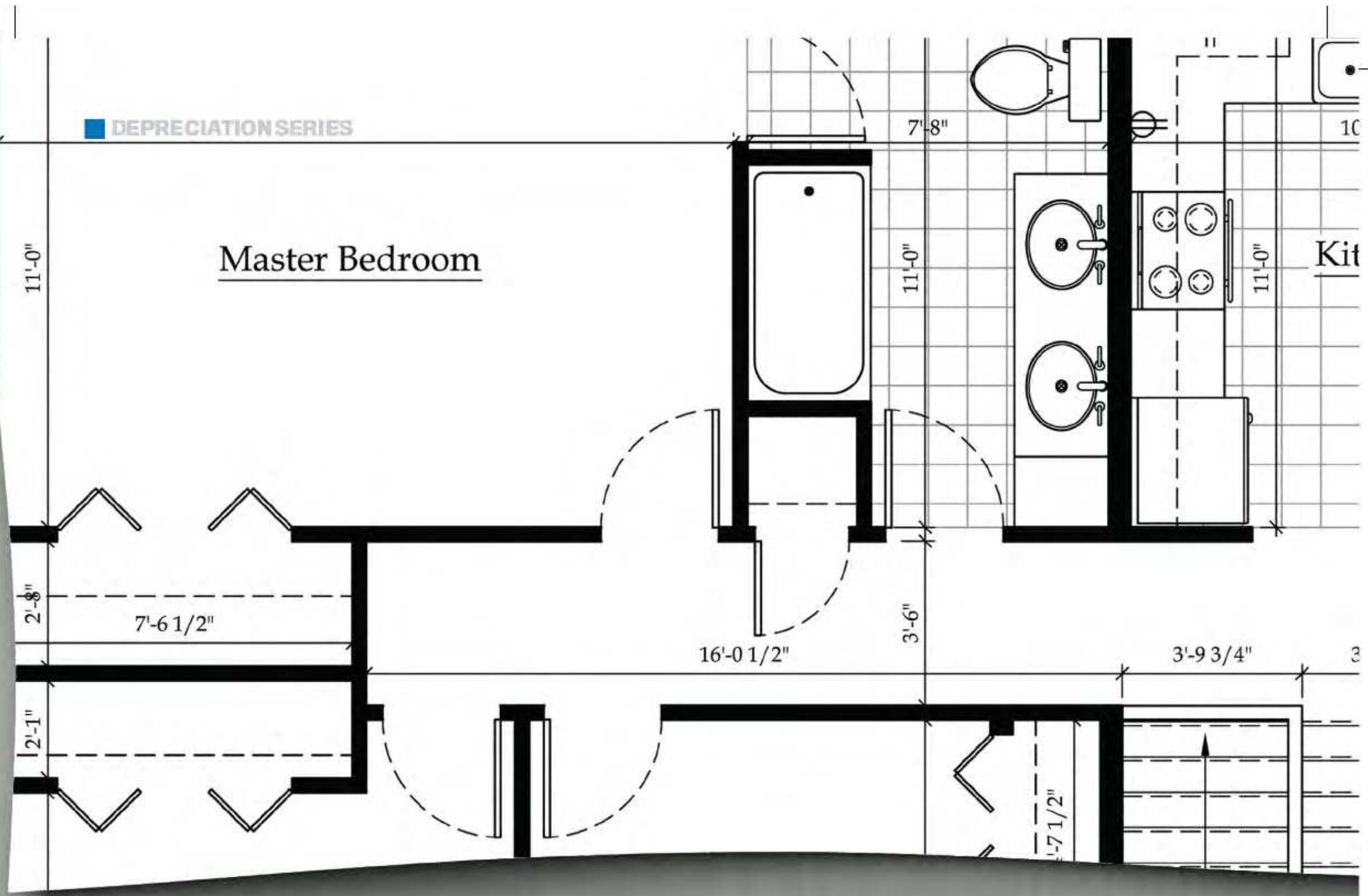
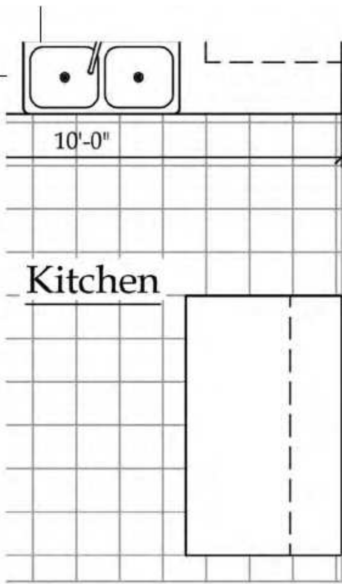


DEPRECIATION SERIES PART 2

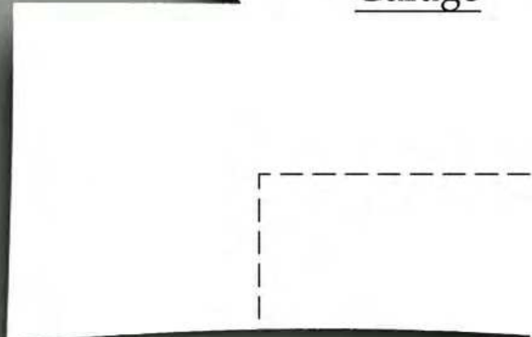
BRAND SPANKING NEW

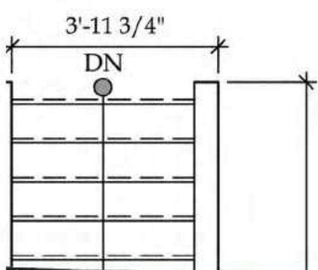
A lot of investors are drawn to the idea of a buying a brand new, never-before-lived-in property and part of the appeal is the impressive benefits at tax time. In the second instalment of this four-part series, Stefanie Garber investigates how depreciation impacts on new and off-the-plan properties

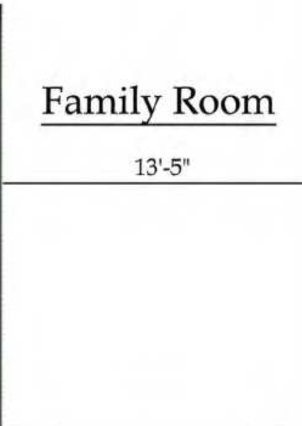
SPISEP14_Depreciation part2_VB_AM.indd 50 14/07/2014 11:31:08 AM

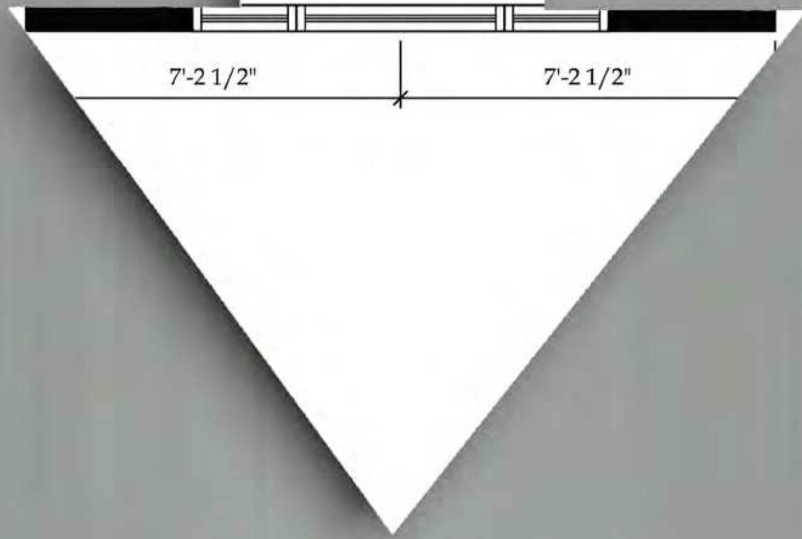


"YOU GET THE MOST DEPRECIATION POSSIBLE BECAUSE EVERYTHING IS BRAND NEW"









Depreciation is a tax write-off designed to compensate investors for wear and tear on an income-producing asset. In the case of rental properties, investors may be able to claim a tax deduction for the deterioration of the building as well as any fixtures and fittings.

While this tax policy can benefit all investors, the rewards are particularly high if you buy brand new or off-the-plan, according to Tyron Hyde from quantity surveying firm Washington Brown.

"You get the most depreciation possible because everything is brand new," he says.

"Something you own from the outset is going to have the maximum levels of depreciation and thereafter, it's going to have a declining value."

Depreciation applies to two elements of property investment: the building and the plant and equipment. Investors who own structures built after 16 September 1987 can claim depreciation over the course of 40 years. As such, buying early in the building's life gives investors a chance to collect the most deductions, Mr Hyde says.

In addition, fixtures and fittings within all properties depreciate at various rates depending on their "effective life", the amount of time the Australian Taxation Office (ATO) has ruled the object will last. Window blinds, for example, are deemed to have an effective life of 10 years while gas hot water systems have a life of 12 years.

SPISEP14_Depreciation part2_VB_AM.indd 51 14/07/2014 11:31:17 AM

"When you're buying new, you're getting the fittings at the start of their effective life. All tax office rulings for effective life are based on new items," Mr Hyde says.

Investor Julian Cofield chose to buy a house and land package partly due to the tax advantages.

"When you're looking as an investor, you want to try to get as much bang for your buck as possible. Obviously a new property, as opposed to an older property, is going to give you the most depreciation," he says.

In some cases, the pay-off can be more than the investor anticipated. When Peter Foldes bought a new apartment in Perth, he was aware of depreciation but had no idea how much it would be.

"I'd been told by peers it was a necessary step and on a new property, it might be $5,000 or $6,000, which I thought sounded fantastic. Then in my first year, I actually got just under $10,000," he says.

Calculating depreciation

While the building loses 2.5 per cent of its cost value each year according to the ATO, investors have two options for calculating wear and tear on the plant and equipment: the prime cost method and diminishing value method. The age of the property can influence which option is a better deal.

Investors with new properties get the full benefits of depreciation

Household items depreciate at different rates

Under the prime cost method, the fixture's value decreases by the same amount every year until its effective life is over, according to Mark Calleja from MCA.

Mr Hyde gives an example of carpet. If the carpet is worth $2,000 and has an effective life of 10 years, you can claim around $200 each year for 10 years.

$$\text{Asset's cost} \times \frac{\text{Days held}}{365} \times \frac{100\%}{\text{Asset's effective life}}$$

Source: ATO

On the other hand, using the diminishing value method, the amount you can claim is higher at first but decreases over time, Mr Calleja says. The rate of depreciation used for the prime cost method is doubled, then calculated as a percentage of the remaining value each year.

Using the same example as previously, the $2,000 carpet would depreciate at 20 per cent instead of 10 per cent using this method. As such, in the first year, the investor would get $400 or 20 per cent of $2,000 back. The next year, the investor could claim 20 per cent of $1,600 (around $320). Investors can claim on this equation indefinitely, as the base value will never get to zero, Mr Hyde says.

$$\text{Base value} \times \frac{\text{Days held}}{365} \times \frac{200\%}{\text{Asset's effective life}}$$

Source: ATO

The diminishing value method also allows investors to write off some cheaper items more quickly. Any plant or equipment costing under $300 can be claimed in full immediately, Mr Hyde says.

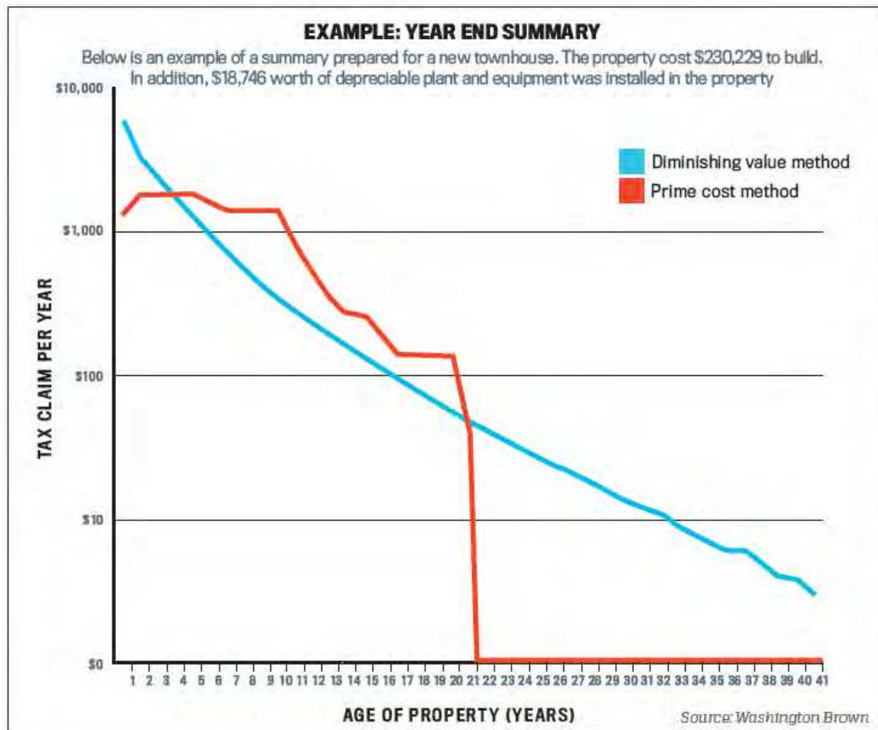
Meanwhile, items costing between $300 and $1,000 can be lumped together in a low value pool that depreciates at a faster rate - 18.75 per cent in the first year and 37.5 per cent in each year after.

Mr Calleja suggests investors buying new properties may be best off using the diminishing value method.

"You can see there's an advantage of using the diminishing value earlier on and that's especially true for a new property," he says.

In the example schedule contained in this article, investors using the diminishing value calculation could collect $5,796 for plant and equipment in the first year alone. By comparison, the prime cost method would return only $1,312.

By year ten, however, the situation has reversed. The diminishing value formula gives a write-off of only $339, while prime cost still provides $1,357.



SPISEP14_Depreciation part2_VB_AM.indd 52 14/07/2014 11:31:19 AM

Partnered by Washington Brown

EXAMPLE OF BREAKDOWN OF ASSETS

This is an example of some items of plant and equipment that can be claimed, as well as the tax benefits they might offer

Source: Washington Brown

DEPRECIABLE ITEM	COST	EFFECTIVE LIFE	PRIME COST	DIMINISHING VALUE
Air conditioning: controls	$1,779	10	10%	20%
Hot water system	$1,688	10	10%	16.66%
Carpet	$2,310	10	7%	20%
Dishwasher	$647	10	10%	Low value pool: 18.75% in first year, 37.5% in following years
Clothesline	$220	5	20%	Under $300: write-off by 100% in first year

Mr Hyde suggests off-the-plan investors thinking of selling within a few years may choose to claim more upfront. In addition, owners of negatively geared properties may need a cash injection early on rather than consistent returns over 10 years.

"With negatively geared investors, the rent hasn't gone over their mortgage payments and they need those deductions off their personal income tax to help them afford the property," Mr Hyde explains.

"The property becomes more affordable over time as rents go up and interest payments go down - depreciation helps them get there quicker."

Common property

Many investors buying off-the-plan choose townhouses or apartment complexes. While most are familiar with depreciation, Mr Hyde says they are often surprised that they can claim for the common property as well.

"When you're buying into a high-rise, everyone gets a share in the depreciation on the common property," Mr Hyde says.

This share is based on unit entitlements - the higher your entitlements, the greater the portion of common property you are able to write-off. However, Mr Hyde warns that owners also pay more for the benefit they receive.

"The higher the entitlement, the higher the property price as well. That also means you're going to be paying higher levies and so forth. You buy a part of the lift but you also pay a part of the maintenance," he says.

When Mr Foldes had a schedule prepared for his new apartment in a 20-unit complex, he had not considered the common property at all.

"I was surprised at the value that the common areas came to and the impact it had on my personal claim. Things like the security system and the gates for the car park were all factored in," he says.

Gerry Nolan is an investor who bought into a unit complex within 10 kilometres of the Brisbane CBD. He found the complex's amenities, including the pool and the gymnasium, gave him an instant boost at tax-time.

"Because it was in a complex, a lot more items are thrown into the mix and you share in the benefit of depreciation. It includes a lot of things that you wouldn't commonly find in an ordinary house," he says.

Factoring in depreciation

While depreciation benefits are maximised in a new property, that alone may not make it a solid investment.

Many developers include a depreciation schedule as part of their marketing for off-the-plan properties, Mr Hyde says. These estimates help investors understand the after-tax holding costs and make more informed choices.

In some cases, investors may consider how the type of fittings in a new property will impact on their out-of-pocket expenses. Mr Hyde gives the example of two houses selling for the same price near Cairns.

"In one house, every room had a fan and it was tiled all the way through. In the house next door, every house had an air conditioning split system and it was carpeted," he says.

"There is a massive difference in depreciation numbers despite the similar price."

By his estimate, air conditioning could provide a write-off of $2,000 a room, as opposed to $300 a room for fans. Similarly, carpet depreciates over 10 years, while tiles are deemed to last around 40 years.

"WHEN WE'RE BUYING INTO A HIGH-RISE, EVERYONE GETS A SHARE IN THE DEPRECIATION ON THE COMMON PROPERTY"

"That makes a big difference to the end number," he says.

Where investors are building their own properties, they may take into account differing levels of deductions when selecting their fittings.

Despite the benefits, Mr Hyde encourages investors to see depreciation as only one element of their decision-making process.

"I would probably consider having tiled floors if it meant I was more likely to get a tenant in that market. Carpet may give you quicker depreciation but I think it's important to focus on what is likely to get you a tenant and what the resale value is going to be," he says.

Similarly, all our investors indicated that depreciation was a consideration, but not a deciding factor, in their decision to buy a new unit or house.

Mr Foldes believes he overlooked this policy's importance in the past and intends to give it more weight in the future.

"Before it was more of a beneficial afterthought whereas now it would form part of the original decision-making process," he says.

"That's not to say I would make the purchase decision based on depreciation alone, but it would certainly be a consideration in terms of budgeting calculations and cash flow."

Mr Cofield sees depreciation as part of the equation when picking a property, although not the most important part.

"I wouldn't say it was the only factor but it's certainly something to factor in. The ability to be able to depreciate could make a property more affordable in the long run," Mr Cofield says. ■

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

SPISEP14_Depreciation part2_VB_AM.indd 53 14/07/2014 5:16:47 PM