

Interest capitalisation

Contributed by Stuart Barker

Interest capitalisation.

Many property investors may have heard of capitalisation of interest when it comes to structuring a financial package for financing an investment property.

It is very important that this is treated with extreme caution for a number of reasons as outlined below.

Firstly the tax department has spent years fighting this issue all the way to the high court where they finally won on the basis that it breaches section 4A of the tax act in that the primary consideration is the avoidance of tax.

Had they lost in the high court they would have simply changed the law.

Secondly, consider the following;

The average client borrows around \$400,000 these days to purchase a property including costs. If we are to consider a capitalisation program it will affect the structure that we place clients in, as we have to provide split facilities and cross collateralize all securities. We can also not offer the comfort of fixed facilities, as all facilities will need to be at variable rates.

Capitalising interest on a typical investment loan would see debts escalate somewhat out of control as follows.

End of year 1 @ 8.07%	\$432,280
End of year 2	\$467,165
End of year 3	\$504,865
End of year 4	\$545,607
End of year 5	\$589,637

Assuming interest rates remain constant at 8.07% (remember we can't fix them). This equates to \$189,637 interest and growing.

Over the same period assuming rents remain constant (say \$350pw) and averaging tax deductions at say \$9,000 a client

will have an extra \$27,200 per year in cash flow to either spend on lifestyle or pay off their home loan, less property management and rates etc. leaving an extra say \$24,000 per year. This equates to an extra \$120,000 over 5 years.

At the end of year 5 a client would be around \$70,000 worse off assuming they are reasonably disciplined and rates do not move against them. To gain any benefit at all they would have to be guaranteed substantial capital growth because they are immediately eating into equity they do not yet have. We assume also that the tax department does not come down on them as the penalties and interest could destroy them. I say this because this type of facility has a habit of attracting the attention of the Tax department and at the very least is likely to attract an audit.

I point this out because in the "Taxation Examiner" newsletter (Nov-Dec) I quote the following;

"While the general anti avoidance provisions of Part IVA of the Income Tax Assessment Act 1936 are not considered applicable in this case, (the provision of a line of credit facility) the application of Part IVA depends on the detailed analysis of the facts of each case. The Commissioner considers that a scheme in relation to a loan facility would need to have the same features as those set out in paragraphs 16 to 19 in Taxation Ruling TR 98/22 before Part IVA could be applied."

Although, they go on to say that the ruling I.D. 2006/298 is positive they strongly suggest that advice be taken from a reputable, independent tax consultant- not the finance broker!

At the end of the day I could not recommend that a client enter into this kind of financial arrangement.

I would much prefer that a client sought a stand by line of credit facility to guard against unforeseen cash flow problems than locking into a scheme, which is fraught with financial danger.