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

There are two ways in which the Land component of a property affects your depreciation.

Lets look at -

- Is the value of my property in the Land or Improvements?
- Does depreciation really occur? We generally buy a property and sell it down the track for more. Does everything go up in value?

The real key to both of these 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. Land is also a non-renewable resource. It is the demand for land and especially excess demand in desirable locations that is the major driving force in property price increases.

Before we begin, an update on Depreciation, IRD and the Government. There will be changes made to the depreciation regime over the coming years, when exactly who knows. The current case that is in progress between an investor and IRD is progressing very slowly as anticipated, with no developments recently. Dr Cullen announced in the Budget that there will be a review into Residential Investment property depreciation but we were already aware of this, so nothing new to report at this stage.

Is the value of my property in the Land or Improvements? 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 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 Registered valuation that you may have had completed to determine the market value of the property prior to purchase. 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. Lets look at an example and see how the two valuations can have an effect.

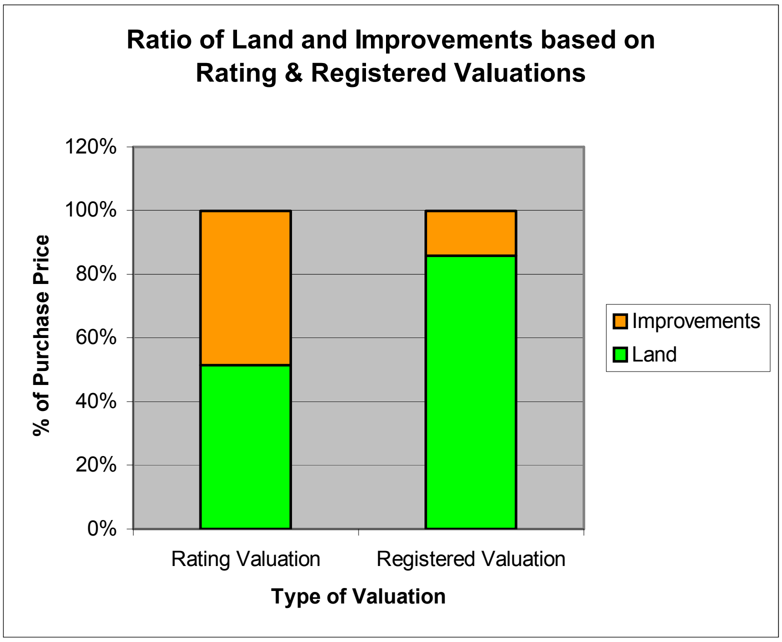
Example

Purchase price - **$650,000**

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

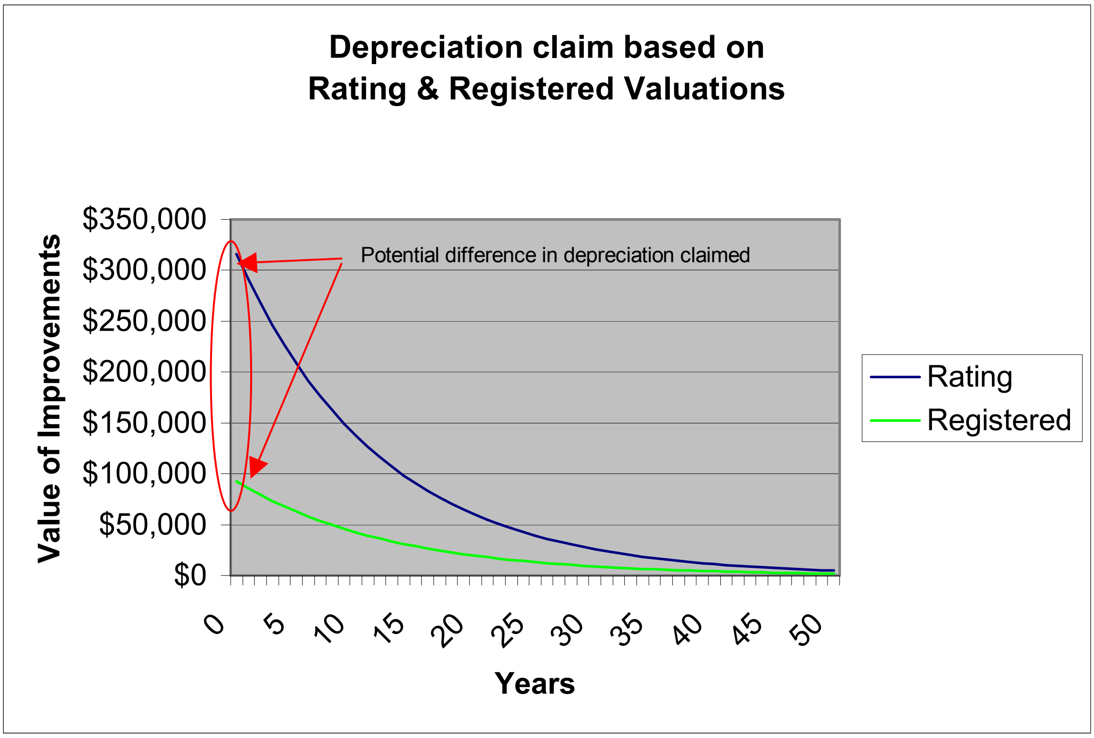
Which is right and which is wrong? This is a whole new debate. My response would be that the registered valuation completed for sale and purchase, would be far more accurate than the rating valuation. The rating valuation could also be up to 3 years old and things can certainly change over this time.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

Lets 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.

The graph below shows a potential difference in the value of the improvements when these ratios are applied to the purchase price. This results in over $200,000 difference in the value of improvements to which depreciation is then calculated. This will make a massive difference to the depreciation claimed over the time of ownership. So which one should be used? The correct valuation to use would be the one that is **most current** at the date of purchase of the property.



Hmmmm …….food for thought. How can there be such a difference in the Rating and Registered valuations which then results in huge variances in the depreciation which can be claimed. Perhaps this needs to be looked into in the review being conducted by Dr Cullen.

Does depreciation really occur? This is the second area that land value has a considerable impact on for depreciation. There is continual debate over depreciation and whether it should apply to property, as history has shown that property prices generally increase over time. As this is correct it is important to look at what component of the property has increased in value. Is it the land, improvements or a combination of both? The correct answer is often a combination of both.

Inflation and an increase in building costs etc. does mean that the cost to build a property will increase over time but we need to then determine if the asset wears out or depreciates at a faster rate than the rate of increase in building costs. For most items within a rental property this is a clear cut YES, the items will depreciate at a greater rate than inflation. An example of this is carpets.

Example

	Cost of carpet new	Depreciated value based on age and new cost
2004	$5,000	$3,350
2005 (Inflation say 3%)	$5,150	$2,311
2006 (Inflation say 3%)	$5,304	$1,595

This example shows that for items such as carpets with a low life span they will still depreciate at a faster rate than the growth or increase due to inflation. Depreciation has occurred!

On some other items with a longer life span such as the building structure, with a depreciation rate similar to the inflation rate, there could be questions over whether the increase in building costs has also meant that the second hand value has increased, surpassing the original book value at the date of purchase. However with inflation currently so low I do not believe this is a major factor.

What happens to the land value? As much as people would love to argue with me I strongly believe that the majority of the increase in property values is Land. It is simply supply and demand. Land is a non-renewable resource and it is the demand that people have to live in a particular location that causes property prices to rise at a rate considerably higher than inflation.

Lets look at it this way. If you have two identical dwellings, lets say 30 years old, on the same sized piece of land, one in Mangere Auckland and the other in Remuera Auckland, will the value be the same? Two identical properties but different locations. The answer is obviously No. People will pay far more for the property in Remuera as it is currently a favourable location. This can also be demonstrated by neighbouring suburbs, an example of this can again be seen in Auckland. Over the past decade Mt Eden had massive growth in Values as it became the place to be. What happened to neighbouring suburbs? They also increased but not at the same rate. These neighbouring suburbs are now seeing further increases as Mt Eden hits mass. The demand is not for the type of dwelling but the location or land position.

In an overly inflated market people may pay a very inflated price, above what a Residential Valuer would expect, this is surely “key money” that is being paid again for the location. It does not demonstrate an increase in the value of the dwelling or improvements.

Yes individual items within property do depreciate, they do clearly wear out over time. The majority of property value increase is due to the demand for the land or location.

Surely this is why Land is classified as a non-depreciable asset.

The influence that the Land value has from a depreciation perspective is huge.