Interest

Question 1

I am a tax subscriber. I have a few questions about deductibility of refinanced mortgage interest to ask. I'm seeking to refinance my current mortgage to buy a new investment property. Could you please advise me the deductibility of associated expenses?

1. **Application Fee**
2. **Mortgage Insurance**
3. **Additional Interest on top of existing interest.**

Answer

The application fee and mortgage insurance fall within the definition of borrowing expenses. These are apportioned for days in the year and are deductible over 5 years or the term of the loan, whichever is shorter. The extent of deductibility depends on whether all the funds are used for investment or business activities.

Clearly understand that the Courts have when determining deductibility of interest, consistently applied the "use" test meaning the use of which funds have been put.

The interest on the loan (or portion thereof) to purchase the investment property is tax deductible.

The interest on any funds expended to pay out the private home mortgage is clearly non-deductible.

Question 2

There was a recent Tax Ruling (March 2012) to do with split loans where the ATO retrospectively prohibited the capitalisation of interest payments in the investment loan compared to interest being paid in the linked home loan. Does this mean that the general principle of capitalising interest payments in other stand-alone loan products (overdraft, lines of credit etc.) is also under attack?

Answer

No, Taxation Determination TD2012/1 is very specific as to what arrangements were affected as outlined below.

Investment loan interest payment arrangements

While investment loan interest payment arrangements may vary in the precise loan and security details, they all have similar financial and purported tax effects. An investment loan interest payment arrangement will exhibit all or a significant number of the features set out as follows:

(a) The taxpayer(s) own at least two properties: one property is the taxpayer(s)' residence and the other is used to derive rent ('investment property').

(b) The taxpayer(s) have an outstanding loan which was used to acquire the residence (or refinance an earlier loan used to acquire the residence) ('home loan'), an outstanding loan which was used to acquire the investment property (or refinance an earlier loan used to acquire the investment property) ('investment loan') and a line of credit or similar borrowing facility with an approved limit ('line of credit'). All three loan products are typically (but not always) provided by a single financial institution.

(c) The respective interest rates on the home loan and investment loan are typically at or about the same rate. The interest rate on the line of credit is typically (but not always) higher by a small margin (for example, 0.15%).

(d) The investment loan is typically an interest-only loan for a specified period with principal and interest repayments required thereafter, or the interest-only period may be extendable.

(e) The line of credit typically has no minimum monthly repayment obligations provided the balance remains below the approved limit. Alternatively, it may require minimum monthly repayments equal to the accrued interest.

(f) The home loan, investment loan and the line of credit are each secured against the taxpayer(s)' residence and/or investment property.

(g) The line of credit is drawn down to pay the interest on the investment loan as it falls due. Where no repayments are required on the line of credit, the taxpayer(s) will generally not make any repayments, which results in interest on the line of credit being capitalised and compounded. Where monthly interest repayments are required on the line of credit, the taxpayer(s) meet such repayments from their cash flows.

(h) Typically all or a significant proportion of the taxpayer(s)' available cash inflows (including that which the taxpayer(s) otherwise might reasonably be expected to use to pay the interest on the investment loan) are deposited into their home loan or an 'acceptable loan account offset account',[2] which has the effect of reducing the interest otherwise payable on the home loan.

(i) If the line of credit reaches its approved limit before the home loan has been repaid, the taxpayer(s) may apply to increase the limit on the line of credit in conjunction with a corresponding decrease in the available 'redraw' amount in the home loan.

Question 3

A family trust has borrowed $100,000 from the trustee's friend since 8th May 2009. They entered a loan agreement with an interest rate of 8.5%, but the total interest charges have not been paid until now. Can the family claim tax deduction of the total interest charges for the period from 8th May 2009 to 30th June 2012 for the 2012 tax return, if the trust uses accrual basis accounting method?

Answer

The family trust can claim the entire tax deduction for the interest in the year it is paid. Of course, this is conditional on the Family Trust **not** having accrued the expenses claimed a tax deduction in the 2009, 2010 and 2011 years.

Question 4

I am looking to calculate loan interest on a business loan. Many years ago, it was calculated by the "Rule of 78". Would you please send a link to the method that is currently acceptable to the ATO?

Answer

The relevant tax ruling is TR93/16 and we have forwarded you a copy.

Question 5

Consolidation of home loans after marriage – can there be complications if one loan is for a rental and the other is for personal use?

Answer

Yes, there can be complications because the waters can get very muddy. The fundamental test for deductibility of interest is the "use" test, i.e., the use to which the funds have been put – if they have been used for business or investment purposes then they are generally deductible.

Of course, after several years it may be difficult to determine this. For this reason, it is never a good idea to merge business or investment loans with personal loans.

Question 6

I have a query in relation to interest deductibility for an individual. Individual Client sold an investment property in August 2011 and incurred a capital loss which is carried forward. It was fully financed, and the second investment loan (unencumbered) was not able to be repaid i.e., still unpaid.

Can the client claim the interest as a tax deduction on this unpaid investment loan in future returns until repaid even though investment property no longer exists however, interest is still being charged as the loan is unable to be paid on settlement?

Same question also for a Solicitor who takes out a practice loan to set up a practice in a partnership. Several years later the Partnership folds and the Solicitor goes out as a sole practitioner. The loan still exists as it is unable to be repaid and interest is still being charged. Can the Solicitor still claim interest deductibility as purpose of original loan no longer being valid although he is still in practice?

Answer

Taxation Ruling TR2004/4 refers to the Full Federal Court decisions in the cases of Brown and Jones. The ruling refers to investments in businesses, rental properties, and share.

Question 7

If a Shareholder borrows money from the Company to purchase the shares from another Shareholder, is the interest applicable under division 7A tax deductible to the shareholder?

Answer

The fundamental test for deductibility of interest as consistently applied by the Courts is the "use" test, i.e., the use to which the funds have been applied. In this case as it has been to purchase income producing shares, the interest will be deductible.

Question 8

My client bought a residential investment property in a discretionary trust at the height of the boom. It was 100% financed. They now wish to sell the property, possibly at a loss of $100,000. Assuming the bank accepts the equity in their own home as security against the loan; will they be able to continue to deduct the interest on the remainder of the loan? The loan has been an interest only loan. If the interest is deductible can the loan be changed to principal and interest repayments? Is there a time limit for deduction of the interest?

Answer

It is likely that your client could continue to claim interest on a loan after the investment property sold. There are a few cases surrounding the deductibility of interest on the remainder of the loan, namely, FC of TV Jones, 2002 ATC4135, FC of T v Brown, 1999 ATO 4600. Some positive points of the cases are outlined in the following:

1. All the proceeds of the sale should be used to repay as much of the loan as possible.
2. Endeavour to appear to be unable to repay the loan from other assets.
3. Do not refinance the loan to extend its term or increase the interest rate. You must appear to be doing all that is possible to eliminate the loan.
4. If the loan is already fixed at the time the investment is sold, then you have an argument that you could not pay it out. This is a factor to consider if you are refinancing before the sale.

Question 9

My client recently purchased a new home for her to reside in. She has held an investment property for a number of years that she has rented out and claimed interest on this mortgage as a tax deduction. She held a fair bit of equity in this investment property due to repayments made over the years and growth in its value. The remaining mortgage was $100,000 on this investment property prior to the purchase of her new home. It is an interest only loan.

When she purchased her residential home, she refinanced both properties and transferred some of the debt to her investment property so that she could claim tax deductions on the interest that she was paying. She had built up a lot of equity in this investment property and hence was able to transfer the debt to this property. The mortgage now on the investment property increased to $200,000 thus providing additional interest expense.

Is my client entitled to claim tax deduction for the interest on the investment property given the increased debt? There is no line of credit in operation so it would seem that TD 2012/1 would not operate to deny deductions. The interest is paid entirely out of my client's own cash reserves and not through a line of credit.

Please provide any references to legislation where such interest is not allowable as a deduction.

Answer

There are no specific references in the legislation – see ITAA97 s8-1. Interest is deductible to the extent to which it is incurred in gaining or producing assessable income or in carrying on a business for that purpose and it is not of a capital, private or domestic nature (ITAA97 s8-1).

Unfortunately, your client has nowhere to go on this as the income producing property had already been purchased and debt was merely transferred to it.

Taxation Ruling TR2004/14 – in determining the deductibility of interest the courts and tribunals have looked at the purpose of the borrowing and the use to which the borrowed moneys have been put.

Taxation Determination TD93/13 – the security given for the borrowed money is totally irrelevant.

Question 10

I have recently seen a new client and I am concerned about how they have been structured with the new loans that have been used to purchase an investment property.

The scenario is: The property was purchased for $390,000 using a combination of two loans. The first loan is for $332,000, interest only. No problems here. The second loan is a Line of Credit (LOC) of $102,000 which the deposit was paid, $38,990, and then the final settlement amount of $33,053 for remainder, stamp duty and legals.

However, they are having the interest for loan one taken out of the LOC and they are paying the rates and insurance out of the LOC also. The interest is being capitalised which is of concern. They are not making any loan repayment to the LOC and the rent from the investment property is being paid into an offset account against their PPR.

This scenario smells of the Hart's case and I am concerned for the clients that they have been given the wrong advice initially. Could I please get your opinion in relation to the deductibility of the LOC, the strategy which they are using?

Answer

A really topical question, as we deal with this in detail in our updated commentary in this edition on Hart's case. If the client wants to claim a tax deduction on the capitalised interest, then we would recommend a private ruling be applied for.

The client was not necessarily given the wrong advice, it definitely is a tax deduction (s8-1) – the only question is whether IVA (anti-avoidance provision) applies to deny the "tax benefit." In practice, I do **not** claim capitalised interest in these situations due to the view expressed in Tax Determination TD 2012/1.

Question 11

We have a client who borrowed money from Timercorp back in 2007 to purchase timber lots from Timbercorp. The company went into liquidation back in 2009.

The client was instructed to stop making monthly repayments while the class action against the Directors was in action. That has now come to an end and the ruling was in favour of Timbercorp.

Our client accepted the discount offer from Timbercorp to pay out the outstanding balance which amounted to around $55,000. The client's income for the year is in excess of $300,000.

Can the client claim the interest paid out (2014) against his income or do we have to regard the total paid back as a capital loss and defer it against possible future income?

Answer

Timbercorp had a number of projects and we suggest the settlement statement regarding the final outstanding balance will outline the character of the payments.

If the final payment is to clear a loan that has already been discounted, then we suggest this is a capital payment unless interest has been separately and clearly identified in the payment.

Question 12

I have a loan facility for $300,000, where $200,000 is used for income producing purposes and $100,000 for private use. The $100,000 was drawn down a few years after the $200,000 was utilised first.

Now I understand that the deductible interest is only the portion that relates to the $200,000 i.e., 2/3rds of the total interest is deductible for tax purposes.

However, if I have an offset account attached to this loan facility and I deposit say $100,000 into this account, is then the deductible portion the interest on the $200,000 balance, i.e., assuming the $100,000 loan is offset by the $100,000 deposit.

This assumes that the private portion of the loan facility is $0.

Or do I still claim only 2/3rds or the total interest on the account as the $100,000 deposit is apportioned at 2/3rds against the loan facility.

Answer

You are correct in saying that only 2/3rds are a tax deduction. This is the "use test", the use to which the funds have been applied and this has consistently been held by the Court in a number of cases.

In our view, in extending the "use test", the offset account would be applied against the **total** $300,000 including the non-deductible portion.

Question 13

What happens about Tax if you get a small inheritance from a deceased estate from the US?

a. If it is still invested overseas or if you bring the money into Australia?

b. If it is left in the States what happens with taxes on any interest earned?

Are taxes on interest payable in Australia or in the US?

Answer

- There are no Australian death duties or estate taxes, or any other tax on this inheritance.
- If interest is earned in America, advise the I.R.S. you are a non-resident and withholding tax will be deducted. In your Australian tax return, you must disclose the **Gross** interest and claim a tax credit for the U.S. withholding tax.

Question 14

Regarding deducting interest, Where Investment property and business loans were initiated and one's principal home was used as security for these loans.

Now principal home has been sold, loan is paid out.

The other loans that were taken out and another loan has also been taken out to acquire and investment (rural land) with a principal home on it. Can the interest of these loans continue to be deductible?

Answer

The fundamental test for deductibility of interest as consistently applied by the courts is the "use" test meaning the use to which the funds have been put.

Security is not relevant – if the loan proceeds have been used to purchase income producing assets then you will get a tax deduction for the interest.

So, for each current loan trace where the loan proceeds were applied – if they were used to pay out a prior loan – how were the loan proceeds of that prior loan applied?

If you are in a situation where investment loans (used to purchase income producing property) have been paid out but you still hold some investment property…. but you have then taken out a loan to purchase a private residence then this interest will not be deductible for the simple reason the new mortgage was taken out to purchase a private residence. Therefore, it is so important to seek advice before taking out new loans or paying off a loan.

Question 15

We have been long term members and have a question regarding family trust distribution of interest to a non-resident beneficiary.

In a past publication, you wrote that interest income in a family trust retains its character and can be distributed to a non-resident beneficiary and attracts 10% tax. Our family trust has earned interest from bank deposits and we would like to distribute just that interest to a beneficiary who is a non-resident for tax purposes, and we would also physically pay the amount owed to her in her beneficiary account.

Our accountant states that the interest was earned by the family trust, not the beneficiary personally, and distribution to her would be taxed 32.5%. Could you clarify?

Answer

Yes, income does retain its character as it flows through a trust but here is the crucial distinction.

You can distribute and allocate interest income to the non-resident beneficiary, but it is the RESIDENT TRUST that has earned the interest.

Trust this clarifies the matter.

Question 16

I have a client who purchased an investment property back in 2005 for $275,000. They borrowed the full amount of the purchase price plus associated stamp duty and costs. The loan has been 'interest only' for the whole period.

Unfortunately, they have been in and out of work and have not been able to reduce the principal on the loan and have just sold the property for $215,000. They have reduced the debt from the sale of the property, but they roughly have a debt still of $100,000 which is secured against their PPR.

My questions are:

1. **Is the interest on this loan still tax deductible?**
2. **Where in the tax return if it is tax deductible should it be claimed?**
3. **Should the loan be quarantined, or can it be combined with their home loan?**
4. **Does it have to now be P & I?**

Answer

The 'Use Test' governs the deductibility of the interest expense on a loan.

As long as the initial loan has not been refinanced, interest on the amount is still tax deductible after the sale of rental property.

You continue to claim the interest expense in Item 21 of the individual tax return.

Question 17

I was having breakfast with my friend B who asked me a tax Q. regarding Rental Losses in Australia. He worked overseas for several years UK & France. He was a non-resident for tax purposes. He accrued Rental Losses here, but he says his international firm accountants have said that he cannot accrue the rental losses for future use. I believe that neither the UK nor France allow overseas rental losses to be claimed against Income earned in these countries.

ATO says: "Australian and foreign residents: Australian residents now calculate an overall tax loss based on their worldwide income and deductions. Foreign residents calculate a tax loss on the basis of their Australian income and deductions incurred in earning that income."

I believe that B can claim the rental losses accrued if he returns & becomes an Australian Resident for Tax Purposes. Can you advise please?

Answer

You are correct.