

Pre-paid interest

“Claim a tax deduction this year and save”

The strategy in a nutshell: Pre-pay the interest on your investment loan now for the next 12 months and you may be able to claim a tax deduction for that interest in your current year's income tax return.

The strategy

Astute investors understand that borrowing funds to invest significantly boosts the potential to create wealth. This is commonly referred to as 'gearing'. When you borrow money to make an investment that will generate assessable income, you're entitled to claim a tax deduction for the interest expense that arises.

In some cases the interest expense will be less than the income earned (positive gearing), in some cases they will be equal (neutral gearing) and in other circumstances the interest cost may be greater than the income return generated in that year (negative gearing).

The interest is deductible in the year it arises. However, if you have a geared investment portfolio in your own name, you can pre-pay the interest expense on these loans for the next 12 months and receive the entitlement to the deduction today.

You can decide to pre-pay the interest for a period of less than 12 months and still receive an immediate deduction, but it cannot be pre-paid for a period greater than 12 months.

Why would you pre-pay the interest?

Pre-paying interest gives you the ability to bring forward the tax deduction (you may be entitled to in the following year) in to the current year. This may provide you with tax planning opportunities from one year to the next.

Additionally by pre-paying interest you are locking in the interest rate for the following year and many providers offer a discounted rate when you pre-pay interest.

It's important to remember that in order to receive these benefits, you need to make the pre-payment before 30 June 2008. Furthermore once the payment is made you cannot claw back any interest payments should the account be closed or repaid.

Case study

Paul has an investment portfolio which will generate him \$13,000 income this year. He has a \$100,000 loan in place which he has used to fund part of his investment portfolio. The loan has interest payable at 8 per cent per annum.

Paul has been making interest payments steadily through 2007-08 on this loan and has now been made aware of the ability to prepay his interest expense for the next 12 months.

Paul also earns \$78,000 salary income every year.

The table below shows the savings Paul can generate by prepaying his interest liability for the 2008-09 income year before 30 June 2008.

	No prepayment	With prepayment
Salary income	\$78,000	\$78,000
Investment income	\$13,000	\$13,000
Assessable income	\$91,000	\$91,000
Interest deduction – 2007-08 year	(\$8,000)	(\$8,000)
Prepaid interest for 2008-09		(\$8,000)
Taxable income	\$83,000	\$75,000
Tax payable (including Medicare)	\$21,545	\$18,225

By implementing the pre-payment strategy, Paul has brought forward a tax saving of \$3,320.

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