TAX with Shukri Barbara

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Interest – when is it deductible?

For most geared investors, interest is generally the largest deductible claimed against rental income, writes **Shukri Barbara**, so it demands attention

DETAILED RECORD KEEPING IS ESSENTIAL FOR INVESTORS

When interest on a loan helps to produce a rental loss over a financial year, an investment property is referred to as 'negatively geared'.

The net loss is generally offset against the owner's other income, reducing the tax payable, making the investment property more attractive. Ensuring that interest can be claimed as a deductible is therefore critical.

For interest to be deductible, the principal loan funds borrowed have to be applied to an income/rental producing asset. Apportionment is necessary where the loan is used to fund both a rental investment and a private asset. Record keeping is essential in these situations.

Many investments are acquired by couples, partners or families. When they have children, some couples lose an income as one stays home. The other partner then uses their sole income to pay the interest on a loan that is in both their names.

So, is the working partner able to claim 100 per cent of the interest paid as a deduction on their tax return? The simple answer is no. A claim for deducting interest expenses can only be made on the basis of equity on the title.

If the stay at home partner has no other income, the net rental loss can be carried forward to offset income in subsequent years, but they lose tax savings in the current year.

Planning ahead can maximise tax benefits by changing the proportion of ownership – say from 50/50 to 99/1. This can be done for one property. Ownership of future acquisitions can also be framed to suit the circumstances where the stay at home partner returns to work.

Sometimes, interest and loan repayments made by members of a family syndicate are based on their capacity to pay and, as such, differ from the equity portions reflected on the title deed. Calculating an equalising factor is only available privately – for example, by agreeing that net proceeds after capital gains tax on sale be distributed to reflect the contributions.

Again, meticulous records need to be kept to avoid conflict.

Solutions that offer a faster reduction of a home loan balance while maximising deductions of interest on rental investments should be carefully scrutinised. 'Split' loans in their various forms generally mean interest on the investment loan is capitalised, while all income, including rent, is directed towards reducing the home loan with its non-deductible interest expense.

This type of arrangement is considered tax avoidance in its extreme forms. Interest on the capitalised interest is not deductible.

Given the attitude of the Australian Taxation Office (ATO) it is recommended that rental income be deposited into the rental investment loan account to cover the interest expense. When rent is less than interest and other expenses, using another loan, including a line of credit, is practical.

The interest on that component should be deductible. Where the line of credit is also used for private expenditure, keep detailed records to calculate the deductible portions of interest and to explain to the ATO in case of an audit.

Detailed documentation is also recommended when consolidating several small loans into one or two new loans on a re-structure, or when borrowing more to finance another investment after a positive revaluation.

Records help to match interest expenses against the rental of each property thus minimising the chance of an ATO enquiry about why a claim for interest expenses has changed dramatically from the previous year.

Consulting your financial adviser or property tax specialist is always best before entering into a transaction. ■

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