Make Hay While the Sun Shines – Claiming Interest During Construction of a Residential Rental

The ATO have issued a draft ruling on claiming expenses when you are constructing a rental property. TR 2021/D5
https://www.ato.gov.au/law/view/print?DocID=DTR%2FTR2021D5%2FNAT%2FATO%2F00001&PiT=99991231235958&fbclid=IwAR0IAFNOdKMzqPcho6-FIEI6-cOFGjggwMwWMflgbmx46UbHamRM2ZYDyJ8

From 1st July, 2019 the deduction of expenses relating to vacant land have been severely restricted. Specifically, in regard to the costs associated with vacant land that you are holding to build a residential rental property. You are not allowed a deduction for expenses relating to the land until the house is built and able to be listed for rent. For more details about this and how it can even apply to when a rental property is being repaired click here
https://bantacs.com.au/Jblog/claiming-property-expense-when-not-rented/#more-369

TR 2021/D5 at paragraph 27 finds that while the interest on the loan for the land might not be tax deductible the interest on the loan for the construction costs is tax deductible if your intention is to rent out the property once it is completed. Even if the progress payments are drawn from the same loan as the land, the interest can be apportioned.

This is a draft ruling so the final ruling could take a completely different view. We have contacted the ATO and have in writing that they do not expect that this part of the ruling will be challenged. Afterall it is the ATO's opinion and is only classed as a draft so that the profession can comment and they are unlikely to object.

In the unlikely case that the final ruling takes a different view you are still protected from any fines or penalties if you claim interest during the draft period. The only consequence is that you would have to pay back the tax you have saved. That is of course unless the amendment period has expired. The ATO have a blanket approach that the amendment period is 2 years from the notice of assessment but the law gives you 4 years in many cases. Nevertheless, it is quite possible that by the time the ATO come out with the final ruling and on the very slim chance it is different to the draft, the period of time within which the ATO will audit you will have expired.

This amendment period limit works both ways so the risk is if you don't amend now your amendment period may expire by the time the final ruling is released and you will lose the opportunity completely. We recommend a bird in the hand approach knowing there are no negative consequences other than having to pay back what you would not have anyway, without the amendment.

What to do Now?

You still have time to amend your 2020 and 2021 tax returns if it is less than 2 years from the date on the assessment notice. If you own a rental property with another person you have 4 years to amend but you will need to argue with the ATO. For people reading this blog years after it was written refer to our blog on amending your tax return for the fine print. https://bantacs.com.au/Jblog/amending-past-years-tax-returns/#more-141

Is it worth Amending?

We have done a few test samples and it is not always worth our fees to amend compared with the tax refund generated if we have to do all the work and your loan arrangements require apportionment. There are of course plenty of times when it is worthwhile and there are things you can do to keep the accounting fees down.

The first step is to calculate how much interest you could have claimed. If the construction loan is separate from the land loan then this is simply a matter of looking at the bank statement for the construction loan. Once you have this amount a rough rule of thumb is that your refund is likely to be 1/3rd of this amount, higher of course for high income earners or just 19% for low income earners. If we prepared your original tax return and you know the amount of interest you have missed out on claiming then our amendment costs will be minimal because you have done most of the work.

This ruling does not change the fact that the interest on your land loan is not deductible. So if your construction loan and land loan are combined, the interest will need to be apportioned. Here is a link to our apportionment calculator. https://www.bantacs.com.au/shop-2/apportionment-calculator/ Doing this yourself will save you accounting fees. Using this correctly will allow you to provide us with the exact amount of the construction interest so again keep the amendment cost to a minimum.

In the year that the property did become available for rent we would have already claimed a tax deduction for some of the interest so it is important to make sure the interest you calculate as needing to be amended only covers the period up till the property became available for rent.

In short – as long as you have missed out on claiming a few hundred dollars or more in interest it is probably worth amending your tax return. It is important to do this before the amendment period has expired.   If you haven't already done your 2021 tax return make sure you include interest on a loan for the construction costs of a future rental property.