propertybuyer®

Washington Brown
QUANTITY SURVEYORS

THE RESIDENTIAL PROPERTY INVESTOR'S GUIDE TO DEPRECIATION

HOW TO SAVE MONEY ON TAX

TYRON HYDE

TAX SAVINGS 100% GUARANTEED

Editorial and publishing by Major Street Publishing: www.majorstreet.com.au
Cover design by Heather Sheldrick: heather@sheldrickrose.co.uk
Internal design by Production Works

CONTENTS

MY FIRST PROPERTY DEAL

I must have been about 25 years old when I did my first property deal. I was the quantity surveyor for a project to convert the Balmain RSL building into residential apartments. At that time I was living in Leichhardt and I knew the block and thought it would be a pretty good investment.

I approached the developer and told him I was interested in buying an apartment. I didn't have a lot of cash, so I had to go halves with a friend. We put in $1,000 each as a holding deposit to secure a one-bedroom unit, with a loft, for $220,000. We thought that was a good start, we didn't even have to fork out the 10% for the deposit

Then the builder went broke halfway through the construction. It was a nightmare. It took another three to four years to finish the project. What a headache.

In the meantime, however, while construction was being delayed, the value of the property almost doubled. So, our $220,000 one-bedroom unit was worth around $400,000. We had signed our contract on the original price which meant our $1,000 initial deposit returned quite a handsome profit for my friend and I.

That was my first taste of property investing and it was one of the best deals I've ever done. My friend was very happy too.

I know that not every property deal will deliver the same level of profit, but residential property is still one of the most popular investment vehicles among Australians. According to the Australian

Taxation Office's (ATO's) statistics, more than 2.5 million tax returns submitted rental deductions as part of their claim. That means there's a whole heap of property investors out there!

YOUR PROPERTY INVESTMENT STRATEGY

Having invested in several properties myself, I always believe you need a sound and smart strategy. And I'm not just talking about good capital growth and high rental yields. It's also about improving your cash flow as an investor.

Every property investor has his or her own strategy. Some investors prefer negatively-geared properties, while others look to positively gear for ongoing income. Some buy for the short term, others see property as a long-term asset.

Whatever the strategy, the first thing an investor should do is ensure they claim depreciation on the property. Depreciation helps investors by reducing their taxable income, therefore helping their cash flow.

Based upon depreciation and other rental property deductions, investors can vary the amount of tax they pay during the year if they apply to the ATO to do so.

One easy way to work out whether you can claim depreciation is to simply visit the **Washington Brown website and use the free depreciation calculator**. By entering simple data about a property, an investor can quickly determine if they should be claiming depreciation or not.

The first thing an investor should do is ensure they claim depreciation on the property.

Many investors think their property is too old to claim depreciation deductions and in most cases this is simply not the case. If an investor has forgotten to claim depreciation they can always backdate a claim – but only two previously lodged tax returns can be amended.

If you have a medium-term strategy, it is advisable to understand what's in the depreciation schedule for the property. As time goes on, and you update or repair part of your property, you should ensure that you claim any 'balancing adjustment' you are entitled to.

For example, if you purchase a unit for $300,000 and the carpet is valued at $3,500. Let's say, seven years later the carpet was replaced but within the depreciation schedule the carpet still has $1,000 left to run. You can claim that $1,000 in full the moment the carpet is replaced. And, of course, you can start claiming the value of the new carpet as well.

In this ebook we explain to residential property investors the importance of claiming depreciation allowances and how this can make a difference to their cash-flow, depending on the age and type of property they invest in.

WHY I LOVE PROPERTY

Before we go too much further, I'd like to share with you exactly why I love property. There are a myriad reasons and here are the main six.

REASON # 1 – You can add value

One of the principal advantages of investing in property is that you can buy a rundown old property and increase the value of your investment by getting your hands dirty, or paying someone to get theirs dirty!

In comparison, it would be hard to add value to the Commonwealth Bank shares I own. Sure, I bank with the Commonwealth, but I don't think my day-to-day savings account is going to add much value to the bank's profits and in turn increase the value of my stock portfolio. Admittedly, I can vote when it comes to the company's annual general meeting, but are the voting rights attached to my 1,000 shares really going to make a difference?

Installing new carpet, painting and adding new blinds, that will make an immediate difference to the returns on a property that I have invested in.

REASON # 2 – There is limited supply

A builder once said to me, "You can't make property from a plastic mould". I like the fact that property takes a while to plan and build because, in my opinion, the demand and supply equation has a lot to do with the price of property.

A development across the road from where I live in Bondi has been 'in council' for three years now. This means it has taken three years for all the planning approvals to be passed – before construction has even started. And it will probably take two more years to build. That's five long years for the developer.

With shares, however, the company can make a capital raising at any time or issue options to directors or employees. This type of activity can dilute your shareholding making your piece of the pie smaller.

In contrast, you or the government can't just issue another house and lot or land package in Bondi or any suburb you happen to like.

REASON # 3 – There are some capital gains tax exemptions

Unlike any shares I currently own, the home I live in does not attract capital gains tax (CGT) when I decide to sell it. The sale of your principal place of residence is one of the only assets that you won't pay capital gains tax on. This has proved lucrative for many Australians, and I can't see the law changing in this regard for a long time.

REASON # 4 – It's easy to KISS (Keep it Simple, Stupid)

I like property because it's easier for me to understand compared to shares or other types of investment.

Granted I work in the property industry, but I know if I buy a property for $500,000 I can get $600 a week rent. There will be expenses that I can work out and I can use the **Washington Brown depreciation calculator** to work out my depreciation claim. Simple.

Have you ever read a share prospectus or company annual report and completely understood it?

REASON # 5 – I am master of my own domain

I like property because I can be the master of my own domain. I can be the CEO of my property portfolio, the CFO of my investment and answerable to the board directors that I care about – my wife.

I don't know about you, but I'm pretty sick and tired of hearing about golden handshakes to CEOs who have done the wrong thing to their staff or shareholders. I'm over self-interested company directors who pretend they have shareholder company value at heart. Do they really?

As the CEO of my property portfolio I can guarantee I'm looking out for number one!

REASON # 6 – It's not a constant reminder

I like property because I'm not reminded of how much I have lost or made every day.

Regular sharemarket updates in the media mean you are constantly aware of the gyrations of the market and the value of your shares. And it's really not necessary.

I personally don't wake up and wonder what the Nasdaq did overnight and I don't want to worry about how that's going to affect my share portfolio – if at all. If I need to have my property valued for any particular reason, for example if I plan to sell it or borrow against it, I will employ the services of a valuer. At all other times, as long as it's not causing me any problems and the tenants are paying their rent, then I'd prefer to let it appreciate in value in the background without being a constant reminder.

WORKING FOR YOURSELF

If you own your own business – providing it's a half decent business – your business will continue to make money, even when you take holidays and aren't there. You will have staff working for you or products that sell whether you are working or not.

If you invest in property, you will also be earning a passive income because you will have tenants paying you a rent. Over time, your property will increase in value, adding further to your net wealth without you having to do much work on it.

Passive income is the goal – and understanding depreciation will add further to this income.

BUYING BRAND-NEW VERSUS ALMOST-NEW

Some residential property investors prefer to invest in brand-new properties, while others opt for older ones that they can renovate and re-sell for profit. So, which is the better investment strategy?

Let's have a look at some of the pros and cons of buying brand-new and almost-new properties. Depending on your investment strategy, you may pick up some helpful hints for your next purchase.

Investing in brand-new property – the PROs:

- **Tax depreciation benefits are at their highest when the property is brand-new.**
- **With brand-new property you maximise your available tax deductions which adds a significant boost to your cash flow position.**

Depreciation allowances for new properties can yield big tax breaks. Investors can claim a 2.5% depreciation allowance on the construction cost. Plus you'll also be entitled to claim the full amount of depreciation allowances on plant and equipment items, such as blinds, ovens, carpets and air-conditioners, which will all be brand new.

By way of example, the owner of a brand-new, Melbourne, high-rise unit recently purchased for $440,000, was able to claim $12,000 in depreciation in the first year.

Buying brand-new property often carries the developer's profit, which you pay for in the purchase price. If you buy something 'newish' – say a five to ten year old property – there is a fair chance that it has been bought and resold a few times, therefore the value is now reflected in a more realistic way on the open market.

In slower market conditions, many investors seek out newish properties where the actual construction cost is close to the current purchase price. The tax benefits to the investor in these circumstances are threefold.

Investing in 'newish' property – the PROs:

- **There is less stamp duty to pay**
- **There is an increased chance that the capital gain and depreciation deduction, relative to the purchase price, has also increased**
- **If the investment property is, say, five years old, there are still 35 years left of deductions to claim.**

Also, due to recent changes to depreciation laws by the ATO, plant and equipment items installed after 10 May 2006 that are depreciated using the diminishing value method, do so at a higher rate than those installed prior to this date.

I've invested in brand-new properties before but with today's market conditions, I personally prefer to buy property that is five to ten years old because I still get lots of depreciation. With new, but not brand-new property, I can research the resale values of any surrounding property to make sure I am not paying too much.

LOW PRICED PROPERTY, HIGH DEPRECIATION RATIO

But, just to add another level to the debate, I also like investing in lower-priced residential property… and here's why.

Did you know that lower-priced property often has a higher depreciation ratio in relation to the purchase price?

During one of my recent media interviews, a journalist took me to task and asked me to explain my comments on this issue. Most of us know that higher-priced property tends to rent on a yield far less than lower-priced property, don't we?

But why is this? Why doesn't a luxury house in Vaucluse in Sydney or Toorak in Melbourne, for example, rent on the same yield as houses in less affluent suburbs? Or even when you have two properties in the same suburb, why is the yield of a one-bedroom flat greater (as a percentage of purchase price) than that of a four-bedroom property?

There are three main reasons for this:

1. Wet areas

Known in the trade as 'wet areas' – kitchens, bathroom and laundries – are more expensive to build, compared to bedrooms, on a per square metre basis. And the greater the construction cost, the more you can depreciate.

So a lower-priced property – for example, a one-bedroom apartment – still has a kitchen and a bathroom and as we increase the number of bedrooms (which are cheaper to build), and increase the price we pay for larger dwellings, the construction cost – as a ratio – decreases.

2. White goods

White goods in wet areas are also depreciable at a higher rate. Wet areas have items such as ovens, dishwashers, range-hoods and a clothes-dryer included within them.

These items depreciate at a quicker rate than brickwork and concrete.

So, as you add more bedrooms, or rumpus/other rooms to the mix, you reduce the effective life of these highly depreciable items.

Remember, it is better to have an item depreciating at 20% per annum as opposed to it depreciating at the building allowance rate of 2.5% per annum because you get your deductions faster.

3. Land value

As the price of the land increases, the house or construction cost decreases (as a percentage).

For example, we see many house and land packages where the ratio of construction cost to purchase price is roughly 50/50. This means if the final purchase price was $500,000, the land portion is $250,000 while the construction cost is the remaining $250,000.

When you start moving up the ladder to the luxury end of the market there is only so much building you can physically put on the land.

For instance, there was a recent landmark sale in Bondi, Sydney, where the developer paid approximately $4 million for a 100m^2 block of land. The most the developer will be able to build on this property is a maximum of 300m^2 internally (three-storeys).

Even if the developer uses gold-plated taps, I doubt they would physically be able to spend $2 million on the construction of this property, which is far less than the 50/50 ratio that can be achieved at the lower end.

The table below better illustrates this theory. These are all suburbs of New South Wales. You would get similar returns from comparable suburbs in other states.

RETURNS FROM NSW SUBURBS

Suburb	Median Price	Yield
Palm Beach	$2.7 m	1.25%
Rose Bay	$1.7 m	2.86%
Double Bay	$2.0 m	2.79%
Bellevue Hill	$3.2 m	2.32%
St Mary's	$275 k	5.48%
Penrith	$300 k	5.03%
Quirindi	$159 k	6.03%
South Grafton	$195 k	6.40%

I've talked to other industry players and peers and they all confirmed the validity of this trend. So in summary, here's my take on why high-end property has a lower yield:

- Supply and demand is certainly a factor. There will always be less demand for higher-end property.
- People are less inclined to pay rent for land, so it makes sense that properties with a higher land value, as a factor of the overall property value, will, as a ratio, rent for less.

- The capital gains tax-free status that we currently have on property that is your principal place of residence is a very effective wealth creation strategy which leads to people upgrading as opposed to jumping back into the rental market.
- Our national obsession with home-ownership means we are often only willing to pay so much rent before we switch to a mortgage. With a home-ownership rate of around 70%, we're up there with Canada, the UK and New Zealand as having the highest home-owner concentration in the world.
- A large proportion of those wanting to live in a high-end property are from the 'family' segment of the market. The thought of moving every two years may drive that market to look for more stability.

RESIDENTIAL PROPERTY INVESTING AND FIRST HOME BUYERS

First home buyers seem to be a popular topic of discussion in Australia. They're either getting a lot of government incentives and grants on the one hand, or they are finding it tough to get into the property market due to rising house prices on the other.

Over the years, I've been invited to talk at various conferences. Just recently, at the end of one of my presentations, a young, fresh-faced lad raised his hand and asked me: "I'm a first home buyer and I plan to live in my property for a year then move out and turn that property into a rental. Can I still claim depreciation when I move out?"

Now each state has its own first home buyer's incentive schemes (or first home owner grants, as they are sometimes called) and they are continually changing. But the simple answer is yes. First home buyers can still claim depreciation once they move out. This seems to be a growing trend. People are buying properties for the first time, living in them for a certain period of time, and then renting them out.

Having someone else pay your mortgage could be a good strategy for some people, particularly if they can only afford to buy in a certain area (say the outer suburbs) but they would prefer to live elsewhere, for a while at least. It's like having their cake and eating it too.

But let's have a closer look at the implications of this.

FACT: You must occupy the home as your principal place of residence for a continuous period of at least six months, commencing within one year of the completion of the transaction to which the application for the first home owner grant relates.

THE (TAX) LAW

The Income Tax Assessment Act 1997 determines what types of properties qualify for the building allowance deduction (for a full explanation of building allowance deductions please see the Washington Brown ebook, *How to Calculate Depreciation and What to Claim For*, available from **www.washingtonbrown.com.au**).

According to Section 43-90 "Residential Accommodation" is classified as a type of property that can attract building depreciation allowances, providing that was its intended use (as residential accommodation) at the time of completion.

Luckily for first home buyers, this requirement is satisfied even if the accommodation was intended to be used for private purposes or to be owner-occupied after its completion. The important part of the Act relates to how the property is used in the "current year of use".

Put simply, it's OK to live in the property for a year or so, then move out and claim depreciation. But before all the first home buyers get excited, let's drill into the nitty-gritty of this and the potential savings or benefits.

FIRST HOME BUYER GRANTS FAVOUR BRAND-NEW PROPERTY

First of all, let me point out that the first home buyer grant currently favours buyers who purchase brand-new property. By favouring new property, the government is hoping to stimulate building activity – which is generally the first industry to lead the way out of a recession.

The building industry also stimulates other industries such as retail (people need to buy new TVs, lounges and other items when they move into a new home) and this has a knock-on effect on the wider economy.

For this reason, the following comparison tables below look at new properties. I am also showing you the difference between using the diminishing value method, which accelerates the allowances you can claim and the prime cost method, which evenly spreads out the allowances you can claim. The method of calculation you use will depend, in large part, on how long you intend to use the property as an investment.

NEW VS OLD PROPERTY BEING RENTED AND DEPRECIATION ALLOWANCE

SCENARIO 1 – Property investor purchases a new property and rents it out immediately. How much can be claimed?

	Year 1	*Year 2*	*Year 3*	*Year 4*	*Year 5*
Diminishing value method					
$300,000 new house	$9,000	$6,000	$6,000	$5,000	$5,000
$500,000 new house	$12,000	$10,000	$9,000	$9,000	$8,000
$300,000 new high-rise	$9,500	$7,000	$6,000	$5,000	$5,000
$500,000 new high-rise	$13,500	$11,000	$10,000	$9,000	$8,000
Prime cost method					
$300,000 new house	$5,000	$5,000	$5,000	$5,000	$5,000
$500,000 new house	$9,000	$9,000	$9,000	$9,000	$9,000
$300,000 new high-rise	$5,000	$5,000	$5,000	$5,000	$5,000
$500,000 new high-rise	$9,000	$9,000	$9,000	$9,000	$9,000

SCENARIO 2 – First home buyer purchases a property – lives in it for one year – then rents it out. How much can be claimed?

	Year 1	*Year 2*	*Year 3*	*Year 4*	*Year 5*
Diminishing value method					
$300,000 new house	nil	$6,000	$6,000	$5,000	$5,000
$500,000 new house	nil	$10,000	$9,000	$9,000	$8,000
$300,000 new high-rise	nil	$7,000	$6,000	$5,000	$5,000
$500,000 new high-rise	nil	$11,000	$10,000	$9,000	$8,000
Prime cost method					
$300,000 new house	nil	$5,000	$5,000	$5,000	$5,000
$500,000 new house	nil	$9,000	$9,000	$9,000	$9,000
$300,000 new high-rise	nil	$5,000	$5,000	$5,000	$5,000
$500,000 new high-rise	nil	$9,000	$9,000	$9,000	$9,000

There are two things that become obvious from these examples:

1. The amount a first home buyer can claim is only affected while they live in the property. This makes sense because while you live in the property, it is still depreciating, so you just can't claim the depreciation as a tax deduction.

2. If you did buy a property as a first home owner and lived in it for a year, using the diminishing value method would still be more beneficial in the short term. Again, it is best to check with a qualified quantity surveyor to ensure you maximise your tax savings in your own particular circumstances.

While I don't intend to advise first home buyers (or any other property investor) whether now is a good time to enter the market or not, I'd like to say that if you do turn your castle into a rental, don't ignore the depreciation benefits you're entitled to. As Kerry Packer once famously said, "Pay your tax, but don't tip them. They are not doing that good a job!"

THREE MOST COMMONLY MISSED ITEMS PROPERTY INVESTORS CAN CLAIM

Claiming depreciation on residential property is one of the most important steps in an investor's journey. But those new to property investing can be forgiven for overlooking some items of depreciation.

The three most commonly missed items property investors can claim are:

- Design and professional fees
- Council costs
- Builder's profit.

Most people know about the more common plant and equipment items such as carpets, ovens and blinds that they can depreciate in an investment property. But the three listed above often get missed and unclaimed.

DESIGN FEES

I bet you didn't know you could depreciate design fees? By design fees, I'm talking about architectural fees, engineering costs, and any other design fees involved in creating the property. They are all legitimate tax deductions against your income.

COUNCIL FEES

The second, commonly forgotten or unclaimed item, is council fees. A lot of investors overlook claiming the costs associated with dealing with councils. This is not just limited to building application and development application fees, but may include council contributions, for instance, costs a developer may have to spend on local community works, like building a playground. You can claim your portion of these costs as part of your depreciation claim.

BUILDER'S PROFIT

It is also important to note that if you engage a builder directly to construct your investment property, the builder's profit component of the work can be claimed. However, if you buy a property from a speculative builder/developer then you cannot claim the builder's/developer's 'profit'.

From my experience, it always pays to have a quantity surveyor look over your investment property to ensure you are claiming the maximum depreciation allowances.

From my experience, it always pays to have a quantity surveyor look over your investment property to ensure you are claiming the maximum depreciation allowances.

CONTACT US

Washington Brown, www.washingtonbrown.com.au, has offices around Australia. The nationwide email contact address is: info@washingtonbrown.com.au. Or individual office contacts are:

SYDNEY
Ph: 02 8324 7440
Suite 25, 321 Pitt Street
Sydney NSW 2000

BRISBANE
Ph: 07 3041 4151
Level 23, 127 Creek Street
Brisbane QLD 4000

PERTH
Ph: 08 6270 6386
Level 3, IBM Building
1060 Hay Street West
Perth WA 6005

MELBOURNE
Ph: 03 8678 1886
Level 2, 222 Latrobe Street
Melbourne VIC 3000

CAIRNS
Ph: 07 4027 9511
181 Mulgrave Road
Cairns QLD 4870

ADELAIDE
Ph: 08 8311 3998
213 Greenhill Road
Eastwood SA 5063

HOBART
Ph: 03 6118 2711
127 Bathurst Street
Hobart TAS 7000

CANBERRA
Ph: 02 6108 3603
33/2 Endeavour House
Captain Cook Crescent
Manuka ACT 2603

DARWIN
Ph: 08 8911 0410
Paspalis Centrepoint
Level 148-50 Smith Street
Darwin NT 0800

Washington Brown
QUANTITY SURVEYORS