DEBT RECYCLING
THE GOOD, THE BAD & THE TAX EFFECTIVE

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We are constantly inundated with information about our burgeoning house prices, which require ever increasing mortgages to finance them.

The size of these mortgages mean they will be with us for the best part of 20-30 years and soaking up a substantial amount of income that could otherwise be used to accumulate retirement wealth. Historically the focus was on repaying the mortgage before embarking on wealth creation strategies. However, the time taken to repay the modern mortgage means that our most productive income earning years will be behind us by the time we are mortgage free. This has resulted in the development of savvy strategies for the tax effective accumulation of wealth and repaying the mortgage concurrently. One such strategy is debt recycling.

Debt Recycling – what is it and how does it work?

In simple terms this strategy involves the conversion of non-deductible debt into tax deductible debt. The primary objective is to reduce the non- deductible debt faster while accumulating wealth through increasing tax efficient investment debt.

Broadly, debt recycling works as follows:

1. All surplus cash flow is used to reduce the mortgage, thereby, increasing equity in the home.

2. At the end of a regular period of time (generally one year), an amount equivalent to the increase in equity is re-borrowed and invested in growth investments.

3. All investment earnings, tax refunds resulting from the deductible interest and other surplus cash flow are used to further reduce the mortgage and increase equity in the home.

4. At the end of the second year you reborrow an amount equivalent to the increased home equity to purchase additional investments.

5. The above process is repeated over a number of years (or other suitable period) in a disciplined manner to gradually reduce the mortgage whilst increasing investment debt and investing in growth assets.

A separate loan should be established for investment purposes to clearly distinguish between the investment loan and the mortgage. This not only creates an easy to follow paper trail come tax time, but also ensures ATO requirements are met.

Example

Brian's family home is worth $1.0m with a mortgage of $350,000. He earns $250,000 p.a., with surplus cash flow of $30,000 p.a.

Year 1

Brian contributes $30,000 into the mortgage and reduces it to $320,000. He then establishes a separately identifiable line of credit, draws down $30,000 and invests this in growth assets. This results in no increase to the overall debt level; however, interest on $30,000 of the total debt is now tax deductible to Brian.

	No Debt Recycling	Debt Recycling
Mortgage Repaid	7.8 years	7.2 years
Interest Paid (Mortgage)	$113,520	$105,538
Net Asset Value after 15 years	$386,745	$473,731

A 15 year analysis of employing debt recycling versus not employing it yields the following results: The debt recycling strategy is expected to repay the mortgage 0.6 years faster and save around $7,982 in interest.

Additionally, the net investment value of the geared portfolio after 15 years is some $87,000 higher. This can be attributed to the compounding effect of investing earlier.

Why recycle debt?

This strategy has a number of benefits, some of which are immediate and others realised over time.

The key benefits are:

- Investing immediately rather than waiting for the mortgage to be repaid allows the power of compounding to start working earlier. As the old adage goes it's time in the market, not timing the market that brings success.
- Improving the tax effectiveness of the debt by converting inefficient non-deductible debt into tax deductible debt.
- Reducing the mortgage faster by directing all surplus cash flow, investment income and tax refunds for this purpose.
- Investing at regular intervals alleviates the timing risk in volatile markets, ensuring a disciplined approach to investing.

Is debt recycling appropriate for you?

This strategy is suitable for clients with the following characteristics:

- Long term investment horizon – a geared investment into growth assets requires an investment time frame of at least 7 years to smooth out the inevitable ebbs and flows of the market.
- Growth oriented risk profile – gearing magnifies both gains and losses in a portfolio and investing in growth assets such as shares requires a reasonable tolerance to volatility.
- Free cash flow – individuals should have sufficient surplus cash flow (without relying on investment income) to fund the investment debt as well as repay the mortgage.
- High income wealth accumulators – investment debt is most tax effective for those on high marginal tax rates who have a number of years until retirement.
- Discipline – the excess cash flow, investment earnings and tax refunds need to be used to reduce the mortgage rather than fund lifestyle expenses.

As with any strategy involving debt there are risks involved. Gearing has the potential to magnify losses as well as gains. Therefore, caution must be exercised to ensure the level of gearing is affordable and prudent. Declining property values and high loan to value ratios may place pressure on the ability to re-borrow as the equity is eroded.

Individuals should ensure there is sufficient, stable surplus cash flow to fund the investment gearing without relying on the investment income.

Furthermore, the primary source of income should be adequately protected via appropriate risk insurance.

Prior to embarking on a debt recycling strategy you should seek professional advice to ensure it is a suitable strategy for your personal circumstances.

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