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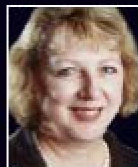

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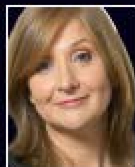

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Tyron Hyde covers all you need to know about claiming depreciation on your investment property

Renovation cash back

EVERYDAY I TURN ON THE TV, there is a new renovation show. No wonder the sector is booming! According to the Australian Bureau of Statistics, the value of alterations and additions to residential buildings is estimated to be over $500 million for 2013 alone. All up, property investors are claiming $25 billion worth of rental deductions in one year, so it's little wonder the sector has come under scrutiny from the tax office.

Around June every year the ATO warns property investors to be careful about what they claim. If you are claiming repairs to your property, make sure they are legitimate and not capital improvements (i.e. a renovation). It's quite a grey area and can get confusing. Part of the reason is that the word "repair" is not defined in the tax legislation. Therefore, the ATO takes its ordinary meaning, which is "the restoration of a thing to a condition it formerly had without changing its character".

Tax ruling TR 97/23 is the bible when it comes to defining what constitutes a repair and what doesn't. It's quite long and complex, so an easy way to summarise it is with the following list of questions:

- Was the work related to the wear and tear of the property while it was an income-producing asset for you?
- Were the repairs you carried out undertaken when you initially bought the property? If so, these are defined as "initial repairs" and cannot be claimed as an outright deduction.
- Did you replace a whole item in its entirety? If so, this is not a repair.
- Did you improve the material when you carried out the work? If so, this is considered a capital improvement, not a repair, and is to be depreciated.

The best way to highlight what constitutes a repair is through a series of examples.

Example 1: Jack and Jill buy a rundown 1930s weatherboard property that needs some work carried out to bring it to a rentable state. Five cracked roof tiles have caused leakage that damaged the carpet in one of the bedrooms. They replace the carpet and the cracked tiles and get a plumber to fix the faulty hot water heater.

This work clearly seems like repairs in nature but unfortunately it is not, as the "damage" was done prior to Jack and Jill acquiring the property. The ATO has defined this as "initial repairs" and these costs are considered to be capital works and should be depreciated over time as part of the building allowance.

Example 2: Jack and Jill buy a rundown 1930s weatherboard property that is already housing a tenant. The tenant continues to rent the property for 10 months, then moves out. After the tenant leaves the owners discover five cracked roof tiles that caused the roof to leak and damaged the carpet in the bedroom. They replace the carpet and cracked tiles and get a plumber to fix the faulty hot water heater.

Guess what? This is the same work, but in this case Jack and Jill can claim it as an outright deduction (a repair). This is because they believe the damage was caused after they bought the property and was in part due to tenant wear and tear.

Example 3: Jack and Jill buy a rundown 1930s weatherboard property with tenants. The tenants move out after nine months and the owners discover five cracked roof tiles that caused the roof to leak, which led to carpet damage in the bedroom. They replace all the carpet and the whole roof. They also get a plumber to replace the faulty hot water heater.

In this case, because Jack and Jill decided to replace the whole carpet, roof and hot water heater the work will need to be depreciated at 2.5%pa over 40 years and not claimed as an outright deduction.

If Jack and Jill had only repaired the hot water heater, a mixture of outright deduc-

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tions and depreciable items would have been allowed. This would have been as long as the items had been clearly differentiated.

Example 4: Jack and Jill own a 1930s weatherboard property for several years before deciding to fix the dilapidated fence. The old fence was made out of timber palings. Cash strapped, Jack and Jill decided to fix the front fence only, leaving the rear and sides alone. They decide a brick fence would be more suitable and would add value to the property.

In this example, although Jack and Jill owned the property for a while and only fixed part of the problem, they can still only claim this work over 40 years as opposed to an outright deduction. This is because the material they used was an improvement to the existing product or an upgrade.

So, if you think you can buy an old property, renovate it straight away and get a massive deduction in one hit, think again. At the end of the day, all these repairs can be claimed against your taxable income. Some just take a little longer than others.

Before we leave this discussion, let's look at another case study.

Renovating an old property

An investor recently purchased an apartment shell that had been part of an old government defence building. The developer refurbished the building and subdivided the entire property into 20 new individual apartment shells, giving the opportunity to individual buyers to complete the fitout to their liking.

The planning permit stipulated that once the fitout was completed all owners were to engage a building surveyor for the purpose of attaining a certificate of final inspection, which would make it a completely new property.

This is an interesting scenario because the original building is quite old but the apartments will be "new". The investors definitely needed to know if they would be able to claim depreciation on the building, even though the original structure (pre-subdivision) was over 50 years old.

In this case, the answer is yes and no. Let me explain. Building allowance deductions are available to property investors for work carried out – such as concreting, brickwork and other items related to the structure of the building. The key to whether these deductions were allowed was the date the construction commenced. In this instance, construction of the original structure commenced long before July 1985; therefore the investor will not be able to claim depreciation on the original structure.

On the other hand, the investor would be able to claim capital works carried out by the developer to turn this development into the 20 individual units. This might include items such as design, surveyor fees, strata fees and structural works to separate the apartments.

Furthermore, the investor would be able to claim any works involved with fitting out the property. This might include the costs of the kitchen, wardrobes, toilet and bath.

The date of construction in this example applies to individual capital works.

So the new kitchen installed in June 2010 can be claimed at 2.5% for 40 years from that date. Here are a couple of tips:

- Make sure the developer provides you with a depreciation report at the time of settlement. The best way to ensure this occurs is to have this provision written into the contract so that there is a legal requirement to provide this information.
- Make sure you separate your claim into plant and equipment items – such as ovens and dishwashers – and building allowance (capital works) items to maximise your claim.

Most common mistakes

Most investors are keen on improving second-hand property when they purchase it. They tend to focus all their energy and attention on the execution of the renovation work. More often than not these investors are inclined to adopt the mindset, "The faster the completion, the sooner the returns."

While this is not entirely false, it can be a classic example of "haste makes waste". In a rush to get the desired outcome, most investors are not aware that they are missing out on gains they could have been getting even while they were still in the process of carrying out their final plan for the property. Let us discuss the common mistakes investors make before renovating a newly bought pre-owned property.

Immediately discarding items that can be claimed as depreciation assets. It is easy for old and used carpets, blinds, curtains, stoves, dishwashers, and light fittings to present themselves as obsolete and no longer valuable when a property upgrade is the first thing on your mind. But while these obsolete items might not be usable anymore, it does not mean they cannot be claimed as a tax deduction.

Each of these taxable items can actually be assigned a value that can be claimed as a deduction against the investor's tax. Deduction in tax is actually considered money gained. When investors discard these items, they are also indirectly throwing money away. In cases where the items can no longer be recovered from disposal, with the help of photographic representation and a good quantity surveyor you may be able to salvage something from such a situation.

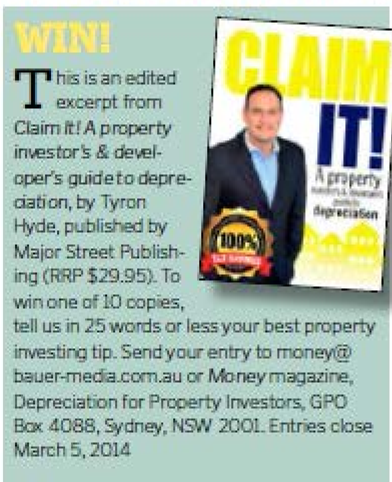
Note: The property needs to have been income-producing for a period of time once you have purchased it in order to claim any residual or scrapping value.

Failing to obtain a depreciation schedule. Before you dispose of any old items in your income-producing property, conduct an inspection with your quantity surveyor to identify the original value of each item. These values are the basis of the tax deductions you can get by the end of your first year as the new owner of the property.

Failing to obtain a schedule on completion of renovation. The depreciation schedule that you get for your pre-renovated property is intended to back up your depreciation claims on its old and existing assets. This depreciation schedule does not cover

WIN!

This is an edited excerpt from *Claim It! A property investor's & developer's guide to depreciation*, by Tyron Hyde, published by Major Street Publishing (RRP $29.95). To win one of 10 copies, tell us in 25 words or less your best property investing tip. Send your entry to money@bauer-media.com.au or *Money* magazine, Depreciation for Property Investors, GPO Box 4088, Sydney, NSW 2001. Entries close March 5, 2014



the new assets that have been installed on your property as part of the renovation. To do this right, a new depreciation schedule will be required.

Claiming new replacement items. Don't get too excited once you have completed your renovation and think that whatever you have installed can be written off immediately. A new item, such as the carpet, has to be depreciated over its effective life, or the time frame specified for the said item to last, before it needs to be replaced. .

Not all construction costs can be claimed as a tax deduction. Here are some of the things that don't qualify:

Demolition costs. When claiming depreciation of a building you are essentially claiming what is there now. So it stands to reason that the costs involved in removing the existing structure to make way for a new property can't be claimed.

Site clearing. Similar to demolition, the costs involved in clearing the land are not eligible to be claimed. These two jobs are essentially getting the site ready to begin work. It is important to note that excavating the site for a basement can be claimed as that's considered part of the new basement.

Landscaping. Trees and grass grow and therefore don't depreciate over time. However, it's worth noting that landscaping can comprise many different elements, such as retaining walls and concrete elements, which are static and therefore can be claimed. In short, if it grows, you can't claim it. (And yes, that garden gnome is depreciable!)

Developer's profit. If you buy a property from a builder or developer, the developer's profit cannot be included as a construction cost.

Depreciation on previously renovated property

Most property investors now know you cannot claim building depreciation for properties constructed before July 1985. But what if your property was built before 1985 and was later renovated, prior to you taking ownership? Can you claim depreciation on the renovations? The simple answer is yes. The law doesn't exclude those renovations just because they are part of an old building. As long as the renovations commenced after 1985, you are entitled to depreciate them. And the good news is that even minor renovations can yield a significant amount of depreciation.

For instance, we are constantly seeing properties with a $25,000 makeover. This may include new carpets, new blinds, a new bathroom and a new kitchen. This type of renovation could result in depreciation benefits of between $5000 and $7000 in year one alone.

The reason this figure is relatively high, compared with the amount of expenditure, is because the items being replaced have a relatively low effective life, which means you can claim them quicker.

This makes sense and is the reason they needed replacing in the first place. In simple terms, carpet can be claimed quicker than brickwork and concrete because it will wear out faster.

When it comes to what items can be claimed as part of the building allowance, and what items can be claimed as plant and equipment, you can choose the effective life or depreciation rate of an item that goes into the plant category, but you can't choose the effective life of an item in the building allowance category. These must be claimed at 2.5%pa.

The ATO determines which items go into each category based on such factors as: the degree of affixation to the property; the physical life of the asset; manufacturing specifications; industry standards; the level of repairs by users of the asset; if the asset is leased.

If you are unsure of the cost of any item in your investment property, I would suggest you get a quantity surveyor in before you renovate.

Once I inspected a property on the day before settlement. The owner was planning a small renovation. I depreciated the normal items – yet he was also replacing all 10 light fittings. I concluded that those 10 light fittings had a residual value of $600 and he could write them off immediately. The owner was very happy!

To round off this discussion, let's work through another example.

The makeover

Let's do some number crunching. Jackie, an investor, buys a property built in 1988 that has an existing tenant with three months to go on their lease. She believes the original kitchen and bathroom are in desperate need of a makeover to meet market expectations.

Without an independent estimate by a qualified quantity surveyor, Jackie's tax deduction in regards to this renovation would be zero. The potential deductions she's missing out on are shown in the table below.

By way of explanation, here are some key facts about this situation:

- When Jackie finishes her new kitchen and bathroom she can start claiming those new items at 2.5% again.
- Jackie demolished these items voluntarily and was still able to claim the amounts in full.
- The property was built after 1985 – that's the year the ATO allowed investors to claim the building allowance (bricks, tiles, etc.)
- The property was also income-producing prior to the renovation.

In a nutshell, it pays to know what you're entitled to, and if you don't, find someone who does who can help you. ***M***

HOW IT WORKS

INSTALLED IN 1988	ESTIMATED VALUE	
	WHEN INSTALLED	WHEN DEMOLISHED[1]
Kitchen cupboards	$16,000	$8000
Kitchen wall tiles	$2500	$1250
Kitchen plumbing	$1700	$850
Kitchen electrical	$1060	$530
Shower screen	$1500	$750
Vanity	$1300	$650
Bathroom tiling	$4400	$2200
Bathroom ceilings	$2700	$1350
Immediate deduction		$15,580

Source: Tyron Hyde as at January 2013. [1]Calculated on the basis of 2.5%pa (flat) over 20 years, equal to half original value.

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