ORD MINNETT

Why fix and prepay interest?

Clients using margin loans for investment often can't see the potential for tax and cash flow benefits from structuring with fixed and variable rates. In addition, many won't be aware of the option to pre-pay fixed interest within a financial year and claim a tax deduction. Financial advisers can add real value to clients by discussing these options.

How your clients can benefit from fix and prepay:

A fixed rate margin loan has potential to be self-funding before any capital gain over the term.

Fixed amount of borrowing costs for fixed rate portion of loan provides cash flow certainty.

Potential to claim an income tax deduction in the current financial year.

About Rachel

Rachel has a role as an executive manager and is an Australian tax resident on the second highest income tax bracket. She is confident in managing moderate borrowing levels but also wants greater certainty about the monthly household budget.

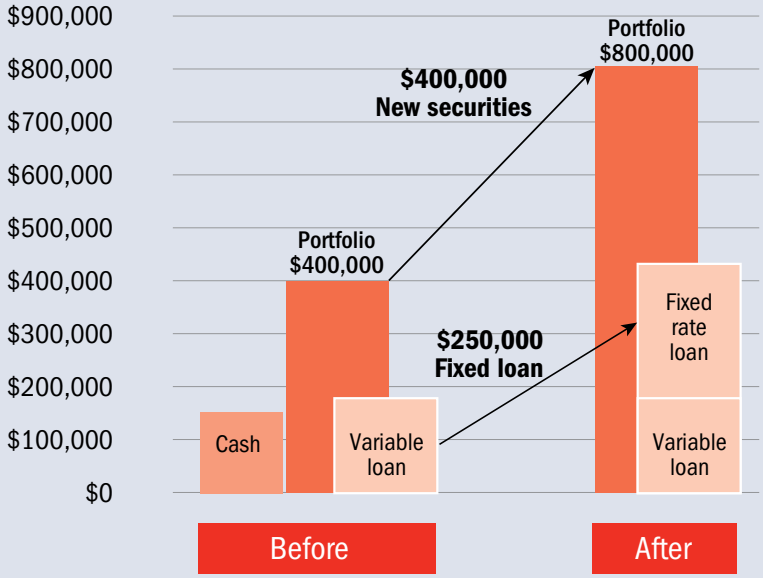
Rachel has some cash savings for investment over the coming financial year and also has an existing $400,000 portfolio of shares with a $180,000 variable loan. There has been a capital gain on the portfolio during the financial year and fully franked dividends paid, both taxable. Rachel also has a dividend forecast of $16,960.

Rachel's opportunity

Rachel wants to increase the size of her portfolio by a further $400,000 to maximise her investment outcomes. She has $150,000 in cash and plans to borrow a further $250,000.

She approaches her financial adviser who explains the benefits and issues relating to fixing and prepaying interest on the margin loan.

As the chart shows, Rachel's gearing on her new portfolio has now increased from 45% to 54%. ($180,000/$400,000 = 45% to $430,000/$800,000 = 54%).



The baseline

The investment portfolio is held on capital account. Rachel is eligible to claim franking credits. A change in any assumption will alter the portfolio outcomes on the next page.

1-year prepaid fixed interest rate for a $250,000 loan	6.89% p.a.
Variable rate	6.70% p.a.
Dividend Yield (81%[1] franked)	4.24% p.a.
Marginal income tax rate (including Medicare Levy)	39%

[1]Source: State Street STW ETF https://www.ssga.com/au/en_gb/intermediary/etfs/funds/spdr-spasx-200-fund-stw.

Portfolio advantages.

Cash flow certainty

To better manage cash flow and budgeting, Rachel opts to use a fixed rate for a portion of her margin loan, with the remainder on a variable rate. The fixed rate portion provides certainty of interest payments over the term of the loan, while the variable rate allows her to manage gearing levels in the coming year.

Potentially claim an income tax deduction in the current financial year.

The situation:

- Rachel is an Australian resident for income tax purposes. She will use the loan to invest in income producing shares and managed funds.

The outcome:

- Generally, Rachel should be entitled to claim up to 12 months of prepaid interest in the current financial year.

Prepaid interest on fixed rate loan $250,000 fixed rate loan multiplied by 6.49%	$17,225
Potential tax deduction Prepaid interest multiplied by marginal income tax rate of 39.00%	$6,718
Net annual borrowing cost for fixed rate loan Prepaid interest less potential tax deduction	$10,507
Potential franking credit $16,960 forecast dividend multiply by Corp Tax Rate of 30% divided by (1 - Corp Tax Rate) multiplied by 81% franking	$5,888

Fixed rate margin loan is likely to be self-funding before any capital gain over the term.

The situation:

- The financial adviser assesses how the securities acquired using the loan, and Rachel's own capital must grow to cover her after tax costs on her fixed rate loan (excluding potential capital gains tax).

The outcome:

- The net after-tax cost/benefit represents 1.37% of the fixed rate loan amount. This means dividends and the value of franking credits received covers Rachel's fixed rate borrowing costs (on an after tax basis). Capital Gains Tax is not considered in this example.
- If Rachel had opted for a variable rate loan at 6.70% pa (see table below), the net after-tax benefit would be 1.49%*.

*A small change in any assumption, for example, a reduction in the actual dividend paid could cause the variable rate loan to not be self-funding on an after tax basis.

		Fix and Prepay 12 months in advance (at 6.49% p.a.)	Variable, monthly in arrears (at 6.70% p.a.)
A	**Assessable income** Forecast dividend on additional shares plus potential franking amount.	$22,848	$22,848
B	**Interest expense** Interest payable on $250,000 loan portion.	-$17,225	-$16,750
C	**Net Taxable Income** Assessable income (A above) less fixed interest cost (B above) assuming it is fully deductible for income tax purposes.	$5,623	$6,098
D	**Pre-tax benefit** Forecast dividend earned on additional shares, less interest cost.	-$265	$210
E	**Potential Tax Benefit** Net taxable income (C above) multiplied at marginal income tax rate of 39.00% less potential franking offset.	$3,695	$3,509
F	**Net after tax benefit** Pre-tax benefit + tax benefit (D + E)	$3,430 or 1.37% Potential Benefit	$3,720 or 1.49% Potential Benefit

Need more information?

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