Debt Recycling! Does shuffling funds around really change the nature of the debt?

Well, a lot of this has to do with whether your dominant purpose is a tax benefit. Yep Part IVA, the ATO's secret weapon that defeated capitalised interest arrangements.

Debt recycling, suggests that you can change non tax deductible debt into deductible debt by buying whatever the promotor is selling. Very rarely do they actually say that means this debt over here becomes tax deductible. This is usually implied by the way they talk about the loans, but a critical reading will show this is not actually the case. You might be moving debt around but that is not going to change its nature. Please read up and understand the basics so you can ask the tough questions.

The first rule of debt recycling is that what the money is used to buy determines whether the interest on the loan is tax deductible. Borrow to buy the house you are going to live in, the interest on that loan is not tax deductible. Borrow to buy a source of income such as a rental property and the interest on that loan is tax deductible. Obviously, you will concentrate on paying off the loan on the home you are living in first. This is generally achieved by making the loan for the investment property interest only. The ATO don't seem to mind this.

Promoters of debt recycling suggest you use the income from the property to pay down your home loan. The question you then ask is *'ok well, how do I pay the interest on the rental property loan and the rates etc'*? If they say borrow that through a line of credit or the like, then ask why. If they say because the interest on the new borrowings are tax deductible, ask does that pass the ATO Part IVA test and do they have a ruling on that.

Part IVA is the ATO catch all for arrangements that do not pass their sniff test. These are the sorts of questions you can expect:

1) Was the dominant reason for you entering into the arrangement for the tax benefit i.e. what other possible reason could you have for doing things this way?
2) Is the arrangement artificial and contrived? Is there a valid non tax related reason for the loans to be set up in this way?
3) If not for the tax benefit would you organise your affairs this way?
4) Is there anything in the documentation promoting or setting up the loans suggesting there is a tax benefit?

If Part IVA applies, they will not allow the interest on the additional borrowings to be claimed as a tax deduction and you may be left locked into an expensive loan arrangement with none of the benefits plus fines and interest from the ATO. Ask the promotor whether they have an ATO product ruling on their loans and make sure the arrangement described in the ruling fits exactly your circumstances. If they don't, apply for your own ruling.

Another more legitimate way these arrangements are promoted is using the excess income after paying interest and property expenses to pay down your home loan. If you can find a property that will do this from the start, then great. You are probably looking for a property that is in an area where people do not want to own their home i.e. remote mining towns so rent demand is high. Positive cash flow is more easily achieved with a new property, so the building depreciation is at a maximum. If you think this property will hold its value and at least keep pace with inflation, then it is worth crunching the numbers. These numbers need to be very carefully crunched because market forces are such that it would still be surprising for you to have income left over to pay off your home. Sure, you would if you put down a good-sized deposit but that is not the strategy here. If you have any cash pay it off your non-deductible debt, then use the extra equity in your home to secure a 100% lend on the investment property. This is the first step in maximising deductible debt legitimately.

Here is a link to a spreadsheet that will allow you to work out whether a property is going to give you a positive cash flow to help pay off your home loan.
https://www.bantacs.com.au/shop-2/property-cash-flow-calculator/ Do this calculation over and over again for lots of what ifs for different interest rates and rent changes and look at how properties in different markets compare.

Now, once you have a property that provides a positive cash flow consider that you are not actually increasing your tax deductible debt so you don't need any clever loans or for that matter whatever the debt recycling promotor is selling. All you need is an interest only loan on your investment property and at least part of your home loan flexible enough to accept additional payments. Generally, banks will offer a better interest rate for a fixed loan which means you can't make extra repayments. It may be worth your while to split your home loan into a fixed part and a variable part so you can make the extra payments off the variable one. Just set the variable loan for the amount you hope to be able to pay off over the term of the fixed loan.

If you can't find a property that will produce more income than it is costing you then consider shares that are returning earnings geared towards franked dividends rather than capital growth. This may produce some excess income that you can use to pay off your home. There is a catch in that shares are expensive to borrow against, so it is probably only economical to borrow any excess equity you have in your home to invest in shares rather than using the shares themselves as security against your borrowings. At least shares are easier to sell off to use the capital gain to further reduce your non deductible debt. But make sure the original purchase price is paid off the deductible loan used to buy the shares in the first place.

Now I can hear you saying but if I choose to pay down non tax deductible debt first, wouldn't any sane person do that? The judge in an earlier Harts case, on capitalised interest agreed. It is common sense, but the Harts eventually lost on a very simple argument from the ATO. With the flare of a full house in a poker game they produced a pamphlet from the bank recommending the loan arrangement for the tax benefits. Game over, Part IVA applied, dominant purpose of the arrangement was a tax benefit.

Further Reading

- https://www.bantacs.com.au/Jblog/keeping-the-nexus-between-the-borrowing-and-the-expenditure/#more-352

- https://www.bantacs.com.au/Jblog/mixed-purpose-loans-explained/#more-1395