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How to Manage Debt

A quick look at handling debt within a family

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DEBT & BORROWINGS BOOKLET

Often as an accountant I am asked to assist individuals & business's understanding and gaining finance to assist them in business. Of late, I have helped more individuals and families with their private finances and manage debts through my business but also through community service organisations where I serve. Given the World financial crisis we are going through has its basis in individuals, business and Government borrowing what they can not afford to repay, it is timely for ALL to set their house in order.

The following information is based upon sound accounting principles and advice from others that I respect and honour. It is understood that not all of what follows applies to you and I have targeted my comments to that of a family or couple, but **I strongly suggest you read the Foundation Section** before perhaps leaping ahead to what may matter most to you. I do suggest though that it all be read and not just parts.

This is not advise specific to your situation. You should not solely rely on what is stated by contact us so we can be of specific assistance. As the markets and tax laws change, you need up to date advice before acting. Contact us for that advice.

FOUNDATION

Not all debt is bad. It is understood there is a need to borrow money to finance the acquisition of Assets such as Property and Cars. Sometimes money is also borrowed to finance the establishment of a business and its outlays until it is profitable and self sustaining. These circumstances are not covered in this booklet. I am concentrating on over exposure to debt or using debt to finance consumables or to service other debt.

No matter what the reason, be aware that debt is a form of bondage. Your contract binds you until it is released. The terms and conditions on the contract most certainly are in favour of the Lender. If we are not careful, debt can be a financial termite to the happiness and well being of our homes and family. When we make purchases on credit we kid ourselves into thinking we own things when in fact we do not. Also, what we have purchased can be many more times the original cost due to interest and finance charges.

Those that save and buy with cash will always have more as they have saved and not paid interest charges. Not only do they save on interest charges, but they earn interest. We pay a great cost for immediate gratification rather than learning some patience when we are buying goods and services that are not urgent.

It has been said “Interest never sleeps nor gets sick or dies. It never goes to hospital, it works 24/7/365, never goes on holidays or takes a vacation. Once in debt, interest is your companion every minute of the day and night. You can not shun or get away from it. You can not dismiss it. It neither entreaties, demands, or orders and whenever you get in its way or cross its course or fail to meet its demands, it crush’s you”.

We should never enter into financial bondage through consumer debt without carefully weighing the true costs and impact on our lives and those we love and respect.

SIMPLE RULE FOR BORROWING

There are 2 broad types of interest.

- Interest that is allowed as a tax deduction. Known as deductible interest.
- Interest that is NOT allowed as a tax deduction.

Traditionally, interest is only deductible to the extent that the borrowed money is used to derive taxable income. A classic example is where money is borrowed to invest in shares. The interest expense is deductible against the dividend income from the shares or against the Capital Gain on the sale of the share.

Now the simple rule is not so simple as there are plenty of cases that take away the certainty of the immediately deductibility of the interest expense. It is best to speak with us directly on your situation if you intend to claim the interest expense as a tax deduction.

Where money is borrowed to buy private consumer items and holidays or non-business and non-income producing Assets, then the interest is not deductible and the Borrower gets no relief through the tax system. This type of interest is even more imposing as the Borrower is totally responsible for the costs with no tax relief. The misconception that the costs of interest is discounted by inflation is only applicable to loans that have a fixed rate of interest and the fixed rate is lower than interest rates that are rising.

TYPES OF BORROWING

It never ceases to alarm me of the various ways that Lenders devise on how to loan money to a public that are almost debt addicts. I was aghast when “low doc” and “no doc” loans were about some years ago. Tis more the pity that they are making a come back. Be assured that loans are so structured to protect the Lender and gouge the Borrower if all the terms and conditions are not met.

Interest can be paid in advance or in arrears. It can be paid annually, monthly, on occasions, weekly or even daily. Some loans are very dangerous by their nature. That is they are not for a set sum such as what is needed to by a car, but they are for any amount that is needed up to a maximum sum. That maximum is based on the value of the security used to gain the loan. A market example is the “Line of Credit” facility

which in my experience the most abused type of loan yielding the best result to the Lender.

CREDIT CARDS & FDA LOANS

I have been amazed how there are still financial advisors advocating a system, that when followed will reduce the interest payable on a non-deductable loan, but has shown in practice to not work and leave the Borrower worse off.

The system is simple. A strict budget of home finances is set. You divert all your income onto your FDA or House Loan thus reducing the loan balance and reducing the interest charge. In the interim, purchases are made on a credit card. The credit card is then paid off from the FDA or House Loan when due. The interest savings coming from adherence to the home budget, the interest free period on the credit card and the savings component from the Income being left against the FDA loan and reducing the Balance.

The system works well and has been used for many years before it became popular and sold in the market place. The major problem with it and why it fails is that it requires the financial budget set to be strictly adhered to. Australians are not good at being strict with adhering to household budgets. So when they blow the budget, it is not long before the FDA is growing and the Credit Cards are maxed out. So be weary and ONLY get involved with these systems if you are genuine in reducing our debts and you do have the resolve and self control to stick to the budget of expenditures over many many years.

DEBT REDUCTION

There are very few debts that can not be reduced and paid out early. Sometimes we are tempted to reduce debts by combining several loans into one, usually the housing loan that has a very long term. Usually, when this is done, the interest paid is more than if the shorter term loans were left alone and another solution was made.

Loan Repayments

Most loans can be repaid in shorter bites. Rather than paying \$400 a month or \$4800 (12 x \$400), it is better to pay \$100 a week rather than \$400 a month. The effect is 2 fold :

1. Making payments weekly reduces the debt balance each week and as interest is mostly calculated on daily balances, the weekly reduction does have an impact.
2. Making 52 weekly payments of \$100 totals \$5200 whereas 12 x \$400 a month totals \$4800. So paying weekly basically has you paying 1 extra monthly payment for the year.

Credit Cards

The basic principle of having a credit card is convenience and it is also an unsecured loan. It is convenient to use a credit card and not have to carry the cash around. Also, it is a quick source of short term credit as the debt is unsecured and has low monthly repayments.

But the interest rates are high on unpaid balances. Because the amounts we owe may not be very high in some cases, we may ignore the balances owing on the due date and be happy to be charged the interest. I guess some who read this may have several cards, all maxed out and paying lots of interest.

I have helped some in these circumstances. In some cases we were able to get a new card that offered a honeymoon rate (low rate for the first 6 months) and transferred the old cards amounts to the new card. We then worked a system to direct as much as we could against the card and then towards the end of the honeymoon rate, got another card and did it all again until we ran out of new cards or the debt was repaid

Just watch out for credit cards that have loyalty schemes. These may come with annual fees also and all sorts of built in benefits such as travel insurance. It has been my experience that some of these cards are great as the frequent flyer points earned or bonus points earned are valuable to the user. But be assured they come with a cost, which usually is an annual fee and high interest rates on unpaid amounts owing.

Loans and GST

In business, we need to be careful with the type of loan we are securing as it will impact on the GST treatment of the Asset we are acquiring. Please contact this office to review these options if you are seeking to claim the GST on the Asset acquired and using finance to acquire the Asset.

What Loan to pay down first

Simply put, if you want to pay down debt quickly and get out of the bondage of debt, below are some points to consider and a table that you could use as a plan.

- ✓ There may be some penalties paying down a loan more quickly than agreed. Check these and calculate if the interest savings are extinguished by early repayment penalties.
- ✓ Where loan interest is tax deductible, then you need to speak with us first to ensure the total after tax effect is in your favour.
- ✓ Be careful to not combine loans if you can. The effect is usually a lower repayment amount each month on the combined loan than what was being repaid on the un-combined individual loans, but the term is extended and thus the interest expense is much higher.
- ✓ Try and pay down loans faster that have the highest interest rate.
- ✓ When loans each loan is paid out, transfer the payment on that loan to another and accelerate the repayments until they are all extinguished.

See the following table as a simple example.

Months	Visa Credit Card	Mastercard	Car Loan	Pool Loan
1	100.00	100.00	50.00	80.00
2	100.00	100.00	50.00	80.00
3	100.00	100.00	50.00	80.00
4	Paid Out	200.00	50.00	80.00
5		200.00	50.00	80.00
6		200.00	50.00	80.00
7		200.00	50.00	80.00
8		Paid Out	250.00	80.00
9			250.00	80.00
10			250.00	80.00
11			250.00	80.00
12			250.00	80.00
13			250.00	80.00
14			250.00	80.00
15			250.00	80.00
16			250.00	80.00
17			Paid Out	330.00
18				330.00
19				330.00
20				330.00

You will note that as loan is paid out, the repayment of that loan is then appropriated to the next loan to be paid down and so forth.

Home Budgets

Uncontrolled consumer debt usually comes about as the family and individual budgets are not completed or adhered to. Where there is no budgets down on the income that is derived, there is no control, no management and usually high levels of consumer debt.

I have written a paper specifically on home budgets and invite you to also read this and apply the principles. It can be found at http://holzlaw.com/smsf_white_papers.php and downloaded for your information.

Helping Family with Debt

Some parents do not teach the principles and responsibilities of debt to their children. The outcome of us all when we are not pre-taught, we make mistakes and hopefully learn from mistakes. It would be most prudent to save our children the pain and long term outcomes of bad financial decisions if we took the time to teach them and also help them at the onset of them gaining financial independence.

You may need to help them get started in a small loan for the 1st car by becoming the guarantor. We all know that when we are the guarantor, it means we pay when they default. Hence this is usually a small loan ☺.

This then gets the kids a good credit rating and they also learn about how debt works and how expensive interest is. I remember my son seeing interest being charged on a statement and was most upset at this, but also they had the hide to charge interest on a public holiday and even on Christmas Day.

Be careful with credit cards. Make sure the limits are small. You know already what the dangers are, but best they get used to credit cards with small limits and how the system works whilst they have you as the safety net.

Conclusion

Make sure you manage you money and not have it manage you. Make sure you keep consumer debt low and do your best to close loans down as fast as you can. Debt is a terrible master and is unrelenting in its demands.

Contact us if you have any questions or need help with anything listed.

Regards

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