Depreciation on Residential Investment and Commercial Property

“the missed opportunity”

VALUBOOK for Accountants Version 1 Mar 2019

Overview

This VALUBOOK is a step by step guide to help you identify if a specialist depreciation apportionment can be completed for your client. The result is accurate opening book values across the property that will ensure compliance with IRD requirements for your client and provide a positive impact on cashflow.

For you it's about peace of mind in knowing the assessment has been completed by experts.

The VALUBOOK compiles extracts from various IRD publications, and structures it to give you increased confidence in advising clients on property depreciation matters.

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Property Depreciation

Although the concept of depreciation is a common practice for accountants and business owners, there are many that are not maximising depreciation for Residential Investment and Commercial Property.

Extract from IR260 – Depreciation – a guide for business.

> Depreciation allows a deduction for capital expenditure, where a deduction wouldn't normally apply and acknowledges that the asset will eventually wear out or become outdated.
>
> For tax purposes, the reduced value of an asset is recognised by allowing a deduction against income for the depreciation of that asset from the time it is used in a business until it is sold, disposed of or discarded.
>
> This means the cost of the asset will be written off over its useful life. Once the whole cost price of the asset has been written off, no further deduction is allowed.
>
> When you calculate your depreciation deduction it's important to remember:
>
> - the date you acquired the asset, since this determines which rates are available to you
> - which industry and/or asset category best describes your depreciable asset.

Extract from IR260 – Depreciation – a guide for business.

> Although it's compulsory for you to claim a depreciation deduction, we recognise there can be instances where you may not want to.
>
> If you don't want to claim depreciation on an asset, and you want to avoid paying tax on depreciation recovered when it was not claimed, you should elect not to treat the asset as depreciable.
>
> You can't pick and choose the years in which you depreciate an asset. However, if an asset periodically will be and then won't be used in your business (such as a residential building that is temporarily let), you may choose whether or

not to depreciate the asset in each period. Our Rental income (IR264) guide discusses this option in more detail.

If you elect not to depreciate your asset, it will no longer be a depreciable asset and the depreciation recovery or loss on sale provisions won't apply to it.

It is important to note that special rules apply for the depreciation of buildings and property, continue reading.

Why is there confusion?

Many property professionals and owners mistakenly believe that with the changes announced in the IRD's Interpretation Statement IS 10/01 and the 2010 Budget that there will be no depreciation deductions available for property.

While this is true for the majority of properties for "building structure", depreciation is available on the "fit-out" component of the property as well as "plant & equipment".

We are several years on from these changes and yet many professionals and investors are unaware of the implications of these rule changes and more importantly, the substantial benefits that can be gained through claiming depreciation correctly.

Understanding Interpretation Statement IS 10/01 - Residential Rental Properties—Depreciation of Items of Depreciable Property

Extract from Interpretation Statement IS 10/01

Summary

This interpretation statement sets out the Commissioner's view on determining whether an item in a residential rental property is a separate item of depreciable property, or is part of the building. It concludes that if an item in a residential rental property is distinct from the building and it meets the definition of "depreciable property", it may be separately depreciated. If an item is part of the building, it cannot be separately depreciated, but can be depreciated with the building.

A residential rental property is comprised of several different items. It is important that the correct approach is applied to determine whether these items are regarded as distinct from or part of the building, because this affects the depreciation rate to be applied and the tax treatment of expenditure on repairs.

Sometimes different approaches have been taken in respect of the depreciation treatment of some items within a residential rental property. For example, questions have arisen as to whether items relating to the residential property (eg plumbing and piping, electrical wiring, internal walls, and doors) are to be treated as part of the building or as items separate from the building. The Commissioner considers that it is not correct to break down a residential rental property into such separate items for depreciation purposes. While this statement applies only in respect of residential rental properties, many of the principles are also likely to apply in the context of commercial properties and other assets.

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 three-step test:

> **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.
>
> **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.

Please note that although within the above summary it states, "While this statement applies only in respect of residential rental properties, many of the principles are also likely to apply in the context of commercial properties and other assets." It has since been clarified that this is not the case and only applies to residential property. This is covered in more detail below in "STEP 1 – Gain a greater understanding".

Understanding Budget 2010 – changes to property depreciation

Extract from Fact sheet - Building depreciation 21 May 2010

Building depreciation changes

What is changing?

- Depreciation deductions will no longer be allowed for buildings with an estimated useful life of 50 years or more, such as rental houses and offices.
- These rules will change for all such buildings from the 2011/12 income year. For most businesses they will be effective from 1 April 2011.

Why?

- Data indicates that, on average, New Zealand buildings do not drop in value over time. The current depreciation allowances therefore give a tax preference to owning property.
- The new rules will better reflect how buildings actually change in value and make the tax treatment of property fairer compared to other forms of investments. This will encourage productive investment in the economy.

Key facts

- These changes will affect landlords, property investors, property investment companies and some business owners, who can currently claim depreciation at 3 per cent (by the diminishing value method) or 2 per cent (by the straight line method) of the purchase price of their building.
- Building owners will still be able to claim deductions for repairs and maintenance, to maintain the condition and value of their properties. They will also still be able to claim depreciation deductions for "fit outs" not considered part of the building. The Government intends to review the treatment of commercial “fit out” and, if necessary, amend the rules prior to 1 April 2011 to address any uncertainty in this area.
- Building owners will be able to apply to Inland Revenue for a provisional depreciation rate if they consider a class of buildings, has an estimated useful life of less than 50 years.
- These changes will raise $685 million in 2011/12, rising to $690 million in 2013/14.

Depreciation loading changes

What is changing?

- Businesses will no longer be able to claim 20 per cent accelerated depreciation on new plant and equipment.
- This change will apply to assets purchased after Budget day. The old rules will continue to apply for assets purchased before this date.

STEP 1: Gain a greater understanding

- Residential
- Commercial
- Determining Depreciation rates
- Case studies

Residential Property

IS 10/01 concluded the following in relation to specific assets within a residential property when the "three-step test" is applied;

Extract from Interpretation Statement IS 10/01

> 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.

These assets as assessed by IRD were a sample only, and there are many more items that can be separated for depreciation. Initially, assets and depreciation rates should be separated in accordance with the IRD depreciation Industry Category "Residential Rental Chattels." Other assets that pass the "three-step test" can be separated and depreciated in accordance with the IRD depreciation categories for "Asset" classes or other "Industries" where assets are used in a similar way. Examples of assets that meet this criteria are Retaining Walls and Fences.

Commercial Property

In August 2010 the IRD and Treasury published an Issues Paper to address unintentional negative impacts of the 2010 budget changes on non-residential properties, and to propose legislation to implement the required law changes. These changes were confirmed by the Revenue Minister in a fact sheet released in December 2010.

The law clarifies that fit-out associated with commercial, industrial, recreational and certain short-term accommodation—motels, hotels, rest homes, some serviced apartments and hospitals, for example—are able to be separately depreciated. The items of fit-out that are separately depreciable are described in the Commissioner's "Building Fit-out" asset category. This lists over 90 items.

So, despite the removal of building depreciation, commercial property owners are still able to claim depreciation on building fit-out and plant, which includes, but is not limited to, items such as;

- **Partitions (non-load bearing)**
- **Electrical Reticulation**
- **Plumbing**
- **Light fittings**
- **Floor coverings**
- **Lifts**
- **Air-conditioning**
- **Fences**
- **Roller doors**
- **Fire alarm systems**

and much more.

The IRD states that the following items are part of the building and cannot be depreciated:

> "For a building with an estimated life of 50 years or more, the non-depreciable building core includes foundations, the building frame, floors, external walls, cladding, windows, external doors, internal stairways, the roof and load-bearing structures associated with the building such as pillars and load-bearing internal walls."

Determining Depreciation Rates

With Residential Investment Property many people mistakenly believe that only items listed within the IRD Industry category "Residential Rental Property Chattels" can be included for depreciation; this is incorrect. The following clarifies how depreciation rates are identified. For Residential property any item that passes the "three-step test" can be depreciated and we use the following process to identify the applicable depreciation rate. Fences are an example of this and are found in the "Building Fit-out" category.

Extract from IR265 – General Depreciation Rates

The depreciation rates are set out in industry and asset categories. Assets which are unique to one or two specific industries are listed under the industry category. Assets which are typically used in a variety of different industries (for example, tanks, boilers and heating) are listed under the asset category.

How to find the right rate

Follow this step-by-step process to find the right depreciation rate.

1. See the "Industry" category list in the contents pages. If there is an appropriate industry category for your industry and your asset is listed there, use that depreciation rate (either DV or SL), otherwise go to step 2.
2. See the "Asset" category list in the contents pages. If there is an appropriate asset category and your asset is listed, use that depreciation rate (either DV or SL), otherwise go to step 3.
3. If the asset is listed under an industry category (step 1) which isn't your main industry, and you use the asset in a similar way to the industry shown, use that depreciation rate (either DV or SL), otherwise go to step 4.
4. If none of the first three steps apply, use the default class from the appropriate asset category if the description of the default class is applicable to your asset.
5. If none of the first four steps apply, use the default class rate from the appropriate industry category if the description of the default class is applicable to your asset.
6. Where there is no appropriate listing for your asset under an industry or asset category, you can apply for a provisional depreciation rate.

You can search for a specific asset across all industry and asset categories using our depreciation rate finder at www.ird.govt.nz

Case studies

Residential - Newly built

Purchase Price:	$565,000
Age:	Newly Constructed
Condition:	Good
Chattels & Fit-out:	$41,317
1st Yr depreciation:	**$6,403**
Tax savings 1st Yr:	$2,113

Residential - Older Home

Purchase Price:	$584,338
Age:	50 Years
Condition:	Average
Chattels & Fit-out:	$29,114
1st Yr depreciation:	**$3,749**
Tax savings 1st Yr:	$1,237

Examples of residential and commercial properties from across NZ

Completed in the 3 months prior to publication

For residential properties - try out the online calculator:

www.valuit.co.nz/depreciation-the-detail/examples/

Residential - New apartment

Purchase Price:	$409,000
Age:	Newly Constructed
Condition:	Good
Chattels & Fit-out:	$43,865
1st Yr depreciation:	**$7,344**
Tax savings 1st Yr:	$2,424

Residential - Refurbished

Purchase Price:	$921,000
Age:	30 years
Condition:	Good - Refurbished
Chattels & Fit-out:	$40,313
1st Yr depreciation:	**$6,271**
Tax savings 1st Yr:	$1,881

Commercial - Offices

Purchase Price:	$2,304,348
Age:	12 years
Condition:	Good
Fit-out & Plant:	$395,439
1st Yr depreciation:	**$68,568**
Tax savings 1st Yr:	$19,199

Commercial - Office / Warehouse

Purchase Price:	$2,670,000
Age:	40 years
Condition:	Average
Fit-out & Plant:	$124,884
1st Yr depreciation:	**$17,233**
Tax savings 1st Yr:	$4,825

Commercial - Office / Retail

Purchase Price:	$1,818,000
Age:	60 years
Condition:	Average
Fit-out & Plant:	$81,979
1st Yr depreciation:	**$12,717**
Tax savings 1st Yr:	$3,561

Commercial - Refurbished Offices

Purchase Price:	$3,582,000
Age:	20 years
Condition:	Good - Refurbished
Fit-out & Plant:	$393,728
1st Yr depreciation:	**$54,817**
Tax savings 1st Yr:	$15,349

STEP 2: Will my client benefit from a specialised depreciation apportionment?

Use the following flow charts as a tool when talking with a client.

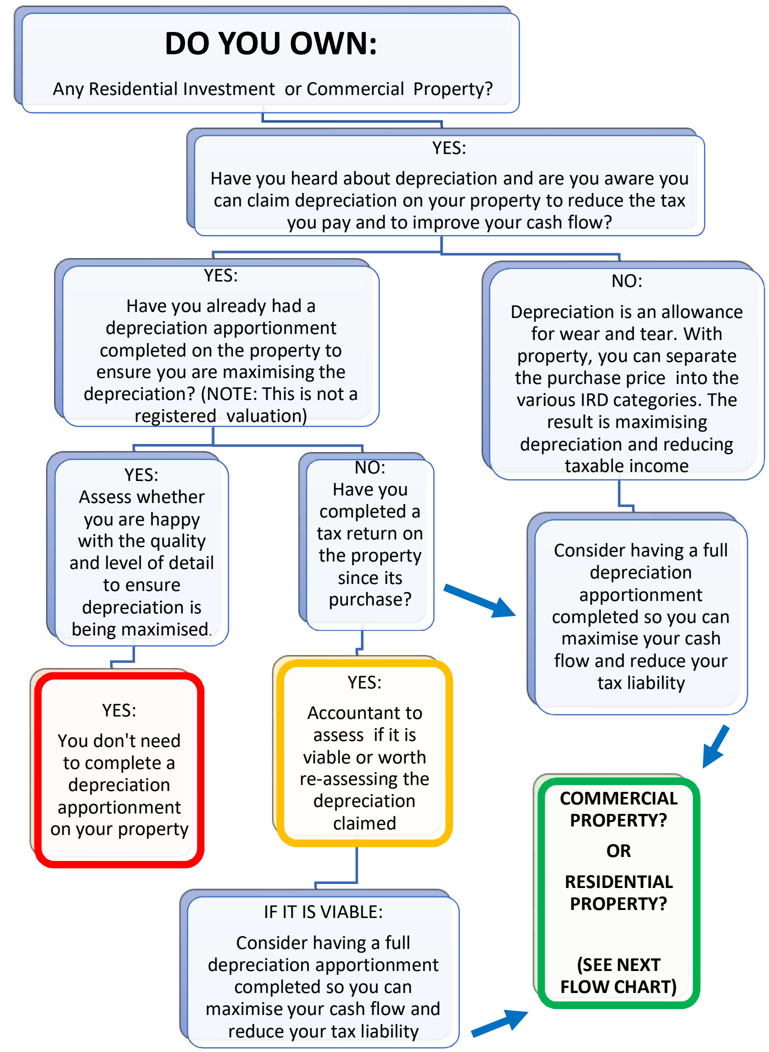
You may want to consider including this into your year-end questionnaire.

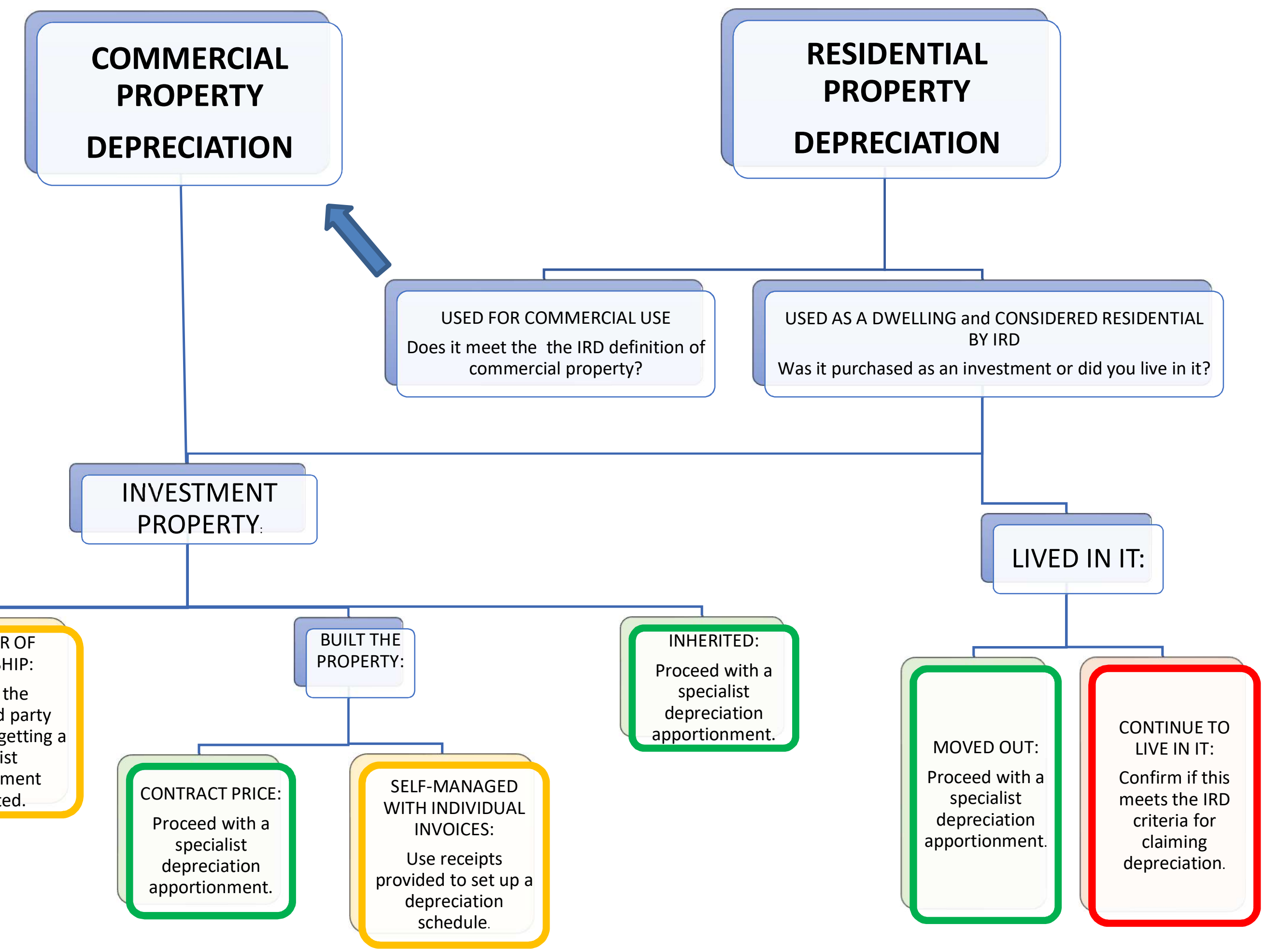
- ***Have you purchase any Commercial or Residential Investment property?***

Then simply talk them through the flow charts

It can be complicated due to all of the rules around property depreciation, but this is aimed at making it easy.

creating value through property depreciation




COMMERCIAL PROPERTY
DEPRECIATION
RESIDENTIAL PROPERTY
DEPRECIATION
USED FOR COMMERCIAL USE
Does it meet the the IRD definition of commercial property?
USED AS A DWELLING and CONSIDERED RESIDENTIAL BY IRD
Was it purchased as an investment or did you live in it?
INVESTMENT PROPERTY
LIVED IN IT:
NEW PURCHASE:
Proceed with a specialist depreciation apportionment.
TRANSFER OF OWNERSHIP:
Confirm the "Associated party rule" before getting a specialist apportionment completed.
BUILT THE PROPERTY:
CONTRACT PRICE:
Proceed with a specialist depreciation apportionment.
SELF-MANAGED WITH INDIVIDUAL INVOICES:
Use receipts provided to set up a depreciation schedule.
INHERITED:
Proceed with a specialist depreciation apportionment.
MOVED OUT:
Proceed with a specialist depreciation apportionment.
CONTINUE TO LIVE IN IT:
Confirm if this meets the IRD criteria for claiming depreciation.

STEP 3: Assess individual circumstances

- Associated Party Rule
- Inherited Property
- Holiday homes
- Commercial OR Residential?
- Insurance proceeds

The following details how and if depreciation can be claimed based on special circumstances that may apply to your client.

Associated Party Rule

Extract from IR260 – Depreciation – a guide for business.

Transferring depreciable assets between associated persons.

Under normal rules a purchaser is entitled to claim depreciation based on the purchase price of an asset. The new owner of a second-hand asset can claim depreciation based on the amount paid for the asset, as long as it's an arm's length sale where:

- the sale is bona fide and the purchase price is a fair market value for the asset
- the purchaser buys the asset for use in income producing activities and the seller no longer uses it for income-producing activities.

The fact the parties are related doesn't prevent depreciation being claimed. In the case of transfers of assets between associated persons (apart from assets transferred under a relationship agreement - see page 29) a restriction applies to the amount and rate of depreciation that may be claimed by the person acquiring the asset.

Depreciation on an asset is restricted to the base value of the asset purchased from an associate, being the lower of:

- the price the seller originally paid for the asset (or, if applicable, the market value of the asset at the time the associated seller was first entitled to depreciate the asset)
- the price paid by the buyer.

This applies unless we give written approval to use the price paid by the buyer. To grant approval, we must consider such treatment is appropriate in the circumstances.

Inherited Property

Extract from IR260 – Depreciation – a guide for business

If the property has been inherited, the cost price for depreciation purposes is its market value at the time the property is transferred to the new owner. The exception is for a spouse, civil union partner, or de facto partner where transfer is at cost or adjusted tax value.

Holiday Homes

Extract from IR260 – Depreciation – a guide for business

Where a holiday home is considered to be a "rental" property, depreciation may be claimed. The proportion of depreciation claimed on the assets will vary depending on the degree of actual rental time.

The facts of a particular case always need to be considered carefully and so it may be necessary to seek advice from a tax advisor before making any claim for depreciation or other expenses on a holiday home.

Extract from IR264 – Rental Income – Tax rules for people who rent out residential property and holiday homes

Special rules for mixed use assets, including holiday homes apply. These rules came into effect from the beginning of the 2013-14 tax year.

If, during the tax year, your property is used both for "private use" and "income earning use", and it's unoccupied for 62 days or more then you have a mixed-use holiday home. The rules don't apply if your property is a residential property used for long-term rental.

If you own a mixed-use holiday home, you might need to pay tax on the income you earn from letting it and apportion some of your expense claims.

Commercial OR Residential?

Extract from Income Tax Act 2007 – section YA1 Definitions

commercial building
means a building that is not, in part or in whole, a dwelling, unless use as a dwelling is a secondary and minor use

commercial fit-out means an item to the extent to which it is—

(a) plant attached to a commercial building, but not used inside a dwelling within the commercial building:

(b) attached to, and non-structural in relation to, a building, if the item is not used for weatherproofing the building and—

(i) is not used in relation to, and is not part of, a dwelling within the building; or

(ii) is used in relation to, but is not part of, a dwelling within the building, and the building is a commercial building

dwelling

(a) means any place used predominantly as a place of residence or abode, including any appurtenances belonging to or enjoyed with the place:

(b) does not include any of the following, in whole or part:

(i) a hospital:

(ii) a hotel, motel, inn, hostel, or boarding house:

(iii) a serviced apartment for which paid services in addition to the supply of accommodation are provided to a resident, and in relation to which a resident does not have quiet enjoyment, as that term is used in section 38 of the Residential Tenancies Act 1986:

(iv) a convalescent home, nursing home, or hospice:

(v) a rest home or retirement village, except to the extent that, in relation to a relevant place, it is, or can reasonably be foreseen to be, occupied as a person's principal place of residence for independent living:

(vi) a camping ground:

(c) despite paragraph (b)(iii) and (v), for the purposes of section CB 16A (Main home exclusion for disposal within 5 years) and the definition of **residential land**—

(i) includes a serviced apartment described in paragraph (b)(iii):

(ii) does not include, in whole or part, a rest home or retirement village

Based on these definitions and discussion with a number of accountants the consensus is that residential properties rented for short term use such as through AirBNB would meet the definition of commercial property for depreciation purposes.

Insurance Proceeds

Extract from IR260 – Depreciation – a guide for business

Damaged assets

You must take into account any insurance proceeds, indemnity damages or compensation payments you receive when an asset is damaged. If such payments exceed the cost of repairing the damaged asset, the surplus isn't a capital receipt but must be deducted from the adjusted tax value of the asset for depreciation purposes. If the result is a negative amount, that amount is considered to be gross income in that year.

Irreparably damaged assets are considered to be disposed of for a consideration of the amount of any insurance proceeds, indemnity payment or other consideration received in relation to that event or damage.

A full deduction is allowed for disposal costs, including demolition costs.

Lost or stolen assets

The loss or theft of a depreciable asset constitutes a disposal if the asset isn't recovered in the income year in which the loss or theft occurs.

Any insurance proceeds, indemnity payment or other consideration received in relation to the loss or theft of the depreciable asset is taken to be consideration received, minus disposal costs (where applicable), for the disposal of that asset.

This consideration for the disposal will then be used in calculating the gain or loss on disposal of the asset. If the lost or stolen asset is recovered in a subsequent income year, and is still owned and used or available for use in deriving income, the following assumptions apply.

- You're considered to derive gross income equal to any loss on sale deduction allowed in the previous year. The gross income will be considered to be derived either in the year of disposal or of recovery.
- You're considered to have acquired the recovered asset on the date it was retrieved at the adjusted tax value that applied at the beginning of the year of loss or theft.

STEP 4: Give direction on what's required

Once you have walked through the flow process with your client and assessed the individual circumstances, you will be in a position to advise them on your recommendation of whether they should consider seeking further clarity on the completion of a depreciation apportionment.

Referring your client to an expert in this area, such as Valuit, will ensure that further questions are asked, confirming that there will be sufficient benefits. Factors such as the age and condition of the property, details of the Rating or Registered Valuation, and ownership of fit-out will all have an impact on the potential benefits.

STEP 5 : Incorporate depreciation schedule into Accounting system

The final step is to incorporate the individual assets "opening book values" into the depreciation schedule and ensure this is updated as part of the normal accounting process.

A depreciation apportionment report will provide opening book values and depreciation rates for all assets across the property.

The report will be a breakdown of the property purchase price and will be effective as at the date of settlement.

It is as simple as that. Don't let your client miss the opportunity!

Ensure every client that has purchased property is maximising their depreciation, the benefits are substantial!

Important Notes

This publication is intended as a resource to assist accountants with understanding the rules around property depreciation. This is not an exhaustive guide and VALUIT insists that before advising clients on property depreciation matters you are clear on IRD requirements.

VALUIT has been in operation since 1998 and has specialised in depreciation apportionments for property owners since inception.

VALUIT completes apportionments in accordance with IRD requirements and utilises valuation principles.

Key resources used in compiling this VALUBOOK are as follows;

- *IR260 – Depreciation – a guide for business*
- *IR264 – Rental Income – Tax rules for people who rent out residential property and holiday homes*
- *IR265 – General Depreciation Rates*
- *Interpretation Statement IS 10/01*
- *Fact sheet - Building depreciation 21 May 2010*
- *Income Tax Act 2007 – section YA1 Definitions*

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