Just a bit of Baloney

The Depreciation Changes

Spot the Difference

Not Much So Let's Do the Numbers

Tyron Hyde from our friends at Washington Brown has written an update on the depreciation changes proposed in the 2017 Federal Budget. CLICK HERE for Tyron's full post.

We thought it would be a good idea to expand on his summary and provide some examples of how the changes may affect our property investor clients. Tyron notes 9 key points from the draft changes that we don't disagree with (mostly):

1. *If you acquire a second-hand residential property which contains "previously used" depreciating assets, you **will not** be able to claim depreciation on those assets.*

   Our comments:

   - This does not affect existing property owners who will continue to apply the same rules as previously; and
   - Second hand depreciating assets represent such items as dishwashers, ovens, garage door openers and other things that can be "easily" removed from a property (see point 4. Below); and
   - Previously used means exactly that irrespective of whether these items have been depreciated previously or not.

2. *Acquirers of brand new property will carry on claiming depreciation exactly the way they have done so to date.*

   Our comments:

   - New fixtures purchased for a renovation can be depreciated.

3. *The proposed changes only relate to residential property. Commercial, industrial, retail and other non-residential properties are not affected in the slightest.*

4. *The building allowance or claims on the structure of the building has not changed at all. You will still need a Depreciation Schedule to calculate these deductions. This component typically represents approximately between 80 to 85 percent of the construction cost of a property.*

   Our comments:

   - Separately identifiable components of the building itself that are not "easily removed" such as light fittings and other fixed items will continue to be depreciated in accordance with your depreciation schedule.

     Therefore, we recommend all investors continue to obtain a depreciation schedule for each property (CLICK HERE for a free quote for your schedule from Washington Brown).

5. *The proposed changes do not apply if you buy the property in a corporate tax entity, super fund (note Self-Managed Super Funds do not apply here) or a large unit trust.*

   Our comments:

   This is the only point I slightly disagree with Tyron.

   - Tyron suggests this may mean more people will acquire property in corporate structures. Our advice is to be very careful because there can be costly Capital Gains Tax Implications if you own property in a company and those costs could easily outweigh any additional depreciation benefit from side stepping these changes. If you are considering purchasing a property it is best to **talk to us early on (07) 54489600**.
   - There may be a way to maximise your depreciation claims using the corporate exemption but without buying your property in a company. So, if your focus is on absolute tax minimisation then **give us a call (07) 54489600** and let us help you pay less tax.

6. *If you engage a builder to build a house and it remains an investment property, you will still be able to claim depreciation on both the structure and the Plant and Equipment items.*

7. *If you renovate a property that is being used as an investment, you will still be able to claim depreciation on it when you have finished the renovations.*

   Our comments:

   - For both 6 and 7 above the test for your depreciating assets will remain whether it has been “previously used”. So, if you score a bargain dishwasher or chef stove (second hand) on Gumtree then you will not be entitled to a deduction for that item.

8. *If you renovate a house, whilst living it in, then sell the property to an investor, the asset will be deemed to have been previously used and the new owner cannot claim depreciation.*

9. *Whilst investors purchasing second-hand property can now no longer claim depreciation on the existing plant and equipment, they may have the benefit of paying less capital gains tax when they sell the property.*

   Our comments:

   - When buying or selling a residential investment property it is worthwhile considering valuing the depreciating assets. Any reduction in the value of those assets will reduce your capital gains tax payable on the sale proceeds.

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Let’s Do The Numbers

From a dollars and cents perspective we analysed a typical property investment held for 10 years under both the old rules and the new rules and the results are very interesting. Our analysis showed the Return on Investment and net cashflow for the property to be higher following the changes.

> *That shocked us but it makes sense, given this scenario, and we will explain why below the numbers.*

The Scenario

An investor purchases the following property on 8 May 2017. The property details are as follows:

Purchase price	$ 625,000	Including purchase costs
Includes Depreciating Assets	35,000	Presumed 12% average depreciation rate
Loan	468,000	75% LVR 25y P&I
Annual rent	30,000	Increasing by 2% p.a.
Presumed Tax rate	30%	
Sale price in 10 years	765,000	After transaction costs

The same property is purchased on 10 May 2017 (after the depreciation changes) with the following additional sale details:

Sale price in 10 years	765,000	After transaction costs
Includes Depreciating Assets	10,000	Per assessed value

Summary of the Property Financial Performance Across 10 Years

Depreciation Examples

	8-May-17 Before Changes	10-May-17 After Changes
Property Purchase Price		
Land Cost	320,000	320,000
Building & improvements	280,000	245,000
Depreciating Assets		35,000
	600,000	600,000
Property Sold in 10 Years		
Land Value	320,000	320,000
Building & improvements	445,000	435,000
Depreciating Assets		10,000
	765,000	765,000
10 Year Holding Period		
Rent Received	328,492	328,492
Less Cash Rental Costs	(335,281)	(326,633)
Less Depreciation		
Building	(46,250)	(46,250)
Other Assets	(25,252)	-
Taxable Surplus/(Loss)	**(78,292)**	**(44,391)**
Income Tax Benefit/(Cost)	23,487	19,047
Capital Gains Tax Cost	(21,000)	(17,250)
Net Cashflow from Property*	**135,698**	**137,926**
Return on Investment (IRR)	**5.4%**	**5.5%**

* Includes capital loan repayments

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The results seem counter intuitive with both return on investment and cash returns increasing following the changes. On closer inspection, this makes sense given the presumed scenario but it won't be the same for every property.

> *The take away is do some numbers before you buy and if it is worthwhile, let us implement a strategy to realise the best outcome.*

Our Final Thoughts

It's not really that bad and although the scenario above seems to benefit investors, it will really come down to the specifics of your property.

These changes are unlikely to make a big change to buying behaviour or property prices and nor should they, given the relatively small impact on return on investment in most cases.

> *If the government is seriously thinking these changes will make housing more affordable then they would appear to be mistaken.*

Investors will (and should) demand a return commensurate with their risk and this means where costs increase, or in this case tax benefits are planned to reduce, investors will simply adjust rents to achieve a market return.

In our humble opinion, housing affordability will be most affected by increasing the supply of land and reducing development and compliance costs. Time will tell on the final economic outcome of these changes but the numbers indicate it may not matter either way.

If you are focussed on maximising your deductions, we have a strategy you can engage so give us a call (07) 54489600.

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