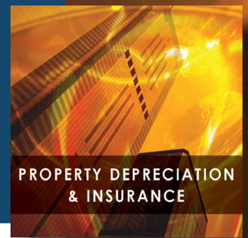
Napier & Blakeley

Property Tax Allowance Deductions



How to maximise the cash from your investment

Property Ownership

Why is it that when talking about investments, the discussion is based on a net before tax return, and the issue of after tax return is never given proper consideration? In this article using some basic rules of tax depreciation, we will show a simple example of how deductions, when properly calculated, can improve the net after tax cash return of a property investment.

Division 40 ITAA 1997

This part of the Act covers the principles of decline in value of a depreciating asset. The definition of a depreciating asset is a separate lengthy topic. Some examples of depreciating assets are:

- Air conditioning
- Fire services
- Lifts
- Carpet
- Hot water units

For owners of income producing property, capital allowance deductions are directly related to the cost of the depreciating asset. In simple terms, if one has paid $500 for a curtain, the opening cost for decline in value (depreciation) is $500. Despite the fact that it may cost $350 to buy and install as a replacement item.

This change in cost is based on the principle of reasonable apportionment that is defined in Subdivision 40-195 of the ITAA 1997. The opening value of any depreciating asset is not necessarily based on the age of the asset but on its income producing capability. This part of the Act will apply to all the depreciating assets of income producing buildings. Subdivision 40-195 assumes that there are no restrictive clauses within the real estate contract that ascribe values to the various depreciating assets. It also assumes that the depreciating asset has been purchased in its current condition, to generate income.

If the depreciating asset is not capable of generating income (say replacement is necessary) then the asset is considered to have nil value.

The tax ruling 2014/4 effective 1 July 2014 lists different depreciating assets and their respective effective lives, which in turn establishes the depreciation rate. Subdivision 40-105 also sets out rules to self assessing effective lives for a depreciating asset which allows better write-off rates.

Division 43 ITAA 1997

This part of the Act covers the principles of building allowance and structural improvements. It covers the structure and fabric of a building including the footings, concrete and steelwork, blockwork, roof, cold water services, electrical cabling, floor tiling, and similar items.

Rates for building allowance and structural improvements are 0, 2.5% or 4% dependent on the use of the building and construction commencement date.

In contrast to the depreciating asset, Division 43 allowances are based on the actual construction cost of the asset at the time it was first built and written down to the date when the property became income producing in the books of the investor.

For building allowance, dates are very important, however unlike Division 40, under Division 43 the age of the building is relevant; the older the building, the less the total claim. Any commercial building (except traveller accommodation) that commenced construction before 20th July 1982 is not eligible for building allowance. The start date for traveller accommodation is 21st August 1979 and for residential dwellings is 18th July 1985.

What if this information is not available from the vendor?

Tax ruling 97/25 basically provides the avenue for the owner to have an assessment done by a suitable qualified professional quantity surveyor such as Napier & Blakeley.

Example – see Table 1

The simple example below shows how a properly prepared property tax allowance assessment can provide icing on the property investor's cake. We used a $5m office building with 1800m² net lettable space, rented at $250m² to give a total of $450,000 annual income. We also know that it was built in 1995 and includes a land component of $500,000.

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Table 1 :
After tax return following assessment of plant equipment

Purchase Price	**$5,000,000**	
Income Pre Tax 1800m2 @ 250m2	**$450,000 (A)**	**9% yield on purchase**
Tax (say 30%)	**$135,000 (B)**	
Net income before deductions	**$315,000** **(A) - (B)**	**6.3% after tax yield with no depreciation**
Compared to:		
Income pre tax	**$450,000 (A)**	
Depreciation & building allowance	**$179,795 (C)**	**From N&B Report - 1st year**
Total taxable income	**$270,205** **(D) = (A) - (C)**	
Tax payable after depreciation	**$81,061** **(E) = (D) * 30%**	
Net income after depreciation	**$368,939** **(A) - (E)**	**7.38% yield on purchase after depreciation** **17.12% increase in cash return**

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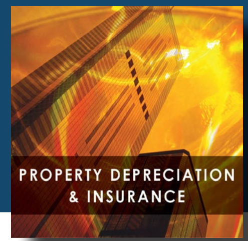

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Property Ownership

There are many benefits to be taken from close scrutiny of the expenditure on built assets. What happens with any capital works expenditure for renovations or upgrades during ownership?

By way of example, an invoice which is received for a sum of $50,000 for some demolition works and improvements may enter the books at $50,000 with a 2.5% claim per annum.

Generally any demolished portions are then left in the accounts until written down to zero. Identification of the individual demolished works is not the easiest process but it is important to realise that when works are demolished, there may be residual values to the depreciating asset and building which can provide significant deductions for an owner.

The day comes when the decision to sell is made. Whether a gain or a loss is realised, a vendor will need to understand their liabilities within the capital gains and income sections of the Act.

A building is too often sold with depreciable assets at written down value without due consideration of income tax and capital gains liabilities. Careful consideration is required in order to make any judgement with regard to selling at written down value. What if, taking the example below (see Table 2) the vendor had chose to sell at written down value and this happened to be $1.00 (example only).

All that would remain for the purchaser is $64,000 building allowance annually for the remainder of the 40 years. This would effectively mean a reduction to the cash return by $34,800 in the first year or 11%. Would a purchaser pay $5,000,000 asking price just as easily?

Points to consider :

- Before buying a property, look at the after tax return prior to making a judgement on value
- Whilst owning a property, consider the effect of demolition, change of use and disposal, and how it would improve after tax return.
- When selling a property, understand the effect of deductions taken on capital gains tax and income tax.

Other points to watch out for :

- When purchasing a business and inherit ing the assets of that business, the value of depreciating assets is the value as it exists in the books of that business. Consider a separate contract for various assets.
- Purchasing a property that was first developed by a non tax paying entity. There is entitlement to building allowance unless the property commenced construction after 1 July 1995.

  As far as depreciating assets are concerned, the notional written down value or the net pre-existing book value should be taken.

We know not everyone gets it wrong. However a rather large proportion of property investors have misconceptions of capital allowances which make it difficult for them to achieve the full potential of their investments.

Common Statements made that are incorrect :

"The property is old so there are no depreciation claims left".

Wrong!

"The vendor was a non tax paying entity (church and the like) who did not claim their allowances, therefore it is available to us as the purchaser."

Wrong!

"A copy of the vendor's depreciation schedule was appended to the contract, therefore we have to take the written down values."

Wrong!

"Depreciation claims are based on the construction cost."

Not always!

Next time you look at property, it might pay to look into the tax side before making an investment decision.

Table 2 :
After tax return using written down value for plant & equipment ($1)

Income Pre Tax (net outgoings, per annum)	**$450,000 (A)**	**9% yield on purchase**
Tax (say 30%)	**$135,000 (B)**	
Income before deductions	**$315,000 (A) - (B)**	**6.3% after tax yield before deductions**
Compared to:		
Income	**$450,000 (A)**	
Builidng allowance (annual)	**$64,000 (C)**	**From vendor**
Total taxable income	**$386,000 (D) = (A) - (C)**	
Tax payable after building allowance (say 30% tax rate)	**$115,800 (E) = (D) * 30%**	
Net income after depreciation	**$334,200 (A) - (E)**	**6.68% yield on purchase after depreciation 9.5% increase in cash return**

Contact

Paul Mazoletti p. 07 3221 8255 m. 0408 749 202 e. pmazoletti@napierblakeley.com

Matthew Koppel p. 07 3221 8255 m. 0439 765 580 e. mkoppel@napierblakeley.com

Kath Hemphill p. 1300 730 382 m. 0409 227 709 e. khemphill@napierblakeley.com