Umbrella Property Accountants

ATO's spotlight on rental properties interest expense

General interest deductibility checklist for landlords

Following the progressive interest rate rises in Australia over the past 12 months, it is anticipated that interest deduction claims for rental properties will significantly increase for the 2023 income year compared to previous years.

Coupled with the high error rate for rental property interest claims in recent years, and the fact these claims represent a large proportion of rental property claims each year, it is expected that the ATO will pay closer attention to (and scrutinise) these claims for the 2023 income year.

For this reason, the following checklist summarises the **general guidelines** that need to be considered when claiming interest deductions for landlord clients for the 2023 income year. The checklist deals with a range of common situations in which interest expenses are incurred by landlords in respect of both residential and commercial rental properties.

Situation in which interest is incurred	General interest deductibility guidelines
1. **Acquiring a pre-existing rental property**	Interest expenses incurred on moneys borrowed to acquire a pre-existing rental property will be deductible during periods that the property is either genuinely available for rent (e.g., the property is listed with a real estate agent for rent) or actually rented to tenants. Refer to S.8-1 and TR 95/25. Interest expenses incurred on any portion of a borrowing that is used for private purposes (e.g., to renovate the family home or to buy a private vehicle) are **not** deductible. **Interest incurred between contract date and settlement date** Interest expenses incurred between the contract date and the settlement date for the purchase of a property (e.g., in respect of moneys borrowed to pay part or all of the deposit) can also be deductible. However, a deduction is only available where there is **no room for doubt** that the property being purchased is to be used solely for rental (or other income-earning) purposes. Refer to *Steele v FCT* [1999] HCA 7 (*'Steele's case'*), *Ormiston v FC of T* [2005] AATA 978 (*'Ormiston's case'*) and TR 2004/4.
2. **Preparing a property for rent after its acquisition**	Interest expenses incurred during a period that a pre-existing property is being prepared for rental after it was purchased (e.g., to undertake repair and maintenance work) can be deductible. However, a deduction can only be available where: • there is **no room for doubt** that the property is to be used for rental purposes; • the period over which the interest expenses are incurred is not so long that the necessary connection between the expenses and the property's rental income is lost; and • continuing efforts are undertaken in pursuit of the taxpayer's rental purpose in relation to the property. Refer to *Steele's case*, *Ormiston's case* and TR 2004/4.
3. **Acquiring vacant land to build a rental property**	Where borrowed moneys are used to acquire vacant land to build a rental property, interest expenses incurred are **not deductible during the construction period**, because of the 'vacant land' rules in S.26-102. ❶

Situation in which interest is incurred	General interest deductibility guidelines
	In this case, where a **residential property** is being built, interest deductions can generally only be claimed from the time that: • the completed property can be lawfully occupied (e.g., an occupancy certificate has been issued); and • the property is either rented or genuinely available for rent. Until these requirements are satisfied, a **residential property** is **deemed** to be vacant land for the purposes of S.26-102(4). ❷ The above restriction for claiming interest during the construction of a residential rental property equally applies for any period that an existing residential property is **substantially renovated** for rental purposes. Refer to S.26-102(4) and TR 2021/D5. ❷ Where a **commercial property** is being built, interest deductions can generally only be claimed from the time that an eligible substantial and permanent structure (e.g., a building) is *"in use or available for use"* on the land. It appears that this would at least occur where the completed premises are capable of being occupied (e.g., where an occupancy certificate has been issued).
4. **Buying a rental property 'off the plan'**	Where borrowed moneys are used to buy a rental property **'off the plan'**, interest expenses incurred are **not deductible during the period the property is being constructed**, because of the 'vacant land' rules in S.26-102. ❶ In this case, interest deductions can generally only be claimed based on the guidelines noted above at 3., for a rental property that is being built or constructed.
5. **Taking a property off the market for repairs and/or improvements**	Where a rental property is taken off the market by a landlord for a period that repairs and/or improvements are undertaken to the property, the deductibility of interest expenses incurred during such a period is based on the following general guidelines: (a) **For a residential property originally constructed or substantially renovated by the landlord** – Interest deductions will be denied under the 'vacant land' rules in S.26-102 during such a period, unless *"minor maintenance and repairs"* are carried out during this period. Refer to paragraphs 46 and 47 (in Appendix 1) of TR 2021/D5. ❸ (b) **For a pre-existing residential property acquired by the landlord or for commercial premises** – The vacant land rules in S.26-102 do **not** deny deductions for holding costs incurred where such premises are temporarily unavailable for rent whilst repairs and/or improvements are undertaken to the property. This is subject to the requirement that the premises are still **capable of being occupied**. In this case, interest expenses incurred during this period will generally be deductible, provided there is a genuine intention that the property would be used for income-earning purposes (e.g., as a rental property) as soon as the work is completed. Refer to *Steele's case*, *Ormiston's case* and TR 2004/4.

Situation in which interest is incurred	General interest deductibility guidelines
6. **Repairing/renovating a rental property, buying depreciable assets for a property and paying for deductible property expenses**	Interest expenses are generally deductible under S.8-1 (subject to the 'vacant land' rules in S.26-102), in respect of borrowed moneys that are used for any of the following purposes: • For repairs and/or renovations to the property. • To purchase depreciable assets for the property. • To pay for deductible rental property expenses.
7. **Penalty interest on the early repayment of loan**	Penalty interest incurred on the early repayment of a rental property loan can be deductible under either: • S.8-1 – where the underlying property has not been disposed of and continues to be held; or • under S.25-30 – where there has been a discharge of a mortgage, including in circumstances where the underlying property has been disposed of. Refer to TR 2019/2.
8. **Loan shortfall after the sale of a rental property**	Interest incurred in respect of a loan shortfall amount after a rental property is sold can be deductible where certain requirements are satisfied. This includes the requirements that: • the net proceeds from the sale of the property should be fully applied towards the repayment of the loan; and • the length of time between the disposal of the property and the incurring of interest expenses is not too long so as to suggest that the loan is being kept on foot for reasons other than the former rental activities. Refer to TR 2004/4.

❶ *Broadly, the vacant land rules in S.26-102 deny a deduction for holding costs (e.g., mortgage interest, rates and insurance) that are incurred in relation to land on which there is* ***no*** *substantial and permanent structure that is in use or available for use. Refer also to TR 2021/D5.*

❷ *Where residential premises are constructed or substantially renovated, a special* ***deeming rule*** *applies in S.26-102(4). Where this deeming rule applies, the premises do* ***not*** *qualify as an eligible substantial and permanent structure (i.e., the land is deemed to be vacant land) until they can be lawfully occupied and are at least genuinely available for rent. This ensures that holding costs (e.g., interest expenses) that are incurred in relation to the property are* ***not*** *deductible (because of S.26-102) until the above requirements are satisfied. Refer also to paragraphs 21 to 25 of TR 2021/D5.*

❸ *Where the deeming rule in S.26-102(4) applies for residential premises that are being constructed or substantially renovated by a landlord, this rule applies throughout the landlord's ownership period of the land (refer to paragraph 23 of TR 2021/D5). This means that otherwise deductible holding costs would generally be denied under the vacant land rules when such a property is* ***not*** *available for rent after its initial construction or substantial renovation. This can include during periods of vacant tenancy while repairs and improvements are being carried out to the property.*

However, the ATO provides a concessional compliance approach in situations where a rental property (which was originally constructed or substantially renovated by a landlord) is temporarily unavailable for rent (i.e., for short periods) for reasons other than an exceptional circumstance or natural disaster (which are already excluded from the 'vacant land' rules).

For example, the ATO's concessional compliance approach would generally apply where such a property is temporarily unavailable for rent during any period(s) that ***"minor maintenance or repairs"*** *are carried out to the property. In this case, the ATO advises that it will* ***not*** *apply compliance resources to review holding cost deductions (e.g., interest deductions) claimed during these periods, provided those holding costs are otherwise deductible under S.8-1. This requires that there is a genuine intention that the property would be used for income-earning purposes (e.g., as a rental property) as soon as the work is completed. Refer to paragraphs 46 and 47 (in Appendix 1) of TR 2021/D5.*