Strategy 7

Offset your investment loan to retain tax efficiency

If you have already paid off your home loan, you may want to put your emergency cash reserve in a 100% offset account linked to your investment loan.

What are the benefits?

By using this strategy, you could:

- Earn a higher after-tax return than a cash account, and
- Withdraw the money for any purpose without affecting the tax-deductibility of the loan.

How does the strategy work?

In Strategy 2 we explained why you might want to hold your emergency cash reserve in your home loan or a 100% offset account linked to your home loan.

But what should you do if your home loan has been repaid and you only have an investment loan?

In this scenario, holding your emergency cash in your investment loan or 100% offset account linked to your investment loan, could enable you to earn a higher after-tax return than using a separate cash account.

However, if you want to access the money for non-investment purposes, paying it into a 100% offset account linked to your investment loan is likely to be a more tax-effective alternative than paying it into the investment loan itself.

This is because an offset account is separate from your investment loan account. As a result, you can make repayments (and access them if required), without affecting the size of the investment loan or the tax deductibility of the interest.

Conversely, if you pay money into the investment loan itself, you'll reduce the size of the loan and if you redraw the money for non-investment purposes, you can't claim the interest on the amount redrawn as a tax deduction.

This means you could end up in a situation where part of your interest is tax deductible and the rest is not (as the following case study shows).

	Investment loan	100% offset account linked to an investment loan
Can you access your emergency cash for any purpose?	Yes	Yes
Do withdrawals for non-investment purposes reduce the tax deductibility of the loan?	Yes	No

Case study

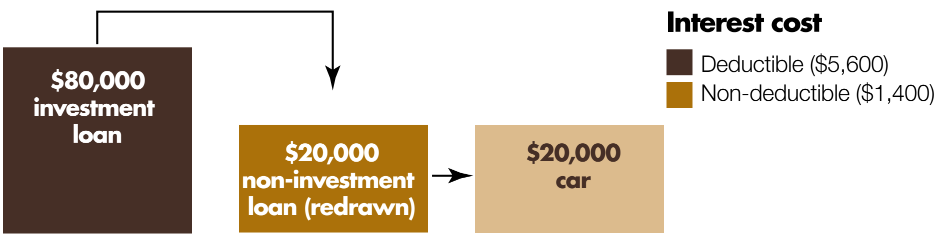
After paying off her home loan Laura, aged 45, used some of the equity in her home to set up an interest only investment loan for $100,000, and invested in a share fund. The interest rate on the investment loan is 7% pa.

She recently received an after-tax bonus of $20,000 from her employer and plans to use the money to buy a car in 12 months. In the meantime, she wants to reduce the interest payments on her investment loan and is considering the following options:

1. Paying the bonus directly into the investment loan, or
2. Paying the bonus into a 100% offset account linked to the investment loan.

If she chooses option 1, the balance of her investment loan will drop to $80,000. However, when she redraws the $20,000 to buy her car, she won't be able to claim the interest on this part of the loan as a tax deduction. As a result, she'll end up with a mixture of deductible and non-deductible debts.

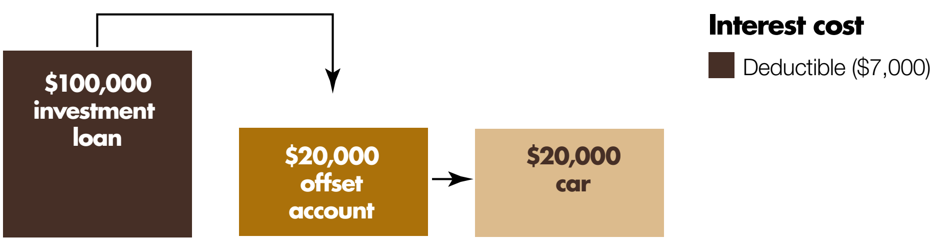
Option 1: after withdrawing $20,000 from investment loan



With option 2, the balance of her investment loan will stay at $100,000, but she'll save the same amount of interest as option 1, as interest is only payable on the difference between her loan account and offset account (ie on $80,000).

Also, when she withdraws the $20,000 from her offset account to buy her car, the size of the investment loan will not be affected and the interest payments will continue to be fully tax-deductible.

Option 2: after withdrawing $20,000 from offset account



Tips and traps

- To take advantage of this strategy your investment loan must have a 100% offset account. If your current loan does not have this facility, check with your lender to see if it can be added. In many cases the lender will only allow an offset account for the portion of the loan subject to a variable interest rate.
- Line of credit facilities don't generally offer a 100% offset account. Even if a personal sub-account is in credit, the lender may not offset this against the outstanding investment loan sub-account.
- If you need to borrow money for a non-investment purpose and don't have an offset account, then it's usually better to borrow using a separate loan rather than redraw from your investment loan. This way it's easier to keep track of what interest costs are deductible and non-deductible when completing your tax return.
- Once you have paid off your home loan, it can be a good idea not to cancel the mortgage. This may allow you to use the equity in your home to borrow for investment or non-investment purposes (up to your original pre-approved borrowing limit), without additional State Government mortgage duty or Land Titles Office registration fees.