[4.8.6] Deductibility of Loan Interest (section 97(2)(e))

1. Introduction

The deductions which can be made in computing taxable Case V rental income are set out in section 97(2) TCA 1997. Paragraph (e) provides for a deduction in respect of ‘interest on borrowed money employed in the **purchase, improvement or repair of the premises**’. The loan concerned must be used for one or more of these purposes. The borrowed money can be used for both residential and commercial premises. Money incurred on the construction of a premises and the purchase of the site for that premises is regarded as being incurred on the purchase of the premises. In the case of residential premises, section 97(2J) (inserted by section 5 Finance Act 2009) imposes a cap of 75% on the amount of interest that can be deducted where the interest accrues on or after 7 April 2009. However, section 97(2K) (inserted by section 15 Finance Act 2015) provides for the reinstatement of the 100% deduction where residential premises is let to tenants in receipt of certain social housing supports – see paragraph 11 below for details.

Where borrowed money is used to purchase, improve or repair an entire premises but only part of the premises is let, the interest must be apportioned between qualifying and non-qualifying interest on a just and reasonable basis, for example, on the basis of the floor area that is let/not let.

The provisions of section 97(2)(e) also apply to the purchase of foreign premises. Although rental income from foreign property is assessed under Case III rather than Case V, section 71(4) TCA 1997 applies section 97(2)(e) to foreign rental income and provides for the same deduction for interest on borrowed money as that allowed in computing Irish rental income.

2. Security for loan

For interest to be deductible under section 97, it is not necessary for the loan to be secured on the premises in question. For example, in the case of interest on a loan that is secured on an individual’s principal private residence and used for the purchase, improvement or repair of a rented premises, the interest is deductible under section 97 in the normal manner. However, interest is not deductible where the loan is obtained on the security of a rented premises but is used for purposes other than its purchase, improvement or repair.

3. Timing of deductions

Interest can only be deducted during the period in which the premises are let.[1] This means that interest is not deductible for the period following the purchase

[1] Referred to in section 97(3) as “during the currency of the lease” or “the period during which the person chargeable was entitled to the rent.”

of the premises up to the time a tenant enters into a lease, nor after the period of the last letting. In the case of the first letting of a premises, section 105 requires **actual occupation** by the lessee before interest can be deducted. Interest incurred in the period between lettings is deductible provided that the landlord does not occupy the premises during that period and a new lease is granted.

4. Direct purchase etc. of premises[2]

Interest is deductible under section 97(2)(e) where the money borrowed is used, inter alia, to purchase a rental premises. However, the borrowed money must be used or employed **directly** in the purchase of that premises. Where a premises is acquired indirectly through a company using borrowed money, the money borrowed will have been used to purchase an interest in the company and will not have been employed in the purchase of the premises. The position is not altered by the fact that –

- the investor's borrowed money is subsequently used by the company to purchase the premises, or
- the investor may be able to receive rental income directly from the tenants of the premises, or
- the investor may be able to sell the premises by selling his or her underlying shares in the company.

The position just outlined applies equally where the borrowed money is used to purchase an interest in any other type of entity such as a property-owning trust.

The same treatment also applies for money borrowed for use in the improvement or repair of a premises. Relief is only available where such money is employed **directly** in the improvement or repair of the premises.

Interest on a loan to acquire an **option to purchase** a premises is not deductible even if that option is subsequently exercised.

5. Transfer of properties between spouses or civil partners

There is no deduction for interest accruing on or after 6 February 2003 where let residential premises is purchased from your spouse, or, on or after 27 July 2011 where let residential premises is purchased from your civil partner. This restriction does not apply to purchases between –

- spouses who are legally separated or divorced, or

- civil partners who are separated under a deed of separation or other agreement, arrangement etc. which gives rise to a legally enforceable

[2] Most of the material in this Paragraph was published in Tax Briefing 66, page 5.

obligation and which has been entered into as a result of the partners living apart in circumstances where the separation is likely to be permanent, or where the civil partnership has been dissolved.

6. Registration with the Private Residential Tenancies Board

With effect from 1 January 2006, interest on loans used to purchase, improve or repair a residential premises is not deductible where the landlord has not complied with the registration requirements of Part 7 of the Residential Tenancies Act 2004 in respect of all tenancies relating to the particular premises for the tax year or accounting period in question.[3] See Tax Instruction 4.8.10 for details.

7. Stamp duty and legal fees[4]

Interest on any loan, or part of a loan, that is used to pay stamp duty, legal fees and other expenses incurred in relation to the purchase, improvement or repair of a premises is not deductible. Only interest relating to the **actual** purchase, improvement or repair costs is deductible.

8. Interest rate caps and cancellation fines[5]

Interest rate caps (IRCs) set an upper limit to the interest rate on variable rate loans for a specified period, which may be for the duration of the loan but is generally for a shorter period. They may be affected as part of a loan agreement or by a separate agreement with the lender or with another institution. The IRC provider agrees, in return for a fee (which may be paid up-front), to compensate the borrower if interest rates rise above the agreed upper limit.

In **Tax Briefing 25,** Revenue confirmed it would treat a payment for an IRC as part of the interest expense relating to a loan. Where the interest on the related loan is an allowable deduction in calculating profit rent under Case V, the payment for the IRC is also allowable. Where, however, the 75% interest restriction applies (see paragraph 11), only 75% of the IRC payment can be deducted instead of the usual 100%.

In certain circumstances, a financial institution may impose a fine of an additional amount of interest on the cancellation of a loan. The amount of the fine is treated in the same manner as any other interest paid on the loan which gives rise to the fine and is, where applicable, also subject to the 75% restriction on the amount that is deductible.

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[3] Section 97(2I).
[4] The material in this Paragraph was published in Tax Briefing 50, page 14.
[5] The treatment of interest caps was dealt with in Tax Briefings 25 (page 17) and 50 (page 14).

As the period to which the IRC refers is generally shorter than the loan period, a once-off payment for an IRC should be spread over the IRC period, in accordance with normal accounting practice, so that the payment is matched to the periods to which it relates.

In Revenue's view, a payment received from an IRC provider is not a payment of rent or a payment in the nature of rent and accordingly does not fall to be charged under Case V. However, where the cost of the IRC is allowable in accordance with **Tax Briefing 25**, Revenue agrees that the related IRC income may in practice be taken into account in computing profits under Case V for the relevant year or accounting period.

9. Temporary restriction on interest deductibility for residential premises (Bacon Report)

Finance (No 2) Act 1998 terminated the deductibility for interest on borrowed money used on or after 23 April 1998 in the purchase, improvement or repair of residential premises in the State, and on or after 7 May 1998 in relation to foreign residential premises. Notwithstanding what the premises was when acquired or how it was previously utilised, the restriction applied for any tax year or accounting period during which the premises was, at any time during that period, a rented residential premises. The restriction also applied where, at any time after 23 April 1998, a person vacated his or her principle private residence and turned it into rented accommodation. This restriction applied from the date of change of use, irrespective of when the borrowed money was used.

Finance Act 2002 restored interest relief for residential premises where the interest accrued on or after 1 January 2002, regardless of when the property was purchased.

It was possible to avoid the temporary interest restriction where certain transitional conditions were met or where a particular type of residential premises was exempted. Full details of the transitional arrangements and exemptions are contained in **Tax Briefing 32**, page 30.

10. Replacement Loans

Where a loan used for the purchase, improvement or repair of a rented premises is replaced by another loan, interest paid on the replacement loan is not, in strictness, deductible under section 97(2)(e). This is because the replacement loan is used to replace the original loan and not directly for the specified purposes. However, Revenue practice has been to treat the interest on a replacement loan as being deductible, subject to certain conditions. Revenue practice has varied over time and these variations were outlined in a number of Tax Briefing articles – issues 33 and 50 that dealt, respectively, with the introduction and removal of the interest restriction.

Tax Briefing 33 (September 1998, page 3) recognised that some taxpayers would wish to take out replacement loans to enable them to avail of a more beneficial interest rate or a more suitable method of repayment. Subject to claims being dealt with on a case-by-case basis, the general position was that interest on a loan that **directly** replaced an existing qualifying loan on a rented premises was allowed where:

- The replacement loan did no more than replace the outstanding balance on the existing loan, **and**
- The term of the replacement loan was no longer than the balance of the term of the existing loan.

A change in the type of loan from annuity to endowment, or vice versa, that met the above criteria was allowed.

Separate loans, rather than amalgamated loans, were to be taken out where:

- Existing borrowings were refinanced and further amounts were borrowed (for whatever purpose), **or**
- A number of loans were refinanced at the same time.

A Revenue practice of apportioning loans between qualifying and non-qualifying purposes was to be discontinued in relation to loans that were taken out after 30 September 1998.

Tax Briefing 50 (October 2002, page 13) made a distinction between replacement borrowings for residential and commercial premises in that while commercial borrowings were looked at on a case-by-case basis, taxpayers with residential borrowings did not need to seek pre-clearance provided that the conditions outlined in **Tax Briefing 33** had been met.

In relation to existing borrowings, the general position was that interest on an existing qualifying loan for residential premises qualified as a deduction where there was a variation of the terms of such a loan, for example, repayment period extended. It was a question of fact in each case as to whether the existing qualifying loan still existed or whether a new replacement loan had been taken out. Generally, where there was a variation in the basis on which payments were allocated between interest and capital or where the period of the loan was extended for genuine commercial reasons on an arm's length basis and not for the avoidance of tax the existing loan was treated as continuing.

The practice outlined in **Tax Briefing 33** of requiring a replacement loan to do no more than replace the outstanding balance on the existing loan and the term of the replacement loan being no longer than the term of the existing loan was discontinued from 1 January 2002 where the existing loan was replaced for genuine commercial reasons on an arm's length basis and not for the avoidance of tax.

While it would have been preferable if separate loans rather than amalgamated loans were taken out where existing borrowings were refinanced and further amounts were borrowed or a number of loans were refinanced at the same time, it was recognised that in refinancing situations it was increasingly common for financial institutions to require the amalgamation of all existing loan facilities into one separate loan as part of their security requirements. Accordingly, it was accepted that interest on amalgamated borrowings that accrued on or after 1 January 2002 would qualify for relief where:

- The capital and interest in respect of each rented residential premises could be readily identified and traced back to the original borrowings, **and**
- Borrowings were amalgamated for genuine commercial reasons on an arm's length basis and not for the avoidance of tax.

In all cases, the onus was on the taxpayer to make a just and reasonable apportionment of qualifying interest and non-qualifying interest especially where loans were amalgamated and there was a subsequent sale of a premises. In the case where the taxpayer financed the purchase of premises with amalgamated loans, he or she could not claim any further interest as a deduction in respect of the part of the amalgamated loan that referred to the premises that had been sold. The remaining qualifying interest after apportionment was deductible.

Example

Jenny has three properties, a principal private residence and two other houses, which are let. Originally her principal private residence and one of the rental properties were secured by two separate loans on each of the properties. She purchased the third property by refinancing and releasing equity in her principal private residence. Jenny subsequently amalgamated the two loans into one single loan to obtain a lower mortgage interest rate. She then sold the first rental property. What interest will qualify as a rental deduction in that event? The amalgamated loan will be treated as if it were three separate loans as follows:

- The original loan used to purchase the principal private residence
- The original loan used to purchase the first rental property
- The equity release in the principal private residence used to purchase the third rental property.

She must apportion the borrowings on a pro-rata basis between the property that was sold, the property retained and the rental property. She may make a deduction in computing rental income for the interest relating to the remaining rental property only. Mortgage interest relief may be claimed in the normal way for the part of the borrowings relating to the principal private residence only.

It remains the case that the capital and interest in respect of **each** rented residential property must be readily identified and traced back to the original borrowings and that borrowings are only to be amalgamated for genuine commercial reasons on an arm's length basis and not for the avoidance of tax. It is not necessary that replacement loans in the case of borrowings for commercial premises obtain pre-clearance from Revenue. However, in the event of a Revenue audit, taxpayers must be able to demonstrate that a just and reasonable apportionment of qualifying and non-qualifying interest has been made.

11. Restriction of interest relief for rented residential premises

Where a loan has been used to purchase, improve or repair a rented **residential** premises and interest on the loan **accrues** on or after 7 April 2009, only 75% of the interest on the loan can generally be deducted as a rental expense.[6] For the purposes of the 75% restriction, the interest is treated as accruing on a daily basis. The date the loan is taken out is not relevant.

However, from 1 January 2016 a landlord who rents residential premises for a period of 3 years to tenants in receipt of certain social housing supports may, notwithstanding the general 75% interest restriction on such premises, deduct the balance of the interest accrued in each year of the 3 year period as an expense in computing the taxable rents from the premises in question. The rolled-up interest balance is treated as accruing on the day after the 3 year period ends and relief is obtained by way of a claim to Revenue **after** the end of the period.

For example, an individual lets residential accommodation to a housing support tenant for a 3 year period ending on 31 December 2018. The additional interest i.e. 25% for each of the tax years 2016 – 2018 inclusive is deemed to accrue on 1 January 2019 and is taken into account, along with interest actually accruing in 2019, in computing the taxable rents from the property in question for 2019. Please refer to Notes for Guidance - Part 4 for further information.

Landlords must submit a Declaration of Undertaking Form to the PRTB in order to avail of this initiative.

- For tenancies commencing on or after 1 January 2016, the undertaking must be submitted at the same time as the tenancy is required to be registered in accordance with section 134 of the Residential Tenancies Act 2004 (i.e. within 1 month of the start of the tenancy).
- For tenancies which commenced prior to 1 January 2016 (where the tenancy would be a "qualifying lease", within the meaning of section 97(2K)(a) TCA 1997, if it commenced on that date), the undertaking must be submitted by 31 March 2016.

[6] This restriction was introduced by section 5 Finance Act 2009.

The 75% restriction does not apply to loans taken out in respect of non-residential property and the full amount of interest continues to be deductible in such cases. In the case of mixed residential and non-residential premises interest should be apportioned on a just and reasonable basis before the restriction, where appropriate, is applied to the residential part of the interest.

See paragraph 8 above for the effect of the 75% interest restriction on fees for interest rate caps and cancellation fines.