Depreciation …… the basics.

As you have an interest in property investment you may have heard the terms "Chattels Valuation" and "Depreciation".

Before we begin let's clarify the term "Chattels Valuation". I prefer to refer to it as a "Depreciation Apportionment" as what we are 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.

Depreciation is all about cash-flow and as investors cash-flow is critical.

Basics

First, 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 an 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.

It's all about cashflow

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 let's 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 considering 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.

NOTE: this may change if the Government introduces "Ring fencing" of losses. These losses would then be held against the property and used to offset future profits.

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. From 2011 the house structure depreciation rate was reduced to 0% from 3. All of the other assets generally depreciate at 8% – 66.7%. per annum.

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.

Summary

Depreciation is an allowance for "wear and tear" and is claimed as a non-cash expense against the income you receive.

The aim is to **MAXIMISE DEPRECIATION.** The more depreciation you claim the less tax you pay and obviously the more cash you have in your pocket.

Depreciation is all about cash-flow and as investors cash-flow is critical.

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