Tax considerations of offset accounts and redraw facilities

Linda Bruce, Senior Technical Manager, FirstTech | 24 October 2024

When a client borrows to purchase a home that they will live in, the interest expenses on the loan are not tax deductible. Clients in this situation are often advised to pay off their home mortgage as quickly as possible to reduce the interest expenses on non-deductible debt.

In practice, there are various ways to reduce these interest expenses. Some clients may have made extra repayments to reduce their home loan balance, which can be accessed through a redraw facility. Others may have put the extra amount in an offset account to minimise the interest on the loan. The choice between using a redraw facility or an offset account can significantly impact financial planning strategies.

This article explores the most frequently asked questions regarding the tax implications of using an offset account compared to a redraw facility.

The Centrelink implications are not covered in this article however its important to note that there are important differences between the two options, with offset accounts assessed as a financial investment that are asset tested and deemed.

It’s also important to note that not all loan providers offer offset or redraw facilities, so clients will need to check with their lender to find out what options are available and whether they are cost-effective.

Colonial First State

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Key concepts

When is interest tax deductible?

Section 8-1 of the Income Tax Assessment Act 1997 (ITAA 1997), which is the general deduction section of the tax law, allows a tax deduction for losses and outgoings to the extent that they are incurred in gaining or producing assessable income, except where the outgoings are of a capital, private or domestic nature, or relate to earning exempt income.

The ATO outlined their interpretation of section 8-1 and the general principles governing deductibility of interest in Tax Ruling **TR 95/25**. At a high level, interest expenses on a loan can be tax deductible to the extent that the borrowed amount is used to purchase an income-producing asset.

For instance, if a client borrows money to purchase an income-producing asset, such as a portfolio of shares or an investment property that generates assessable income, they can generally claim the interest on the investment loan as a tax deduction.

On the other hand, if the client borrows to purchase an asset for personal use, such as a home to live in or a car for private use, the interest on the loan will not be tax deductible.

It's important to note that the outstanding amount of a non-deductible loan can become a deductible loan when the asset purchased by the originally borrowed amount begins to produce income. For example, the interest on the outstanding loan initially used to purchase a home to live in can become tax deductible when the property is rented out and starts to generate rental income.

Impact of using a redraw facility or offset account

Offset account

An offset account is a separate savings account that is linked to a loan account by the lender. This linkage allows the balance in the offset account to reduce the interest charged on the loan. However, the offset savings account is distinct from the loan account, and does not reduce the outstanding loan amount.

Does the account balance of an offset account affect the deductibility of the interest on the linked loan?

The short answer is no.

While the amount kept in the offset savings account can affect the interest charged by the lender, it does not reduce the outstanding loan amount, and it does not affect whether the interest charged by the lender is tax deductible. As previously mentioned, the deductibility depends on whether the asset purchased with the borrowed amount is generating assessable income for the client.

Is there any interest income from the offset account that needs to be declared in the tax return?

An offset account is generally structured so that no interest is earned. This is one of the conditions for the ATO to accept that a loan offset arrangement is an acceptable arrangement[1].

As clients are not entitled to receive interest income for the amount in the offset account, they are not required to declare any interest income in their tax return.

Redraw facility

If a client has made loan repayments ahead of time, the extra payments they made to reduce the principal of the loan may be accessed through a redraw facility, if the lender offers it.

For tax purposes, any amount taken out of the redraw facility is treated as a separate borrowing. Whether the interest on the new loan is tax deductible depends on whether the client uses the newly borrowed amount to purchase an income producing asset.

Frequently asked questions

Question 1:

Kate and Nigel are a married couple with a home loan of $1 million and $300,000 in a linked offset savings account. The lender calculates the interest on the loan based on the $700,000 difference between the home loan and the offset account balance.

They plan to invest $200,000 from their offset account into an investment portfolio held jointly. As the balance in the offset savings account decreases, the interest expenses on the loan calculated by the lender will increase.

The question is whether the increase in interest expenses is connected to the investment portfolio and, therefore tax deductible?

Answer:

Unfortunately, the increase in interest expenses is not tax deductible for Kate and Nigel.

For tax purposes, the interest expenses on the $1 million home loan are not tax deductible because the existing loan was used to purchase their residential home.

While an offset savings account may be linked by the lender to the loan to reduce the calculation of the interest expenses, it remains a separate savings account from the home loan.

Withdrawing an amount from the offset account to invest in an investment portfolio that generated assessable income for the couple can result in a higher amount of interest payable, however, it does not change the nature of the existing non-deductible loan that was used to purchase the home. Therefore, the increase in the interest on the existing loan cannot be tax deductible.

Would the outcome be different if a redraw facility is used?

Yes, the outcome can be quite different.

If Kate and Nigel are ahead on their loan repayments, they may be able to access these extra loan repayments through the redraw facility (subject to the lender's rules).

Taking additional loan amounts from a redraw facility is considered a new loan. If this new loan is used to purchase an asset that produces assessable income, such as an investment portfolio, the interest on the new loan can be tax deductible.

Question 2:

Jack has an investment loan. He wants to take an amount out of the loan's redraw facility to make a personal super contribution.

Is interest on this new loan tax deductible?

[1] TR 93/6

Answer:

Unfortunately, the answer is no.

An investment in a super fund is held under the name of the trustee of the super fund, and investment income is not assessable income in the hands of Jack. There's no sufficient connection between the outgoing interest expenses and Jack's assessable income. Therefore, interest expenses on the borrowed amount to make a personal super contribution are not tax deductible.

Further, section 26-80 of the ITAA 1997 allows an employer to claim interest expenses on the amount an employer borrows to make employer contributions, and this section specifically disallows a deduction for financing costs such as interest on a loan to make any other types of contributions.

Question 3:

Can a non-deductible debt become a deductible debt?

Answer:

Yes, the interest on an existing loan can become tax deductible if the asset purchased with the loan begins to produce assessable income.

For example, in 2020, Sina borrowed $1.5 million to purchase a home to live in.

In 2024, Sina moved overseas and rented out her former home.

The outstanding loan amount of $1.2m is now associated with a property that's generating assessable income for Sina. When lodging her Australian tax return, Sina must declare the rental income as assessable income, and the interest on this loan can be claimed as a tax deduction to reduce her taxable income.

Question 4:

Are there situations where using an offset account, rather than paying down the loan and accessing the extra repayments through a redraw facility, is more tax effective?

Answer

Yes, if an existing loan is a tax-deductible debt, or an existing non-deductible loan will become tax-deductible in the future, using an offset account rather than paying down the loan can be more beneficial for tax purposes if the client plans to use the money in the offset account for private purposes.

Example – using an offset account

In 2018, Linda and Peter borrowed $1 million to purchase their first home. They deposited any savings into an offset savings account linked to the home loan, while continuing to make only the minimum required loan payments.

In 2024, Linda and Peter were looking to buy a new home. At this stage, they have an outstanding home loan balance of $800,000 as well as $500,000 in the offset account.

Upon finding a new home, they withdrew the $500,000 from the offset account to pay the deposit and other incidental costs.

They then rented out their old home. The interest costs on the $800,000 outstanding loan can be tax deductible as the property purchased with the initial borrowing is now producing assessable income for the Linda and Peter.

What if a redraw facility was used?

If, over the years, Linda and Peter had used their extra savings to pay down the home loan, they would have reduced the outstanding loan amount to $300,000. When their former home is rented out, the interest on this $300,000 would be tax deductible. This is significantly lower than the scenario where they used the offset account.

Assuming the lender allows it, if Linda and Peter take the $500,000 extra loan repayments out of the redraw facility to help purchase the new home, the interest on this new loan would not be tax deductible. This is because any amount taken out of the redraw facility is treated as a separate borrowing, and the newly borrowed $500,000 is used to purchase their residential home.

In comparison, Linda and Peter could claim a higher tax deduction on the outstanding amount of their first home loan if they had used an offset account instead of paying down the home loan.

How to contact us

Adviser Services 13 18 36

firsttech@cfs.com.au