DOES IRD HAVE THE ANSWER YET?

It is now close to a year since IRD made a media announcement around changes to the depreciation regime, this was to be followed by an interpretation statement which has now been done. So does it give us an answer?

The "Interpretation Statement was released on Friday and although we now have some direction, it is not yet set in concrete and will not be for some time. This really doesn't help you when it comes to filing a return for a client with property. So what are the changes likely to be?

Submissions to IRD for comment are open until 31 March 2007 so please make sure you have your say.

WHAT DO WE KNOW?

- The building depreciation rate has been changed to 3% DV
- Plant, equipment, fixtures, chattels etc. have had depreciation rates increased

LET'S ASSUME IT GOES AHEAD!

- Some items in residential rental properties will be classified as part of the building for depreciation. Items indicated are; 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
- The "building fit-out" category may be deemed to only allow for separation of these assets if purchased separately to the building. **(No clear distinction has been made that this is to only apply to Residential and NOT Commercial property)**
- Additional items such as fences and clotheslines etc that are common with residential property and do not form part of the building may also be included in the "Residential Rental" depreciation category.

SO WHAT HAS LEAD TO THIS UNDERSTANDING?

The following are extracts from the interpretation statement and media statement, these give an overview of IRD's reasoning. Please take the time to review the entire Interpretation Statement and put your comments forward in a submission to IRD.

The "building fit-out" category may be deemed to onl*y allow for separation of these assets if purchased separately to the building.*

> "Following from the above analysis, the meaning of "building fit-out (when in books separately from building cost)" requires some **actual action** of fitting out, as well as being "in the books" (i.e. it is something that is physically done, rather than just existing items being re-categorised). It is considered that what was intended by the words was that such expenditures made subsequent to the acquisition of the property were by the owner or a tenant. However, such assets that would properly be considered part of the building under the "combined asset vs component assets" approach could still not be separately depreciated under the legislation. The words used in the introduction to DEP 1 and in the title of "building fit-out (when in books separately from building cost)" do not indicate that the "combined asset vs component assets" approach was irrelevant. The words used in DEP 1 appear consistent with those used in the depreciation legislation."

Some items in residential rental properties will be classified as part of the building for depreciation. Items indicated are; 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

> "The Commissioner concludes that the approach to determine whether a particular item is part of or separate from the building, is to assess the item's physical and functional status. Essentially, two inquiries have to be made.
>
> - **Physical separation:** Does the item look like it is physically a separate item from the building? How is the item "fixed" to the building? Can the item be removed and relocated somewhere else without difficulty?
>
> - **Functional separation:** Does the item do something that is different to the function of the building? Would the building be regarded as complete without the item?
>
> To decide whether the item should be treated as a separate item or as part of the building, requires legal analysis based on both of these two inquiries. If an item is a distinct physical unit and performs a separate function independent from the building, then it would be considered a separate item and depreciated accordingly. If the item is not a distinct physical unit, does not have a separate function and the building could be regarded as incomplete without that item, it will be part of the building and not depreciated separately."
>
> "The appendix to this statement contains examples illustrating how the Commissioner considers the tests would apply to some specific assets. While

the examples do not cover every possible item, they do give a practical application of the tests to some items. The assets covered are:

- plumbing and piping
- electrical wiring
- internal walls
- internal and external doors
- garage doors (when the garage is part of the residential rental building)
- wardrobes and cupboards (built into the wall)
- kitchen and bathroom cupboards
- wardrobes and cupboards (not built into the wall)
- carpets
- linoleum
- tiles (floor and wall)
- curtains
- blinds
- water heaters and hot-water cylinders.

The plumbing and piping, electrical wiring, internal walls, internal and external doors, garage doors (when the garage is part of the residential rental building), wardrobes and cupboards (built into the wall), kitchen and bathroom cupboards, linoleum, and tiles (floor and wall) are not separate assets, but rather are part of the building. Wardrobes and cupboards (not built into the wall), carpets, curtains, blinds, and water heaters and hot-water cylinders are items that can be regarded as separate from the building, so can be depreciated at a different rate."

WHEN WILL THE CHANGES TAKE EFFECT?

"Taxpayers who have been using the component approach will be required to add the value of the various "components" they have been depreciating individually into the cost of the building and also combine the depreciation claimed for those individual assets. This will identify the asset to be depreciated, the cost of that asset and the depreciation claimed to date. They should then use the building depreciation rate to claim depreciation for that asset.

Taxpayers will be required to take this approach from the first available income year (the earliest period for which no return has been filed or assessment issued).

Taxpayers will not be required to adjust previous income years. Should the asset be sold or leave the tax base for some other reason - such as a change in use - any depreciation that had been over-claimed as a result of using the incorrect building fit out depreciation rates will be corrected as a result of the adjustment required by section EE 41 of the Income Tax Act 2004.

For cases still under investigation, or proceeding through the disputes process, Inland Revenue will consider allowing the taxpayers to take up the

> Commissioner's approach to settle the matter. A taxpayer may of course decide not to settle and to take the matter through the disputes process if they do not agree with the Commissioner's treatment."

PENALTIES?

Every source I have spoken to has said no. This is backed up by the following that was part of the Media Statement made in May 2006.

> "Property owners who have been splitting these components out from the cost of the building will have overstated their depreciation claim in the past, but we won't be asking them to adjust previous years' income," says Miss Ferguson.

CONFUSION STILL REIGNS

To help yourself and investors we are changing our reports. We will reintroduce the depreciation rates we believe will be applicable. We will break the report into items we consider will be buildings, those we believe will still be considered at the higher rates and then a few items in the grey zone where you and the client can make the decision to claim at the building rate or the higher rate.

It does appear that most local IRD offices are following a directive that was given several years ago and disallowing all items that are not listed in the residential rental category. I would suggest this will be rectified once we have certainty from IRD.

There are still considerable benefits to cash-flow for property investors in claiming the depreciation they are entitled to.

There has been a lot of publicity around the proposed changes and some have moved away from claiming completely. The levels of depreciation will be reduced but there are still great benefits for most investors in maximizing their depreciation through a full apportionment or "Chattels Valuation". Let's be honest, in recent years investors have had it pretty good.

I have put a calculator on our website that estimates the depreciation levels on a worst case scenario so check it out. www.valuit.co.nz

EXAMPLE - *Worst case*
Purchase Price: $350,000
Age: 15 years
Land Value : $180,000

Year one depreciation
With apportionment: $7,416
Without apportionment: $5,040
ADDITIONAL $2,376

Over 5 years close to $8,000 additional depreciation is claimed, this does still have positive benefits on an investor's cash-flow!

Remember a detailed breakdown can also help to minimise recovery.

I hope this is of help to you. If you have any questions please feel free to email me at steve.t@valuit.co.nz

Submissions for comment are open until 31 March 2007. The following is a link to view the full document. http://www.ird.govt.nz/public-consultation/

Regards

Steve Tucker
Managing Director