Tax Effective Borrowing

Before undertaking any borrowing, consider the taxation implications and take professional advice. Income producing investments should be geared, if possible.

Apportionment of Interest

When an asset is purchased for both income producing and private purposes, any interest paid on borrowings must normally be apportioned on some reasonable basis, e.g. kilometres driven, floor space, etc.

In determining the deductibility of the interest payments, you must look at the purpose of the borrowing to which the interest payments relate.

Where possible you should try to ensure that you reduce the level of your private debt prior to incurring tax-deductible debt. Tax deductions reduce the net cost of debt.

Convert Non-Deductible Interest

This may be feasible in a SME where a director or shareholder is repaying a private loan such as a mortgage.

It may be possible to convert non-deductible interest repayments on a private loan to deductible interest payments if the company borrows the funds.

In this instance, a company would borrow funds to pay a dividend to its shareholders.

- Interest on such a loan is tax-deductible
- The company must have sufficient accumulated profits and franking credits to pay the dividend
- The shareholder then receives a franked dividend which he uses to make the private loan repayments.

Deduction for Post-Business Interest

The ATO will allow a deduction for interest paid after a business has ceased earning income in certain circumstances. This would apply if the funds were borrowed solely for an income earning purpose and there is no legal entitlement to repay the principal but the business incurs an unavoidable stream of interest outgoings.

Investment Loan Interest

- Ask your bank if you can defer repayments on your rental property loan as long as possible. However, it is best to have some separate levels of minimum repayment in respect of both your residential loan and your rental property loan.

- Try to maximise the percentage borrowing against your rental property (if you have equity in your residential home, the bank will often be flexible)

- Use your excess cash to repay your residential loan as quickly as you can

- Ask your bank if you can increase your rental property borrowings to pay for all the costs related to your rental property. Alternatively, ask if you can maintain a separate (flexible) overdraft facility to cover all the costs of your rental property, such as repairs, agent's fees, capital improvements, advertising, council rates, land tax etc.

- Use an interest offset deposit account as your everyday account (i.e. your wages can be paid into this account), with the interest otherwise payable on the deposit account reducing the interest payable on your residential loan.

- Consider the possibility of intra-marriage transfers. For example, if you are looking to rent out your long-standing jointly owned residence and purchase a new home, consider transferring your old residence wholly into the name of one spouse, who would borrow to make the acquisition. The new residence could perhaps be acquired by the other spouse. However, remember the stamp duty cost and do not get too 'cute', for example by transferring and setting up rental arrangements between spouses in order to claim interest deductions.

- Take care when planning and get your borrowings and repayments right the first time. If you mistakenly increase your rental property loan for a private purpose and then try to refinance this cost, you will put yourself in a difficult position.

Investment Loan Interest – Pitfalls to Avoid

There are a number of pitfalls that you should look out for and avoid.

- Don't use a split loan borrowing facility (i.e. one loan with two notional sub-accounts for separate borrowing purposes).
- Don't use two separate loans that are completely linked by having just one joint credit limit and one joint minimum monthly repayment. Ensure that there are separate limits and separate repayment levels for each loan.
- Don't use a facility offered by a bank or other financial institution that promotes the "tax savings" in its marketing materials.
- Don't enter into an arrangement with a bank that provides "unusual" terms - such as an indefinite deferral of repayment on one part of the borrowing.
- Don't enter into an arrangement which provides you with a tax saving, but which comes at a real commercial cost, such as payment of a higher interest rate or other charges
- Don't redraw amounts for private purposes from your rental property loan, as this will mix the purposes and reduce the deductible element.

Borrowing to Fund Super Contributions for Employees

Employers faced with limited funds but major expenses of a non deductible nature should consider borrowing to fund super contributions on behalf of their employees, using the limited funds to pay non deductible expenses.

Note, if superannuation contributions are not made in time, later payments forced by the superannuation guarantee charge will not be tax deductible and a penalty may apply.

Negative Gearing

This may be explained as paying more interest and other outgoings that you receive in income from your investment. There are also other (non-cash outgoings) such as depreciation which are also tax deductible.

Although negative gearing reduces the holding cost of an asset through tax savings as a wealth accumulation technique, it is predicated on eventual capital gains. As such choose a quality asset to invest in, taking independent financial advice.

Split or Linked Loans

When purchasing a rental property considerable care needs to be taken with the financing arrangements. Take advice from a competent tax practitioner (not the financial institution or the finance broker) to avoid being steered into arrangements which are not tax effective and difficult to unwind.

Tax Determination TD 2018/9

This deals with the deductibility of interest expenses incurred by a beneficiary of a discretionary trust on borrowings on-lent interest-free to the trustee.

In summary interest will only be deductible where

- The beneficiary is presently entitled to income of the trust estate at the time the expense is incurred, and
- The expense has a nexus with the income to which the beneficiary is presently entitled.

TD 2018/9 suggests that it is unlikely the interest will be 100% deductible and that some apportionment may be necessary.