"YOU'RE ABLE TO CLAIM A DEDUCTION FOR YOUR PROPERTY, JUST LIKE YOU WOULD BE ABLE TO CLAIM DEPRECIATION FOR A UTE AS A TRADESPERSON"

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PROFITING FROM LOSS

Depreciation can save investors thousands at tax time, but this write-off is frequently misunderstood. In the first instalment of this four-part series, Stefanie Garber investigates how investors can benefit as their property grows older

In circumstances where property prices are rising by the year, it seems counter-intuitive that buildings lose value over time. Yet even as buyers and tenants are prepared to pay more for properties on the market, the structure and its contents are becoming tired and worn.

The Australian Taxation Office (ATO) acknowledges this phenomenon in the form of 'depreciation' and provides a tax break to compensate investors. Any income-producing asset, including a rental property, may attract depreciation benefits, according to Tyron Hyde from Washington Brown.

"You're able to claim a deduction for your property, just like you would be able to claim depreciation for a ute as a tradesperson," he says.

Mr Hyde explains depreciation is highest when a property is newly built, then gradually decreases.

"The newer the property, the more depreciation you'll get, which makes sense because at the beginning of a property's life it hasn't depreciated yet at all," he says.

How is depreciation calculated?

Like much of taxation, depreciation can seem complex at first glance. However, investors who take the time to understand this policy can reap substantial rewards, Mr Hyde explains.

Firstly, depreciation can apply to rental properties in two different ways: as a building allowance and as a plant and equipment write-off.

"The building allowance is the bricks and concrete and other structural parts. That depreciates over 40 years from when it is brand new," Mr Hyde says.

The ATO sets the rate of depreciation for buildings at 2.5 per cent per annum over this four-decade period, according to Mr Hyde.

However, only properties built after 16 September 1987 qualify for this type of allowance. Dwellings built between 1985 and 1987 were previously included but their eligibility expired in 2010.

Yet properties built before this cut-off may still attract depreciation write-

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offs. Firstly, a renovation can reset the clock on the newly constructed portions of the property, explains accountant Mark Calleja from MCA.

"If you were to do a renovation on a property in terms of a capital improvement to that property, you would be able to depreciate that component of the renovation over time," he says.

Provided the work was completed after 1987, current landlords can claim the write-off even if the work was paid for by a prior owner, explains Mr Hyde.

Given the amount of damage properties suffer over the years and the tough competition for tenants, a large number of properties fall into this category.

"There are not a lot of properties we see that are built before 1987 that haven't been renovated in some form in order to get a tenant," Mr Hyde says.

The other element of depreciation is plant and equipment deductions. These can be claimed regardless of the property's age, Mr Hyde explains.

"There are a lot of things that can be considered plant and equipment. The term refers to items that help you in your business or your investment," he says.

In a rental property, this category may include the carpet, oven, dishwasher, blinds, air conditioner and other loose items that can be removed from the property. In large apartment buildings, plant and equipment may encompass the owner's share of big ticket items as well, according to Mr Hyde.

"If it's a high-rise, it might be a portion of the lift or the ventilation plant in the basement, or the air conditioning system," he says.

Deductions on these items can be claimed for the duration of their "effective life", which varies from item to item.

"All the plant and equipment items have different rates of depreciation because some things are going to wear out quicker than others," Mr Hyde says.

"AN INVESTOR WHO IS RENTING OUT THEIR PROPERTY IS ABLE TO CLAIM A TAX DEDUCTION FOR SOMETHING THEY PHYSICALLY HAVEN'T SPENT MONEY ON"

The guidelines for most equipment are laid out in a tax guide issued by the ATO. As an example, the ATO has ruled that a lift has an effective life of 30 years while carpet has a life of 10 years. As a result, if $2,000 worth of carpet is installed, the owner would be able to claim $200 a year for a decade, Mr Hyde explains.

"The effective life has been determined by the Australian Taxation Office, which takes into consideration a range of variables to determine how long the item is expected to last," Mr Hyde says.

In some cases, Mr Hyde believes the ATO's ruling on the "life" of these items may be unrealistic.

"Personally, I think 40 years for a kitchen is ridiculous. When was the last time you saw a 40 year-old kitchen? It's not pretty, especially if you're trying to get a tenant," he says.

"The ATO also believes shower screens last 40 years. I don't want to shower where the screen is that old."

Once the value has been written off to zero or the maximum effective life has been reached, depreciation benefits run out, Mr Calleja explains.

"If we have a capital asset that costs $1,000 and we depreciate it over the lifetime of its use, we claim depreciation of $100 a year for 10 years," he says. "Once you get to $1,000, you can't depreciate that asset anymore."

How much can you save?

The returns investors can expect to see will vary with their personal circumstances and the nature of their property. Mr Hyde gives an example of a house that initially cost $100,000 to build.

"You can claim 2.5 per cent, or $2,500, per annum for 40 years from the time it was new," he says.

"If you come along and you buy that property when it is already 20 years old, there's $50,000 left for you to claim over the next 20 years."

In this way, Mr Calleja explains, depreciation is one of the few tax benefits that accrues without the investor paying up front. As the cost of building is incorporated into the cost of the property, the benefit comes back to the owner without an additional outlay.

"An investor who is renting out their property for income-producing purposes is able to claim a tax deduction for something they physically haven't spent money on," Mr Calleja says.

The returns offered by this policy will also depend on your salary and financial position. Depreciation

Depreciation overview

CAPITAL ALLOWANCE

Eligibility: residential rental property built or renovations completed after 16 September 1987
Duration: 40 years
Rate: 2.5 per cent per annum
Includes: structure, fixtures and permanent fittings

PLANT AND EQUIPMENT

Eligibility: all residential rental properties
Duration: depends on effective life of item
Rate: variable
Includes: non-structural items including carpets, blinds, white goods or air conditioners

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reduces your taxable income, in turn reducing your tax liability in that financial year.

"If you've been paying tax on $80,000 per annum and you get a depreciation report, your accountant will say you should have been paying tax on $70,000," Mr Hyde says.

"The higher your tax bracket, the more the depreciation is effective," he points out.

Mr Calleja gives the example of an investor falling into the 32.5 per cent tax bracket. For every dollar of depreciation this investor claims, they will get 32.5 cents back in their return. However, if the investor were in the highest tax bracket, they would get 47.5 cents back per dollar.

Similarly, while self-managed super funds holding property can also claim depreciation, their returns are likely to be limited. The maximum tax rate is only 15 per cent, according to Mr Calleja. Super funds in the pension phase may pay no tax at all.

"If you have a super fund that is in the pension phase and you pay zero per cent tax, putting in a deduction for depreciation would be pretty pointless," Mr Calleja says.

A word of caution

While a lower tax bill is always welcome, Mr Hyde warns against placing too much importance on tax advantages.

"I am the biggest advocate in the world for maximising depreciation, but I see a lot of people focus too much on deductions and not enough on the things that should drive investment buying decisions," Mr Hyde says.

He believes factors such as population growth, infrastructure, historical trends and lifestyle drivers should carry far more weight than possible deductions.

On the flip side, he also sees many investors fail to claim tax benefits, generally due to a lack of education.

"The main trap would be not doing it because you think your property is too old," he says.

He urges investors to do their research to ensure they fully understand their entitlements. While he believes accountants are much better informed about depreciation than 20 years ago, some still fail to recommend these write-offs to their clients.

"There are still investors out there who don't know about depreciation," Mr Hyde says.

In one case, a client came to him having built a $10 million factory 10 years previously without ever claiming depreciation.

"My estimate was that he probably missed out on about $4 million in deductions," Mr Hyde says.

If you have overlooked depreciation in the past, Mr Calleja advises tax returns can be amended for up to two years to catch up on lost returns.

How to claim depreciation

In order to make a deduction, owners need to know the original construction costs of the property. Where this is unknown, a qualified quantity surveyor must be hired to estimate the costs. An ATO ruling has held that real estate agents, property managers, accountants and valuers are not appropriately qualified to make this calculation.

When an owner is unsure of a property's history, quantity surveyors may also be able to determine when renovations took place, Mr Hyde explains.

"Internal renovations can be the hardest to get the age of because you don't have to go through the council in a lot of cases, so there are no records of when the renovation occurred."

A skilled surveyor might examine the colours or materials in the room to work out when that design scheme may have been fashionable. In addition, they use online resources like RP Data to search for before and after photos.

"We might research on the website and say 'Okay, at this point in time, the property was un-renovated and at this point, it was renovated'," he says.

A key consideration is whether the surveyor specialises in depreciation. In Mr Hyde's view, a surveyor's understanding of the tax regulations can make a major difference to the investor's bottom line.

"The depreciation deduction on your investment property is the only deduction that can be subject to particular interpretation of the tax act. Every other deduction you get is based on the invoice you receive," he says.

"Therefore I would make sure as an investor that I maximise the only deduction that can be open to interpretation and skill." ■

In upcoming editions of Smart Property Investment *we will investigate how depreciation applies to renovations, older properties and off-the-plan purchases – so make sure you don't miss an issue!*

INVESTOR PROFILE

GERRY NOLAN

My involvement with property began in 2009 from an investment perspective. I bought my first property in 1985 but really didn't understand investment until a lot later on. I now have four properties and one inside my super fund.

The properties in Dubbo and Albury are established houses. In Ballarat, I identified that council had planned to develop three new areas, so I bought a recently completed property in one of those areas. There is nothing like a brand new property to get good depreciation write-offs.

My strategy is to tackle regional areas in different states to avoid land tax and to pick up on the economies of different states. We look for things like whether properties are close to good infrastructure such as shopping centres, schools and transport.

The best thing about depreciation is that while your property is appreciating in value, it's actually depreciating in terms of the value of its construction materials. From an investment perspective, the government is kind enough to allow investors to write-off all of that depreciation, resulting in a much lower taxable income.

With depreciation benefits, I decrease my taxable income by about $30,000 a year. I find out each tax year exactly what my properties are costing me out of my own pocket and over the past 12 months, I think they might have cost me $20 to $30 a week each. It has taken five years to get there but I have continually improved each property and ploughed money back into them.

I have a long-term strategy. I'm not planning to sell until I'm retired.

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