

## To depreciate or not depreciate – that is the question

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In the 2003 income year, over one million taxpayers claimed rental property deductions, with more than 200,000 of them being new entrants to the market in that year. Accordingly, it is not surprising that whenever anything is said by the Tax Office on what can and cannot be claimed for such properties it draws attention. Not only attention from the tax press, but also from the media generally.

Against this backdrop, the Tax Office has recently released *Draft Taxation Ruling 2004/D3* in which it sets out its view on what is "plant" for residential rental properties. What is plant in a residential rental property is critical for taxpayers as only plant can be depreciated under Div 40 of *ITAA 1997*. In addition, the new draft ruling considers briefly the deductibility of capital expenditure on assets associated with residential properties under Div 43 of *ITAA 1997* (which deals with capital works). Once the draft ruling is issued in final form, it will apply both before and after its date of issue – replacing the previous ruling on the subject, *Income Tax Ruling IT 242*. However, taxpayers who have applied *IT 242* can continue to rely on that ruling if it provides them with a higher depreciation deduction.

### **What is a residential rental property?**

The new draft ruling applies only to rental properties such as houses, apartments, units and flats. It does not apply to hotels and motels or a resort or similar property providing short-term accommodation and a caravan, houseboat or other mobile home.

## **Assets in a residential rental property**

Since the purchase of an asset for a rental property is generally on capital account, the expenditure incurred will not be immediately deductible under the general deduction provision in sec 8-1 of *ITAA 1997*. Accordingly, a deduction for assets associated with residential rental properties will only be available under either of the following:

- Div 40 – which allows a deduction for certain depreciating assets; or
- Div 43 – which allows a deduction for capital works.

In general, a deduction under Div 40 will be more favourable to a taxpayer than a deduction under Div 43 as the rate of depreciation under Div 40 will be higher than that in Div 43. Accordingly, taxpayers will usually be seeking to argue that an item is "plant", and the Tax Office that an item is not plant but is rather capital works.

### **Depreciating assets – Div 40**

In broad terms, under Div 40 a taxpayer can obtain a deduction for depreciation of an asset based on its effective life. Also, an immediate deduction is available for depreciating assets costing less than \$300 and for assets in a low-value pool. However, Div 40 does not apply to a deduction that is available under Div 43.

### **Capital works – Div 43**

Less favourably to taxpayers, Div 43 provides a 2.5% deduction for capital works (including buildings), such as structural improvements and to extensions, alterations, or improvements to buildings used for residential accommodation if construction started after 17 July 1985 and was used to produce assessable income.

Plant is expressly excluded from the definition of construction expenditure and is therefore not deductible under Div 43. Instead, it is depreciable under Div 40.

### **Only plant is depreciable under Div 40**

Division 40 provides a deduction for assets that come within its definition of "plant". If an asset is not plant then that asset will not be depreciable under Div 40. Where an

asset is not plant, however, expenditure on that asset may still be deductible under Div 43, if it involves "capital works".

### **When is an asset plant?**

The term "plant" is defined to include articles and machinery (sec 45-40 of *ITAA 1997*). Accordingly, the term not only takes on its ordinary meaning but extends to include articles and machinery.

To date, no Australian court has considered the meaning of the term plant in the context of rental properties. However, there have been a number of AAT decisions on the issue. According to the Tax Office, the meaning of plant established in court decisions should be considered in light of the AAT decisions.

### **The ordinary meaning of plant**

Having accepted that the term plant takes on its ordinary meaning, the Tax Office identifies two main issues relating to the ordinary meaning of plant, namely:

1. whether the rental property itself is plant; and
2. whether any of the property's fixtures and fittings are plant.

### **Is the rental property plant?**

In general, if something is the "setting" for a taxpayer's income-earning activities then it is not plant as ordinarily understood.

Only rarely, will buildings, structures or the like, or parts of them, be more than merely the setting as the function performed by them will be so related to the taxpayer's operations or special that it warrants it being held to be plant. According to the Tax Office, except in exceptional circumstances, residential rental properties will almost invariably be the setting of the income-producing operations and will therefore not be plant.

## **Are the fixtures and fittings plant?**

Something that forms part of the fabric of the property, or that is an integral part of its structure, is also not plant because it is part of the setting of the income-earning activity.

According to the Tax Office, whether an item forms part of the property's structure or retains a separate identity is a question of fact and degree to be determined by examining the following factors:

- whether the item appears visually to retain a separate identity;
- the degree of permanence with which it has been attached;
- the incompleteness of the structure without it; and
- the extent to which it was intended to be permanent or whether it was likely to be replaced within a relatively short period.

No single factor is determinative and the relative importance of each factor varies depending on the nature of the item.

Where the item does not form part of the premises it will come within the ordinary meaning of plant where the function performed by the item is so related to the particular taxpayer's income-earning activities or special that it warrants it being held to be plant. In the residential rental context, this would only occur rarely as the required close relationship between the function performed by the item and the rental income-earning activities will not exist.

## **Articles**

As noted previously, the term plant in Div 40 expressly includes "articles". The term "article" is not defined in tax legislation but in case law it has been interpreted broadly to include a curtain, a desk and a bookshelf. However, an item will not be considered to be "article" if it is a structure attached to land or if it is an integral part or the "fabric" of such a structure.

## **Machinery**

The term plant also includes machinery. According to the Tax Office, determining what is "machinery" is a two step process.

1. It involves an identification of the relevant thing (unit) or things (units) based on its functionality.
2. It involves a determination of whether that thing or each of those things falls within the ordinary meaning of "machinery".

Machinery will be plant whether or not it is an integral part of a building or is a part of the setting of the taxpayer's income-earning activities.

### **Identifying the relevant thing(s) or unit(s)**

A unit is generally something that has an identifiable, separate function. However, it need not be self-contained or used in isolation and it may vary the performance of another unit. An item is not a unit simply because it is described as a system.

An item may be made up of several components. To determine what the relevant unit is, the taxpayer needs to consider the function of each component and of the larger composite item. A door handle, for example, is part of the door and not a separate unit. Similarly, a freestanding spa pool that is made up of the shell, skirt, heater, pump, filter and piping is one unit.

In other cases, separate units may work in conjunction with each other to achieve a common objective. For example, a fire safety system may consist of several components including, for example, an indicator board, hydrants, piping, alarms, smoke detectors and sprinklers. All these components function together to form the system. However, each component also performs its own discrete function independent of the others and, therefore, each component is a separate unit.

The question of whether an item in a residential rental property is machinery depends on if the item is a unit, part of a larger unit or whether its components are separate units. The answer will be a matter of fact and degree, based on all of the circumstances of the particular case.

## **Determining whether the relevant thing(s) or unit(s) are machinery**

There is nothing in the definition of plant to suggest that machinery should have a meaning other than its ordinary one. The term "machinery" is defined in the Macquarie Dictionary , 3rd ed, 1999, to mean:

- an apparatus consisting of interrelated parts with separate functions, which is used in the performance of some kind of work;
- a mechanical apparatus or contrivance;
- a mechanism; and
- something operated by a mechanical apparatus, as a motor vehicle, a bicycle, or an aeroplane.

The modern ordinary meaning of machinery also includes devices that "utilise in various processes minute amounts of energy, in the form of electrical impulses", eg computers and microprocessors.

Machinery does not include anything that is merely a reservoir or conduit, such as ducting, piping or wiring. If the ducting, piping or wiring forms part of a unit that is a machine then it is machinery, but if it is merely connected to, but not part of, a unit that is a machine then it is not machinery, eg mains laid and used for supplying gas are not parts of a machine and cannot be machinery.

## **Calculating depreciation**

Once a taxpayer has determined that an item is plant, the next step to take is to calculate the depreciation of that item.

To calculate the depreciation of plant in a taxpayer's rental property, the taxpayer may choose to use:

- the effective life the Tax Office determines; or
- the taxpayer's own estimate of an asset's effective life.

## **What is an effective life?**

The effective life of an asset is the period of time that a depreciating asset can be used by any entity to produce assessable income:

- assuming it will be subject to wear and tear at a reasonable rate;
- assuming it will be maintained in reasonably good order and condition; and
- having regard to the period within which it is likely to be scrapped, sold for no more than scrap value or abandoned.

## **Effective life reviews**

In addition to releasing its views on what is plant for residential rental properties, the Tax Office has also recently released a new schedule of effective lives.

The Tax Office's determinations of effective life are "safe harbour lives" because they will not be challenged in an audit process. However, if a taxpayer believes the Tax Office's determination of effective life is unsuitable for their situation, the taxpayer can self-assess the effective life of their asset (sec 40-105 of ITAA 1997). If the taxpayer does so they may be asked to justify the asset's effective life.

In general, a taxpayer may only use the Tax Office's determination that applied at the time the taxpayer acquired the depreciating asset.

## **Change of an asset's effective life**

The fact that the Tax Office has determined a new effective life for an asset does not automatically allow a taxpayer to recalculate an asset's effective life, even if the asset did not previously appear in the Tax Office schedule. A taxpayer can only recalculate the effective life of an asset each time the nature of the asset's use has changes. Some examples of changes in use are:

- the taxpayer's use of the asset turns out to be less or more rigorous than the taxpayer expects (or is anticipated by the Tax Office's determination used by the taxpayer);
- legislation prevents the asset's continued use; and
- changes in technology make the asset redundant.

Set out below is a table showing some examples of assets that are depreciable and some examples of assets that are not depreciable. The table also includes the new effective life determinations that came into force on 1 July 2004. In other words, taxpayers may only use the determinations for assets the taxpayer acquires on or after that date.

Asset	Depreciable	Reason	Effective life from 1/7/04
Carpet	✓	Within definition of article	10
Curtain	✓	Within definition of article	6
Desk and bookshelf	✓	Within definition of article	13 1/3
Stoves, cooktops, ovens	✓	Within definition of machinery	12
Electric or gas hot water systems	✓	Within definition of machinery	12
Solar or hot water system	✓	Within definition of machinery	15
Kitchen cupboards fixed to rental premises	X	Cupboards are fixed to premises and intended to remain in place permanently and therefore form part of the setting of the landlord's rental income-earning activities. As the kitchen cupboards, insulation batts, built-in wardrobes	

		and tubing are not plant, they cannot be depreciated under Div 40, but a deduction may be available under Div 43.	
Insulation batts	X	Although not fixed to the premises they generally remain in place indefinitely. They lose their separate visual identity, form part of the setting and add to the completeness of the premises.	
Built-in wardrobe	X	Built-in wardrobes form part of the premises as they are fixed to the premises, remain in place indefinitely, do not retain a separate visual identity and add to the completeness of the premises.	

## Conclusion

Considering the ongoing debate over what can and cannot be depreciated when it comes to rental properties, it is unlikely that the recently issued draft ruling will represent the final word on the matter. The issue has always proved to be a controversial one, with the focus being on evidence that taxpayers sometimes make unfounded claims. Although difficult to resolve, the issue is one that deserves attention. Not only because it affects over one million taxpayers, but also because it is important to have certainty in this area to minimise the costs of complying with the tax law.