Claiming interest on investment loans

What you need to know now

The abundance of flexible lending options and packages is good news for property investors by giving more Australians the opportunity to build wealth through property investment.

However, this flexibility can often cause complications with loan interest deductions.

To avoid being one of the 1,000 odd Australian taxpayers lumped with a hefty penalty each year, it's important to understand the distinctions.

A good place to start is by understanding what the ATO considers a 'genuine rental property'.

Simply put, a genuine rental is when the property is rented or available for rental.

This means you must be able to show a clear intention to rent the property, advertise the property so someone is likely to rent it, set the rent in line with similar properties in the area and avoid unreasonable rental conditions.

What is of 'interest' to the ATO?

When you take out a loan to purchase a rental property and the property is rented, or available for rental, you can claim the interest charged on that loan, or a portion of the interest, as a deduction in that financial year.

You can also claim interest charged on loans taken out to purchase depreciating assets or to pay for repairs and renovations.

However, if you start to use the property for private purposes, you cannot claim the interest expenses you incur after you start using the property for private purposes.

Building your portfolio, literally

If you take out a loan to buy land to build a rental property or to fund renovations to a property you intend to rent out, the interest on the loan is deductible from the beginning of the loan.

However, if the intended purpose of the property you are building changes, you can't claim the interest as a deduction after that point.

For example, if 12 months after building the property you decide you want to live in it, you cannot claim the interest after your intentions change. Defining exactly when 'intentions change', and therefore when you are no longer able to claim

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interest as a deduction, depends on a variety of factors unique to you. Discuss this with your accountant.

Double duty loans

Sometimes you obtain finance to purchase two or even three things at once – like purchasing a rental property as well as a new car.

In this case, the interest on the loan must be allocated according to the amounts borrowed for each purpose, deductible and non-deductible.

If the loan is for both rental property and private purposes, and the account has a fluctuating balance with money coming and going, you will need to keep accurate records to work out the proportion of the interest that applies to the rental property. That is the only part you can claim.

Part of our role is to help you structure your loan accounts to make it easy to identify the different uses for tax purposes.

This is a major reason why many people choose finance brokers to help them versus going directly to lenders.

We take the time to understand what you are trying to achieve over the longer term and explain the range of options, structures, benefits, and consequences of the finance you are seeking.

Should I stay or should I go?

If your intention is to buy a new home and rent out your previous home, you can claim interest, or part of the interest, on the loan funding the property that is rented (the property that is generating an income).

So, if there is an outstanding loan amount on the previous home, the interest outstanding on that loan, or part of the interest, will be deductible.

You cannot claim the interest on the loan used to buy the new home because it isn't generating income.

This is the case even if the loan for the new home is secured against the former home.

It's complicated

There are more complicated investment loan interest payment arrangements that require individual assessment to determine allowable deductions.

These include 'linked' or 'split' loans that involve two or more loans or sub-accounts for private purposes and business purposes.

Repayments are allocated to the private account while the unpaid interest on the business account is capitalised to maximise your potential interest deduction (by creating interest on interest).

The ATO may determine that this arrangement creates a tax benefit because the deduction for interest actually incurred on the investment account is greater than the amount of interest that might reasonably be expected to have been allowable but for using the loan arrangement outlined above.

See – it even sounds complicated!

In this case they may disallow some (or all) of your interest deductions.

It's important to get professional tax advice here.

It is absolutely worth doing it right.

Rental property deductions can be complicated, but accuracy in your claims is an important element in successful investing.

Doing it right helps build and protect your wealth.

Doing it wrong, however, can bring about a tax audit and potential penalties.

That's a headache you don't need.

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