An overview of dealings with IRD and potential depreciation changes 2004 - 2006

APRIL 2004

VALUIT OBTAIN DIRECTION ON DEPRECIATION FROM IRD.

You may have become aware recently of murmurs in the media over potential changes to the depreciation regime. This has come as a result of a case that is currently being reviewed, between an investor and IRD. Valuit is assisting the investor's accountant in this case and we are working to get the issues resolved.

I have a column in the April KPI magazine which you may like to read but be aware we have made further progress since this article was written.

What are the proposed changes?

A local Auckland IRD office has raised a question over the interpretation of the depreciation regime and is arguing that items such as Electrical reticulation, Plumbing and other Building Fit-out items should not be allocated the higher depreciation rates as published in IRD publications. Instead these items should depreciate as part of the building structure at 4%.

Valuit has no objection to change, as change is a sign of progress. However the change must be for the right reasons. Since being involved in this case I have undertaken considerable research on how the depreciation regime is currently being utilised. I have seen areas that do need change but I believe the proposed IRD changes are the wrong changes and will cause confusion around the whole issue of depreciation.

What will these potential changes mean?

Some depreciation rates may decrease to 4%. This will not have a major impact on most investors. It will however reduce your short-term depreciation claim. If your plan is to hold the property long term it will simply mean that you will have a higher depreciation claim later in ownership. This change simply defers the claim to later in ownership.

Will we be penalised for what we have done in the past?

I believe not. In the case that I am involved in and subsequent clients that have had questions asked, penalties for an unreasonable interpretation have been waived. The interpretation that Valuit has been working to, is held by almost every professional that we have spoken with since the introduction of the new depreciation regime in 1993. We believe the IRD will struggle should they decide to penalise everybody, I'm sure this will get many thousands of people up and jumping. We also have correspondence from IRD accepting that their publications are unclear, infact the publications give no support to their interpretation, hence why we are all currently claiming depreciation as we are.

Where to from here?

In January this year I wrote to the IRD Commissioner asking for direction over how we should be claiming depreciation prior to a final ruling being made. The response from the IRD can be summarised as follows:

They have no indication as to when his may be resolved; it has already been in progress for several years. Therefore as investors we cannot simply ignore the issue of depreciation until a final ruling is made.

The local offices of the IRD have been directed to wherever possible avoid assessing cases until IRD head office have been able to complete a review of the issue of building fit-out being claimed at the published rates by residential property investors. If an assessment must be made the local office have been directed to use the 4% Building rate for items of Fit-out and investors will be able to request a reassessment should the decision go in favour of the current interpretation.

What should be included in 31 March tax return?

IRD has also given advice on this. They provided three options as follows:

OPTION 1
File their returns on a conservative basis (as per the advice set out in our IR 263 booklet) and wait for IRD head office to complete their review

OPTION 2
File their returns on a conservative basis and follow the disputes resolution process issue a Notice of Proposed Adjustment to the Commissioner;

OPTION 3
File their returns based the interpretation that has been held in the past. However you should be aware that unlike the first two options, this choice may expose taxpayers to the possibility of having shortfall penalties imposed. (Note: This is not a misinterpretation penalty and as mentioned above I believe IRD will have a hard time penalising all investors.)

Which option to use?

As Valuits expertise is in apportioning the purchase price and we are not accountants we have always advised that you to seek advice from a specialist property accountant prior to submitting any tax returns, and now is no different.

We have also notified a large number of accountants of the current situation and they will need to make an informed decision as to how they wish to treat this. Many do not see this as a major issue and the Accounting Institute would not at this stage, appear to have alerted their members or given any direction on this. Of the accountants we have had dealings with most would appear to be going for option 2 and 3.

I hope this helps clarify the confusion for you. Keep an eye on our website as we will be adding a section to keep you up to date with progress. We will also send you an email if there are any major developments.

Regards

Steve Tucker
Managing Director
Valuit Asset Appraisals Ltd

JULY 2004

What do the proposed Depreciation changes mean to you?

By Steve Tucker
Managing Director

What a couple of weeks it has been. Since the discussion paper was released I have been busy in meetings with Investors, Property Professionals and MP's discussing the impact this is going to have.

Put very simply the proposed changes will mean some depreciation rate changes. These rate changes will be in the form of reducing the rate for some items and therefore the depreciation in the short term. Over the long term the depreciation will be very similar. The result will be a reduction in cash flow for investors in the early years of ownership.

I have done some examples as part of a group of Professionals that is working together to inform investors of what is going to happen.

The graphs and table below will help to explain the effects on cash flow and here is an explanation.

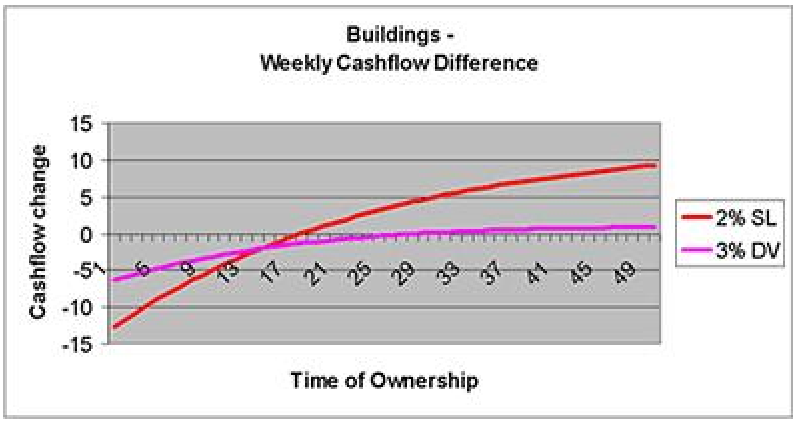
BUILDINGS

As an investor currently depreciating your $100,000 building at 4% Diminishing Value (DV) the depreciation is $4,000 in the first year.

The IRD proposes the depreciation rate to be 3%DV or 2% Straight Line (SL).

With the rate at 3% DV the deduction would be $3000 in the first year. Therefore, you would be approx $330 worse off or 6$ per week for cash flow in the first year based on a tax rate of 33%.

If you claimed the proposed 2% Straight line the deduction would be $2000 in the first and every year after. Therefore, you would be approx $660 worse off or $12 per week for cash flow in the first year based on a tax rate of 33%.

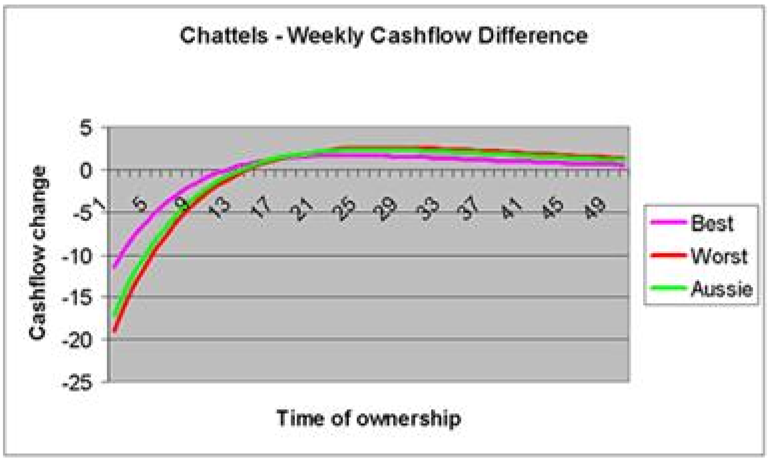


CHATTELS AND FIT-OUT

As an investor you can currently claim depreciation separately on fit-out and chattels. These are at various rates but on average work out to approx 10% DV. For Chattels and Fit-out worth $60,000 this would mean $6,000 in depreciation in year one.

We are unsure of what items exactly IRD will classify as building for depreciation but some of the items that we currently claim at increased rates will default back to the building rate as shown above. As we are unsure I have done two calcs. One based on a worst case scenario (larger number of items reduced to the building rate) and a best case scenario (Few items)
Under the best case scenario it is estimated that the average depreciation rate would drop from the current 10% to 7%. This would reduce your first year cash flow by approx $600 or $12 per week.

The worst case scenario would reduce the average depreciation rate back to approx 5% which would mean a reduction in cash flow of $1000 or $19 per week. A big drop.

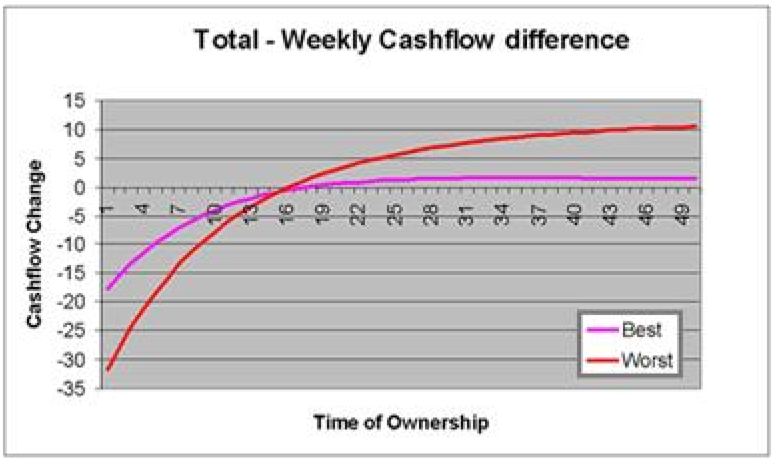


SUMMARY

These cash flows are only for the first year and the table and graphs show the effects over a longer period. The key for an investor is to have cash flow in the early years of ownership when expenses such as interest are high.

When you combine the reduced cash flow from the Building as well as the Fitout and Chattels the cashflow loss for you as an investor with $100,000 of Buildings and $60,000 of Fitout and Chattels would be $900 - $1,650 in the first year or $17 - $32 per week!

This would hurt you as an investor.



Best Case scenario cash flow change per year including Buildings, Chattels and Fit-out

	Year 1	Year 2	Year 3	Year 4	Year 5	Yr 10	Yr 15	Yr 20	Yr 30	Yr 50
$ Yearly	924	799	690	593	507	207	50	29	81	72
$ Weekly	17.77	15.38	13.27	11.40	9.75	3.99	0.97	0.56	1.56	1.39

negative value positive value

Worst Case scenario cash flow change per year including Buildings, Chattels and Fit-out

	Year 1	Year 2	Year 3	Year 4	Year 5	Yr 10	Yr 15	Yr 20	Yr 30	Yr 50
$ Yearly	1,650	1,449	1,267	1,102	954	397	56	158	386	550
$ Weekly	31.73	27.86	24.36	21.20	18.34	7.64	1.07	3.05	7.43	10.58

negative value positive value

Where to from here?

As investors it is a great idea to make a submission commenting on the discussion paper. For this I will be in contact again in the near future giving you a little more of a brief along with the details and address for submissions to be made.

The more we speak out the greater the chance of reducing the losses to cashflow.

AUGUST 2004

Hon Dr Michael Cullen
Deputy Prime Minister
Minister of Finance
Minister of Revenue
Leader of the House

SPEECH NOTES

Speech to Property Council of New Zealand

Thank you for your invitation to speak to you today on possible changes to the rules on property depreciation for tax purposes.

I am sure by now many of you will all have read the recent issues paper on the topic, "Repairs and maintenance to the tax depreciation rules".

While these are early days yet in the consultation process, there has been some public comment on the issues paper which I feel merits comment.

One of the more common responses has been that it is good the government is favouring investment in 'productive' activity such as electronics or machinery over 'non-productive' investment in buildings and other structures.

I personally doubt whether it makes sense to make too strong a distinction between productive and unproductive assets. When a firm purchases a machine to make shoes and this is seen to be productive, it still needs someone to build a roof and walls to provide shelter for the machine and its operators.

Those who argue that commercial and industrial buildings are unproductive have probably never tried producing goods and services in the rain, unless they are farmers, of course!

A better way to think about things, and the approach taken by the issues paper, is to ensure that our tax system neither encourages nor discourages particular types of investment, but instead allows investment to flow to where it gives the highest pre-tax return.

The underlying idea is that in the absence of taxes, there would be incentives for investment to take place in the most profitable areas. It is undesirable for taxes to drive investment decisions. This approach should provide confidence to those investing because it provides more certain ground on which to make investment decisions.

Another common response has been to refer to the complexity of the issues paper. I can respond that one of the problems with tax is simply the incredible complexity of the issues that can arise when you look at them in detail - particularly when you start with a first principles approach, as my tax policy officials are wont to do.

The issues paper on depreciation was prepared by tax policy officials, rather than the government, so does take a very high-level, first principles approach. This has led to some mild criticism as to the proposals not having much detail. The reason is that the document does not make detailed proposals but simply suggests possible ways of reducing possible tax biases in the rules and resolving some of the practical problems with their application.

The paper is a first step in the policy-making process. Once submissions have been received, officials will report to me with their detailed recommendations, and at that point the government will consider how it will consult further to ensure the detailed design of any change is also open to scrutiny.

The goal of the writers of the issues paper is modest - they want to avoid having depreciation rates which are too badly wrong. We know is not possible to get tax depreciation rates absolutely right. We know that assets do not decline predictably in nice smooth curves till the last day of their economic lives, at which point they helpfully implode into a neat pile. But we have identified some areas where the rules may be able to be improved.

Officials have argued that the starting point for neutral depreciation provisions is getting depreciation rates as close as possible to measuring how assets would depreciate in the absence of any inflation. The problem is getting as close as possible to this outcome when there is lack of data on how assets actually depreciate.

Take the case of buildings, a topic which I suspect is dear to your heart. At present, depreciation provisions are set assuming that buildings depreciate smoothly to 13.5 per cent of their acquisition cost over their economic life. This converts to a 4 per cent diminishing value rate of depreciation for most buildings. Is this too high or too low?

Some would argue it is much too high. Most properties appreciate rather than depreciate, and of course this is a key reason why many choose to invest in property.

The fact that properties rise in value would not be grounds for denying depreciation deductions on property if appreciation were due to rises in land values, with the value of structures falling over time. But it is difficult to identify changes in value that are attributable to land and those that are attributable to buildings.

If one looks at the specific example of residential accommodation and examines rateable valuations, it appears that in recent years not only has land risen in value, but the average value of structures has increased. Moreover, this increase has been considerably faster than the rate of inflation as measured by the Consumers Price Index.

Looking at these figures, one might question whether buildings would fall in value in the absence of inflation. On the other hand, it is clear that, on occasion, buildings are destroyed to be replaced with newer buildings. Clearly, by this time, the buildings have fully depreciated.
One problem with rateable valuations data is that, over time, fancier new houses or additions and extensions to existing houses boost the average value of buildings.

In the absence of good available data on New Zealand property, one approach is to examine overseas studies. The United States Treasury, in a study carried out four years ago, suggests diminishing value rates for buildings in the range of 2 to 4 per cent.

Allowing buildings to be written off in a straight-line fashion over their economic life (currently estimated to be 50 years) would lead to straight-line depreciation of 2 per cent a year. The diminishing value equivalent would be 3 per cent a year.

Of course, there are always problems in relying on overseas studies. Officials are currently examining whether it is possible to examine rateable valuations data on buildings which have not had approvals for structural improvements - to test whether a 3 per cent rate would be the best possible rate.

The paper also considers the effects of inflation. In my view, the most surprising issue in the paper is the impact of even small rates of inflation on incentives to invest. With 2 per cent inflation and a 5 per cent cost of borrowing, an investment that depreciates at 50 per cent a year has to make a 4.95 per cent return to be a break-even investment. An asset that depreciates at 2 per cent a year needs to earn only a 4.16 per cent return.

Explaining this fact, and reducing the impact of inflation on investment decisions, drives much of the analysis in the paper. The outcome is interesting in that the 20 per cent economic loading, previously seen as a concession, is now seen as a tool in addressing inflation.

The issues paper suggests increasing the loading for shorter-lived assets and reducing it for longer-lived assets, to equalise the returns required from assets that have different economic lives.

The paper looks at a number of specific issues relating to the operation of the current depreciation rules. They include the powers of the Inland Revenue to make special tax depreciation rate rules, and the tax treatment of losses on disposal of buildings and other structures.

On this last point, the paper suggests allowing a loss on destruction of buildings when the destruction is 'involuntary' - say, as the result of a natural disaster such as a flood. It also sets out the arguments for and against allowing a loss on destruction of buildings when the destruction is voluntary. In principle, there is scope to do this, though there are concerns about the potential for tax abuse. Your organisation may have some very worthwhile views on the matter.

The paper examines the growing practice on the part of property owners to break buildings into sub-components for depreciation purposes. The focus is on rental housing, rather than commercial property, since the internal layout of a commercial building is often tailored to the specific requirements of the occupant.

Increasing numbers of owners are apparently separating out from the building components like electrical wiring, internal walls and plumbing. They are then depreciating these components at specified rates, which are higher, and using the building depreciation rate for the remaining shell.

This boosts the average depreciation rate. In principle, the more assets that are broken out and depreciated separately, the lower the depreciation rate should be on the remaining shell.

The issues paper suggests two possible ways of dealing with the practice of separating out the components of rental housing. Both include listing certain structural components - such as wiring, ducting, plumbing and internal walls - and treating them as part of the building. This would limit owners' abilities to boost their buildings' depreciation rates.

The first option is similar to Australian measures for rental housing. It would allow separate depreciation of non-core chattels and fixtures when they are separately identifiable assets and are listed and separately accounted for.

It would allow equipment such as hot water cylinders and air conditioning units to be depreciated separately, as well as items that are not part of the internal structure and can readily be replaced - such as carpets, curtains and light fittings.

A cost to taxpayers of this option is that they would need to have private valuations of such assets when they bought or sold properties.

The second option would involve fewer compliance costs. Owners could choose to depreciate non-core assets such as hot water cylinders and carpets at the building rate. Everything - building and non-core assets - would be treated as one big, composite asset.

This would remove any need for private valuations of assets when rental properties are bought or sold. Another advantage is that replacements of small items such as hot water cylinders could reasonably be thought of as repairs to the large composite asset, with there being greater scope for deducting expenses as repairs and maintenance.

These, then, are the main points covered in the issues paper, as they affect property owners.

The paper is part of the government's Generic Tax Policy Process, which builds consultation with affected taxpayers into the key stages of policy-making - long before any changes are legislated for. The reason for doing this is to achieve better, more effective tax policy. We try to get it as right as possible in what is a very complex area.

The government is not proposing changes to the depreciation rules just yet - instead we are soliciting feed-back on suggested directions of change. When submissions on the issues paper are analysed, officials will make detailed recommendations to the government.

The decisions that emerge from the process will be important ones that will probably affect everyone here today. For this reason, it is vital that your organisation and other interested parties tell us their views on the suggestions put forward in the issues paper - whether or not they are workable, practical, achievable or even sensible.

I understand that submissions have started to roll in, well before the closing date, so there is obviously a lot of interest in the subject and in the issues paper.

I look forward to reading your considered views on the matter.

Thank you.

Source: Inland Revenue Department, New Zealand - Policy Advice Division website.
http://www.taxpolicy.ird.govt.nz/index.php?view=312

SEPTEMBER 2004

PROPOSED CHANGES TO THE DEPRECIATION RULES

It is time to start writing submissions on the proposed changes to depreciation and the following is aimed to assist you in making a submission

THESE PROPOSED CHANGES WILL AFFECT YOU DIRECTLY AND WILL DECREASE THE CASHFLOW FROM YOUR INVESTMENT PROPERTY.

Unfortunately to give you an appreciation of the background this overview is longer than what we would like (but considerably shorter than the 114 page full discussion document!) We suggest ....

grab a coffee (or a beer/ wine),

have a read,

then draft your submission/ letter.

Note there is no right or wrong way to put a submission together. It can be as short as a one page letter. There is no form that needs to be completed with your submission.

The discussion document is just that - the Government want to know what YOU think about the proposed changes. The Valuit document is to get you thinking about the issues.

Your comments do count and can make a difference. If you do not provide your thoughts to the IRD they are likely to assume that you have no issue with what they are proposing!

THE MORE SUBMISSIONS THAT ARE MADE THE BETTER FOR ALL INVESTORS AND THEIR FINANCIAL ADVISORS.

The deadline for Submissions is 30 September 2004.

REPAIRS AND MAINTENANCE TO THE TAX DEPRECIATION RULES - AN OFFICIALS ISSUE PAPER

This is the discussion document that has been prepared by the Policy Advice Division of the Inland Revenue Department and the New Zealand Treasury. The full document can be found at:

www.taxpolicy.ird.govt.nz/publications/index.php?catid=2

The main part, which will affect you as investors, is Chapter 9 (page 95), which deals with “Tax Treatment of Rental Housing”.

The issues papers requests submissions on three specific issues:

1. Do major distortions arise from treating the structural components of a residential rental building as a single entity, and if so what are these distortions?

2. Should taxpayers who adopt the list approach be restricted to a slightly lower depreciation rate?

3. Are there better ways of defining the boundary between the building and other separately identifiable assets?

There are however three important points, which we believe, also need comment from investors:

A. Why do New Zealanders invest in "Residential Investment property"? Is it because of the depreciation advantages? Will these changes reduce investment in property?

B. What will investors do to counter the loss in income as a result of depreciation changes?

C. Why is the door being left open to penalise us?

A range of issues have been put forward in the discussion paper by the officials to which they have requested specific submissions on as noted above. In addition we have extracted a number of points from the Discussion Paper and added our comments (in small blue). Where we have wanted to emphasise a part of the Officials comments we have presented the information in purple.

A. Why do New Zealanders invest in "Residential Investment property"? Is it because of the depreciation advantages? Will these changes reduce investment in property?

New Zealand is a small, capital importing country. If we are to make the most of our opportunities and maximise growth, capital must flow to the most productive areas of our economy. In some cases, however, the tax depreciation rules appear to be distorting investment decisions towards tax-favoured but less productive investment.

Our starting point is recognition that in the absence of taxes, investment would flow to the most productive areas of the economy, maximising our welfare. Taxes, however, can distort people's decisions, with the result that lightly taxed activities will attract more investment, even though they have lower risk-adjusted, pre-tax returns than other investments. Correspondingly, that investment will be at the expense of investment in activities with higher risk-adjusted, pre-tax returns but which are more heavily taxed. *See reference below The outcome is, as a society, we are poorer and we have lower growth than otherwise would have occurred.

Example

> Rose has $100 to invest and has a choice between two investments for a year, both with the same risk. The first investment provides a 5 percent tax-free return. The second investment provides a 7 percent return but is taxed.
>
> As Rose has a 39% tax rate, her choice is between a 5 percent after-tax return from the first investment or a 4.27 percent after-tax return from the second. She therefore chooses the first investment.
>
> In the absence of tax, she would, of course, have chosen the second investment, which had a higher return.

It is not always about returns but more about what people know and understand. There is considerable education on property in the market from advertising, seminars, TV programmes and

Banks. On the other hand there is no real promotion in the market on the other types of investment. Is the reason that we invest in property all about depreciation? – No.

Research completed in 2002 on the net worth of New Zealand households* See reference below identifies the percentage of the population that own assets and the proportion of total asset value for a range of asset categories. Table 9.1 summarises the findings *See reference below.

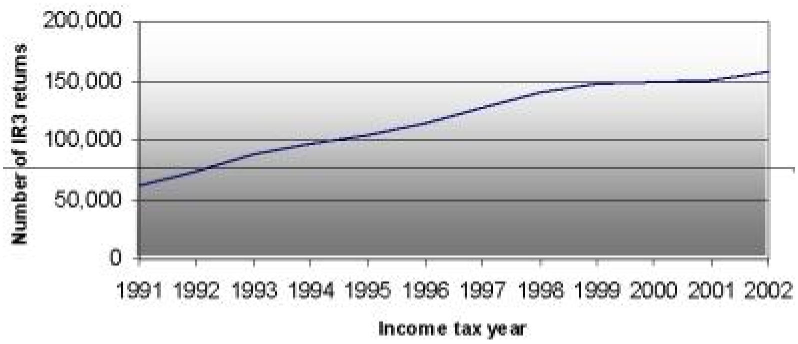
Table 9.1 Asset composition of economic units

	Population with asset (%)	Total value (million $)	Proportion of total asset value (%)	Median ($)
Maori assets	3	8,790	2	15,000
Trusts	4	28,709	6	216,000
Farms	4	Asset type	9	350,000
Businesses	12	38,574	9	43,000
House, living in	48	159,205	36	160,000
Time share	1	137	0	8,000
Holiday home	2	4,361	1	80,000
Rental property	6	18,887	4	135,000
Overseas property	1	4,194	1	40,000
Commercial property	2	7,343	2	150,000
Other property	4	9,863	2	95,000
Superannuation	21	24,737	6	25,000
Life insurance	14	8,797	2	15,000
Credit cards (positive balance)	3	95	0	500
Bank deposits (including bonus bonds)	91	26,000	6	2,300
Shares	21	13,986	3	5,000
Managed funds	9	11,864	3	23,900
Other financial assets	5	5,792	1	30,000
Money owed to respondent	8	3,835	1	5,000
Motor vehicles	77	16,871	4	8,000
Cash	3	191	0	1,600
Collectibles	25	6,857	2	5,000
Other assets	44	6,685	2	3,000
Total value		444,030		125,300

Only a small percentage of investors are professional investors. When you look at the median asset worth which an investor has in rental property compared to Shares, Managed Funds or Superannuation there is very little incentive to invest anywhere but property (even for young investors). Those investing in "residential" property are predominately those heading toward retirement who have discovered that they will have very little to retire on and need to do something for themselves. They also have plenty of equity in their own homes.

Figure 9.1 shows the numbers of taxpayers returning rental income between 1991 and 2002. Over the period, taxpayer numbers increased about 150 percent (or 95,000). The fact that more New Zealanders are now investing in rental properties increases the need for the tax rules for rental property to be broadly correct.

Figure 9.1: Number of taxpayers returning rental income



Property is what investors know. There is a need to save and it is an investment that we can see, drive past and manage ourselves. It is tangible.

Under Section 9.9 the officials note tax is only one consideration that influences decisions to invest in residential housing. A range of possible non-tax factors encouraging investment in rental housing includes - and a list is provided. What is missed off this list are the biggest reasons:

- There is plenty of education and mentoring for potential investors
- Banks are willing to assist landlords
- Safer than other investments (for example - Access Brokerage). People nearing retirement can not afford these types of losses.
- The individual has direct control over their investment
- It is easy
- The returns are relatively consistent.

B. What will investors do to counter the loss in income as a result of depreciation changes?

- One option is to increase rents, which will have an impact on tenants.
- Defer the replacement of chattels that need replacing which will lead to non-maintained properties and lower quality of living standards for tenants.
- When purchasing a new investment property the focus will be to ensure the desired yield is obtained. If the investor does not achieve this then they will not necessarily purchase that property but will look elsewhere. If the supply of new residential rental property does not meet the long-term demand for rental property this will also increase rents. It will dissuade private investors to provide housing stock at a time when the Government is looking to the private sector to provide additional residential rental housing stock. Particularly as more and more rental accommodation is required as New Zealand's home ownership rate declines.

C. Why is the door being left open to penalise us?

Given that this issues paper represents the start of the policy development process, it is too early to include any discussion on the possible application date of any reforms. This is especially the case in relation to the suggestions in the second part of the paper, which should be thought of as longer term possibilities only. In principle, we are of the opinion that, as far as possible, any changes should not affect existing investments. However, this would add to the complexity of transitional arrangements, and submissions are invited on the issue.

There are two exceptions, however, where there are strong reasons for any new rules to apply to investments that are in place at the application date of any new legislation. First, we are particularly concerned about the effects on investment in equipment. If faster depreciation rates for equipment are adopted, our view is that they should be available from the application date for all equipment purchased after the release of the issues paper, so that firms do not have artificial incentives to delay equipment investment.

The second exception is building fit-out for rental housing. Because some taxpayers have been using aggressive fit-out practices, we will recommend to the government that there be no "grandfathering" in this area should the change be implemented. This will not constrain the Commissioner from undertaking audit action for years prior to a change in law.

These so called "aggressive fit-out practices" have been implemented as a result of the instructions in IR260 as the "Process for finding the most suitable depreciation rate". This discussion paper in Section 8 concludes "We consider that the current tax depreciation rules already provide a number of steps for selecting the most suitable depreciation rate in respect of an asset, having regard to factors such as use in different industries". The officials state that no change is needed and yet they wish to hold it open for the Commissioner to penalise residential property investors for "aggressive fit-out practices" which simply follow the rules. There is no question over these rules and their interpretation for any other industry. Why should "residential property" be considered any different?

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1. Do major distortions arise from treating the structural components of a residential rental building as a single entity, and if so what are these distortions?

The officials have identified a number of specific problems:

"…. second problem is that an increasing number of residential rental property owners are claiming separate depreciation deductions for different parts of a building. Examples include separate depreciation deductions for electrical wiring, plumbing, hot water systems, carpets and internal walls. In principle, the more assets which are depreciated separately at rates that exceed the building depreciation rate, the lower the appropriate depreciation rate on the remaining shell . There is some uncertainty as to what assets can be depreciated separately, and this can lead to substantial differences in deductions claimed by two landlords with identical properties" .

This happens everyday in business. The more interest you have in what you are doing the more likely you are to understand what can and cannot be done, this will still happen regardless of the proposed rules. There was no uncertainty over what assets could be depreciated separately for almost 10 years, until the issue was raised by IRD. Investors and their financial advisors have followed the rules in IR260 for claiming depreciation. Confusion started with IR264; which was an overview for property investors and did not cover all of the rules and regulations regarding depreciation. This discussion paper accepts that there is no need for clarification of how the regime works but looks to introduce a completely different set of rules for "Residential" Investment property to those that apply to every other industry. Is this fair?

The officials suggest " …making the rules more certain by providing landlords with two options. Under the first option, a set of separately depreciable assets would be identified, as happens in Australia. These would include lifts, domestic appliances, hot water cylinders, air conditioning systems, light fittings and carpets. However, the set of separately depreciable assets would be limited".

This has caused confusion in Australia and is still not clear. We have a far more detailed and accurate system than Australia and this would be a step backwards. This will cause problems when there are assets in the property, which are not listed. An example of this would be the like of rural properties that may have some degree of machinery or equipment with them. If these items were not specifically listed how would they be treated? Under the current system the investor would be able to locate the depreciation rates for these items from the relevant industry or asset category and claim depreciation accordingly. Any list would have to be incredibly detailed and would still not be exhaustive – this is the very strength of the current system with industry and/or asset categories that can be used.

The officials continue to say "… and the remainder of the building – including wiring, plumbing and internal walls – would be depreciable at the building depreciation rate, as part of the building ".

Classifying some items such as electrical wiring as "buildings" will also cause confusion but certainly not as much as a separate list of chattels . This would however still be creating a new set of rules for

“Residential” property investors to any other industry. The current schedule is easy to follow and it is only the publication of IR264 which has caused confusion for investors, this would not be resolved with a new set of rules for one industry. Confusion would only create a myriad of enquiries for IRD.

As discussed in chapter 1, our goal is to ensure that effective tax rates are as even-handed and consistent across different forms of investment as possible. Any tax reforms ought not to be inconsistent or ad hoc when compared to the general tax system. Our starting position, unless there are good reasons to the contrary, is that the tax rules for rental housing should be consistent with the rules for rental of other buildings, the rules for business occupying their own building and the rules applying to other longer-lived assets.

We believe creating a separate set of rules just for “Residential” investment property will not be consistent. Creating a separate way of handling depreciation purely for one industry could be interpreted as discrimination against that one industry.

There appear to be two key ways in which investment in residential rental properties may be tax-advantaged. First, the depreciation rate on rental property and other buildings, more generally, may be excessive. Second, the growing practice of taxpayers splitting residential rental property into smaller parts is further increasing the overgenerous building depreciation rate.

These do not give over generous claims to investors. It is stated that the rules will not change for any other industry – the assumption being that they are working well. Why is that the rules only give bias to one industry? Representatives of Valuit met with IRD officials in April 2004 to highlight where the real problems are as far as giving bias to property owners. This bias can give some investors huge depreciation deductions above what would be expected, but has been ignored in this discussion paper. The proposed changes in this document will only defer depreciation claims. It will not correct or alter the fact that some investors are able to claim “excessive” levels of deprecation.

By breaking the building out into sub-categories (for example, claiming depreciation on electrical wiring, plumbing and internal walls), landlords are able to access higher depreciation rates and, in some cases, the 20 percent depreciation loading. Although it is accepted that there is some scope for identifying assets and depreciating them separately from the building itself, some of the parts or components currently being depreciated separately are arguably not separately identifiable assets.

What is the difference between residential and commercial? They are separately identifiable in a commercial situation but not residential and where will this separation begin and end? Is a house being used for offices residential or commercial? Is a serviced apartment block residential or commercial? An identical apartment block could be classified differently based on one being private owners and one being run as a serviced apartment and therefore having different rules.

The effect of this practice is to reduce taxable income. Although the legislation provides that depreciation is clawed back by Inland Revenue when the property is sold, taxpayers are able to enjoy the timing advantages, and in some instances these advantages are permanent. There is a clear argument where this behaviour occurs that the depreciation rate accorded the remaining components of the building should be lowered.

Inland Revenue’s interim operational view is the building depreciation rate is inclusive of structural items like electrical wiring and plumbing. Inland Revenue’s Tax Information Bulletin , Volume 5, No. 9 (February 1994) sets out the following view of what is an asset. *See reference below

If this is the case why are these assets even listed within the depreciation regime anywhere? This discussion paper will still allow these items to be separately identified for commercial property.

In better defining the law in this area, we are confining our attention to residential accommodation. The reason for treating residential property differently from commercial property is that changes to the structure or the layout are thought to occur less frequently than they do for commercial buildings.

What are replacement of kitchens and bathrooms, replacement of electrical wiring and other renovations in residences?

In addition, commercial buildings are used for a diverse range of activities. Often these activities may require additional or specialised structural components.

Is there any specific evidence of this? Residential property can also have specific requirements such as accommodation for the disabled (wheel chair access, wider doors as an example). The investment in residential property is a business, as is the investment in commercial property. As in any business your product must meet the requirements of the end consumer otherwise the business will not survive. In residential property the required end product is almost the same with regards to "additional or specialised structural components" with only slight differences between the end products offered (for example quality, number of bathrooms, number of bedrooms, apartment/ house/ unit). In commercial property the "additional or specialised structural components" will generally be the same depending on what your target end market is (for example office space, warehouse, retail). Within these target end markets the requirements will generally be the same with only slight differences between the end products. For example in office space, is it air conditioned, amount of available space, number of lifts).

2. Should taxpayers who adopt the list approach be restricted to a slightly lower building depreciation rate?

There is an argument that those who choose to list non-core chattels and fittings separately should be limited to a slightly lower depreciation rate. This is due to the inclusion of a wider range of assets, most of which will not have a 50-year economic life, being depreciated at more than the building depreciation rate. We invite submissions on this issue.

This we assume is based on the 4% rate supposedly being inclusive of these items when determined. Is there any evidence of this? The fact that items such as electrical and plumbing etc. are separately identified within IR260 and with different rates to the building would suggest that they were intended to be included separately.

3. Are there better ways of defining the boundary between the building and other separately identifiable assets?

We suggest making the rules more certain by providing landlords with two options. Under the first option, a set of separately depreciable assets would be identified, as happens in Australia. These would include lifts, domestic appliances, hot water cylinders, air conditioning systems, light fittings and carpets. However, the set of separately depreciable assets would be limited,

This has caused confusion in Australia and is still not clear. We have a far more detailed and accurate system than Australia and this would be a step backwards. This will cause problems when there are assets in the property that are not listed, This would happen regularly in area's like rural properties that may have some degree of machinery or equipment with them. If these items were not specifically listed how would they be treated? Under the current system the investor is able to locate the depreciation rates for these items from the relevant industry or asset category and claim depreciation accordingly. Any list would have to be incredibly detailed and would still not be exhaustive where as the current system details all assets – this is the very strength of the current system with industry and/or asset categories that can be used.

and the remainder of the building – including wiring, plumbing and internal walls – would be depreciable at the building depreciation rate, as part of the building.

Classifying some items such as electrical wiring as buildings will also cause confusion but certainly not as much as a separate list of chattels. This would however still be creating a new set of rules for "Residential" property investors to any other industry. The current schedule is easy to follow and it is only the publication of IR264 that has caused confusion for investors, this would not be resolved with a new set of rules for one industry. Confusion would only create a myriad of enquiries for IRD.

Currently within the depreciation schedule there are assets listed with a clarification that they are domestic i.e. "Washing machines (Domestic type) we believe this would be the answer. It would allow these items such as "Electrical wiring, Non-load bearing partitions, Plumbing to be listed as they are currently under "Building Fit out" but create a new listing with the suffix (Domestic dwelling – or similar) These items could then have a differing rate to that for commercial and even the same rate as the building shell if that proves correct. This would avoid all of the confusion that these proposed changes could potentially introduce.

Submissions

Your submission needs to be lodged by 30 September 2004, with direct reference to the discussion document, to:

Depreciation Review
C/- The General Manager
Policy Advice Division
Inland Revenue Department
PO Box 2198
WELLINGTON

Or by email:

policy.webmaster@ird.govt.nz

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*This change in investment patterns will cause the returns on investing in the lightly taxed activities to fall and the returns on heavily taxed activities to rise until, on a risk-adjusted basis, after-tax returns from investing in different sectors are equalised.

*The Net Worth of New Zealanders , Retirement Commissioner and Statistics New Zealand, 2002.

* Note that there may be some understatements of housing and rental investments owing to the use of trusts and companies for ownership purposes.

* This statement was provided in the context of repairs and maintenance, but it is also relevant to determining an asset for depreciation purposes.

February 2005.

Submissions for the review of the depreciation regime closed on 30 September 2004.

Other than a confirmation from the IRD that they had received our submission we have not heard how the depreciation review is proceeding.

With 31 March approaching some direction will needed to be provided by the IRD and we await this. In the meantime here are some questions and answers that have been asked by our clients.

Should we still get a chattel valuation completed on property we have purchased this year?

Yes. Under the review the IRD are looking to change some depreciation rates (both increase and decrease various rates) on some categories. The IRD are not looking to stop investors from claiming depreciation.

On what items should we be claiming depreciation?

The IR 260 and IR 264 tax guides detail what depreciation can be claimed on various assets. In the Discussion Document issued by the IRD they mentioned possible categories that may have their rates reviewed. Until a definitive decision is provided by the IRD we strongly recommend that you consult with your tax advisor/ accountant prior to submitting your tax return.

On what basis should our tax return be filed?

We strongly recommend that you consult with your tax advisor/ accountant prior to submitting your tax return. Them following is from advice that Valuit received from the IRD and posted on our website in April 2004.

What should be included in 31 March tax return?

IRD has also given advice on this. They provided three options as follows:

OPTION 1
File their returns on a conservative basis (as per the advice set out in our IR 263 booklet) and wait for IRD head office to complete their review

OPTION 2
File their returns on a conservative basis and follow the disputes resolution process issue a Notice of Proposed Adjustment to the Commissioner;

OPTION 3
File their returns based the interpretation that has been held in the past. However you should be aware that unlike the first two options, this choice may expose taxpayers to the possibility of having shortfall penalties imposed. (Note: This is not a misinterpretation penalty and as mentioned above I believe IRD will have a hard time penalising all investors.)

Which option to use?

As Valuit's expertise is in apportioning the purchase price and we are not accountants we have always advised that you to seek advice from a specialist property accountant prior to submitting any tax returns, and now is no different.

We have also notified a large number of accountants of the current situation and they will need to make an informed decision as to how they wish to treat this. Many do not see this as a major issue and the Accounting Institute would not at this stage, appear to have alerted their members or given any direction on this. Of the accountants we have had dealings with most would appear to be going for option 2 and 3.

MAY 2005

Change is Good …………Depreciation rates are changing!

We have always said that change is good, if it is for the right reason. In September last year we all had the opportunity to have our say against proposed depreciation changes that would have had major impact on Residential Property Investment.

Changes announced

Changes were announced at 2:25pm on Thursday 19th May 2005 as part of the Budget.

How bad were they? No where near as bad as had been anticipated.

The following is a copy of a paper that was released by Dr Cullen in conjunction with the announcements made in his budget speech.

Depreciation changes for better investment decisions

Changes to the tax depreciation rules will see new depreciation rates that better reflect how assets decline in value and reduce compliance costs for businesses. Current tax depreciation rates are likely to be too fast for buildings and too slow for short-lived plant and equipment, which can create tax biases that distort the structure of capital investment away from the best investment opportunities. To deal with any biases, depreciation rates for short-lived plant and equipment will increase and depreciation rates on buildings will reduce.
More neutral tax depreciation rules will mean that businesses have incentives to invest in assets that provide the best commercial returns. The changes will help businesses make better decisions about capital investments.

How will it work?

Improved tax depreciation rates to better reflect how assets decline in value

• Tax depreciation rates for short-lived plant and equipment will be made more consistent with those applying to long-lived plant and equipment. Rates for short-lived equipment will increase.

• Tax depreciation rates for buildings will reduce for buildings acquired from today. The new rates will not apply to existing building investments

Examples

Asset	Old diminishing value rate	Old diminishing value rate plus loading	New diminishing value rate	New diminishing value rate plus loading
Laptop computer	40%	48%	50%	60%
Appliances (domestic)	26%	31.2%	30%	36%

Metal detectors	22%	26.4%	25%	30%
Printing machines (rotary)	9.5%	11.4%	10%	12%
Buildings	4%	(no loading for buildings)	3%	(no loading for buildings)
Dams (concrete)	2%	2.4%	2%	2.4%

Reducing compliance costs for businesses

• To reduce some of the compliance costs to business from having to maintain fixed asset registers, the low value asset threshold will rise from $200 to $500. This will reduce the number of assets that businesses must annually account for on their fixed asset registers and the number of tax adjustments required when disposing of assets.

Example
A company buys a facsimile machine for $450 for use in its office. Under the current rules, the machine would be placed on the company's fixed asset register and tracked and depreciated over its five-year estimated useful life. Under the new rules, the company will be able to claim an immediate tax deduction for the entire purchase price of the machine. This will mean it will not have to track the asset on its tax fixed asset register.

Where to from here?

The changes are included in the Taxation (Depreciation, Payment Dates Alignment, FBT, and Miscellaneous Provisions) Bill, introduced today. Changes to the depreciation rate for buildings will apply to buildings acquired from today, while changes to the other depreciation rates will apply to assets acquired from 1 April 2005. The increase in the low value asset threshold will apply to assets acquired after today.

So what exactly does this all mean for Residential Property Investors?

In Summary

• Building Depreciation Rates to reduce
From 4% Diminishing Value
To 3% Diminishing Value

Effective for buildings purchase from 19 May 2005
(Not current properties)

• Rates for other assets to be calculated on the double declining balance method

This will mean that rates for all other assets will change, the great news is that they will go up!

Economic life (years)		2	3	4	5	6.66	10
Old Provisions	DV Rate	64%	50%	40%	33%	26%	18%
New Provisions	DV Rate	100%	67%	50%	40%	30%	20%

Economic life (years)		12.5	15.5	20	25	33.3	50%
Old Provisions	DV Rate	15%	12%	10%	8%	6%	4%
New Provisions	DV Rate	16%	13%	10%	8%	6%	4%

Example - Appliances were 26% now 30%
Effective for items purchased from 1 April 2005

• The cost at which and asset can be written off instantly has increased
From $200
To $500

This means anything purchased for under $500 can be claimed as an expense rather than having to claim depreciation.

Effective for items purchased from 19 May 2005

The Effects

We have worked through an example to show the comparison using rates from prior to the budget and the new rates.

Purchase Price	$295,000		
		Depreciation (year 1)	Depreciation (year 1)
Apportioned as		Pre Budget	Post Budget
Land	$105,892	~	~
Buildings	$119,471	$4,778	$3,584
Fit out & Chattels	$ 69,637	$6,942	$7,480
		$11,720	$11,064

Less depreciation claimed after budget - $656 or at 39% tax rate $255 more tax to pay

This is not bad considering the proposed changes could have hit investors with $800 - $1,800 more tax to pay on a similar property.

JULY 2005

EVEN MORE BENEFIT!

Well, changes to the depreciation rates have been announced in the 2005 Budget and these were covered in detail in the June 2005 issue of KPI.

Lets look at what it will do to your depreciation

The changes Summarised

- Building Depreciation Rates to reduce
  From 4% Diminishing Value
  To 3% Diminishing Value
  Effective for buildings purchase from 19 May 2005 (Not current properties)
- Rates for other assets to be calculated on the double declining balance method
  This will mean that rates for all other assets will change, the great news is that they will go up!

Economic life (years)		2	3	4	5	6.66	8	10	12.5	15.5	20	25	33.3	50	100
Old Provisions	DV Rate	64%	50%	40%	33%	26%	22%	18%	15%	12%	10%	8%	6%	4%	2%
New Provisions	DV Rate	100%	67%	50%	40%	30%	25%	20%	16%	13%	10%	8%	6%	4%	2%

Example - Appliances were 26% now 30%

Effective for items purchased from 1 April 2005

Examples

New property

Location: Dannemora Auckland
Age: New
Condition: New
Purchase Price: $445,000

		FIRST YEAR DEPRECIATION			
		USING RATES PRIOR TO BUDGET	USING RATES POST BUDGET		
	PURCHASE PRICE APPORTIONED AS				
LAND	$128,947				
BUILDING STRUCTURE	$176,280	$7,051.20	$5,288.40		
FIT OUT &		$23,084.50	$26,101.20		

		FIRST YEAR DEPRECIATION			
		USING RATES PRIOR TO BUDGET	USING RATES POST BUDGET		
	PURCHASE PRICE APPORTIONED AS				
CHATTELS INCLUDING					
Partitions (Non Load Bearing)	$46,097				
Electrical Reticulation	$10,114				
Telecommunications Cabling (Land Based)	$443				
Light Fittings	$2,680				
Furniture (Fitted)	$12,122				
Carpets	$10,603				
Tiles	$9,848				
Blinds	$3,780				
Plumbing Fixtures	$13,343				
Plumbing	$11,526				
Stove (Domestic Type)	$2,450				
Waste Disposal	$340				
Dishwasher	$1,000				
Ventilating Fan	$194				
Ventilating Fan (Roof Mounted)	$1,167				
Heater (Electric)	$450				
Water Heater	$1,536				
Smoke Detectors	$243				
Mirrors	$533				
Handrails	$340				
Burglar Alarm	$1,167				
Door (Roller Or Similar)	$875				
Motor (For Roller Door)	$486				
Clotheslines	$340				
Fences	$1,522				
Aerials (For Televisions)	$243				
Mailboxes	$194				
Driveways And Paths	$2,735				
Watering Systems	$3,402				
	$445,000				
	TOTAL FIRST	$30,135.70	$31,389.6	INCREASED	$1,253.9

		FIRST YEAR DEPRECIATION			
		USING RATES PRIOR TO BUDGET	USING RATES POST BUDGET		
	PURCHASE PRICE APPORTIONED AS				
	YEAR DEPRECIATION		0	DEPRECIATION	1
				INCREASED CASH FLOW (@39% tax rate)	$489.02

Older Property

Location: Glenfield Auckland
Age: 20 Years old
Condition: This property was in average condition at date of settlement, providing 3 bedroom accommodation. The property has been partially refurbished, this including window furnishings, some floor coverings and kitchen.
Purchase Price: $295,000

		FIRST YEAR DEPRECIATION			
		USING RATES PRIOR TO BUDGET	USING RATES POST BUDGET		
	PURCHASE PRICE APPORTIONED AS				
LAND	$105,829				
BUILDING STRUCTURE	$119,471	$4,778.68	$3,584.13		
FIT OUT & CHATTELS INCLUDING		$6,942.00	$7,480.00		
Partitions (Non Load Bearing)	$26,188				
Electrical Reticulation	$5,492				
Telecommunications Cabling (Land Based)	$166				
Light Fittings	$372				
Furniture (Fitted)	$1,492				
Carpets	$881				
Vinyl Flooring	$215				
Curtains	$1,858				

		FIRST YEAR DEPRECIATION			
		USING RATES PRIOR TO BUDGET	USING RATES POST BUDGET		
	PURCHASE PRICE APPORTIONED AS				
Blinds	$63				
Plumbing Fixtures	$5,514				
Plumbing	$5,311				
Stove (Domestic Type)	$441				
Water Heater	$340				
Handrails	$2,264				
Door (Roller Or Similar)	$741				
Motor (For Roller Door)	$278				
Decks	$2,837				
Clotheslines	$263				
Fences	$1,304				
Aerials (For Televisions)	$691				
Pavers	$760				
Mailboxes	$103				
Driveways And Paths	$4,882				
Retaining Wall (Wooden)	$3,466				
Air Conditioners (Split System)	$3,778				
	$295,000				
	TOTAL FIRST YEAR DEPRECIATION	$11,720.68	$11,064.13	DECREASE DEPRECIATION	$656.55
				DECREASED CASH FLOW (@39% tax rate)	$256.05

APRIL 2006

Changes to the depreciation regime arose from an officials' paper released in July 2004. The proposed changes were announced in the May 2005 budget.

Since the budget the Finance and Expenditure Select Committee has been reviewing the Bill. The process was drawn out due to the election in the middle of the process. The Committee has now made its recommendations back to parliament on the Bill and the recommendations have been accepted, the Bill passed through its final stages in Parliament on 22 March and it received Royal assent on 3rd April 2006.

The changes are as follows

Please note that where Plant and Equipment is referred to in the following text it equates to rental property Fit-out and Chattels.

Plant and Equipment purchased prior to 1 April 2005 and for buildings prior to 19 May 2005.
There is no change to the depreciation rates for these assets.

Plant and Equipment purchased after 1 April 2005.
The new formula for calculating the depreciation rates is known as a double declining balance. For plant and equipment with a short life basis this will increase the depreciation rate to apply. The effect of this to the investor is as the item is depreciated quicker they will get the use of this money sooner.

Note the Committee made one change that is intended to make this transition easier and reduce costs for tax payers with assets already purchased in the 2005-06 income year (they will not have to re-enter the new depreciation rates). The option is that the taxpayer may use the old depreciation rates for plant and equipment acquired in the 2005-06 income year and that the new depreciation method only be required for plant and equipment acquired from the beginning of the 2006-07 income year.

Buildings Purchased on or after 19 May 2005.
These buildings are subject to a new (decreased) depreciation rate. This rate is to apply from the 2005-06 tax year and subsequent years. Although the rate has decreased over the long term you will still be able to obtain the same amount of depreciation out of the building, it will just take slightly longer.

What if I had a binding contract to purchase in place before 19 May? Note if there was a binding contract for purchase or construction in place before 19 May 2005 then the rates to apply are:

Plant and Equipment : as if acquired before 1 April 2005.
Building : as if acquired before 19 May 2005.

Limited recognition for Associated Party transfers.
One change from that announced in the budget is that, in very limited circumstances, where buildings are transferred between associated parties after 19 May 2005 the current depreciation rates would apply. The only circumstances where this can happen are:

- Companies - transfers between companies that are 100% owned companies;
- Individuals - transfers of relationship property between husbands and wives or de facto partners (including same sex partners)

Change to the low value asset threshold.
This has been increased from $200 to $500 for items acquired on or after 19 May 2005. This allows a higher immediate deduction if the expenditure is a capital cost.

The Rates

The building depreciation rate has been reduced from 4% Diminishing value to 3%. - This is a 25% reduction and if an apportionment is not completed for an investment property this will have a major impact. The good news is that the rates for Fit-out and chattels have increased so some of the reduction in building depreciation can be offset. The following shows what the old and new rates are for Plant & Equipment (Fit-out and chattels)

Economic life (years)	Old provisions D.V. rate	Double declining balance (New rates) D.V. rate
2	63.50%	100%
3	50%	66.70%
4	40%	50%
5	33%	40%
6.66	26%	30%
8	22%	25%
10	18%	20%
12.5	15%	16%
15.5	12%	13%
20	9.50%	10%
25	7.50%	8%
33.3	6%	6%
50	4%	4%
100	2%	2%

Examples - what does it mean to our cash flow?

When you compare the depreciation using the old and new rates it actually means very little.

NEW PROPERTY		First Year Depreciation	
	Purchase apportionment	Old Rates	New Rates
Land	$ 128,947.00	~	~
Building	$ 176,280.00	7,051.20	5,288.40
Fit-out and chattels	$ 139,773.00	23,084.50	26,101.20
	$ 445,000.00	$ 30,135.70	$31,389.60
$ 1,253.90	MORE depreciation in year one		

OLDER PROPERTY	First Year Depreciation		
	Purchase apportionment	Old Rates	New Rates
Land	$ 105,892.00	~	~
Building	$ 119,471.00	4,778.68	3,584.13
Fit-out and chattels	$ 69,637.00	6,942.10	7,480.64
	$ 295,000.00	$ 11,720.78	$11,064.77

-$ 656.01	LESS depreciation in year one		

It isn't really worth worrying about!

There is still one unanswered question!

What items of Fit-out will IRD allow to be separated from the building structure?

Well this is a question that we have been searching for answers on for many years. When the officials paper was released in July 2004 it sought responses to many questions such as how building fit-out should be dealt with for investment property as well as the proposed rate changes to 3% for buildings and double declining for Plant and Equipment. In the 2005 budget the rate changes were announced and this is what we are talking about in this article. There was no mention of the building Fit-out issue.

There is still confusion over this and I am again pressing for answers. The Finance and Expenditure select committee that reviewed the Bill has also agreed to follow up on the building fit-out issue for me. I wrote to them in February explaining the situation and I have recently had a reply that they are looking into it and hope to have it resolved for us shortly. I have also written to a very prominent politician who is personally following up on the issue for me.

Hopefully we will have some answers on this one soon.

In the meantime happy investing and if you do incur issues with IRD over depreciation please let me know.

Steve Tucker
Managing Director
Valuit Asset Appraisals Ltd

MAY 2006

Yes, depreciation rules for Residential Property Investors will be changing.

Well Tuesday 23rd of May 2006 is a day I will remember for a while. Why? I fielded endless calls and enquiries after an email release from the Institute of Charted Accountants (ICANZ) alerted and subsequently confused people of possible changes to depreciation. Yes I think most of them then called me.

I was also confused after reading the email as it was a little unclear over the level of changes. The general understanding from the email has been that all items listed under "building fit-out" would be reduced to the building depreciation rate of 3%. This was not my understanding after communicating with ICANZ and IRD in recent weeks so I spent the day following up on this as well as taking enquiries.

At around 2pm I spoke with the "National Advisor of Technical Standards" from IRD and confirmed the following with him:

- He confirmed it will not be all items within the building Fit out category, only items that are permanently affixed to the structure such as Partitions, Electrical wiring, plumbing and vinyl flooring. There may also be a few other items. This is far more inline with what I was expecting.
- Official announcement from IRD is due some time this week.
- He also mentioned that the Issues paper prepared by Adjudications and Rulings in December 2005 will be turned into an Interpretation statement that can be expected in 4-6 weeks, with a couple of months to make comment. I was emailed a copy of this paper and within the conclusion of this it indicates the items that it proposes to reduce back to the Building rate of 3%. These are as follows;
    - "......that the plumbing/piping, electrical wiring, internal walls, internal/external doors, wardrobes/cupboards (built into the wall), bathroom and kitchen cupboards, linoleum, and wall and floor tiles of a residential rental building are part of the building itself and cannot be depreciated as items which are separate from a building, and should instead be depreciated at the same rate as the building."

The negative

- It will mean a reduced depreciation claim in the early years of ownership and that means an initial reduced cash-flow benefit. Reducing the depreciation rate simply means it takes longer to get the full depreciation claim it does not remove all the benefit. The positives are far greater.

The positives

- We will have confidence in knowing IRD's stance and can continue to maximise depreciation.
- With recent changes to the depreciation rates, being transferred to "double declining" all of the depreciation on chattels has increased significantly which helps to counter the reduced cash-flow due to the new rules, i.e.carpets did have a 33% depreciation rate which has increased to 40%.
- It has been indicated that there will be no penalties imposed for investors that have been claming the higher rate of depreciation on items now clarified as Building Fit out. The investor will be able to reduce the depreciation rate on these items when they file their next tax return. For those investors currently under review by the IRD we believe they will be given the opportunity to take up the IRD's approach to settle the matter.
- There is still considerable cash-flow advantage for most investors when depreciation is maximised.

The following table illustrates the cash-flow advantages still to be had by maximising depreciation. Remember these are year one advantages only and the benefits to cash-flow are achieved for the life of the asset.

Price	$295,000	$455,000	$246,500 (cost to build, no land)	$445,000	$130,000
Age	4 Years	20 Years	New	New	20 Years
Floor Area	175m2	270m2	170m2	175m2	80m2
Location	West Auckland	Tawa, Wellington	Hamilton	West Auckland	Hawkes Bay
Depreciation in year one					
Without Apportionment	$5,400	$9,550	$7,380	$7,825	$3,300
With Appotionment	$8,300	$15,400	$18,000	$19,000	$5,200
INCREASED DEP WITH APPORTIONMENT	$2,900	$5,850	$10,620	$11,175	$1,900
Year One Cashflow advantage @39% tax rate	$957.00	$1,930.50	$3,504.60	$3,687.75	$627.00

In the meantime if your accountant mentions the email from ICANZ please forward this onto them. My accountant database is postal rather than email so I'm holding off contacting them until the announcement has been made by IRD later this week.

Note at this stage we do not have the above in writing from IRD as their official announcement has not yet been made. From conversation with IRD we expect these points to be noted.

I'll keep you informed

Steven Tucker
Managing Director
Valuit - Specialists in depreciation