

An “fix” to the taxation of housing

When the housing crisis in Australia is discussed, taxation is always considered as a potential cause or solution.

But what is never considered is whether the current deduction “types” that are available for rental properties are appropriate. We once did start this process back in 2017 but we stopped after changing two types of inappropriate expenditures.

The 2017 changes to rental property deductions

In the 2017-18 Budget, the Government announced changes to the deductibility of certain rental property expenditure designed to “*reduce pressure on housing affordability*”¹, as well as overcome other integrity concerns. These changes were implemented in the *Treasury Laws Amendment (Housing Tax Integrity) Act 2017*.

This Act introduced section 26-31 of the ITAA97 that states travel expenditure incurred in gaining or producing assessable income from residential premises is not deductible unless incurred by certain institutional entities or by an entity in the course of carrying on a business. Additionally, this Act ensured that travel expenditure which is prevented from being deducted by this amendment cannot form part of any element of the cost base and reduced cost base of residential premises. The 2017-18 Budget indicated this would raise around \$200 million a year.

This Act also introduced section 40-27 of the ITAA97 which denies deductions for a depreciating asset under Division 40 of the ITAA97 or Subdivision 328-D of the ITAA97 to the extent that the asset is a previously used asset used for the purposes of gaining or producing assessable income from the use of residential premises for residential

This paper considers the appropriateness of a much larger rental property deduction and shows this deduction has led to inappropriate outcomes. This paper considers capital works deductions in Division 43 of the Income Tax Assessment Act 1997 (ITAA97) that are available to rental property owners.

¹ The heading of these two changes in Budget paper no. 2 was “Reducing Pressure on Housing Affordability — disallow the deduction of travel expenses for residential rental property” and “Reducing Pressure on Housing Affordability — limit plant and equipment depreciation deductions to outlays actually incurred by investors”

Division 43 – A forgotten history

Division 43 rewrote Divisions 10C and 10D of the Income Tax Assessment Act 1936 (ITAA36). These Divisions allowed building depreciation to non-residential buildings but in 1986 this was extended to rental properties². At the same time, the rate of this depreciation of the construction costs of all buildings was also increased to 4 per cent (up from 2.5 per cent).

The Hawke/Keating governments did this when they disallowed negative gearing interest expense deductions on properties bought after 17 July 1985. The addition of building depreciation for rental properties was only done to alleviate the concern that removing these negative gearing deductions would affect the cost and supply of rental properties. As the Treasurer said at the time:

“... we have wiped out that outrageous rort [negative gearing] and introduced accelerated depreciation for new buildings or major renovations in order to create more rental property and more opportunities for renters”³

The rate was intentionally well above economic depreciation to help offset any loss of supply that may occur due to the changes to negative gearing.

These changes were seen to create increases in rents and in September 1987 the government reversed its decision and restored negative gearing and consequentially reduced the rate of building depreciation back to 2.5 per cent.

However, the government continued to allow residential properties building depreciation.

How capital works deductions work

Capital works deductions in Division 43 of the ITAA97 allow for the construction expenses of a building to be depreciated over a statutory life where the building is used for an income producing purpose.

Division 43 interacts with CGT as section 110-45 of the ITAA97 requires⁴ the cost base of the building to be reduced by amounts deducted (or amounts that could have been deducted⁵) under Division 43. This is to ensure any building depreciation above the actual depreciation reflected in the final sale price of the building is recovered in an increased capital gain.

² Where construction commenced after 17 July 1985

³ See <https://treasury.gov.au/sites/default/files/2019-03/Equality-Rights-Alliance-att-2.pdf>

⁴ If the asset was acquired either after 7:30 pm AEST on 13 May 1997 or the asset was acquired before that time and the expenditure that gave rise to the capital works deductions was incurred after 30 June 1999.

⁵ TD 2005/47 - Income tax: what do the words 'can deduct' mean in the context of those provisions in Division 110 of the Income Tax Assessment Act 1997 which reduce the cost base or reduced cost base of a CGT asset by amounts you 'have deducted or can deduct', and is there a fixed point in time when this must be determined?

The creation of an industry

As Division 43 only allows depreciation of the construction expenditure, not the purchase price of the building. Therefore, many subsequent purchasers of the property need the seller to inform them of the “undeducted construction expenditure”⁶. However, at least in relation to residential property, this information is not generally provided.

Therefore, the Commissioner has concluded that where it is not possible to ascertain the actual construction expenditure incurred on capital works, an estimate can be undertaken by an appropriately qualified person⁷. This has created an industry of quantity surveyors⁸ who will estimate the initial construction expenditure for buildings to allow the Division 43 deductions to be claimed. These reports are often called “Tax Depreciation Reports”.

Since 2017, when deductions under Division 40 for second-hand or used depreciating assets were denied⁹, Division 43 deductions have been the main component of many of these reports as taxpayers generally know the cost of new assets depreciable assets as they personally acquired them.

The New Zealand experience with building depreciation

Case Study: Lessons from the removal (twice) of building depreciation in New Zealand

The New Zealand government removed depreciation deductions for buildings such as rental housing and office buildings with an estimated useful life of 50 years or more on 1 April 2011.¹⁰

During COVID one of the measures to support businesses affected by the outbreak was the reintroduction of building depreciation, but only for new and existing industrial and commercial buildings, including hotels and motels, but not for rental housing¹¹.

However, during the 2023 New Zealand election campaign both the Labour Party and the National Party announced they would remove the ability for businesses to claim depreciation on commercial buildings (for the Labour Party to fund the removal GST from fruit and vegetables and for the National Party to fund tax cut promises)¹²

⁶ Subsection 262A (4AJA) of the 1936 Income Tax Assessment Act requires the previous owner of a property to provide the new owner with relevant construction cost information

⁷ TR 97/25 Income tax: property development: deduction for capital expenditure on construction of income producing capital works, including buildings and structural improvements

⁸ Paragraph 28 of TR 97/25 states that such an estimation of initial construction expenditure can be undertaken by a quantity surveyor, who has expertise in the relevant type of construction.

⁹ Section 40-27 of the ITAA97

¹⁰ *Property tax changes increase fairness* Hon Bill English Minister of Finance, Media Release, 20 May 2010, <https://www.taxpolicy.ird.govt.nz/-/media/project/ir/tp/news/2010/2010-05-20-budget-2010-tax-announcements/2010-05-20-budget2010-media-release2-pdf.pdf>

¹¹ *COVID-19 tax proposals*, Inland Revenue, <https://www.taxpolicy.ird.govt.nz/news/2020/2020-03-17-covid-19-tax-proposals>

¹² *The removal of tax depreciation on non-residential buildings*, Deloitte, 30 Aug 2023, <https://www.deloitte.com/nz/en/services/tax/research/september-2023-removal-of-tax-depreciation-on-non-residential-buildings.html>

On 28 March 2024, legislation removing of tax depreciation deductions of industrial and commercial buildings with a useful life of 50 years or more was enacted.

When the New Zealand government initially removed all building depreciation in 2011 it stated this was being done to:

“increase fairness and help rebalance the economy towards productive investment”, and that this change would “make the tax system fairer by ensuring the treatment of property is consistent with other forms of investment. This will reduce the incentive for people to buy property purely for tax reasons and will help tilt the economy towards saving, productive investment and exports”¹³.

Facing similar inflated property prices that we face in Australia today caused by inefficient allocation of capital into property, the New Zealand government removed building depreciation for all buildings.

In December 2023, in anticipation of the New Zealand government considering once again to remove building depreciation in New Zealand (after depreciation for commercial building had been reintroduced), the Inland Revenue produced a Regulatory Impact Statement considering this proposal. In this report, Inland Revenue consider the effective lives of certain types of buildings, concluding that:

“the most widely quoted estimates are from the Bureau of Economic Analysis in the United States. These suggest economic depreciation rates of 3.14% for industrial buildings, 2.47% for commercial buildings, 1.14% for residential structures of 1 to 4 units and 1.4% for residential structures of 5 or more units”¹⁴.

In 2010, when building depreciation was first removed in New Zealand, a Treasury analysis of building values from 1994 to 2008 suggested that, on average, buildings had not depreciated in market value in New Zealand over that period¹⁵.

This December 2023 report concluded some form of building depreciation should be retained, but not for residential property. It concludes that providing tax depreciation at effective life rate is important to achieve appropriate asset allocation¹⁶.

However, it should be noted that New Zealand does not have a comprehensive capital gains tax system and so it does not have the correction mechanism that the Australian systems has where building depreciation is above or below economic depreciation.

¹³ *Property tax changes increase fairness* Hon Bill English Minister of Finance, Media Release, 20 May 2010, <https://www.taxpolicy.ird.govt.nz/-/media/project/ir/tp/news/2010/2010-05-20-budget-2010-tax-announcements/2010-05-20-budget2010-media-release2-pdf.pdf>

¹⁴ *Regulatory Impact Statement: Removing building depreciation*, Inland Revenue, 7 December 2023 <https://www.taxpolicy.ird.govt.nz/-/media/d7671cf9077f4b709c9a56dbecf5f936.ashx?modified=20240314003326>
Regulatory Impact Statement: Removing building depreciation, Inland Revenue, 7 December 2023 <https://www.taxpolicy.ird.govt.nz/-/media/d7671cf9077f4b709c9a56dbecf5f936.ashx?modified=20240314003326>

¹⁶ *Regulatory Impact Statement: Removing building depreciation*, Inland Revenue, 7 December 2023 <https://www.taxpolicy.ird.govt.nz/-/media/d7671cf9077f4b709c9a56dbecf5f936.ashx?modified=20240314003326>

All of the above creates two issues with the current operation of Division 43.

Accelerated depreciation

For 25 years Australia has used a capital allowance regime based on the effective life of the asset to avoid economic distortions caused by accelerated depreciation rates¹⁷. However, capital works depreciation is one of a limited number of situations that these accelerated rates still apply¹⁸. The Henry Review described the effective life of Division 43, and the other accelerated depreciation examples as “*distortions that may encourage investment in less productive assets*” and stated that to:

*“improve overall productivity, existing concessional arrangements should also be reconsidered, including statutory effective life caps, **capital works (including buildings)**, exploration expenses and the taxation of agriculture and forestry more generally.”*¹⁹

In Australia, the average life of a brick home has been estimated at 88 years²⁰ and estimated average housing lifespan in the United States has been as high as 130 years²¹. These effective lives accord with the December 2023 report on building depreciation by the Inland Revenue of New Zealand which concluded that economic depreciation rates are 1.14 per cent for residential structures of 1 to 4 units and 1.4 per cent for residential structures of 5 or more units.

The 2.5 per cent depreciation rate provided to residential buildings in Australia is obviously well above these economic depreciation rates and there does not appear to be an appropriate reason for rental properties to have accelerated depreciation.

Issue 2: Purpose

The purpose of allowing building depreciation deductions for residential buildings in 1985, and to allow for accelerated depreciation, was to offset any capital flight from rental properties due to limiting negative gearing. This purpose obviously ended when those negative gearing changes were repealed in 1987.

¹⁷ Following the recommendations *Review of Business Taxation, A Tax System Redesigned, More Certain, Equitable and Durable, Report*, John Ralph, 1999

¹⁸ Statutory effective life caps apply to tractors, harvesters, trucks, buses, aircraft, helicopters and gas transmission and production assets

¹⁹ *Australia's future tax system: Report to the Treasurer*, Australian Government, 2009, https://treasury.gov.au/sites/default/files/2019-10/afts_final_report_part_2_vol_1_consolidated.pdf

²⁰ *Climate Change Adaptation for Building Designers: An Introduction*, Mark Snow and Deo Prasad, February 2011, <https://www.adaptwest.com.au/sites/adaptwest/media/pdf/climate-change-adaptation-for-building-designers---an-introduction.pdf>

²¹ *Residential Building Lifespan and Community Turnover*, Alex Ianchenko Kathrina Simonen and Clayton Barnes, Journal of Architectural Engineering 2020 Volume 26, Issue 3 [https://doi.org/10.1061/\(ASCE\)AE.1943-5568.0000401](https://doi.org/10.1061/(ASCE)AE.1943-5568.0000401)

In a recent 2025 Reserve Bank Research Discussion Paper titled “*Are Investment Tax Breaks Effective?*”²², when that authors consider the effectiveness of a series of tax incentives in the form of additional deductions and instant asset write-off from 2009 to 2023, they concluded that the:

“effectiveness of the policies studied is mixed at best, and probably highly dependent on the nature of the policy and macroeconomic conditions”, generally only having an effect during “downturns which are driven by a shock to credit supply, rather than a sharp decrease in demand.”

Proposed changes to capital works deductions...

For many years it has been obvious that Australian residential building could be seen as an appreciating asset rather than depreciating asset, and even if they are not, that 2.5 per cent over 40 years for residential buildings substantially overstates any economic depreciation of a residential property²³. Therefore, without a compelling reason to retain the substantial accelerated depreciation, the Division 43 rate for residential properties should be reduced.

Accepting the recent New Zealand research, it may be appropriate to reduce the rate for residential buildings to closer to 1% or allow no Division 43 deductions for residential property. Having two different rates would be more complex, but there are already two rates at which Division 43 applies currently.

Removing Division 43 deductions from residential properties would have substantial simplification benefits as, where a taxpayer acquires a second-hand property, there would be no need to obtain a “Tax Depreciation Schedule” as both the depreciable assets acquired in the property, and the construction costs would not be depreciable.

²² Are Investment Tax Breaks Effective? Australian Evidence, Nu Nu Win, Jonathan Hambur and Robert Breunig, 2025, <https://www.rba.gov.au/publications/rdp/2025/pdf/rdp2025-01.pdf>

²³ A good house is hard to find: Housing affordability in Australia Senate Select Committee on Housing Affordability in Australia, 2008, http://www.aph.gov.au/senate/committee/hsaf_ctte/report/index.htm