

FACT SHEET: The Myths of Tax Depreciation Schedules

There are a series of myths about what you can claim in a tax depreciation that just won't go away. In good "Myth busters" style, here are my seven favourite myths that I see in tax depreciations schedules.

Myth #1: When I buy a rental property I can claim a Div 43 capital works deduction at 2.5% over 40 years on the purchase price less whatever I identify as depreciable assets.

This myth seems to be based on the warped understanding that the "construction costs" of a building is the purchase price of the building. That's only the case if you are the first owner (and may not even be in that case... see TR 97/25 on speculative builders). The actual construction costs are what you claim the 2.5% over 40 years on. THIS HAS NOTHING TO DO WITH WHAT YOU PAY FOR THE BUILDING.

Want some proof this is a myth?

- Have a look at section 43-70 of the Income Tax Assessment Act 1997. This explains what is construction expenditure and it lists all the ACTUAL COSTS of construction, not the purchase price for some subsequent purchaser.
- In Taxation Ruling TR 97/25 the Commissioner states that... *"it is not always possible for the purchaser of a building to establish the actual cost of the building, particularly in circumstances where the builder or previous owner becomes bankrupt or is not able, for other reasons, to provide the information."*

He then goes on to state that in these circumstances, he will *"accept a building cost estimate by an appropriately qualified person."*

The only reason the Commissioner states that Qs can do this work is that the average taxpayer cannot estimate the cost of construction of a building in prior years. Every purchaser knows what the purchase price is and don't need a QS to tell them. What they don't know, and need someone to estimate, is what it would

Myth #2: The Commissioner's effective life ruling must be used for all assets, no matter what!

The Commissioner of Taxation is not someone you want to get on the wrong side of. But he is very clear in his yearly ruling on effective lives what this ruling actually applies to.

First, this ruling ONLY APPLIES TO NEW DEPRECIABLE ASSETS. I know I wrote that in capital letters, but can I write it again. It only applies to new depreciable assets.

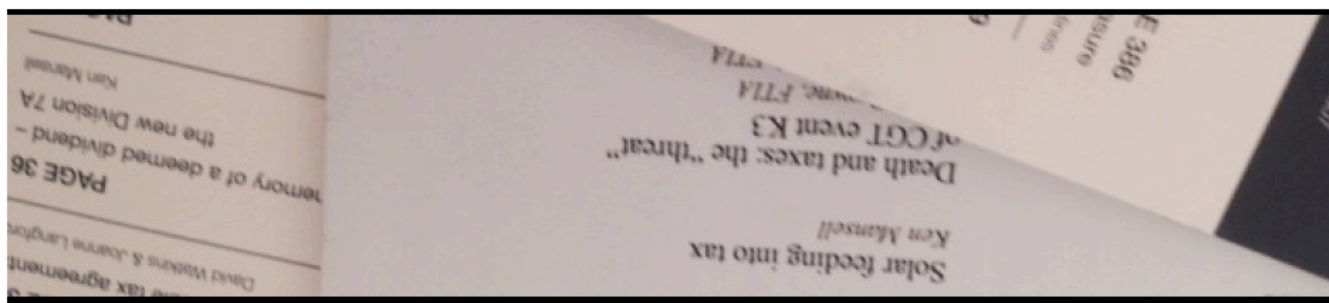
In the 2015 ruling he states that the effective life for new internal window blinds is 10 years. He does not say the effective life for second hand internal window blinds is 10 years. If you buy a 5-year-old building that has 5-year-old internal window blinds you are not required to depreciate the blinds using a 10-year effective life. If you are attempting to get the best outcome for your clients I would hope you would consider that the effective life will be less than 10 years.

Second, if an asset is not in the schedule you still can depreciate it if it is a depreciable asset. The ruling is long but it does not cover every asset.

Want some proof this is a myth?

To quote from every yearly ruling and every yearly "Rental Property Guide" that the Commissioner has ever published... *"In making his determination, the Commissioner assumes the depreciating asset is new and has regard to general industry circumstances of use."*

As a result, the preparer of a Tax Depreciation Schedule should, to maximize the depreciation deductions for the client, assess the effective life of second hand assets and not just assume all the assets in the purchased property are new assets (which they obviously are not in most cases)



have cost to build in the year it was actually built.

- And finally the Commissioner states in his rental property guide *“Remember, none of the following can be used as the construction cost: the purchase price of the building and land, the insured cost or the replacement cost.”*

As a result the preparer of a Tax Depreciation Schedule should either ask the previous owner when the building was built and what it was built for or estimate what year the building was built and estimate what it would have cost IN THE YEAR IT WAS BUILT to build (not what it would cost today to build!)

Myth #3: There are different rules for second hand depreciable assets depending on what the previous owners did with the asset.

There is nothing in Division 40 that mentions second hand assets. Nothing. Nada. Nichts.

It states that if you buy a depreciable asset you need to know what you paid for it and what its effective life is. Once you know this, to the extent you use it for a taxable purpose, you can claim depreciation deductions.

It does not matter if the previous owner fully depreciated it or not (if they did and you paid for it then the previous owner has an assessable balancing adjustment (see Myth #4 for an example)).

Assuming you did not buy it from an associate, it does not matter if they used the prime cost or diminishing value method. You choose what you want to use irrespective of what they used.

So while you may want to ask the previous owner what the undeducted construction expenditure is for the purposes of capital works deductions under Division 43, you don't need to know anything about the previous owners use for a depreciable asset as IT DOES NOT CHANGE WHAT YOU PAID FOR IT OR WHAT ITS EFFECTIVE LIFE IS.

Myth #4 If my assets/ buildings is destroyed I can claim the balance of the depreciation or the undeducted construction costs.

There is some truth in this... if we just ignore that most of these buildings and assets are covered by insurance. Where there is insurance, things are very different.

Starting with Division 43 capital works, it is true that where a taxpayer's capital works are destroyed, then a deduction is permitted for the Undeducted Construction Expenditure. However, if they receive an amount under an insurance policy for the destruction they are required to reduce the Undeducted Construction Expenditure by this amount.

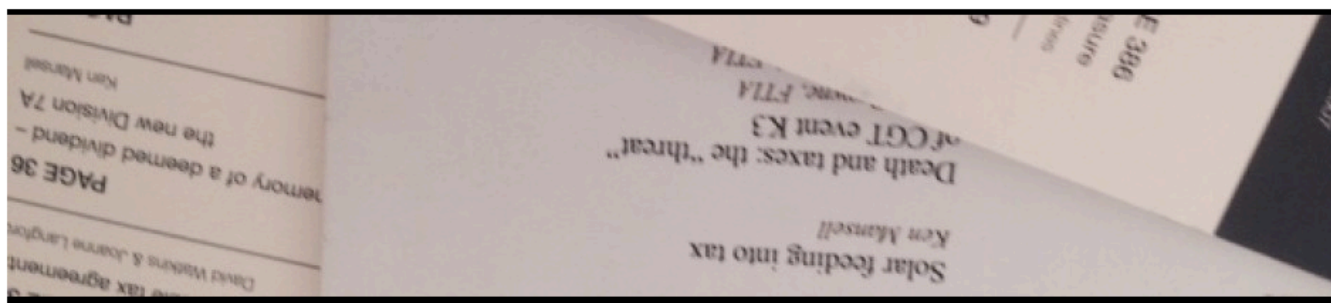
It is worth adding that even if the destruction is voluntary, the taxpayer can still claim a deduction is permitted for the Undeducted Construction Expenditure.

For Division 40 depreciable assets, if a taxpayer ceases to hold a depreciating asset (sold or destroyed) or ceases to use a depreciating asset (don't need it anymore), a "balancing adjustment" will occur.

You work out the balancing adjustment amount by comparing the asset's termination value (sale proceeds) and its adjustable value (written down value). If the termination value is greater, you include the excess in your assessable income but If the termination value is less, you deduct the difference.

And how does insurance change this balancing adjustment? The termination value of a depreciating asset that is lost or destroyed includes the amount received under an insurance policy.

So if it is insured, there is often nothing to deduct when the asset is lost or destroyed.



Myth #5: Once we have found the depreciable asset we can claim depreciation on it.

This myth is so pervasive that I have rarely seen a tax depreciation that acknowledges this issue. Preparers of tax depreciation schedules merely ask whether the property is a rental property and if the answer is yes they prepare a tax depreciation schedule ASSUMING that there is no private use.

In my experience, the owners use most rental properties in holiday locations at some time during the year. And as soon as this happens the numbers in a tax depreciation schedule are incorrect.

Any tax depreciation schedule that informs a taxpayer what to include in their tax return, without considering whether there has been private use, or discussing how to adjust the depreciation amounts if there is private use of that beautiful holiday house sitting on the white sand beach, is at best misleading and at worse wrong.

Myth #7: Once I have spent the money on a depreciable asset or a capital work I claim depreciation on it.

It does not matter when you pay for these assets at all!

For depreciable assets under Division 40, you can start depreciating an asset once it is "used, or installed ready for use". If it has not been delivered year you cannot claim it.

For Capital Works under Division 43, a deduction is not permitted until construction is completed, even though the works may be used in part prior to the completion of construction (see section 43-30).

Myth #6: All the costs in acquiring a rental property should be depreciated in one-way or another in a tax depreciation schedule.

I know that this is already covered in Myth #1 but Qs keep trying to find an asset to attach any and all costs to so they can claim a depreciation deduction. And starting from the purchase price, rather than identifying the assets as the law requires, means that certain expenditure that is not depreciable under either Division 40 or Division 43, get claimed.

For examples:

- The fence is damaged on a rental property and the owner spends money on repairing it. You see the cost the owner has spent, include it in the tax depreciation schedule and depreciate it over 40 years at 2.5%. But it is a repair and should have been claimed 100% in the year in which it was incurred
- Legal costs and stamp duty was paid to buy the rental property. You apportion this cost across the building and the depreciable assets so the cost is reflected in the tax depreciation schedule. But these costs were not the cost of the depreciable assets and definitely were not the cost of construction in relation to a rental property that was built 20 years ago, so the cost cannot be included in a tax depreciation schedule. These costs are included in the capital gains tax calculations when the rental property is sold.

My favourite example of this is where the taxpayer claims a deduction for their strata title levies, and then is told in a tax depreciation schedule to claim the same amount again over a series of years to reflect the common assets. Double dipping at its best... and very wrong.