The taller they are, the harder they fall

When it comes to maximising depreciation benefits, which type of dwelling offers investors the best tax advantage? *Tyron Hyde*, CEO of Washington Brown Depreciation, explains

When I was a skinny 14-year-old, I used to play rugby for the Drummoyne Dirty Reds. One wet Saturday morning my mother drove me out to Cambridge Park, in Sydney's west, to play the locals.

I remember my jaw dropping when the opposition team rocked up driving their own cars – and I wondered how on earth 14-year-olds could have full-grown beards! I guess no one was checking birth certificates that day.

My coach must have seen the look of horror on my face and, adapting the old adage, said: "Don't worry son – the taller they are, the harder they fall."

Cold comfort to me, as we got totally smashed that day. But while the coach was wrong on that particular occasion, what he said does apply when dealing with property and tax allowances on buildings. And we can be more specific about it here. The taller the building, the faster it depreciates.

In order to understand why this occurs, you need a basic understanding of how depreciation works in relation to property.

Boosting depreciation allowances

There are two types of allowances investors can claim when it comes to property depreciation. The first allowance is commonly known as the building allowance. This deduction relates to the structure or fabric of the building, and includes works carried out such as brickwork, concrete, windows and gyprock.

Any work that falls into this category must be depreciated at 2.5% pa. So, if your investment property has $100,000 allocated to the building allowance, you would be entitled to a deduction of $2,500 pa for 40 years. Simple!

The second allowance relates to the plant and equipment within a property. This allowance includes items within your property that, in theory, are easier to remove and have a shorter life expectancy.

Items to be depreciated within this category include ovens, dishwashers, blinds and also common property items like the lifts, ventilation fans in the basement and some common fire service items. These items have a shorter life term, and therefore can be depreciated faster than the building allowance. For instance, if a dishwasher with a value of $1,000 has a 10-year life expectancy, then using the prime cost method, you can claim $100 per year for 10 years.

This is far greater than if it was included as part of the building allowance, where you would only be able to claim $1,000 x 2.5% pa – or $25 pa.

So, it would stand to reason that the more plant and equipment included within your purchase, the higher the depreciation.

So here's the crux of the matter: the higher the plant and equipment, the higher the depreciation allowances and the higher the building, the higher the plant and equipment will be as a ratio to the purchase price.

Taller buildings attract higher plant and equipment allowances

It comes down to what's known in the trade as 'services'. Services can encompass several professions, from hydraulic to fire and mechanical fields.

More services are required, and in some cases are mandatory, for taller buildings.

Some of the services required as buildings increase in height are obvious, such as a lift (transport service). Other services are less obvious, with fire sprinklers, stair pressurisation and intercoms all being depreciable under this category.

The other reason tall buildings have a higher ratio of plant and equipment has to do with the amenities the developer provides. For instance, some high-rise buildings have swimming pools, gyms and even mini cinemas.

In most states across Australia, investment property owners are entitled to claim their portion of these services and amenities. (Sorry, readers in South Australia and the Northern Territory – you miss out. The body corporate owns common items in your state and territories, which is silly considering we're dealing with federal tax law.)

Number crunching

OK, let's look at the numbers.

The first thing to do is to look at a rough ratio of plant and equipment relative to construction cost (see Table 1). Now take a look at how this translates into deductions (see Table 2).

TABLE 1: RATIO OF EQUIPMENT TO CONSTRUCTION COST

Type of dwelling	Percentage
Freestanding house	8–10%
Unit <4 floors	10–12%
Unit 4–8 floors	20–25%
Unit > 8 floors	20–25%

TABLE 2: DEDUCTIONS

Type	Year 1	Year 2	Year 3	Year 4	Year 5	TOTAL
House	$7,000	$5,000	$4,000	$3,500	$3,250	$150,000
Unit <4 floors	$8,500	$7,000	$5,500	$4,750	$4,250	$175,000
Unit 4–8 floors	$10,000	$8,000	$7,000	$6,000	$5,000	$200,000
Unit > 8 floors	$12,500	$10,000	$8,000	$7,000	$6,000	$225,000

These allowances all relate to a purchase price of $400,000 in a capital city – and are very approximate to allow for illustrative purposes only.

As you can see, the taller the building, the more you can depreciate.

But keep in mind, higher depreciation doesn't necessarily make a better investment. It often means there'll be higher levies and additional expenses, and you own less land as well.

But at the end of the day, it's up to you to weigh up the pros and cons… and make that final decision! ☗

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