STRATEGIC ADVISORY LENDING GUIDE

Offset Accounts: Keeping Your Options Open

Offset Accounts are rising in popularity amongst mortgage holding Australians. Approximately 50% of borrowers are now utilising the account structure as the ability to amortise debt faster and therefore reduce the total amount of interest paid becomes more widely recognised. It is however unfortunately the case that less than 5% of borrowers holding an offset account understand or are utilising their facility to its full potential.

In essence, the offset account is a deposit account - not a loan account. By depositing funds into the offset account, **you ARE NOT making a direct repayment to reduce your loan account balance**, but are instead depositing funds into a savings account which 'offsets' against the balance of your home loan, thus reducing your interest obligation.

Due to the additional features, mortgage products with an attached offset account can often attract additional costs to the borrower. As such many question whether the associated account fees or a slightly higher nominal interest rate make the offset account financially beneficial. As you will discover in the example below, if used properly, a 100% offset account can save borrowers many thousands over the term of their loan. However, if a borrower was to simply use their offset account as a temporary transaction account, say; with only a couple of hundred dollars inside the account at any one time, the costs associated with holding the account would likely outweigh the interest saving. Please see the below for an explaination and a comprehensive example.

A common misconception of mortgage holders is that the functionality of an offset account has no benefit over their existing redraw or line-of-credit facilities. This is incorrect, it is well documented through case law and in rulings provided by the ATO that the ease of ability to redefine loan purpose through the proper use of an offset account cannot be replicated through these other facilities. Furthermore without an offset account the only way to reduce the cost of interest would be to amortise down the principle of the loan, with a redraw facility only repayments in excess of the principle obligations can be redrawn, once principle has been paid down the equity is no longer available without a top-up of the facility.

Consider the Scenario:

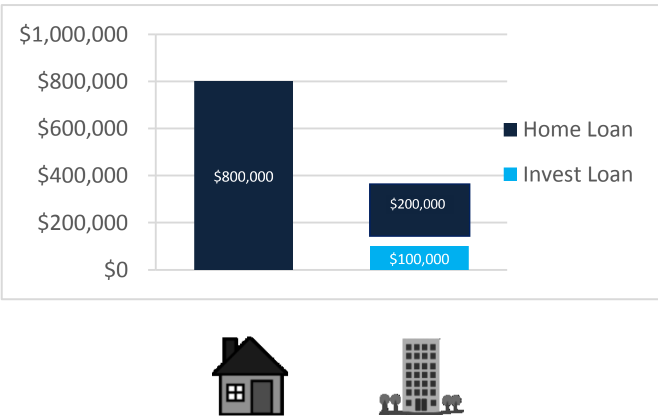
- A newly Married Couple have just purchased a small apartment in Bondi for $625,000.
- Corresponding loan amount of $500,000 (80%LVR).
- Over the following 5 years the pair both live conservatively, affording to pay off $400,000 off their loan balance.
- The resultant balance of their loan account is $100,000.

At the 5 year mark in the above scenario the family grows and the couple have their first child. The Bondi apartment thus outlives its use as the family home as it is now too small for their needs. The couple decide to purchase a new home by way of a house in Mascot for $1,000,000. They also decide that they wish to retain the Bondi apartment as an investment property.

Strategy 1: Loan principle paid down over the 5 years

Obtaining a loan at 80% LVR of their new purchase; $800,000. Assuming no additional savings are available to complete the purchase, the couple are required to extract $200,000 in equity against their Bondi Investment property to make up the other 20% required for purchase. The total debt of $1,100,000 is thus $1,000,000 – Home Loan and $100,000 – Investment Loan. The vast majority of interest repayments would therefore be non-deductible and paid after tax.

This has been visually depicted in the graph to the right:

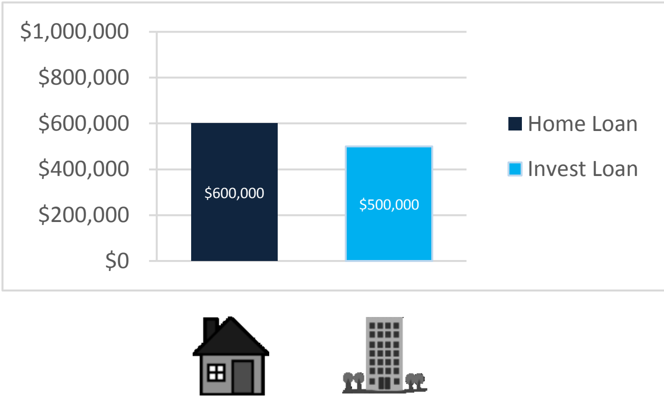


Interest payable on Investment Debt is fully tax deductable; assuming a rate of 5%, the couple can claim $5,000/year.
***Note:** the large amount of non-deductable Owner Occupied debt under this scenario (as per the above graph).*

Strategy 2: Loan repayments made to offset account

The second strategy available to the couple is very similar to the first; the difference however is dependent in how the $400,000 is 'repaid' over said term. If the couple were to have paid down the facility indirectly through depositing repayments to their offset account.

Utilising an interest only period of 5 years will keep the loan account balance constant at $500,000, and the accumulated offset balance available for future cash withdrawal. Thus when the couple proceed with purchasing the new home in Mascot, $400,000 in cash is contributed from the existing offset account, thus minimising the new home loan required and the existing $500,000 Bondi facility is retained as an investment loan, the resultant outcome is a minimisation of non-tax-deductible debt. Assuming the couple pays 30% of their income to tax; this would reflect a 30% discount on the cost of their interest.



As the funds are simply being withdrawn from the offset account – you do not have to justify use of funds to the bank or submit any kind of new application. The original loan against the Bondi property will be classified as investment debt despite part of the funds being used toward the new owner occupied property. Whereas if a mortgagor was to re-borrow, thus requiring a new lending application, you will have to justify the purpose of funds as per the first scenario.

So assuming an interest only rate of 5%, the couple can currently claim **$25,000/year!** This could represent a **saving of up to $11,250 of after tax/disposable income** per year in perpetuity on essentially the same transaction between the two scenarios above, through minimising non-deductible debt.

Underlying Benefits of Offset:

- The Offset Account can be utilised as an everyday transaction account. Every cent in your offset account helps as it reduces the interest you have to pay.
- Although you may not foresee it now your circumstances may change, and opportunities may arise requiring you to restructure your finances – an offset account grants this flexibility and freedom as you can deposit/withdraw funds at your own discretion.
- The additional flexibility granted by an offset account is helping many of our clients 'get ahead'. When used effectively, offset allows borrowers to grow their property portfolios faster than what they could otherwise.
- The example above reinforces the importance of flexibility in debt finance, and keeping your financial options open.

Six Year Rule for CGT exemption:

As a general rule, the ATO provides that your primary residence will be exempt from Capital Gains Tax, further to this if the property has been used for PR purpose for at least 12 months, the CGT exemption may be applied for up to 6 years after the property ceases to be used as a Primary Residence.

As such in the scenario above; the couple may opt to run the Bondi apartment as an investment for up to 6 years and then sell it with no CGT implication across the total 11 years of ownership. It is important to note that only one primary residence can be claimed during any given period, the Mascot house would therefore be subject to CGT during the 6 year period to which the Bondi property is elected as PR. After the sale of Bondi, if Mascot is then elected to be the PR; the liability of the first 6 years is then prorated over the term of ownership.

Shouldn't I be actually paying off my loan account?

Most borrowers have a principal and interest (P&I) loan on their primary place of residence. A P&I loan allocates some of the mortgage repayment to the principal, to reduce the actual amount owing, and some of the repayment to cover the interest accrued from the principal for that month. If the repayment schedule is adhered to, the loan will be fully paid-off in instalments over the agreed term i.e. 30 years.

An interest only facility limits the commitment to the lender to avoid repaying the principle debt. By redirecting these payments to an offset account, the same effective benefit of reducing the applicable interest is achieved, while still providing the structural flexibility as outlined in the above examples. The other important advantage is the guaranteed access to equity, when lending is established at a ratio to valuation, repayments made into an offset account are retained as a cash balance available to be drawn throughout the life of the facility without prior approval. Once a loan is amortised down through principle repayments, the equity cannot later be redrawn without a top-up of a facility which requires a valuation. In the event that a future valuation comes back lower the equity available will be limited if not expended.

Planning based on your individual scenario – not cheaper rates.

Where many mortgage holders are failing in securing the best result is through the misconception that the most important factor of their mortgage is the face interest rate. This could not be further from the truth and clients are often victim to sales focused brokers using a headline interest rate to leverage a customer rather than an in-depth knowledge of the wider implications of a loan product in relation to their portfolio and individual tax position. A personalised loan product with features most suited to the specific situation such as an offset account and an interest only period, as explained above, can potentially save thousands in perpetuity over the duration of your loan.