ASK THE EXPERT

Claiming redrawn loan interest

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Q *We recently increased the loan on our Australian property, can we claim the extra interest?*

A When you own an Australian property that is income producing, for example with a tenant in paying a weekly rental, then you are entitled to claim any costs incurred against the income to reduce any potential income tax payable on the income.

This includes interest on any loan that was used to help purchase the property.

Many people make the mistake in assuming that as long as the loan is secured against the property, or was originally used to buy the property, that all future changes to this loan will also be a tax deduction. This is simply not the case.

In order to claim an interest expense, you must be able to show that when the loan was advanced it was used solely for the purchase of the income producing property.

A major problem occurs when the loan is paid down or increased, and new funds are drawn against it for another purpose. It is the new purpose that will determine if the new loan is allowed as a tax deduction.

For example, if you withdrew A$20,000 from your home loan to go on holiday, this portion of the loan would not be considered as part of the claimable home loan, rather a "holiday loan" that is just secured against the house. The interest cost of the $20,000 new loan would not be allowed as a tax deduction against the rental income and as the holiday was a private expense, the interest cannot be claimed in any case.

Many property owners withdraw some of these new loan funds to help towards the purchase of another income producing property. In this case the new loan advance would be allowed as a deduction against the new property, not the old one, as the funds had been used solely on the new property at the time the bank gave you the funds.

If the loans are combined in the original account and not separated, then the allocation of interest is on a proportional basis.

It is important to understand this, as you can get into problems when trying to claim the interest.

This is especially true when you consider that one day you may move into one of the properties as your personal residence. If so, any interest cost would no longer be a tax deduction as there is no longer an income on the property.

As such, any loan reductions that you could make need to be applied to the loan that was solely related to the purchase of the home you now live in. So you would want to identify that and direct any funds to that loan only.

If the loans are combined, it is essential that you separate them prior to any repayment, as the tax office considers the loans to be paid down proportionately if still combined which is not in your best financial interests.

Debt management is a very important aspect of investment. Ensuring you try and only have debt on income producing assets to ensure tax deductions can be claimed and the cost of personal debt is minimised to improve your overall after tax cash flow and reduce personal living costs.

Whenever you decide to withdraw available loan funds or increase debt on a property you own, you should be mindful of the use and tax consequences in both the short and long term.

There are some key principles to remember when it comes to debt:

- Try to always borrow solely for assets that are income producing and avoid debt on private expenses;
- If you must reduce loan, pay off the loan on the property you are most likely to live in;
- Avoid reducing loans on rental property that you are never intending to live in, pay off your personal home first;
- Consider using "offset accounts" where you deposit your funds into a cash account linked to your loan to reduce the interest cost, rather than actually paying down your loan. This achieves the same result but keep your future flexibility if you need the funds later for personal expenses.
- Where possible, separate your loans so that you can easily track what the actual use and purpose of the funds drawn was.

The Australian Tax Office is very vigilant on tracking these claims so be very careful to not try and claim more that you are entitled.

Steve Douglas is the co-founder and Managing Director of Australasian Taxation Services (ATS), established in Singapore in 1995. ATS provides specialist taxation services to people of any nationality investing in Australian property, as well as Australian expatriates living overseas. Areas of specialisation include the Australian taxation aspects of property investment, as well as expatriate and migration planning.