

The difference between good debt and bad debt

"Debt" can be a nasty, four lettered word to many people, however, there is a marked difference between different types of debt – some can actually be good for you!

The major difference between 'good' and 'bad' debt is its tax effectiveness. For example, many people aim to pay off their mortgage as soon as possible. It is a good strategy because it reduces living expenses and provides security. However, from a tax point of view, a personal loan such as a mortgage is 'bad debt' because the interest on the mortgage is not tax deductible and you must pay tax on your income before you make repayments.

On the other hand, if you borrow to invest in income producing assets, the interest costs become tax deductible because they are a cost associated with earning the income from the investment. From a tax point of view, an investment loan is 'good debt' because of the tax advantages. A key element of many wealth creation strategies is to eliminate bad debt as fast as possible and convert it to good debt. The case study below is one such example.

A case study

Heath earns \$120,000 and is in the 41.5% tax bracket. His home is worth \$600,000. He has a \$400,000 mortgage and is paying \$40,000 a year so it will be repaid in 20 years. He has surplus after tax income of \$18,000. How can Heath best use it to reduce his home loan and maximise his wealth?

His adviser suggests three options. In each one, Heath will own his home outright, will be debt free and will have made allowance for any capital gains tax. The outcome figures show his accumulated wealth after 20 years excluding his home.

The following assumptions are used to achieve these calculations: Managed funds earn 8.5% pa with income returns of 3.5% pa, 80% franked. Loan interest rate is 7.85% pa. Results rounded to the nearest \$1,000.

Option	Strategy	Outcome (future \$)
1	Use the \$18,000 to increase his mortgage repayments so it is paid off in 11 years. Invest \$58,000 every year for 9 years.	\$724,000
2	Maintain his mortgage payments so it is paid off in 20 years. Invest \$18,000 every year for 20 years.	\$768,000
3	Debt optimisation	\$950,000

The debt optimisation strategy progressively converts bad debt to good debt and works like this:

- To use the \$18,000 to increase his mortgage repayments so it is paid off in 11 years. In the first year, the \$58,000 repaid comprises interest of \$31,400 and \$26,600 in capital reduction.
- He then re-borrows \$26,600 as 'good debt' and invests in managed funds.
- He repeats this investment every year until the mortgage is paid off.
- He then invests \$58,000 every year for 9 years.

By investing more money earlier and having the tax advantages of gearing, Heath has come out almost \$182,000 better off. A financial adviser can develop a strategy suited to your circumstances and goals... and don't be afraid of debt.

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