Tax | **Interest deduction**

Prepaying interest

Michael Quinn examines whether prepaying interest in the current low-rate environment makes financial sense for investors

There is a range of eligible tax deductions that can give property investors considerable tax benefits. The ones people usually know about include expenses incurred in the existing financial year, such as interest paid on money borrowed or the payment of council rates, utility bills and various other costs involved in the maintenance of an investment property. What is not so widely known, however, is that it's possible to prepay some expenses for a rental property and claim an immediate deduction.

If you prepay a rental property expense – such as insurance or interest on money borrowed – that covers a period of 12 months or less and the period ends on or before 30 June 2010, you can claim an immediate deduction for it in your 2008/09 tax return. If a prepayment does not meet these criteria and it's $1,000 or more, the deduction claim may have to be spread over two years or more. This is also the case if you manage your rental activity as a small business entity and haven't chosen to deduct certain prepaid business expenses immediately.

What is prepaid expense?

A prepaid expense is expenditure you incur for things to be done (in whole or in part) in a later income year.

If you incur expenditure for something to be done in full in the same income year, it is not a prepaid expense and the prepayment rules do not apply.

What is the 12-month rule?

If you are a small business entity, or an individual incurring deductible non-business expenditure, you can claim an immediate deduction for prepaid expenditure under the 12-month rule if the payment is incurred for an eligible service period not exceeding 12 months and the eligible service period ends in the next income year.

For example, if you choose to prepay your council rates for the 2009/10 financial year and you do so before 30 June 2009, you are eligible to claim the cost of the payment as a deduction in your 2008/09 tax return.

What is non-business expenditure?

Non-business expenditure is any that you incur in gaining assessable income from activities that don't relate to carrying on a business. The most common forms of non-business expenditure are amounts incurred by individual taxpayers in gaining their assessable salary and wage income. Other examples include certain expenditure made for operating a rental property or shares held purely as a passive investment.

Summary of rules including the 12-month rule

- Prepaid expenditure that is subject to the tax shelter rules is apportioned over the eligible service period or 10 years, whichever is less.
- If you are an individual, your prepaid non-business expenditure is immediately deductible under the 12-month rule if
  a) the eligible service period for the expenditure is 12 months or less, and
  b) the period ends no later than the last day of the income year following the year in which the expenditure was incurred.

- If you are an individual, you apportion your deduction for prepaid non-business expenditure over the eligible service period or 10 years, whichever is less, if the eligible service period is more than 12 months, or it ends after the last day of the next income year.

Calculation of your deduction if the 12-month rule is satisfied

If you incur prepaid non-business expenditure and its eligible service period is 12 months or less, and it ends on or before the last day of the next income year, you are entitled to deduct that expenditure in the income year it was incurred.

In most cases, perhaps the most significant tax benefit can be gained from prepaying interest as this is usually the largest sum of money that's paid regularly in relation to an investment property.

Following is an example of four taxpayer scenarios in which each has a different level of assessable income and the results that occur when each claims an immediate deduction for prepaid interest.

For the purposes of the example we have ignored the Medicare levy surcharge that may be incurred by some taxpayers.

In the example, the first taxpayer has a taxable income of $50,000 per annum, the second, $100,000 per annum, the third, $150,000 per annum and the fourth, $200,000 per annum.

Table 1 shows the taxable income and the calculation of the amount of tax payable on each taxpayer's income.

Table 2 shows the potential tax saving when the interest rate is 8% per annum.

Table 3 shows the potential tax saving when the interest rate is 5% per annum.

In summary, it can be seen that:

1. Taxpayer 4 saved the most tax when the interest rate was at 8%.
2. Taxpayer 1 saved the least amount of tax when the interest rate was at 5%.

Based on the above example we can conclude that:

1. Taxpayers generally get a higher deduction (and consequently save more tax) the higher the interest rate and the higher their income level.
2. Prepaying interest when it is at 8% is a better option than prepaying interest at lower rate such as 5% as the tax benefits are notably greater.

It is also important to consider that you need cash available in order to prepay interest and at 5% or similar low interest rates, there may be better uses for your spare funds.

Additionally, at interest rate levels of 4% or 5% such as the market is currently offering, taxpayers should consult their accountant to discuss fixing their interest rates as we are approaching 40-year lows and this could provide some welcome stability in terms of future interest payments.

Tax Calculation: Using the 2008 tax rates and ignoring the Medicare levy surcharge

TABLE 1	Taxpayer 1	Taxpayer 2	Taxpayer 3	Taxpayer 4
Taxable income	50,000	100,000	150,000	200,000
Tax on taxable income	9,600	27,100	47,100	69,600
plus Medicare levy	750	1,500	2,250	3,000
Total tax payable	**10,350**	**28,600**	**49,350**	**72,600**
Prepaid interest (12 months)	**Interest paid**			
Interest rate @ 8%	300,000@ 8% * 12 months		**24,000**	
Interest rate @ 5%	300,000@5%*12 months		**15,000**	

TABLE 2	Taxpayer 1	Taxpayer 2	Taxpayer 3	Taxpayer 4
Interest rate @ 8%				
Assessable income	50,000	100,000	150,000	200,000
Less prepaid interest	24,000	24,000	24,000	24,000
Taxable income	26,000	76,000	126,000	176,000
Tax on taxable income	2,250	17,500	37,500	58,800
plus Medicare levy	390	1,140	1,890	2,640
Total tax payable	2,640	18,640	39,390	61,440
Tax saving:	**7,710**	**9,960**	**9,960**	**11,160**

TABLE 3	Taxpayer 1	Taxpayer 2	Taxpayer 3	Taxpayer 4
Interest rate @ 5%				
Assessable income	50,000	100,000	150,000	200,000
Less prepaid interest	15,000	15,000	15,000	15,000
Taxable income	35,000	85,000	135,000	185,000
Tax on taxable income	4,550	21,100	41,100	62,850
plus Medicare levy	525	1,275	2,025	2,775
Total tax payable	5,075	22,375	43,125	65,625
Tax saving:	**5,275**	**6,225**	**6,225**	**6,975**

This information and examples are intended to provide general information in regard to the prepaying of interest and the potential tax savings that may be made. Each individual situation is different and for this reason,it is recommended you seek the professional advice of an accountant. This ensures that you are taking the correct action to maximise your particular circumstances yet still complying with the necessary legal requirements.

Michael Quinn, director of The Quinn Group (www.quinns.com.au), is an experienced lawyer, accountant and educator. As an integrated professional services firm, The Quinn Group provides the total solution. Clients have access to a range of services that include: accounting and taxation advice, legal counsel, as well as financial and investment planning.
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