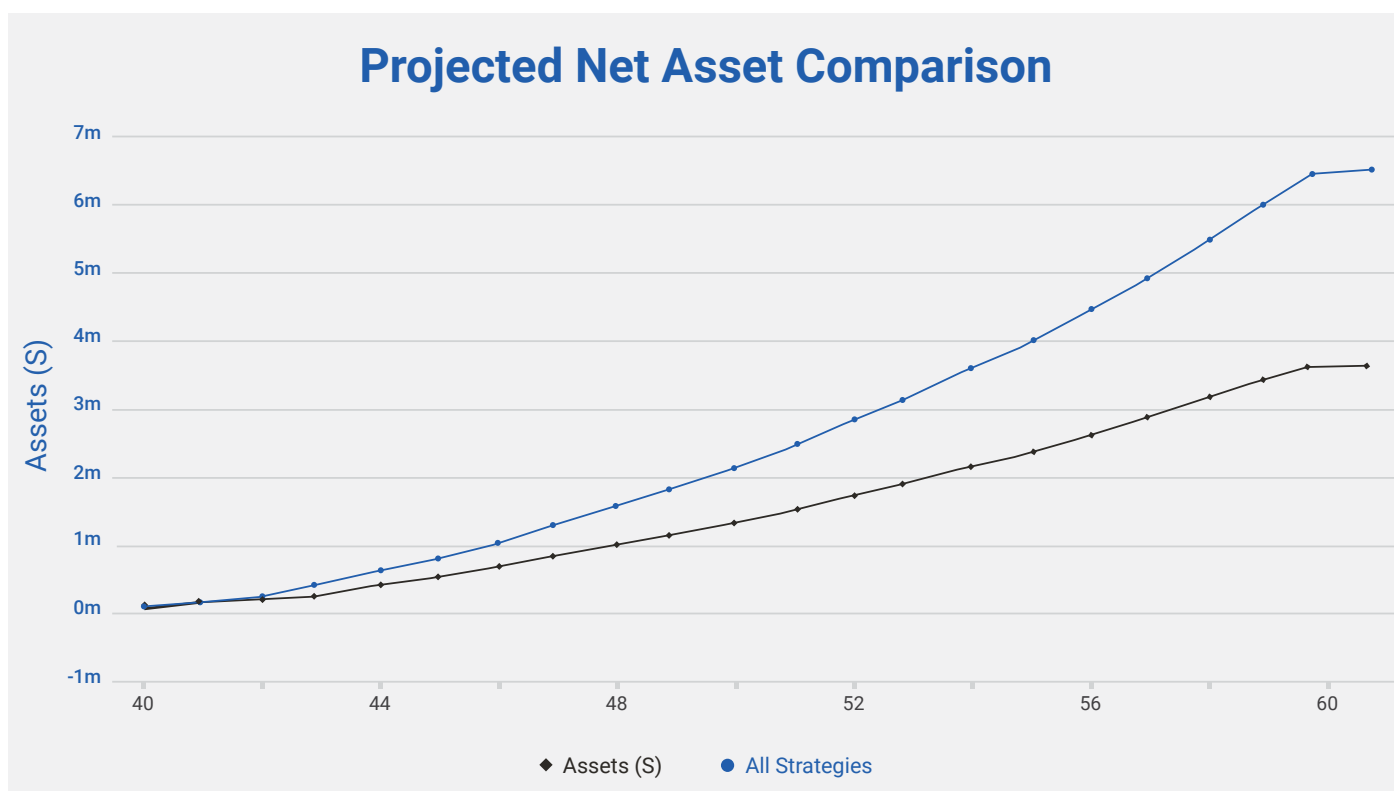
If you don't have enough cash to re-adjust the Loan to Value Ratio in the event of a stock-market crash, you may be forced to sell a significant portion of your portfolio in order to meet the call. Of course, this is the worst time to sell shares. Even if the market bounces back the following day, once the trigger has been breached the margin call is issued and must be rectified. This means you're realising your loss rather than it just being a paper loss. This is a high risk strategy and I highly recommend seeking professional advice before implementing.

In our John and Mary case study we could've used the managed funds that John purchased using equity, and leveraged it up again to acquire even more managed funds. However, as John and Mary have no other spare equity or real means to meet a margin call, this strategy would be considered too risky for them. So we haven't included this in our overall case study results. However, margin loans can be an effective wealth creation tool when used in the right circumstances.

Combining Strategies

In my ten examples of debt management strategies, I've given you an idea of the time savings, the interest savings, and the tax savings that John and Mary could make.

However, the following graph shows you the net difference in their assets (at age 61), after they retire at the age of 60, assuming they implement a range of strategies from this guide, as listed below.



Net difference at age 61 - \$2,853,949

If John and Mary were to implement debt consolidation, debt reduction, debt wash, debt transfer, negative gearing, debt recycling, limited recourse lending, and debt elimination strategies, they'd be more than \$2.8 million better off, than if they'd continued without changing anything.

You can see that using these debt strategies, combined with some basic investment strategies, equates to significant gains over the long-term.

Of course there's other things to consider when it comes to debt, like when to use fixed rates, when to accept Principle and Interest over Interest Only, when to pre-pay interest, and the list goes on. This is why, no matter how much you learn, it's always important to seek professional advice when it comes to your finances.

Well done for making it all the way through guide. I really hope you got something out of it. Please consider sharing it with someone who you think might benefit from its content. From all of us at Nexus, thanks for reading and best of luck with your wealth journey.

Stephen Vick



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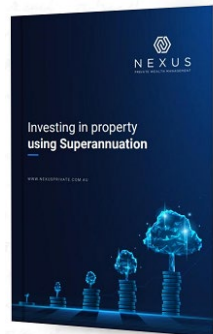
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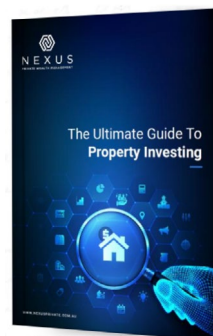
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