

Spare change can liberate

Don't let your spare cash sit idle. Use a home loan offset or redraw account to earn the equivalent of 12.5 per cent.

By Lesley Parker

How does a 12.5 per cent annual return sound? What if I said it was after tax? Would you believe me if I said it's virtually risk-free? In fact, that's the sort of return you can achieve if you "save" by directing money into extra mortgage repayments.

Once a feature of more expensive home loan packages, redraw facilities and mortgage offset accounts come attached to even some "basic" home loan products these days.

Then there are line-of-credit loans where you can also move money in and out – eroding the interest payable on your home loan as long as you're disciplined enough to make sure you stay in positive territory.

"If you have a mortgage, if you want to make your money work smarter, paying money off the top using your redraw or offset facility is the best way to go," the head of consumer advocacy at Resi Home Loans, Lisa Montgomery, says.

You may need to withdraw the money later, "but while it's sitting there, every single day it's saving you money", she says, noting that the interest on mortgages is calculated on the daily balance of the loan.

With redraw, borrowers make extra repayments directly off the loan but these are noted separately as overpayments and can be withdrawn. In contrast, an offset account sits alongside the home loan and the interest earned on that account offsets the interest payable on the home loan (see box). The overall effect is the same.

Montgomery personally prefers redraw because she can clearly see what's happening and gains a sense of achievement from the balance

falling. "I can see the balance drop but I can also see that amount sitting in the overpayment category," she says.

Montgomery isn't as keen on line-of-credit loans, which she considers to be less transparent and require greater discipline to manage.

These loans don't have a set repayment and are generally interest-only. Let's say you set up a \$200,000 line-of-credit home loan but the balance is currently \$170,000. You're not required to make a payment as long as you don't go back over the \$200,000 by drawing funds, she says.

"People put the whole of their pay in there thinking they're saving," she says. "But they're living off a credit card, planning to pay the balance at the end of the month and sometimes, if they're not disciplined, they're not saving as much as they could be. If they don't keep their finger on the pulse, they can fall down."

When it comes to investment property, think twice before using redraw and offset.

"If you have an investment loan and reduce the interest, you're effectively reducing the amount of your tax deductibility," the director of Announcer Financial Planning, Andrew Rocks, says. "Always pay your home loan off [first] before considering reducing investment debt."

If you're living in a property that you plan to turn into an investment property by moving out, choose between redraw and offset carefully, an author and investment adviser at Destiny Financial Solutions, Margaret Lomas, says.

"A lot of people mistakenly believe they can load up the debt before they leave a property [by withdrawing their redraw amounts] and use that money to buy another property," she

says.

The problem is the Tax Office considers the debt you've built up again against that first property to be debt for personal purposes – that is, for the purchase of your new home – which means it's not tax-deductible.

It's not what the debt is secured against that matters but the purpose of the debt, Lomas says.

"Holding that money in an offset account instead will sort that out," she says. "Then you're just taking money out of an account to buy your new house."

The only hiccup may be that offset accounts are generally attached to principal-and-interest loans, she says, and by the time you come to buy another property you may have reduced the debt on the first to such an extent that you've eroded the tax advantages of negative gearing the property.

There's a view in some quarters that it's better to hold excess money in an offset account than use a redraw facility because the bank could stop you redeeming funds should your circumstances change, perhaps if you lost your job.

The argument is that an offset account, in contrast, keeps the money separate from the loan.

However, the head of mortgages for Bankwest, Dean Gillespie, says banks generally have the right under law to roll accounts together when a debt is involved, so an offset account wouldn't be immune. He stresses, however: "I've certainly never seen this done".

His advice: always check the terms and conditions of your home loan for such provisions.

What you'll save

Jean has received \$10,000. She can either put it in a savings account or an offset account/redraw facility linked to her \$300,000 variable home loan.

The savings account is offering 4 per cent interest, so over a year, she would earn \$400 in interest, income on which she would be taxed at 40 per cent, leaving her with \$240.

However, if she places it into the offset account, which earns the same interest as she's paying on her loan – 6.5 per cent – in effect, she would reduce her home loan from \$300,000 to \$290,000.

The annual interest on her home loan would fall from \$19,500 a year to \$18,850, a saving of \$650 – a “return” on which no tax is payable.

Already, Jean is \$410 better off by choosing the offset account.

But, of course, interest is charged daily on home loans and the impact will be felt

for the life of the loan, so let's look at the compounding effect over time.

The InfoChoice lump-sum repayments calculator (infochoice.com.au/calculators/lump-sum-calculator) shows that if Jean is five years into her 25-year loan at the time she makes the \$10,000 lump-sum payment, and assuming she keeps paying the original monthly repayment, she will save \$24,980 in interest and pay her home off one year and five months earlier than otherwise.

That's the equivalent of about \$1250 tax-free a year – or, in effect, a return of 12.5 per cent (though in reality, the savings can't be drawn in a straight line because they would be bigger earlier on, while the loan is still large, and decrease as the loan decreases).

Sources: *Align Financial;*
infochoice.com.au.

