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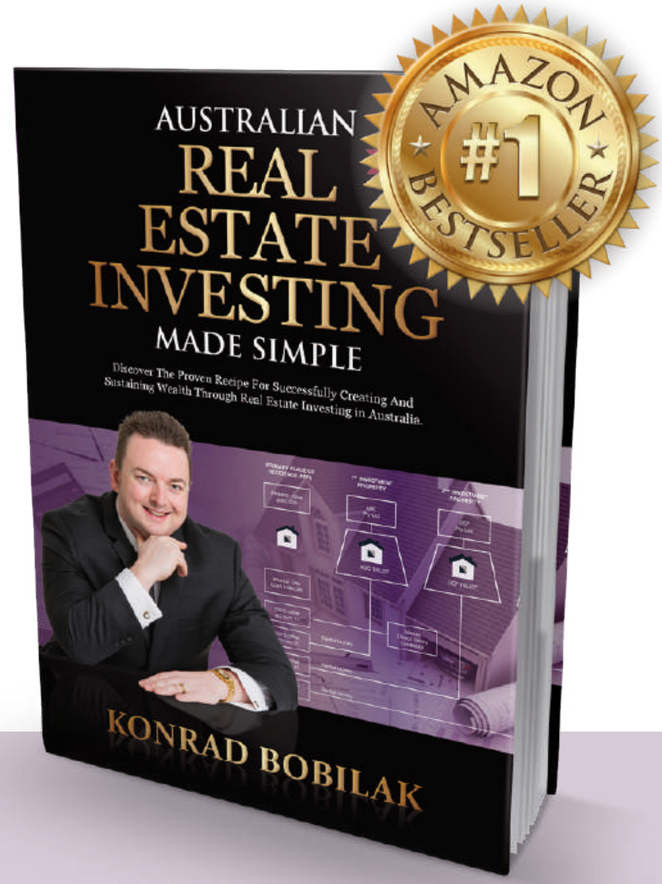

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Special Acknowledgement

Special thanks to Brad Beer, C.E.O of BMT, for contributing
'Chapter 19: Critical Things Every Investor Needs To Understand About Claiming Depreciation Deductions In Investment Properties' to this book.

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Critical Things Every Investor Needs To Understand About Claiming Depreciation Deductions In Investment Properties.

Introduction to property depreciation

Property investors are often looking for ways to improve the cash flow of their investments. Despite this, a large percentage of investors are unaware of property depreciation and either fail to claim depreciation deductions or don't maximise their claim.

The most common reason depreciation is overlooked is because it is considered a non-cash deduction, meaning investors do not need to spend any money to be able to claim it. Most income-producing properties entitle their owners to claim depreciation. A depreciation deduction essentially reduces the investment property owner's taxable income so they will pay less tax.

What is property depreciation and what is required to claim it?

Owners of income-producing properties, both residential and commercial, are required by the Australian Taxation Office (ATO) to report any income earned as part of their annual tax return.

The ATO allows income-producing property owners to claim a deduction for the wear and tear of the building structure (capital works) and eligible removable or mechanical assets (plant and equipment). This claim is called depreciation. The below table outlines the two major depreciation components.

Table 19.1 BMT Capital Allowance and Tax Depreciation Schedule

Investors should consult a specialist Quantity Surveyor such as BMT Tax Depreciation to prepare a depreciation schedule before visiting an Accountant to complete a tax assessment.

Quantity Surveyors are one of the few professionals recognised under tax ruling 97/25 to have the appropriate construction costing skills to estimate building costs for depreciation purposes.

Before completing a tax depreciation schedule, the Quantity Surveyor will liaise with the investor's Property Manager to organise a full site inspection of the property. This inspection allows the Quantity Surveyor to document all depreciable assets in the property in order to calculate their depreciable value. They will also measure rooms with a laser measurer, record assets' brand or model numbers and photograph improvements at the property.

Once the site inspection has taken place, the Quantity Surveyor will then produce the tax depreciation schedule and send it to the investor and their Accountant. The Accountant uses the information provided in the schedule to process the investor's claim when they complete their annual tax return. A BMT Tax Depreciation Schedule outlines all available deductions over the life of the property (forty years).

Capital works deductions explained

Capital works refer to the deduction for the building structure, including eligible fixed assets. Capital works are commonly referred to as division 43 allowance or building write-off. The following graph outlines the rates available for different properties, based on their industry and construction commencement date.

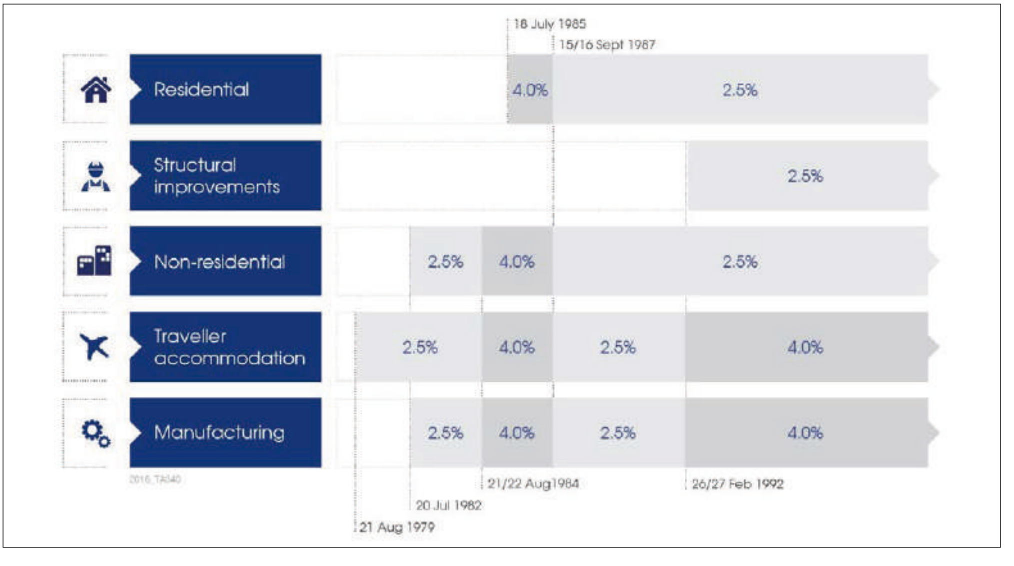

Figure 19.1 Capital Works Deductions Explained

The capital works deduction for residential properties can be claimed at a rate of 2.5 per cent over forty years. Owners may also be able to claim a deduction for structural renovations completed within legislated dates that are considered to be a capital improvement (meaning the renovation improved the value of the structure beyond its existing condition).

Plant and equipment depreciation

Depreciation deductions can be claimed for eligible plant and equipment assets as determined by the ATO. Plant and equipment assets depreciate at a faster rate than the building's structure. Each asset is assigned an effective life by the ATO over which depreciation can be claimed.

The infographic below shows the first full financial year deductions for a range of plant and equipment assets commonly found in a kitchen.

Figure 19.2 The First Full Financial Year Deductions For A Range Of Plant And Equipment Assets Commonly Found In A Kitchen

Under legislation passed on Wednesday the 15th of November 2017, owners of second-hand residential properties which exchanged contracts after 7:30 pm on the 9th of May 2017 cannot claim depreciation deductions for the previously used plant or equipment assets.

Owners can still claim depreciation deductions for any new plant or equipment assets they purchase and install once the property is income-producing such as an oven or dishwasher. Second-hand residential property owners who purchased their property before the cut-off date are eligible to claim depreciation on previously used plant and equipment assets. Owners of brand-new or substantially renovated residential properties and commercial properties are not impacted by the new legislation.

Older properties and depreciation

Investors often wonder about the depreciation differences between older properties compared to new properties. The simple answer is that the owners of newer properties will receive higher depreciation deductions. However, investment properties both new and old can attract depreciation deductions for their owners.

Properties constructed after the 15th of September 1987 attract capital works deductions. Owners of older properties can claim capital works deductions on the residual value of the building up to forty years from construction. For example, if an investment property is fifteen years old, the owner will have twenty-five years left of capital works deductions to claim. If an investor owns a property that was constructed prior to the 15th of September 1987, they should contact a Quantity Surveyor to determine if there are any renovations or extensions that can be claimed.

Even if the work completed on the property was done by a previous owner, structural improvements completed after the qualifying dates can be claimed as a capital works deduction.

Owners of second-hand properties should be aware that if they exchanged contracts on the property after 7:30 pm on the 9th of May 2017, they cannot claim depreciation for used plant and equipment assets. Owners can claim for assets they purchase and directly incur the expense for.

Renovate and depreciate

Investors often purchase a second-hand property as an investment and renovate to increase the property's value.

It is important to note that assets removed during a renovation may still have remaining depreciable value which can be worth thousands of dollars in deductions to the investor.

Owners renovating their investment property should consider the following important things.

1. Arrange a depreciation schedule before starting work

Renovations can provide significant deductions to investors. The owner may be entitled to claim a deduction for the remaining value of any depreciable assets that are removed and disposed of during a renovation.

This process, called ‘scraping’, allows investors to claim the residual value of items removed from a property as a tax deduction in the year the item is scrapped.

A Capital Allowance and Tax Depreciation Schedule should be completed before any work is started, as this schedule will support the owner’s claim. This will allow the Quantity Surveyor to distinguish whether the owner is eligible to claim scraping for capital works. They will also assess whether scrapping can be applied to plant and equipment assets under the current legislation. The Quantity Surveyor should arrange a site inspection of the property to value all items contained within the property and take photographic records before the items are removed.

2. Install new assets that maximise future deductions

When an owner is deciding which parts of their investment property to renovate, they should consider the depreciation deductions available on newly installed items.

Choosing which assets to install when renovating can make a significant difference to investors’ future deductions. This is because the depreciation available for each asset is calculated based on its individual effective life as set by the ATO.

For example, the deductions available in the first full financial year for carpets, floating timber floors and tiles differ quite substantially. If an owner would like to install new flooring to the value of $10,000 but is unsure which flooring type to choose, they should consider the depreciation deductions of each asset to help them decide which option will provide the best return.

By choosing to install $10,000 in carpets, the owner could claim a $2,000 deduction in the first full financial year. Floating timber floorboards would entitle the owner to a $1,333 claim and tiles would attract a $250 depreciation claim.

3. After work is completed

After a renovation has been completed, investors should contact their Quantity Surveyor to update their Capital Allowance and Tax Depreciation Schedule.

The updated schedule should detail the depreciation deductions available for all newly installed plant and equipment assets or capital works expenditure as well as any remaining original assets.

Depreciation case study

1. Before and after depreciation scenario

The additional income received from a depreciation claim can make a huge difference to an investor's cash flow.

Below is a basic property scenario to demonstrate the difference depreciation can make to an investor who bought a brand-new property. The following scenario is based on an investor who falls within the 37 per cent tax bracket. Please note that results will vary based on an individual's circumstances.

Brand-new two bedroom unit priced at $625,000			
Scenario without depreciation claim		**Scenario with depreciation claim of $14,010**	
Annual income	$43,750	Annual income	$43,750
Annual expenses	$40,220	Annual expenses	$40,220
Pre-tax cash flow (income - expenses)	$3,530	Pre-tax cash flow (income - expenses)	$3,530
Cash flow position	$3,530	Tax position (Cash flow - depreciation)	-$10,480
Tax expense (pre-tax cash flow x tax rate of 37%)	$1,306	Tax refund (Tax position x tax rate of 37%)	$3,878
After tax cash position (pre-tax cash flow + tax expense)	$2,224	After tax cash position (pre-tax cash flow + tax refund)	$7,408
Cash flow position per week	$43	Cash flow position per week	$142
Depreciation difference = $100 per week			

The depreciation deductions in this example have been calculated using the diminishing value method.
The example is based on a brand new property and is therefore not affected by the 2017 legislation changes.

Table 19.2 Before and After Scenario Contrasting Differences Without & With Claiming Depreciation

Without depreciation, the investor will be required to pay $1,306 in taxes for the property. As a result, their yearly cash flow position after tax is $2,224 or $43 per week. Simply by claiming depreciation, the investor's yearly after-tax scenario is improved to $7,408 or $142 per week, an increase of $100 per week. By claiming depreciation, the investor has more cash flow readily available.

Choosing between the prime cost and diminishing value method

The ATO allows investors to choose between two methods of claiming depreciation on plant and equipment assets. These are the diminishing value and prime cost method.

Both the diminishing value and the prime cost methods claim the total depreciable value available over the life of the asset. The two methods use different formulas to calculate depreciation deductions, achieving different short and long-term cash flow positions for the property investor.

Under the diminishing value method, the deduction is calculated as a percentage of the remaining deductible balance. The formula to calculate depreciation using the diminishing value method is shown below.

Diminishing value method				
Properties settled pre 10th May 2006				
Opening un-deducted cost	x	$\frac{\text{Days owned}}{(365)}$	x	$\frac{150\%}{\text{asset's effective life (in years)}}$
Properties settled on or after 10th May 2006				
Opening un-deducted cost	x	$\frac{\text{Days owned}}{(365)}$	x	$\frac{200\%}{\text{asset's effective life (in years)}}$

Note: on average this change will increase the rate of depreciation by 33%

2016_TA641

Figure 19.3 Formula to Determine the Diminshing Value Method of Depreciation Deduction

Under the prime cost method, the deduction for each year is calculated as a percentage of the cost. The formula to determine the depreciation deduction under the prime cost method is shown below.

Opening un-deducted cost	x	$\frac{\text{Days owned}}{(365)}$	x	$\frac{100\%}{\text{Asset's effective life (in years)}}$

2016_TA342

Figure 19.4 Formula to Determine the Prime Cost Method of Depreciation Deduction

Investors must consider their individual investment strategy when determining which method is the best choice for them.

If an investor makes their claim using the diminishing value method, they are claiming a greater proportion of the asset's cost in the earlier years of ownership, therefore receiving greater deductions in the earlier years of owning the property. Alternatively, by selecting the prime cost method, the investor is claiming a lower but more constant proportion of the available deductions over a longer period.

Investors should seek advice from an Accountant when choosing a depreciation method. The Quantity Surveyor should provide a Capital Allowance and Tax Depreciation Schedule which outlines the depreciation deductions available using both of these methods for comparison.

Using low-value pooling and immediate write-off

Low-value pooling is a method of depreciating plant and equipment assets at a higher rate to maximise deductions sooner.

The following categories of assets can be allocated into a low-value pool to increase a property owner's cash return:

Low-cost assets: a low-cost asset is a depreciable asset that has an opening value of less than $1,000 in the year of acquisition.

Low-value assets: a low-value asset is a depreciable asset that has a written down value of less than $1,000. That is, the value of the asset could have been more than $1,000 in the year of acquisition, however the remaining value after the previous years' depreciation claim is less than $1,000. Assets meeting this classification are placed in an itemised, low-value pool. An example could include a hot water system valued at $1,100 at acquisition. In the second financial year of ownership, the asset would have depreciated to a written down value less than $1,000, which would make it eligible to be placed in the low-value pool.

Property investors who place assets in the low-value pool can claim them at a rate of 18.75 per cent in the year of acquisition. Utilising the diminishing value method of depreciation, from the second year onwards the remaining balance of the item can be claimed at an increased rate of 37.5 per cent. This rule allows for an increased depreciation deduction on qualifying assets.

Residential assets which form part of a group with a total cost exceeding $1,000 can cause confusion. For example, if a house has a set of six blinds costing around $3,000 it would seem that the set does not qualify for the low-value pool. However, these blinds can be depreciated at a higher rate as they qualify for the low-value pool as individual items.

Earn more now using Pay as You Go

One method that property investors can use to improve the cash flow from their investment property is a Pay as You Go (PAYG) withholding variation.

The PAYG method of tax collection was introduced in July 2000 and replaced previous versions of the same system, such as Pay as You Earn (PAYE). The PAYG system allows investors to take advantage of deductions more regularly, rather than in one lump sum after the end of the financial year.

The PAYG withholding variation estimates an investor's expected tax refund for the financial year and allows their employer to take less tax out of their wages or salary. An Accountant usually organises the PAYG variation by submitting estimated financial information to the ATO. This can be done at any time during the year. For property investors, the tax liability is reduced based on anticipated deductions such as interest, maintenance, rates and depreciation on a rental property.

Once a request has been made, the property owner's employer will reduce the amount of tax withheld, therefore increasing their take-home pay in each wage or salary payment.

Importantly, submitting the PAYG withholding variation does not replace a normal tax return. A tax return must still be filed at the end of the financial year to calculate tax liability.

By obtaining a depreciation schedule immediately after purchasing an investment property, investors can maximise returns immediately through the PAYG withholding variation.

A PAYG withholding variation provides added flexibility for property investors by freeing up extra money throughout the year. This also provides an opportunity for property owners to invest the extra money or reduce loan liabilities.

Sharing wealth with a split depreciation schedule

Ownership structures influence how depreciation deductions are calculated. Properties with multiple owners can create a complex tax situation. A tax depreciation schedule can make life easier for investors and their Accountants by splitting depreciation deductions. This ensures claims are maximised for any percentage of ownership.

When applying depreciation legislation to assets for properties with multiple owners, the cost threshold depends on each owner's interest in the asset. For example, assets valued at less than $300 are usually written off immediately. In a situation where ownership is split, each owner can apply this rule and claim an immediate write-off for items where their interest in the asset is less than $300.

Similarly, when an owner's interest in an asset is less than $1,000, the item will qualify for the low-value pool. By allocating assets to the low-value pool, the rate of depreciation is increased. When there is more than one owner, the value of the asset is distributed based upon the percentages of ownership, which will increase the number of items each owner can place into the low-value pool, therefore increasing the rate of depreciation.

Property investors who place assets in the low-value pool can claim them at a rate of 18.75 per cent in the year of purchase, regardless of how long the property has been owned and rented. From the second year onwards, the remaining balance of the item can be claimed at an increased rate of 37.5 per cent.

In a 50:50 ownership situation, by splitting the owner's interest in each asset, the owners can claim items up to a total individual value of $600 as an immediate write-off. An asset that is valued or costs less than $2,000 will now qualify for the low-value pool and the owner can take advantage of the increased depreciation rates.

Summary

Here are some of the key points to remember about depreciation:

1. Most income-producing properties entitle their owners to claim depreciation.
2. Deductions can be claimed in two ways, as a capital works deduction for the wear and tear of the building's structure and for the depreciation of plant and equipment assets (any removable or mechanical assets within the property).
3. Residential property owners can claim capital works deductions on properties constructed post-1987. For commercial owners, properties attract a capital works deduction if they were constructed post-1982.
4. Owners of second-hand residential properties where contracts exchanged after 7:30 pm on the 9th of May 2017 cannot claim depreciation for previously used plant and equipment assets. They can claim depreciation for new plant and equipment assets they purchase for the property. Owners of second-hand residential properties where contracts exchanged before the cut-off date can claim a deduction for previously used plant and equipment assets.
5. Plant and equipment assets have an effective life as set by the ATO and the depreciation available for each asset is calculated based upon this.
6. If a property owner is considering renovating their property, they should obtain a tax depreciation schedule prior to completing any work. This will allow them to claim any remaining depreciable value of items scrapped during the renovation.
7. After a property is renovated, investors should contact their Quantity Surveyor to determine whether an updated schedule should be completed for all newly installed assets or capital works expenditure.
8. Choosing which assets to install during a renovation can impact the depreciation deductions available for the owner to claim in the future.
9. Claiming depreciation deductions makes a significant difference to a property investor's cash flow.

10. Making a depreciation claim is easy. Property investors should contact a specialist Quantity Surveyor who will arrange a site inspection of the property and complete a tax depreciation schedule for their Accountant to use when completing their annual tax return.
11. Investors can select from the prime cost or diminishing value method when claiming depreciation.
12. Using the diminishing value, an investor will claim more in the earlier years of owning the property.
13. Property investors who select the prime cost method will receive deductions at a steadier rate over time.
14. Low-cost assets and low-value assets can be added to a low-value pool and depreciated at a higher rate to maximise depreciation deductions.
15. A low-cost asset is a depreciable asset that has an opening value of less than $1,000 in the year of acquisition.
16. A low-value asset is a depreciable asset that has a written down value of less than $1,000. That is, the value of the asset is more than $1,000 in the year of acquisition, however, the remaining value after depreciating is less than $1,000.
17. Items under $300 can be immediately written off. Some examples may include garbage bins, garage door closers, bathroom accessories, heat light and exhaust units and smoke alarms.
18. If a property has more than one owner, investors can request a split depreciation schedule. This ensures claims are maximised for any percentage combination of ownership.
19. Rather than waiting until the end of each financial year, investors can choose to use Pay as You Go (PAYG) withholding variation to take advantage of their deductions more regularly.
20. The PAYG withholding variation estimates an investor’s expected tax refund for the financial year and allows their employer to take less tax out of their wages. By claiming depreciation, this will increase the expected refund and therefore reduce the tax taken out of an investor’s income.

About the Author

Konrad Bobilak - CEO and Founder of Investors Prime Real Estate

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Konrad Bobilak, the CEO and founder of Investors Prime Real Estate, has spent his entire career in the Financial Services, Banking, and Real Estate industries in Melbourne. Konrad's formal education consists of a Bachelor of Business Management (B.Bus.Mgt), at Monash University, specialising in Organizational Change, later undertaking further studies in Financial Planning, Mortgage Broking and his ultimate passion, Real Estate. In addition, he has extensive experience in Managed Funds, Risk Insurance, Real Estate Sales, Commercial Lending, Residential Lending, and Asset Finance, as well as being a Financier for one of the four major banks. In his variety of roles, working predominantly with high net worth individuals, Konrad has literally had a wealth of exposure to the unique mindset and financial structures of truly successful people and investors. It is his experience and insight that renders him a most astute investor himself, having personally built a multi-million-dollar property portfolio in Melbourne and Queensland over the last decade; he truly practises what he preaches.

Konrad's unique insights into 'Wealth Psychology' combined with a highly specialised knowledge of the Finance and the Real Estate Industry in Australia, have made him a sought after Real Estate and Finance key note speaker. Having taught tens of thousands of people in Australia, New Zealand, and Fiji, Konrad has had the unique opportunity of sharing the stage with the likes of Sir Richard Branson, Tim Ferris, and Randi Zuckerberg in audiences of up to five thousand people. Konrad has also been a regular contributor of articles to some of Australia's leading published real estate investing media. With real,hands-on experience in building start-up companies to multi-national, Konrad's unique balance of practical, in-the-field sales experience, first-hand depth of experience in finance and real estate knowledge, as well as executive management experience, has resulted in Konrad been one of the most sought after consultants in his field as well as being recognized by many as the one of the most progressive thinkers in the Industry at present.

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Investors Prime Real Estate is a boutique, specialist real estate company which sources premium properties located in Melbourne's Inner ring blue-chip suburbs.

As Investors Prime Real Estate was founded by property investors for property investors, we appreciate the importance of providing the very best performing residential property solutions to our clients, who are seeking properties that will deliver above market, high capital growth potential, over the medium to long term.

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