HOODSWEENEY
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Debt management

Debt management is the process of looking at the types of debt an individual currently has and determining how they can be better structured to serve their purposes and provide opportunities to increase wealth.

Types of debt

Non-deductible debt

Non-deductible debt is debt that is not associated with generating an assessable income. Common examples of non-deductible debt include:

- Home loan on a principal residence
- Personal loans
- Car loans
- Credit cards.

Personal debt can be extremely costly as interest must be paid with after tax dollars. The below table shows how much an individual would have to earn to repay $1,000 in interest costs under each marginal tax rate, including Medicare Levy.

Income thresholds	Marginal tax rate	Gross earnings to repay $1,000 interest
$0 - $18,200	0.0%	$1,000
$18,201 - $45,000	21.0%	$1,266
$45,001 - $120,000	34.5%	$1,527
$120,001 - $180,000	39.0%	$1,639
$180,001 and over	47.0%	$1,887

Deductible debt

Deductible debt is debt that has been used to purchase assets that generate, or are used to generate assessable income. The table below shows how an individual's cash flow is reduced by repaying $1,000 in interest costs under each marginal tax rate, including Medicare Levy.

Income thresholds	Marginal tax rate	Gross earnings to repay $1,000 interest
$0 - $18,200	0.0%	$1,000
$18,201 - $45,000	21.0%	$790
$45,001 - $120,000	34.5%	$655
$120,001 - $180,000	39.0%	$610
$180,001 and over	47.0%	$530

Debt repayment structures

There are two repayment structures available on debt.

1. Principal & interest

Under a principal & interest repayment structure the repayment includes a partial repayment of the principal borrowed along with a payment of the interest charged. The repayment amount is calculated at commencement of the loan and takes into consideration the interest to be charged, the amount and the life of the loan. Upon final repayment the loan will be extinguished.

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2. Interest only

Under an interest only repayment structure the repayment only repays the interest charged on the loan. No repayment of the principal is made until an additional repayment is made to clear the loan.

Interest only repayments are generally lower than principal & interest repayments as they do not include a repayment of the amount borrowed. However, the principal does need to be repaid at a later date.

An interest only repayment structure can be useful for deductible debt as only payment of the tax deductible amount, being the interest is made. This preserves the level of tax deduction as the interest charged is not reduced by the reduction in the balance of the loan.

The loan can be repaid once the investment is sold. Any cash flow savings that are received can be used for other wealth creation strategies.

Gearing

Gearing involves using borrowed funds to make investments in assets such as property, shares or an investment portfolio. Gearing can be attractive to investors because loan expenses and interest costs can often be claimed as a tax deduction.

There are three types of gearing:

1. Negative gearing

Negative gearing is where interest costs exceed the income earned from investments. An investor is able to claim a tax deduction for the difference in income received and borrowing costs. Any excess may be used to reduce taxable income from other sources.

When negative gearing occurs cash flow from other sources will be required to meet the loan repayments and other holding costs not covered by the income earned from the investments.

2. Neutral gearing

Neutral gearing is where the interest costs is equal to income earned from investments. This type of gearing may not impact an investor's cash flow position as the income generated offsets the interest paid. However, cash flow from other sources may still be required to meet principal repayments on the loan or other costs associated with the investment.

3. Positive gearing

Positive gearing is where interest costs are less than the income received from investments. Any income above the interest costs is taxed at marginal rates.

An example of how gearing works

Returns are magnified when using gearing because the investment is larger than it may have been without the use of borrowed funds. It is important to understand that the potential to losses are also magnified.

The example below shows the effect on returns when gearing is used.

	Ungeared 5% loss	Geared 5% loss
Personal funds invested	$50,000	$50,000
Borrowed funds invested	$-	$100,000
Total investment	**$50,000**	**$150,000**
Annual income (5% p.a.)	$2,500	$7,500
Loan interest (8% p.a.)	$-	($8,000)
Net income	**$2,500**	**($500)**
Capital loss (5% p.a.)	($2,500)	($7,500)
Total return	**$-**	**($8,000)**
Return on funds invested	**Nil**	**-16%**

	Ungeared 5% growth	Geared 5% growth
Personal funds invested	$50,000	$50,000
Borrowed funds invested	$-	$100,000
Total investment	**$50,000**	**$150,000**
Annual income (5% p.a.)	$2,500	$7,500
Loan interest (8% p.a.)	$-	($8,000)
Net income	**$2,500**	**($500)**
Capital growth (5% p.a.)	$2,500	$7,500
Total return	**$5,000**	**$7,000**
Return on funds invested	**10%**	**14%**

Gearing is not suitable for all investors. Risks and rewards are magnified and surety of cash flow to cover shortfalls in loan repayments and other investment expenses is crucial.

Investors should obtain financial advice prior to adopting a gearing strategy as careful consideration of an investor's risk profile and circumstances is required.

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