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The ATO is armed with funding and ready to take down dubious investment property claims

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The recent sharp increase in sharemarket volatility coupled with the potential for multiple interest rate cuts this year has set the stage for future property price growth, particularly in Sydney and Melbourne.

On top of that, a wave of federal election promises aimed at helping first-home buyers, most of which boost demand without adding supply, are likely to fuel property price growth further still.

But property investors should proceed with caution. The Australian Taxation Office is on the audit warpath.

Many accounting firms have reported huge increases in audit activity in recent months. In fact, in my own practice we have had more property investor clients audited in the past few months than in the previous 10 years combined.

And the audit activity is set to intensify further. In the recent federal budget, the government allocated almost $1bn to the ATO over the next four years to ramp up tax compliance programs. The government estimates these activities will raise an additional $3.2bn in tax receipts over the next five years.

Importantly, more than $75m of that budget is earmarked specifically for the Personal Income Tax Compliance Program.

Over the past few years, the ATO has greatly improved its ability to crosscheck data. It now receives direct data feeds from banks to track interest payments, from titles offices to monitor property transactions, and from rental bond authorities to detect if people rent out a property.

Recently, it has also added property management software companies into this data network, giving access to detailed transactional data on rental income and expenses dating back to the 2019 financial year.

This enhanced data capability allows the ATO to use technology effectively in identifying taxpayers for audits and to send out letters to tax agents with little cost.

Australia's tax system operates on a self-assessment basis, meaning taxpayers are responsible for proving to the ATO that the information in their tax returns is accurate and complete. The ATO does not need to disprove this information.

Put simply, if you cannot substantiate a tax deduction to the satisfaction of the ATO, it will deny that deduction. Hence, its critical to stay on top of your taxation affairs.

So what should you do?

When it comes to property investors, the ATO is focusing on two key deductions: interest and maintenance expenses.

Any expenditure on a property is typically categorised either as a repair or an improvement. A repair involves work to prevent damage or fix defects to return something to its condition when you purchased the property. On the other hand, an improvement enhances the property beyond its original state.

Immediately after purchasing a property, most expenses are considered improvements and must be depreciated over time.

For repairs, investors can deduct the full expense in the financial year it was incurred. However, if the expense is considered an improvement, the deduction for the expense must be spread over its useful life. The ATO provides a detailed guide on the useful life of various assets. For instance, structural improvements are depreciated at a rate of 2.5 per cent a year.

Determining whether an expense is a repair or improvement is not always straightforward. For example, the expense of replacing an electrical panel was deemed an improvement by the ATO due the invoice noting some of the wiring did not comply with code, despite the wiring being a small part of the cost: It was substantially a like-for-like replacement.

To avoid such issues, property investors should carefully review invoices. If any wording suggests an improvement might have occurred, they should request an itemised invoice to clearly distinguish between repair and improvement costs. If there is any uncertainty, they should engage with their tax agent before they pay for the expense.

Interest expense is often the largest tax deduction for property investors, especially in the 2024 and 2025 financial years given current interest rate settings. Therefore, it's crucial that investors maximise this deduction.

To qualify for a tax deduction for interest expense, taxpayers must clearly demonstrate that the loan is used for investment purposes. This requires a clear audit trail from loan drawdown to when the investment was made.

Don't mix multiple purposes in a single loan. It is particularly critical not to mix non-tax-deductible and tax-deductible debts in the same loan account. Even with tax-deductible loans, separating loans by purpose makes recording keeping clear. If, say, you use part of a loan for property deposits and part for sharemarket investments, it is best to split the loan into two accounts.

When refinancing investment loans, thorough record keeping is essential, especially when loan amounts change, or accounts are consolidated.

Investors must be careful using loan redraw facilities, as each redraw is considered a new loan from a tax perspective. Instead of repaying investment loan principal, set up the loan with interest-only repayment terms and park surplus funds in a linked offset account. This approach preserves the original tax-deductible status of the loan while still allowing you to minimise interest costs – a notional loan repayment.

Unfortunately, I have seen investors make expensive mistakes by relying on advice from well-intentioned but unqualified individuals like friends, bankers, and mortgage brokers. It's essential that investors verify any advice with a registered tax agent.

Property investor must take care not to fall foul of the ATO, particularly now that its auditing capabilities have strengthened.

Stuart Wemyss of the Prosolution Private Clients group is a financial adviser and host of weekly podcast Investopoly.

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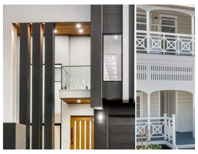

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