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2017 BUDGET CHANGES TO DEPRECIATION

Nicola Woodward MRICS CTA discusses the changes in the calculation of tax depreciation for plant in second-hand residential rental properties.

Overview

In the 2017-18 Budget, the Government announced measures designed to reduce pressure on housing affordability. The tax legislation in relation to investment properties was amended as part of these measures with the intention of limiting deductions.

The purpose of the amendments is to stop entities claiming overstated deductions relating to their rental properties by 'refreshing' the values of previously used depreciating assets in residential rental properties.

Changes to the definition of plant and equipment in a tax ruling in 2004 had already impacted on the amount of depreciation available in residential rental properties.

The impact of the legislation is to defer the benefit of deductions for the decline in value of depreciating assets until the sale of the property where a second-hand property is acquired. This also includes low value pool assets.

The effect of the legislation is that amounts that would previously have been claimed under Division 40 are aggregated at disposal and forms the basis of a CGT event K7. In most instances, this will result in a capital loss that will be offset against the capital gain incurred on the sale of land and buildings.

The Legislation

An outline of the legislation "Limiting depreciation deductions for assets in residential properties" is as follows:

1. Schedule 2 of the Bill amends the Income Tax Assessment Act 1997 to disallow income tax deductions for the decline in value of 'previously used' depreciating plant and equipment that is used by an entity in gaining or producing assessable income from the use of residential remises for residential accommodation.
2. The amendments do not apply to deductions that arise in the course of carrying on a business, or for corporate tax entities, superannuation funds, public unit trusts, managed investment trusts and unit trusts or partnerships.
3. The amount of the decline in value of an asset that cannot be deducted will be recognised as a capital loss (or capital gain) when the asset has ceased to be in use or is sold.
4. The is no effect to new residential premises where:

- New assets are installed ready for use in new residential premises, and
- The value of the asset has not yet declined, and
- No entity has previously been entitled to claim deductions for the decline in value of these assets, and
- Either no one resided in residential premises in which the asset has been used before it was held by the current owner, or the asset was used or installed in new residential premises within six months of it becoming new residential premises, and the asset had not been used or installed ready for use before that use or installation.

Case Study

To illustrate the effects of the new legislation, we have calculated allowances and tax payable for holding a property for five years. We have used a scenario where a taxpayer on the highest marginal rate of tax purchases a ten-year-old house for $350,000, holds it for five years and disposes of it for $500,000.

We have assumed that there is a full year of allowances for each scenario for ease of comparison. We have not examined other allowances and deductions in this example. All tax has been calculated at a rate of 47%.

	Acquired pre 9 May 2017	Acquired post 9 May 2017
Total rental income for 5 years	125,000	125,000
Total Div. 40 for 5 years	(6,900)	Nil
Total Div. 43 for 5 years	(12,500)	(12,500)
Net rental income for 5 years	105,600	112,500
Tax payable for 5 years*	**49,632**	**52,875**
Sales price at the end of Year 5	500,000	500,000
Less plant sold for WDV*	(8,100)	n/a
Adjusted proceeds (a)	491,900	500,000
Purchase price	350,000	350,000
Less opening value of plant	(15,000)	n/a
Less Div. 43 deductions	(12,500)	(12,500)
Cost base (b)	322,500	337,500
Capital gain (a) - (b)	169,400	162,500
Capital loss due to CGT event K	n/a	(6,900)
Net gain	169,400	155,600
Discounted capital gain (50%)	84,700	77,800
Tax payable on disposal	**39,809**	**36,566**
Balancing adjustment for plant	nil	n/a
Tax payable over 5 years	**89,441**	**89,441**

*All tax has been calculated at a rate of 47%.

**Written down value of plant = Opening value - claim ($8,100 = $15,000 - $6,900)

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Outcomes

As you can see, if the plant in the house is sold for written down value. there is no difference in the amount of tax payable, only in the timing of the payments; the benefit is essentially deferred. Whilst it is clearly beneficial to have the cashflow of the tax deductions for the five years of ownership, the calculations required are the same. Therefore, on acquisition of a residential investment property or when a taxpayer makes a property available to let, each item of plant still needs to be ascribed a value.

A depreciation schedule will be necessary to calculate the written down value and the amount of depreciation missed to use in the CGT calculations. It will also be useful to track any disposals or additions of plant in the property during ownership, as the deferred depreciation on each asset will be triggered as it is disposed of and any new assets will be able to be depreciated as usual as they are outside this new legislation.

Nicola Woodward is a Chartered Tax Adviser and Charted Surveyor with over 20 years' experience in capital allowances and tax depreciation. She has been providing advice to Depreciator on a range of tax depreciation matters for 15 years.

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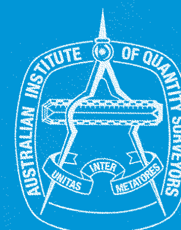

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