# Depreciation – a detailed overview for a book publication

## The basics.

As you have an interest in property investment you may have heard the term "Chattels Valuation". Let's clarify the term "Chattels Valuation". I prefer to refer to it as a "Depreciation Apportionment" as what we are actually required to do by IRD is apportion the purchase price of your property into the various components and depreciation categories, this includes the land and buildings not just the chattels.

There are 3 main advantages that are marketed.

1. **Maximise Depreciation**
2. **Minimise Depreciation Recovery**
3. **Reduce risk of IRD penalties**

Let me explain what these mean to you.

First of all you need to understand what depreciation is. The technical term is "An allowance for wear and tear on an asset over its useful life" IRD is aware of this and therefore allow you to claim a $ amount of depreciation each year as an expense in your accounts. Just as paying the rates is an expense, so is depreciation. The difference is that paying the rates means you open your wallet. Depreciation is a non-cash expense it just happens year after year, no need to open your wallet. Claiming something as an expense in your accounts means that you do not pay tax on that expense.

Let's have a look at an example

| | | | |
|---|---|---|---|
| Rental income | $250 per week | | $13,000 per year |
| *LESS* Cash Expenses | (Insurance, rates, interest etc) | | -$10,000 per year |
| Income for the year | (physical income in your pocket) | $3,000 per year | |

Now lets also take into account the depreciation

| | |
|---|---|
| *LESS* Non-cash Expense (Depreciation) | -$8,000 first year |
| *TAXABLE* income for the year (What IRD taxes you on) | -$5,000 Tax loss |

This example means that you get $3,000 in your pocket for the year, or $57 per week (positive cash flow). However, when it comes to paying tax IRD calculates it on the amount after taking into account depreciation. You still get to keep the $3,000 but you have made a $5,000 loss for tax (negatively geared for tax). Now depending on your ownership structure, you may be able to apply this tax loss to your personal income. (Remember it is a non-cash loss, it hasn't actually cost you anything) Your salary of $45,000 may now be taxed based on a salary of $40,000.

The aim now is to **MAXIMISE DEPRECIATION.** The more depreciation you claim the less tax you pay and obviously the more cash you have in your pocket. As mentioned earlier IRD accepts that assets wear out over time and therefore reduce in value. Every asset lasts for a different period, hence why all assets have varying depreciation rates. Take the house structure for instance, IRD gives it a useful life of 80 years whereas carpets have a useful life of 5 years. The house lasts longer than the carpets and therefore carpets have a much higher depreciation rate. To maximise your depreciation you need to have the purchase price of the property split into every separate individual asset and then apply the correct depreciation rate. The house structure itself only

depreciates at 3% per annum until 1 April 2011 and after this date the depreciation claimable on buildings will be NIL. All of the other assets generally depreciate at 8% – 66.7%.

When you sell your property for a profit, as we all aim to do, IRD will suggest that because the property has been sold for a profit then there has been no depreciation. The simple fact is that most items wear out with use, hence why you were claiming depreciation. This is where you **MINIMISE DEPRECIATION RECOVERY.** By having a specialist chattels valuation/depreciation apportionment completed when you purchase the property you will have a detailed list of all the various assets and their individual values. This gives you a point to argue when you sell the property. If you had no idea of the individual values at purchase it would be impossible to argue that they had decreased over time and were now worth less at the date of sale.

You cannot afford to get things wrong when dealing with IRD, the penalty regime is far too harsh. The only way to **REDUCE THE RISK OF IRD PENALTIES** is to have a chattels valuation/depreciation apportionment completed by a specialist. If you find a valuer that will complete a "market valuation" of the property for finance and also complete a "Chattels Valuation/Depreciation Apportionment" for tax, ask them of their experience and qualification to be able to do this. There are two entirely different valuation methodologies used and they must be capable in both, this is very rare. Check out the chattels valuation experience of your valuer, IRD penalises you not the valuer.

# Current rules in detail.

Over recent years a couple of things have held many investors back from claiming their full depreciation entitlement, and accountants from recommending it.

1. Uncertainty over what IRD would allow to be separated from the building such as electrical wiring and plumbing AND
2. The thought of having to repay a majority of the depreciation through depreciation recovery when selling.

BUT these two hurdles have been removed leaving very little downside to claiming your full depreciation entitlement.

**Building Depreciation**

As was widely forecast in the May 2010 Budget the Government **removed the ability for property investors to claim building depreciation** commencing April 1 2011, **whilst still allowing the depreciation on Chattels and Fit-out**. The big benefit is that it removes the risk of being hit with a big depreciation recovery bill when you sell the property. In the past this has seen many investors claim little or no depreciation, but no longer. The chattels and fit-out can in most cases be proven to reduce in value and therefore recovery on these items will be removed or significantly reduced.

**Fixtures, fittings and chattels depreciation**

In April 2010 IRD released its Final Interpretation Statement on the "Tax treatment of Residential Rental property for Depreciation purposes", finally clearing the confusion surrounding what IRD considers to be part of the building for depreciation purposes and what can be claimed separately.

The Commissioner concludes that the approach to determine whether a particular item is part of or separate from the building, is to apply the following

- Step 1: Determine whether the item is in some way attached or connected to the building. If the item is completely unattached, then it will not form a part of the building. An item will not be considered attached for these purposes, if its only means of attachment is being plugged or wired into an electrical outlet (such as a freestanding oven), or attached to a water or gas outlet. If the item is attached to the building, go to step 2.three-step test:

- Step 2: Determine whether the item is an integral part of the residential rental property such that a residential rental property would be considered incomplete or unable to function without the item. If the item is an integral part of the residential rental property, then the item will be a part of the building. If the item is not an integral part of the residential rental property, go to step 3.

- Step 3: Determine whether the item is built-in or attached or connected to the building in such a way that it is part of the "fabric" of the building. Consider factors such as the nature and degree of attachment, the difficulty involved in the item's removal, and whether there would be any significant damage to the item or the building if the item were removed. If the item is part of the fabric of the building, then it is part of the building for depreciation purposes.

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

***What you need to do to comply with this interpretation statement***

- **For properties you owned prior to 1 April 2011**

**For those investors that haven't had a breakdown of their assets into the various IRD categories on their latest purchases**, you need to think about this, because from April 1st 2011 you will have no depreciation. Consider having a depreciation apportionment completed on those properties purchased in the past few years.

**People selling properties** that have had chattel valuations completed in the past need to consider an exit report to help minimize depreciation recovery. The timeframe for this can be tight as we will need access to the property.

**For those of you that have had a depreciation apportionment completed** you need to ensure that items IRD considers to be part of the building, in line with the interpretation statement, are now being claimed at the building depreciation rate of 3% (Diminishing Value) and in April 2011 these will need to be adjusted to 0%, as well as the building structure. To determine if items are considered to be part of the building the 3 step process as detailed above need to be followed but in most cases this will include partitions, electrical wiring, pluming, plumbing fixtures, kitchen cabinets (fitted furniture), tiles, vinyl, garage doors, telecommunications cabling and some decks and canopies depending on the level of fixing to the building.

- **For purchases after 1 April 2011**

**When buying a property in the future make sure you take full advantage of your depreciation entitlements, it's all about increasing cash-flow.** The issues around depreciation recovery are now negligible and we have clarity from IRD around what can be separated from the buildings. Without an apportionment you will get NO depreciation from 1 April 2011.

# Getting the most out of your property.

**Land as a non-depreciable asset, how big an influence does it have?**

As mentioned in the previous section depreciation is based on what you pay for the property, therefore when you are having a depreciation apportionment (Chattels valuation) completed it will break the purchase price down into all of the various components as published within the IRD depreciation guide.

The key is held in the Land. Land is non-depreciable so obviously the lower the land component of your investment the greater your depreciation claim will be

The first calculation we perform is set by IRD and determines the split between Land and Improvements (The house, fixtures, fittings etc). To complete this calculation we are required to use a Land & Buildings valuation, this can either be a Rating valuation (as completed for rates assessment etc) or a Market Valuation as completed by a Registered Valuer (commonly known as a Registered Valuation). These two different valuations can have a major impact on your depreciation claim.

Put very simply, the calculation looks at the ratio between land and improvements then applies this ratio to the purchase price of your investment i.e. if the valuation shows a land component of 30% then approximately 30% of your purchase price will be land. Let's look at an example and see how the two valuations can have an effect.

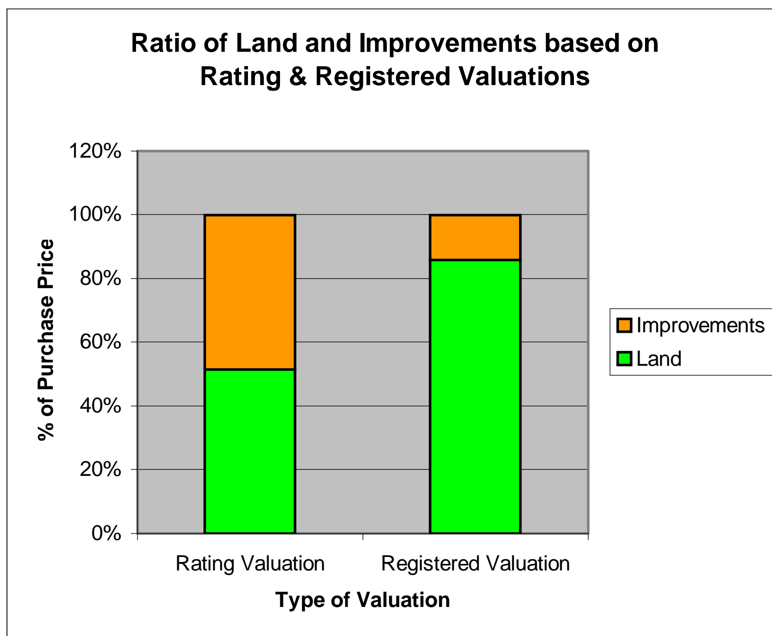
**Example**

**Purchase price -** **$650,000**

| | Rating Valuation | Registered Valuation |
|---|---|---|
| Land | 185,000 | 560,000 |
| Improvements | 175,000 | 93,000 |
| **Total** | **$360,000** | **$653,000** |

Which is right and which is wrong? This is a whole new debate. My response would be that the registered valuation completed for sale and purchase, would be far more accurate than the rating valuation. The rating valuation could also be up to 3 years old and things can certainly change over this time. For depreciation the accuracy of the total value is not what has the biggest impact, the important figure is the ratio of land and improvements.

Let's have a look at what these two valuations will do to your depreciation




Remember the key is the ratio between land and improvements as this ratio is then applied to your purchase price and determines the value of improvements which will be available to claim depreciation on. The above graph shows that in this example the Rating Valuation has a far lower ratio of land.

This results in over $200,000 difference in the value of improvements to which depreciation is then calculated. This will make a big difference to the depreciation claimed over the time of ownership.

**What if I plan to do renovations or improvements?**

Renovation done to the property prior to our inspection can cause problems. Depreciation is based on what you pay and therefore we are completing our apportionment of the property as at the date of settlement. As a result of this we must complete our inspection based on the property as it was prior to any renovations you have instigated.

If it is minor cleaning and painting there is no major issue as long as we are informed. If there has been replacement of assets such as carpets, lights etc. then this can cause problems. To enable us to complete the report in this instance we must have proof of what the asset was like prior to renovation/improvement. This could be in the form of photo's, video, or even the removed asset. We must ensure that we exclude these “new/replaced” items as they are in addition to your purchase price.

Any cost incurred in completing renovations must be provided to your accountant who will incorporate them into your accounts accordingly. This will also ensure that you get the correct write-offs for the items you have replaced.

**I’m looking to Build a house, how does this impact my depreciation?**

There are two payment methods usually used when building a house and both create different results from a depreciation perspective.

The first is paying a building contractor a ‘contract price’ to build the house on a piece of land. In this situation we apportion the contract price into the various asset categories. Your accountant must record any items that you have purchased over and above the contract price separately. These items are claimed for, based on your receipted costs.

The second situation is where you build the house and actually manage the project, paying individual contractors etc. In this instance your depreciation will be based on each individual invoice and it is a matter of allocating the invoices to the correct depreciation category. This can be done very simply by yourself and your accountant. Where you have paid for labour or items and do not have a receipt you will not be able to include these costs for depreciation.

**If I transfer the ownership of my property into another entity, does this effect my depreciation? (Associated Party Rule)**

The Associated Party rule is very important when you are transferring the property from one entity to another, say Private name into a Company. The Associated Party rule states “that depreciation must be based on the lower of, the original purchase price or the transfer price”. Generally the lower will be the original purchase price. In some circumstances Accountants can apply to IRD to have your depreciation assessed, based on the transfer price. This is something you must confirm with your accountant and then advise your Chattels Valuer of.

**What works best for depreciation NEW or OLD properties?**

Obviously with new property there is far more value in the fit-out and chattels as they have not started to depreciate. These items generally have a high depreciation rate due to their short lives so a majority of the depreciation and subsequent cash-flow advantage is when they are newer.

The following is an example of the depreciation on carpets over 3 years which illustrates how the depreciation on an item is far greater in year one when it is new than it is once it starts aging in years two and three.

| ITEM | NEW VALUE | YEAR 1 DEPRECIATION | YEAR 2 DEPRECIATION | YEAR 3 DEPRECIATION |
|---|---|---|---|---|
| Carpets | $10,000 | $ 4,000 | $ 2,400 | $1,440 |

I mentioned earlier the impact the land value has and what we have found is that with sections for new houses becoming smaller and smaller the land value as a ratio to Improvements is reducing giving additional benefit for depreciation.

So if you desperately need the additional cash-flow that depreciation offers then maybe you should consider a new property on a small piece of land in an unpopular area (to ensure low land values). Return on investment may be rubbish but your depreciation claim would be fantastic!

**Apartments ….. are they any better?**

I think when buying an apartment there are far more important issues to consider than depreciation. There are however a couple of positives from a depreciation perspective.

1. **Lower land Value**, because an apartment block has a large number of dwellings on a small land mass there is generally a lower value in Land as a ratio to Improvements. This means that for the value of your purchase your depreciation should be higher.

2. **Lower building structure component-** With apartment blocks there is often very little in the way of structure when compared to a house. This means there is often more value in the fit-out as a ratio to building structure, this is ey now that building depreciation is being removed from 1 April 2011.

**So what does buying blocks of units do to your depreciation?**

It does slightly escalate your depreciation in some cases, as the land value may be slightly lower in relation to the value of improvements in comparison to a single dwelling, but this is not always the case.

Once again it really comes down to the value of land.

# Creating your depreciation schedule

Any one can produce a depreciation schedule for your property including you. The key here is that anyone can increase your depreciation but the aim is to maximise your depreciation claim, this will have the greatest benefit to your cash-flow.

More and more companies are offering Chattel Valuations / Depreciation Apportionments, so is there a difference in reports, and how do you tell who's right and who's wrong when it comes to producing a report?

**Is there really any difference?**

***Reports -*** Most reports are very similar in appearance and in fact most have been modelled off companies who have been in the market from an early stage. Where the most important differences will often be are:

- the gathering of information at the time of inspection.
- quality of records kept.
- methods used for calculating figures.
- Understanding of IRD, their requirements and interpretations.

***IRD Rules –***Almost all property professionals and Valuers have interpreted the majority of the rules as we have, with some minor variances. The most obvious difference for an investor is in the

report. Depreciation is always based on what you pay and therefore we believe any report, for a property that has been purchased as a rental, should contain a full breakdown of the entire purchase price. This is to ensure that values are allocated fairly and to avoid the allocation of too much or too little value to individual assets. The report should therefore include a value on the land and buildings as well as the building fit-out and chattel items.

The key is to ensure that any company completing work for you is conducting research to ensure they are up to speed with rules and changes, ensuring your risk of filing incorrect returns is reduced.

**<u>Questions you need to ask.</u>**

- **Will they be visiting the property?** This really goes without saying but trust me some don't! Some simply use average percentages to determine values, i.e on average, 5% of the purchase price is in floor coverings etc. This inspection is specially important now with the three step process that IRD has introduced to determine if an item is able to be claimed separately. This cannot be done without inspecting the property.

- **Is the report a FULL apportionment of the purchase price?** If purchased as a rental property the report should be a full apportionment of the purchase price and list all components, including Land, Building Structure, Fit-out items (such as fnces) and Chattels items (such as carpets and curtains).

**<u>What they need to ask you.</u>**

- **Was the property purchased as a rental property or formally used as own home?** This will change the way the values are calculated as well as the way the report is presented so it is **crucial** that this is known. If the property was purchased, the settlement date will be the date at which the report is completed and if it was formally your own home it will be completed as at the date it became available for rental.

- **Purchase Price?** As depreciation is based on what you paid this will be required, unless the property was formally used as your own home.

- **Date of settlement?** If the property was purchased as a rental the settlement date will be the date at which the report is completed and if it was formally your own home it will be completed as at the date it became available for rental.

- **Details of any work or renovations completed by yourself?** Any report completed must be completed prior to any renovation or work by yourself or tradesperson. If work has been done, details will be needed so that this can be taken into account and excluded.

- **Transfer of ownership to a new entity?** If a property is transferred from one entity to another i.e. private name into a company or Trust, there are new rules that will apply and it must be confirmed with your accountant as to the best way to proceed.

- **Figures from the Rating or Registered Valuation?** This is required for the calculation to determine the split of Land from the purchase price. It is important that you are asked if you had a valuation completed prior to purchase as the most up to date valuation should be used, not just the rating valuation.

## Completing the report

Inspection and completion of the report should be carried out after settlement. This is to avoid any possible confusion with the values. This is not a market assessment of the total property, but an apportionment of the purchase price. There is a risk that if this is completed prior to settlement the report could be misconstrued by the financial lender as a Valuation for finance.

Depreciation rates should be included. Although not a requirement, this will just have to be done by your accountant who will then charge you. Rates used will be published rates at the time but make sure your accountant double checks to make sure IRD rules have not changed since the report was completed.

## What should the reports be used for?

Not insurance – the values are wrong for this.

Not Finance/ mortgage – the values are very wrong for this.

**Just depreciation!**