CAPITALISING INTEREST AS A TAX DEDUCTION

'Capitalising interest' involves borrowing to make the interest payments on an investment property; allowing the interest to capitalise by means of a line of credit (LOC); and possibly going one step further by using income from the rental property to pay off the loan on your principal place of residence (your home).

This results in tax-deductible interest increasing on the investment loan, while non-tax-deductible interest on your own home is reduced.

However, the main constraint on using this method to pay down a home loan is that it can't have a 'tax benefit' as its dominant purpose, as laid down by Part IVA of the *Income Tax Assessment Act*.

The Australian Tax Office (ATO) has given two recent private binding rulings (PBRs) on the matter: PBR 94265 which allowed capitalised interest to be claimed; and PBR 1011345133229, which did not.

In its published reasons for PBR 94625, the ATO says:

"Capitalised interest deduction expenses which are incurred in the gaining or producing of assessable income are an allowable deduction except where the expense is considered to be of a capital, private or domestic nature.

"In determining whether an interest expense is deductible or not, we consider the purpose to which the borrowing is applied when the interest arises. Generally, interest expenses incurred on a loan used to purchase an investment property is an allowable deduction as it is incurred in the course of gaining rental income which is assessable. The principles governing the deductibility of compound interest are the same as those governing the deductibility of ordinary interest. In your case you are incurring compound interest on a LOC. The LOC is used to pay expenses associated with your rental properties. Accordingly, as the compound interest is incurred in the course of gaining rental income it is an allowable deduction."

On the question of whether this case is caught by Part IVA of the Act, the ATO says:

"The arrangement that is the capitalisation of interest on your LOC is a scheme. You will obtain a tax benefit from entering into the scheme in the form of the deductibility of interest incurred on the capitalisation of the interest from your LOC. However, a reasonable person would conclude that you did not enter into the scheme for the dominant purpose of obtaining a tax benefit. You wish to pay off your home loan as soon as possible to ensure your financial position... Therefore this scheme is not one to which Part IVA applies."

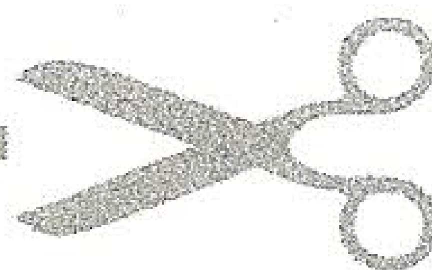
However, in PBR 10113451332 the ATO says:

"The scheme entered into is considered to be dependent on the inextricable linkage between the h loan and LOC in the calculation of t approved limits and the allocation those limits as a whole following a acceleration of home loan payments and any offset account benefits, to allow the home loan limit to fall and LOC limit to rise and in the provision the home as security.

"The Commissioner is satisfied a considering all of the factors in Sec 177D that the proposed scheme is o to which Part IVA would apply. Therefore... the 'additional interest' incurred under the scheme and referable to you shall not be an allowable deduction to you for the ye of income."

Chartered accountant and tax ag Julia Hartman describes the second ruling as standing on "very flimsy ground" in claiming there is an inextricable linkage between the home loan and the LOC.

"The two loans aren't technically linked or split; they simply share the same security through the same bank," she says. "Further, if taken seriously, it could have a ridiculous outcome in normal, everyday transactions. Note, neither of these rulings takes offence at the rent being used to pay off the private



home loan. Nevertheless, the issue is far from certain and I would not recommend anyone capitalise the interest on their rental property without a ruling and they must not be motivated by the tax benefits. A budgeting strategy or financial hardship needs to be the dominant purpose.

"In PBR 94265, the ATO said the arrangement was merely one of paying off the home loan as soon as possible so it didn't have a dominant purpose of a tax benefit. In PBR 1011345133229, the ATO argued that the loan to support the rental property and the home loan were linked because they shared the same security so the dominant purpose was a tax benefit.

"The bottom line is that capitalised interest is tax deductible as long as it isn't part of an arrangement to reduce tax."

Financial planner Noel Whittaker advises homeowners to "tread carefully" with such a repayment method.

"Being a fairly cautious person, I don't think it's a good idea to have a debt that's going up because you could be caught between a debt that's going up and a house that's going down (in value)," he says.

An ATO spokesperson said people should seek advice on their own circumstances.

costly thing you will ever do, claims Nick Lockhart, of investment advisory firm mrd.

"Let's say you have a $400,000 loan on your home, and let's say inflation is running at three per cent per year," says Lockhart.

"This means the real value of your loan would be diminished by three per cent per year, or $12,000 each year.

"By maintaining those borrowings and *not* paying them down, time and inflation is paying down the debt for you, at a rate of $12,000 per year.

"In time, what starts out to be a sizeable loan shrinks to almost nothing.

"Most people can't easily boost their income to pay an extra $12,000 down each year. However, if you let it, inflation will do the work for you."

Lockhart says such a strategy also frees up money to buy an investment property.

"Let's assume you have $250,000 outstanding on your $400,000 home, and the investment property you've just secured is also worth $400,000, with a loan to fund it of $400,000.

"Instead of paying principal and interest, you opt for an interest-only loan. And you use the money you were paying on principal on your home to add one extra property to your portfolio."

Lockhart says history has shown that property values double every seven to 10 years.

Working conservatively on doubling happening every 10 years, "after the 30 years (in which) you otherwise would have paid off your home, you would have two properties – your home and the investment property – and they'd be worth $3.2 million each," he says.

"The combined value of these two properties is $6.4 million, with loans against them of $250,000 and $400,000 respectively."

Accountant and property adviser Chris Gray also believes it's better to put money into an investment property rather than pay off your own home.

The profit made on an investment property can then be used to pay off your principal place of residence.

"In seven to 10 years your investment property has effectively doubled in value so you can then sell it and, after paying a bit of tax, you could pay off your (principal place of residence) home loan in one lump sum," Gray says.

"The whole idea is that it's quicker to buy another property rather than pay off your home loan so you carry on and buy another property and never pay off your home."

Gray concedes there's no guarantee the property market will continue to double in value every seven to 10 years.

He also acknowledges that paying off your own home is the "least risky thing to do", but it's not something he does himself.

"I own about $10 million in property but I don't own my own home," he says.

"I invest in properties of around $600,000 to $800,000, that rent for four to six per cent return, and I rent multi-million dollar properties that only rent for two per cent return.

"Effectively what that means is that I can be getting $8000 to $10,000 a week in rent and then can go and rent a $10 million house for $4000 to $5000; so I'm making $4000 to $5000 a week."

Having "lots of little properties instead of my own home is much more efficient", he says.

"The expensive properties rent for half the amount.

"They rent for two per cent instead of four per cent and all my debt is tax deductible." api