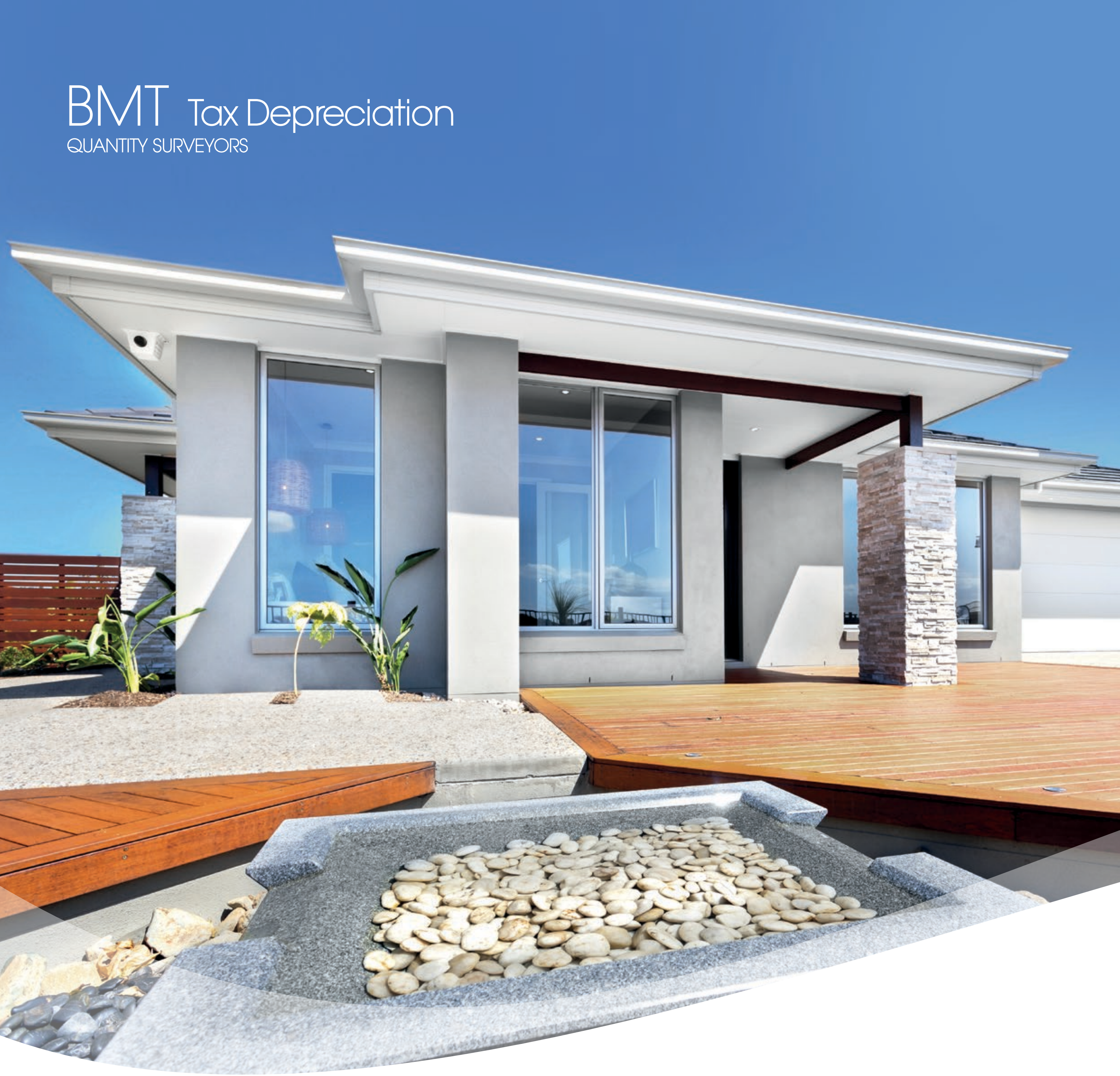
BMT Tax Depreciation
QUANTITY SURVEYORS



Essential facts:

# 2017 BUDGET

## property depreciation legislation changes

An explanation of the Treasury Laws Amendment (Housing Tax Integrity) Bill 2017

# INTRODUCTION

As part of the 9th of May 2017 federal budget, the Australian Government proposed amendments to legislation relating to plant and equipment (division 40) deductions.

The proposed changes, outlined in *Treasury Laws Amendment (Housing Tax Integrity) Bill 2017*, have now been legislated after being passed by the Senate on the 15th of November 2017.

This has resulted in a change to the *Income Tax Assessment Act 1997* and denies property investors from claiming income tax deductions for the decline in value of 'previously used' depreciating assets (plant and equipment) within residential investment properties.

The government's intention in making this legislation amendment was to deliver an integrity measure which addressed concerns that some plant and equipment assets were being depreciated by successive property investors in excess of their actual value.

These changes affect investors who purchase second-hand residential properties after 7:30pm on the 9th of May 2017 by limiting the depreciation they can claim on existing plant and equipment assets.

This White Paper provides further information to help explain the new legislation and details about which investors will and won't be affected by the changes. It will also clarify the process investors should follow going forwards to ensure they claim the maximum depreciation deductions available within the legislative guidelines and to demonstrate the impact this change will have on a property investor's cash flow.

# WHAT CHANGES HAVE TAKEN PLACE?

From the 1st of July 2017, plant and equipment depreciation deductions are limited to only those outlays actually incurred by residential property investors.

The acquisition of existing plant and equipment assets may be reflected in the cost base for Capital Gains Tax (CGT) purposes for subsequent investors.

Existing property investments are grandfathered. This means investors can continue to claim depreciation for plant and equipment assets that form part of a residential investment property purchased prior to 7:30pm on the 9th of May 2017 (including contracts already entered into at 7:30pm AEST on the 9th of May 2017). Investors who fall into this category can continue to claim depreciation deductions until they either no longer own the asset, or until the asset reaches the end of its effective life.

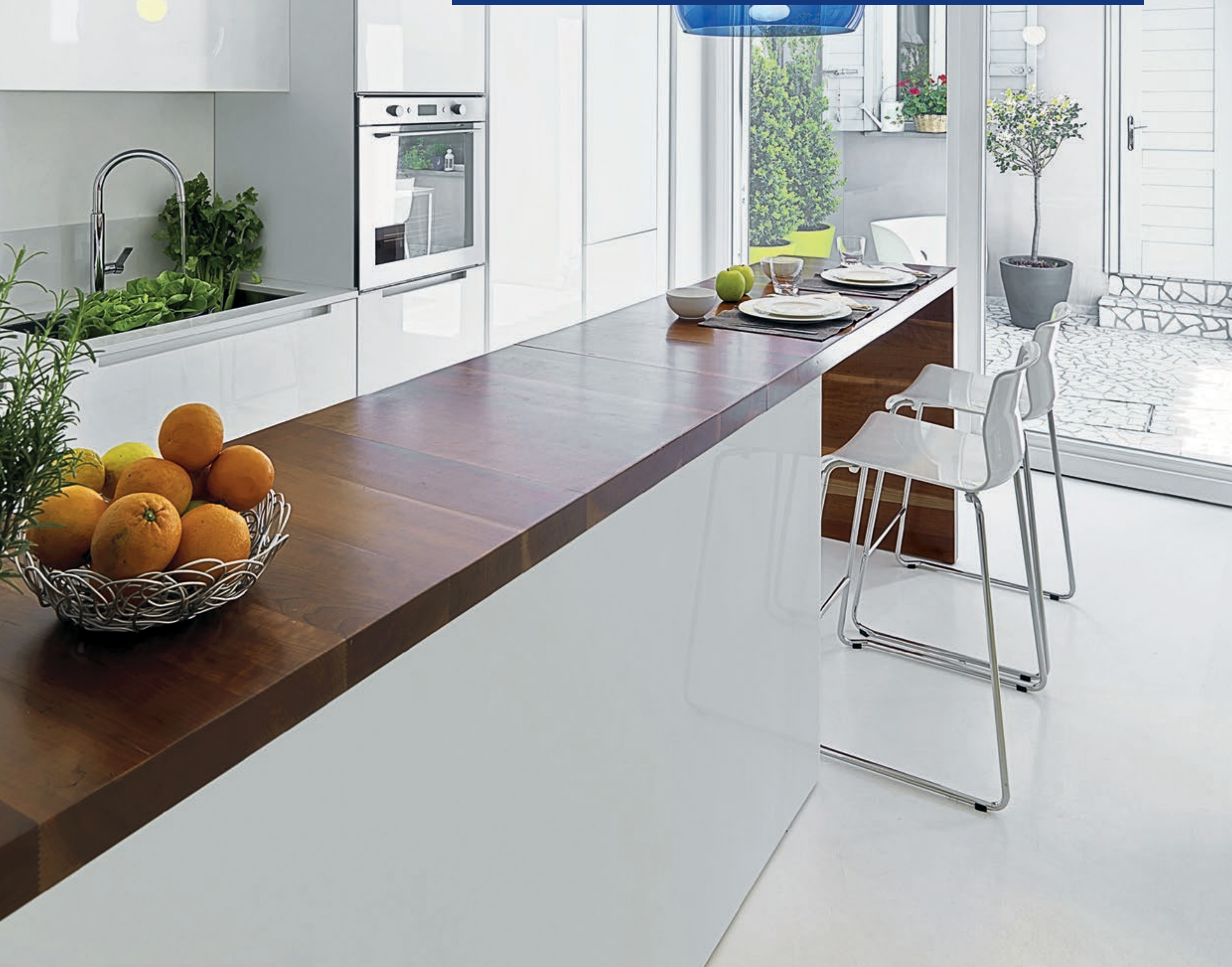
Investors who purchase new plant and equipment assets for a residential investment property after 7:30pm on the 9th of May 2017 will be able to claim a deduction over the effective life of the asset. However, subsequent owners of a property will be unable to claim deductions for plant and equipment assets purchased by a previous owner of that property.

# WHAT ARE PLANT AND EQUIPMENT ASSETS?

Plant and equipment assets are the easily removable or mechanical items found within an investment property.

Below are just some examples of the plant and equipment assets found within residential properties:

- AIR CONDITIONERS
- BLINDS
- DISHWASHERS
- CURTAINS
- GARBAGE BINS
- SMOKE ALARMS



# WHAT DOES THE NEW LEGISLATION MEAN FOR PROPERTY INVESTORS?

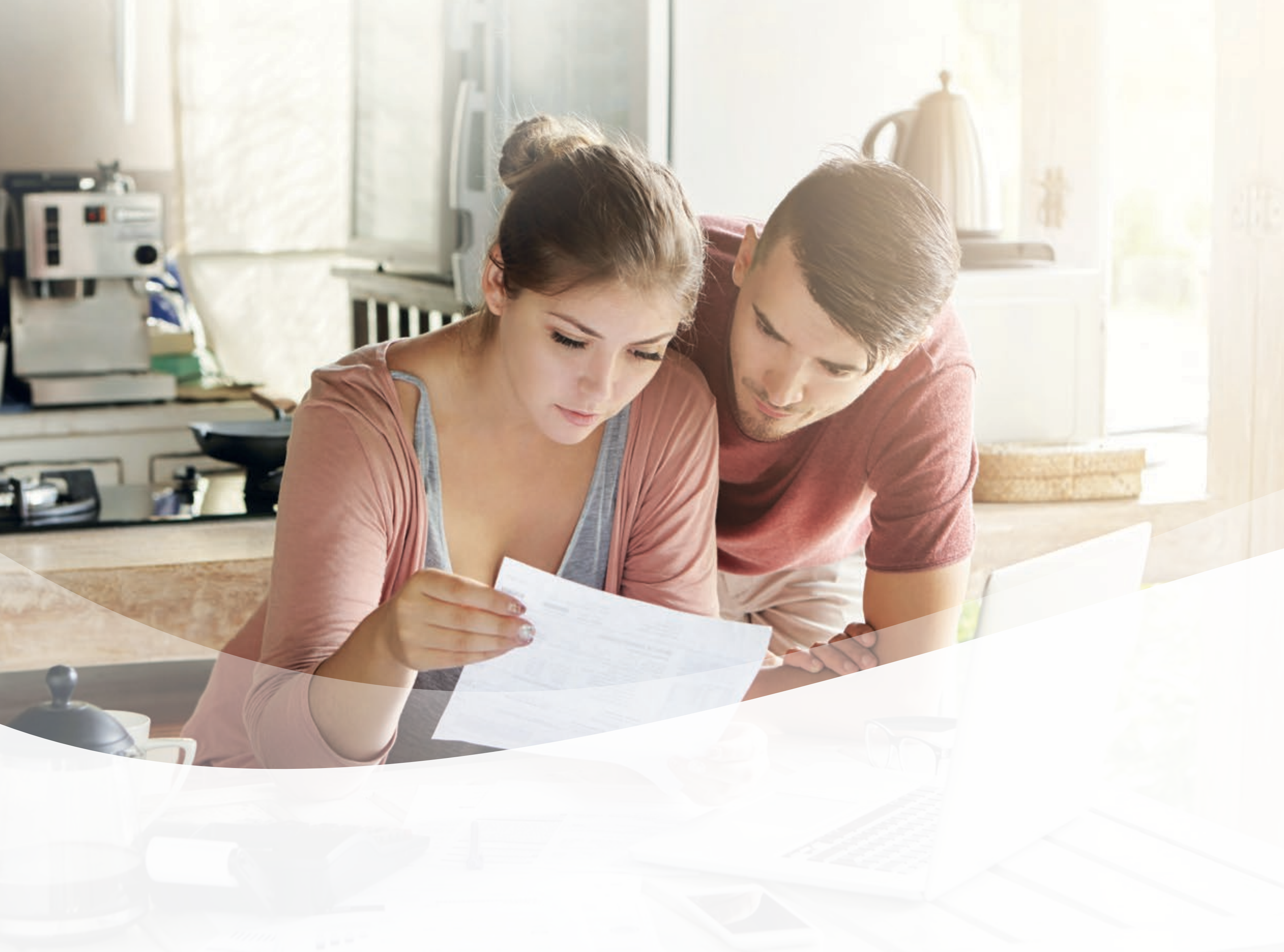
Subsequent owners (those who purchase a second-hand residential investment property) who have exchanged contracts or who will exchange contracts after 7:30pm on the 9th of May 2017 will not be able to claim depreciation on existing plant and equipment assets.

> "Any additional assets which an owner adds to a property can be depreciated as normal."

Investors will still be able to claim qualifying capital works deductions (division 43) which are the deductions available on the structure of the building and assets considered to be permanently fixed to the building. This includes any capital works carried out by themselves or a previous owner.

The capital works deduction is available on residential investment properties that commenced construction after the 15th of September 1987. These deductions typically make up between 85 to 90 per cent of the total claimable amount.

Existing investments will be grandfathered, which means any investor who exchanged contracts on a residential property prior to 7:30pm on the 9th May 2017 can still claim plant and equipment depreciation as normal. The exception to this is when plant and equipment assets are considered previously used for non-taxable purposes. To learn more, see the section regarding turning a home into an investment property later in this White Paper.



## WHO WILL BE AFFECTED?

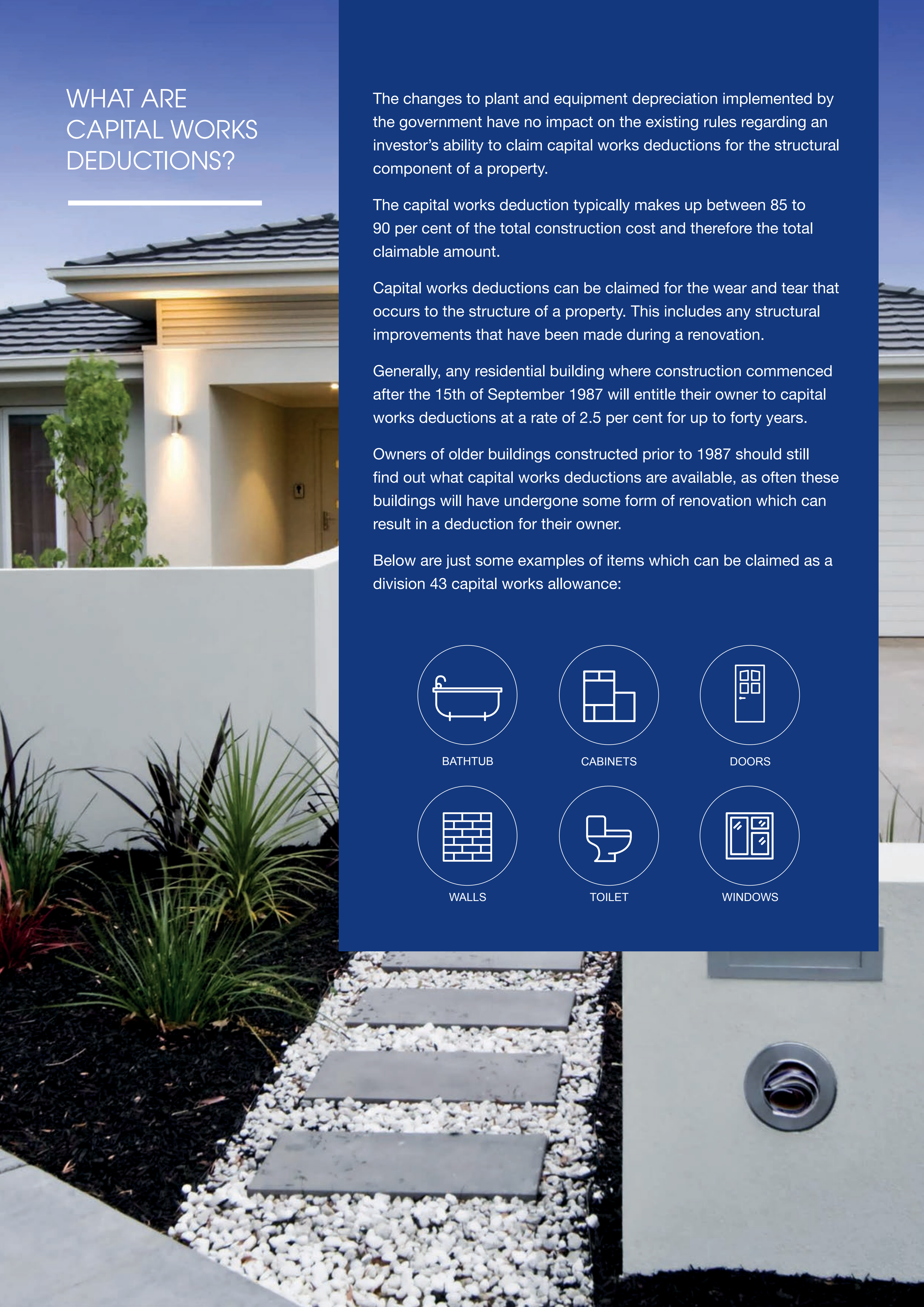
- Property investors who exchange/d contracts **after 7:30pm on the 9th of May 2017** to purchase a second-hand residential property

## WHO WILL NOT BE AFFECTED?

- Owners of brand new residential properties, regardless of when purchased, will not be affected
- Residential property investors who exchanged contracts **prior to 7:30pm on the 9th of May 2017.** However, a property owner will not be able to claim depreciation on pre-existing plant and equipment assets within properties which have been lived in as a primary place of residence and the owner decides to rent the property out **after the 1st of July 2017**
- Properties considered substantially renovated by the previous owner
- All investors can still claim plant and equipment depreciation for brand new assets they install and incur the expense for
- Non-residential/commercial properties
- The amendments do not affect deductions that arise in the course of carrying on a business
- Superannuation plans (other than Self-Managed Super Funds) that hold residential property
- Public unit trusts and managed investment trusts
- Corporate tax entities including properties held under company entities

## EFFECT ON NEW PROPERTIES

- Investors will be able to depreciate plant and equipment assets within a new property as they have been previously
- Developers who build a new residential property will have a six month grace period in which they can rent out the property (in the situation where they can't sell it) and will continue to be able to sell the property to an investor with full depreciation entitlements
- If a Developer decides to do this, assets will be considered trading stock and no depreciation can be claimed by the Developer while they are renting the property



# WHAT ARE CAPITAL WORKS DEDUCTIONS?

The changes to plant and equipment depreciation implemented by the government have no impact on the existing rules regarding an investor's ability to claim capital works deductions for the structural component of a property.

The capital works deduction typically makes up between 85 to 90 per cent of the total construction cost and therefore the total claimable amount.

Capital works deductions can be claimed for the wear and tear that occurs to the structure of a property. This includes any structural improvements that have been made during a renovation.

Generally, any residential building where construction commenced after the 15th of September 1987 will entitle their owner to capital works deductions at a rate of 2.5 per cent for up to forty years.

Owners of older buildings constructed prior to 1987 should still find out what capital works deductions are available, as often these buildings will have undergone some form of renovation which can result in a deduction for their owner.

Below are just some examples of items which can be claimed as a division 43 capital works allowance:

BATHTUB

CABINETS

DOORS

WALLS

TOILET

WINDOWS

# OTHER INVESTMENT SCENARIOS

## Turning a home into an investment

- Properties which have been lived in and turned into an investment property by their owners **prior to the 1st of July 2017 are not affected.**
  Owners can continue to claim plant and equipment depreciation and capital works deductions

- A property owner **will not be able to claim depreciation on pre-existing plant and equipment assets** within properties which have been lived in as a primary place of residence where the owner decides to rent the property out **after the 1st of July 2017.** Plant and equipment assets within this scenario are considered previously used

- The new legislation restricts an owner from claiming depreciation on any previously used plant and equipment assets unless the asset is considered trading stock

- Regardless of how existing assets are treated, under this scenario, **owners can claim depreciation on all brand new assets they add to the property**

# RENOVATED PROPERTIES AFFECTED BY THE CHANGES

Any additional work completed by the current owner on the property which is classified as capital improvements can be included in a BMT Tax Depreciation Schedule and claimed as normal.
This includes both capital works and plant and equipment.

Qualifying capital works additions (works that commenced construction from the 26th of February 1992) completed by a previous owner can be included in a BMT Tax Depreciation Schedule and claimed by the current and future owners for the remaining forty years.

If a property is considered to have been substantially renovated by the previous owner for selling purposes, then an investor can claim depreciation on the new plant and equipment assets along with any new or old qualifying capital works deductions available.

It is important to note that if an entity has previously been entitled to any depreciation deductions for these assets, or if someone lived in the property before it was held by the current owner/investor, then **they will not be able to claim any ongoing plant and equipment depreciation on the assets.**

All previously used plant and equipment will be excluded from the depreciation schedule. These assets will be included in a capital loss depreciation schedule for the purposes of claiming a capital loss, allowing the owner to adjust their CGT liabilities where applicable.

## Substantial renovation works

Following are some examples of structural and non-structural works that could be considered substantial.

**Structural:** altering, removing or replacing foundations, floors, supporting walls, or parts thereof (interior or exterior), lifting or modifying roofs, replacing existing windows and doors where brickwork is altered (single to double door).

**Non-structural:** replacing electrical wiring or plumbing, replacing, removing or altering non-supporting walls, or parts thereof (interior or exterior), plastering or rendering an entire wall or walls, removing or replacing kitchen cupboards, bathroom fixtures, air conditioning or security systems.

## Cosmetic changes

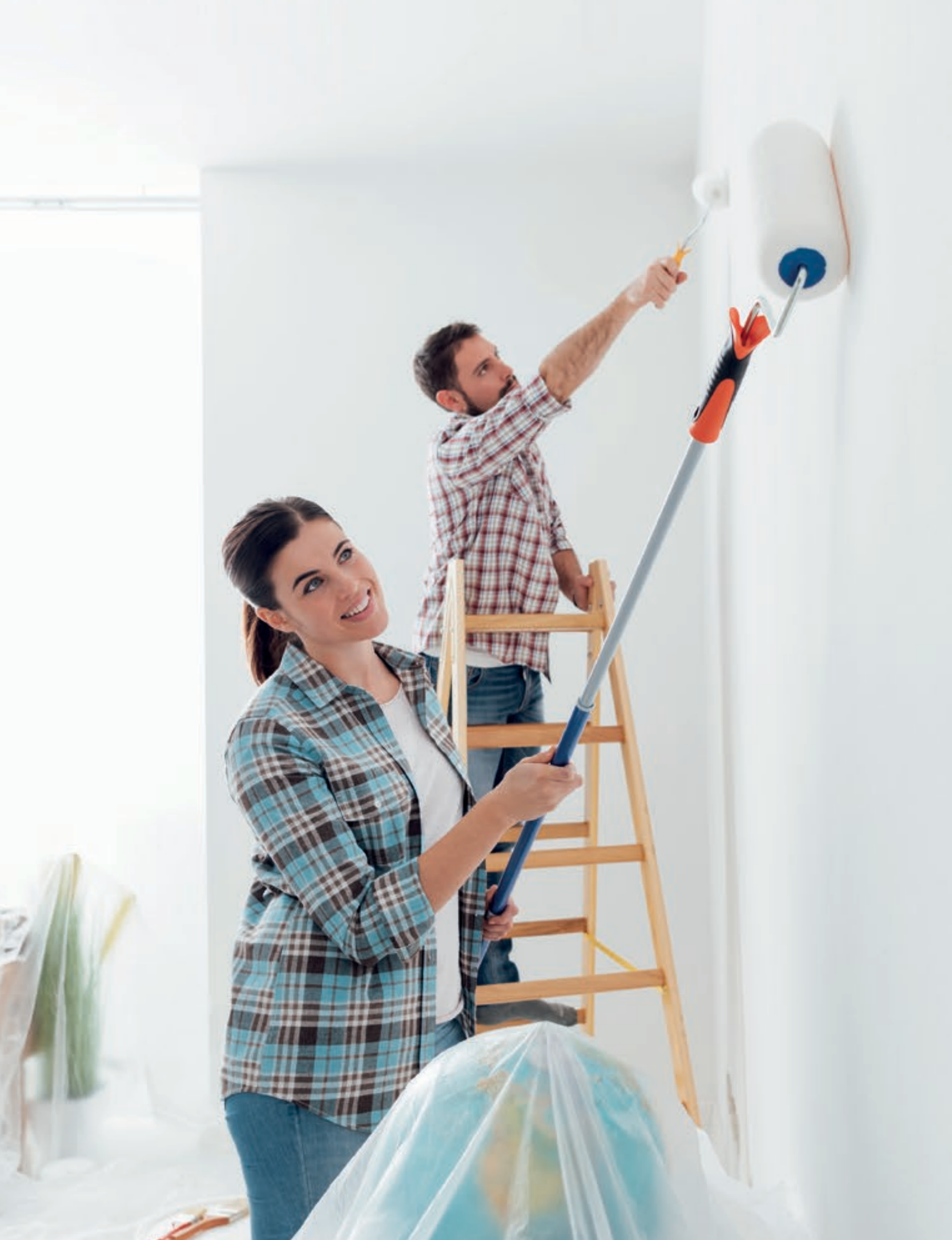
Cosmetic changes are not considered substantial. Examples include work such as painting, sanding floors, removing and replacing fittings such as lights, replacing curtains or carpets.

According to the Australian Taxation Office (ATO), the term substantial renovations is defined in legislative section 195-1 as:

‘Substantial renovations’ of a building are renovations in which all, or substantially all, of a building is removed or is replaced. However, the renovations need not involve removal or replacement of foundations, external walls, interior supporting walls, floors, roof or staircases.

Renovations need to satisfy the following criteria to establish whether the renovations are substantial:

- The renovations need to affect the building as a whole; and
- The renovations need to result in the removal or replacement of all or a substantial amount of the building



# EFFECT ON CAPITAL GAINS TAX (CGT)

Capital Gains Tax (CGT) is a form of income tax which a property owner is liable to pay within the financial year that they sell their property.

Introduced on the 20th September 1985, CGT is the tax payable on the difference between what it cost you to purchase an asset and the amount you received when you disposed of it.

| | | | | |
|---|---|---|---|---|
| Selling price **minus** selling costs | **Minus** | Original purchase price **plus** associated selling costs | **Equals** | Capital Gain (or loss) |

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When you sell a property this triggers a 'CGT event'. Investors may not be liable for paying CGT if they fall within any of the exemption rules provided by the Australian Taxation Office. This includes a main residence exemption and the CGT discount available to those who sell a property they have held for longer than twelve months. For further details, refer to **bmtqs.com.au/capital-gains-tax**

The recent law changes affecting claims for plant and equipment in a residential investment property allow a capital loss to be calculated when an asset is disposed of (e.g., scrapped or sold as part of the sale of the property) for less than its original cost, and depreciation claims for the asset were denied because of the changes. Under the CGT rules, a capital loss can generally be offset against a capital gain and if there is no capital gain in the current year, the capital loss can generally be carried forward and offset against a future capital gain.

In order to calculate a capital loss on disposal, the original value or cost of the asset would need to have been determined at the time of purchase. The asset's termination value (e.g., selling price or scrap value) would then need to be determined on the disposal of the asset. The capital loss as outlined above would be calculated as the difference between the asset's termination value and its original value or cost, assuming no depreciation amounts for the asset were allowed as deductions.

The calculation of a capital loss is particularly relevant in certain situations, including when an asset is scrapped, where there is a partial or full CGT main residence exemption, and where the contract date and settlement date for the sale of the property occur in separate financial years.

The capital loss amount on the disposal of an asset will include the depreciation amount that could not be claimed by the owner (as a result of the recent changes). Further, the capital loss on disposal should be equal to the depreciation amount that could not be claimed in relation to the asset, where the termination value happens to be equal to the asset's written down value. However, in accordance with ATO guidelines, an asset's termination value does not necessarily equate to its selling or market value.

# HOW THE CHANGES WILL AFFECT DEDUCTIONS

The following tables show the deductions an investor would receive for both a three year old and a ten year old residential property purchased for $600,000.

They demonstrate the capital works and depreciation deductions that can be claimed by a residential property investor who exchanged contracts **prior to 7:30pm on the 9th of May 2017** compared with the likely depreciation deductions they could claim if they have exchanged or intend to exchange contracts and purchase a property **after this date under the new legislation.**

| Three year old residential property, purchase price $600,000 | | | |
|---|---|---|---|
| **Depreciation and capital works deductions for property purchased prior to 9th May 2017** | | **Capital works deductions for property purchased after 9th May 2017** | |
| 1st full year | $12,716 | 1st full year | $7,155 |
| 5 year total | $56,114 | 5 year total | $35,775 |

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The depreciation deductions in this scenario have been calculated using the diminishing value method.

| Ten year old residential property, purchase price $600,000 | | | |
|---|---|---|---|
| **Depreciation and capital works deductions for property purchased prior to 9th May 2017** | | **Capital works deductions for property purchased after 9th May 2017** | |
| 1st full year | $9,857 | 1st full year | $6,125 |
| 5 year total | $45,750 | 5 year total | $30,625 |

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The depreciation deductions in this scenario have been calculated using the diminishing value method.

As these tables demonstrate, property investors who exchanged contracts prior to 7:30pm on the 9th of May 2017 will benefit from the full depreciation claim.

For a three year old residential property, this would equate to $12,716 in deductions in the first full financial year or $56,114 in depreciation deductions over five years. For a ten year old residential property, this would equate to $9,857 in deductions in the first full financial year or $45,750 in depreciation deductions over five years.

An investor who purchases the above property types after 7:30pm on the 9th of May 2017 will see their first full financial year claim reduced as they will only be able to claim the capital works deductions and any plant and equipment depreciation for items they install themselves. However, as you can see, there are still substantial deductions available for these owners.

# CHANGES TO DEPRECIATION SCHEDULES

For properties affected by the new legislation, when BMT Tax Depreciation prepare the Capital Allowance and Tax Depreciation Schedule, we will include a capital loss depreciation schedule as an appendix.

This schedule will include a detailed calculation of all plant and equipment depreciation that could not be claimed throughout ownership due to the amended legislation. Depending on the scenario, the property owner can use this schedule to claim a capital loss to reduce capital gains tax liabilities when applicable. This capital loss will offset a capital gain and if needed can be carried forward to offset future capital gains.

The schedule also will include plant and equipment assets added to the property by the current owner and show the deductions which can be claimed each financial year. It will also include the capital works deductions eligible to can be claimed each year.

## Example: capital loss depreciation

The table below shows a summary of the capital loss depreciation which is calculated using both the diminishing value and prime cost methods.

Original division 40 cost: $26,787

| Capital loss depreciation as @ | Capital loss division 40 diminishing value ($) | Cumulative capital loss division 40 diminishing value ($) | Capital loss division 40 prime cost ($) | Cumulative capital loss division 40 prime cost ($) |
|---|---|---|---|---|
| 26-May-17 to 30-Jun-17 | 2,753 | 2,753 | 1,139 | 1,139 |
| 1-Jul-17 to 30-Jun-18 | 5,302 | 8,055 | 2,228 | 3,367 |
| 1-Jul-18 to 30-Jun-19 | 3,893 | 11,948 | 2,228 | 5,595 |
| 1-Jul-19 to 30-Jun-20 | 3,282 | 15,230 | 2,228 | 7,823 |
| 1-Jul-20 to 30-Jun-21 | 2,581 | 17,811 | 2,228 | 10,051 |
| 1-Jul-21 to 30-Jun-22 | 1,871 | 19,682 | 2,217 | 12,268 |
| 1-Jul-22 to 30-Jun-23 | 1,389 | 21,071 | 2,102 | 14,370 |
| 1-Jul-23 to 30-Jun-24 | 1,055 | 22,126 | 2,102 | 16,472 |
| 1-Jul-24 to 30-Jun-25 | 966 | 23,092 | 2,102 | 18,574 |
| 1-Jul-25 to 30-Jun-26 | 708 | 23,800 | 2,102 | 20,676 |
| 1-Jul-26 to 30-Jun-27 | 533 | 24,333 | 2,002 | 22,678 |
| 1-Jul-27 to 30-Jun-28 | 413 | 24,746 | 1,037 | 23,715 |
| 1-Jul-28 to 30-Jun-29 | 328 | 25,074 | 1,004 | 24,719 |
| 1-Jul-29 to 30-Jun-30 | 264 | 25,338 | 659 | 25,378 |
| 1-Jul-30 to 30-Jun-31 | 215 | 25,553 | 659 | 26,037 |
| 1-Jul-31 to 30-Jun-32 | 177 | 25,730 | 603 | 26,640 |

Below are some of the key features a BMT Tax Depreciation Schedule will include when prepared for a second-hand residential property where contracts are exchanged after **7:30pm on the 9th of May 2017:**

- Accurate calculations of any qualifying capital works deductions
- Provides a calculation of the capital loss plant and equipment depreciation for the owner's Accountant to calculate a reduced CGT liability when applicable
- Provides details of any qualifying capital works deductions for structural items that have been removed so they can be written off
- Identifies and calculates deductions for any additional works and renovations completed by previous owners which qualify for additional capital works deductions
- A depreciation schedule for any plant and equipment assets added by the owner
- A summary of available deductions using both the prime cost and diminishing value methods as well as including low-value pooling where applicable
- A split report can be provided when there is more than one owner to show deductions based on their ownership percentage
- A specialist will complete a detailed site inspection to obtain records and photographs to substantiate the claim
- ATO compliance, observing the Income Tax Assessment Act 1997 and Tax Ruling 97/25
- The ability to access MyBMT, our free online portal which allows you to stay up to date with a depreciation schedules progress, to add and remove assets as changes take place and to allow access to all members of an investment team

## Example: capital loss depreciation

The table below shows an example of the capital loss depreciation schedule which is calculated over five years using the diminishing value method.

Capital loss diminishing value method schedule (years 1 - 5)

| Tax grouping | Total cost @ 26-May-17 ($) | Effective life (Years) | Basic rate (DV) | Depreciation allowance | | | | | TWDV @ 1-Jul-21 ($) |
|---|---|---|---|---|---|---|---|---|---|
| | | | | 26-May-17 30-Jun-17 Year 1 ($) | 1-Jul-17 30-Jun-18 Year 2 ($) | 1-Jul-18 30-Jun-19 Year 3 ($) | 1-Jul-19 30-Jun-20 Year 4 ($) | 1-Jul-20 30-Jun-21 Year 5 ($) | |
| Division 40 - plant and equipment (effective life rates) | | | | | | | | | |
| Existing unit specific | | | | | | | | | |
| Air conditioning - packaged unit | 8,916 | 15 | 13.3 % | 117 | 1,173 | 1,017 | 881 | 764 | 4,964 |
| Automatic garage door - controls | 171 | 5 | 100.0 % | 171 | 0 | 0 | 0 | 0 | 0 |
| Automatic garage door - motors | 721 | 10 | 37.5 % | 0 | 0 | 0 | 0 | 0 | 89 |
| Bathroom accessories - freestanding | 235 | 5 | 100.0 % | 235 | 0 | 0 | 0 | 0 | 0 |
| Blinds | 3,865 | 10 | 37.5 % | 0 | 0 | 0 | 0 | 0 | 479 |
| Carpet | 4,202 | 10 | 20.0 % | 83 | 824 | 659 | 527 | 422 | 1,687 |
| Cooktops | 753 | 12 | 37.5 % | 0 | 0 | 0 | 0 | 0 | 93 |
| Dishwashers | 1,433 | 10 | 20.0 % | 28 | 281 | 225 | 0 | 0 | 351 |
| Exhaust fans | 433 | 10 | 37.5 % | 0 | 0 | 0 | 0 | 0 | 54 |
| Garbage bins | 243 | 10 | 100.0 % | 243 | 0 | 0 | 0 | 0 | 0 |
| Garden sheds freestanding | 541 | 15 | 37.5 % | 0 | 0 | 0 | 0 | 0 | 67 |
| Hot water systems | 1,443 | 12 | 16.7 % | 24 | 237 | 197 | 0 | 0 | 385 |
| Light shades | 631 | 5 | 37.5 % | 0 | 0 | 0 | 0 | 0 | 79 |
| Ovens | 1,578 | 12 | 16.7 % | 26 | 259 | 216 | 180 | 0 | 561 |
| Rangehoods | 766 | 12 | 37.5 % | 0 | 0 | 0 | 0 | 0 | 95 |
| Smoke alarms | 271 | 6 | 100.0 % | 271 | 0 | 0 | 0 | 0 | 0 |
| Water pumps | 585 | 20 | 37.5 % | 0 | 0 | 0 | 0 | 0 | 72 |
| Subtotal | 26,787 | | | 1,198 | 2,774 | 2,314 | 1,588 | 1,186 | 8,976 |
| Total division 40 - effective life rate | 18,492 | | | 1,198 | 2,774 | 2,314 | 1,588 | 1,186 | 6,651 |
| Total division 40 - pooled (page 17) | 8,295 | | | 1,555 | 2,528 | 1,579 | 1,694 | 1,395 | 2,325 |
| Total division 40 | 26,787 | | | 2,753 | 5,302 | 3,893 | 3,282 | 2,581 | 8,976 |
| Cumulative capital loss total | | | | 2,753 | 8,055 | 11,948 | 15,230 | 17,811 | |

# WHY IT'S IMPORTANT TO SPEAK WITH A QUANTITY SURVEYOR

**It is more important than ever that you consult with a specialist Quantity Surveyor** to discover what depreciation can be claimed for any investment property.

Quantity Surveyors are qualified under the Tax Ruling 97/25 to estimate construction costs for depreciation purposes and are one of a few select professionals who specialise in providing depreciation schedules.

A BMT Tax Depreciation Schedule will be tailored to suit every individual's property investment scenario in line with the new legislation, ensuring that all deductions are maximised.

For investors who are planning on selling a property affected by the new rules, a BMT Tax Depreciation Schedule can be provided to assist them and their Accountant to perform a calculation adjustment for CGT liabilities.

# CONCLUSION

While the Australian Government have made changes to depreciation legislation, it is important for investors to understand how this affects their individual circumstances.

A large percentage of investors will be unaffected by the change; including those who exchanged contracts on a residential property prior to 7:30pm on the 9th of May 2017, those who purchase/d brand new or substantially renovated residential properties before and after this date and those who own or purchase commercial properties.

For those investors affected by the change, in most cases substantial depreciation deductions will still be available to claim, as capital works deductions are unaffected. Owners will also still be able to claim plant and equipment deductions for any items they add to an income producing residential property themselves and directly incur the expense.

A specialist Quantity Surveyor, such as BMT Tax Depreciation, can provide the expert advice required to ensure maximum depreciation and capital works deductions are identified. These deductions are outlined in a comprehensive depreciation schedule prepared in line with current legislation and tailored to an individual's scenario.

It is also important to understand the implications on CGT when a property is being sold and to discuss this with your Accountant or Tax Adviser.

For further information on any property investment scenario, speak with one of the expert staff at BMT Tax Depreciation on **1300 728 726**.

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