

Media Release
Date 20.5.2010

Higher rents forecast as Budget alters tax rebate rates on investment properties

Watch out for rising rents in the coming 12 months. That's the warning from both finance Minister Bill English and a leading property investment expert following the Government's Budget announcement released today.

Tax depreciation rates on investment properties will be reset to zero next year, while special 'loading allowances' covering new asset purchases will be removed altogether – under the Government's Budget released today.

The Budget outlined that effective from the 2011/2012 income year - for most investors, this will mean from 1 April 2011 - depreciation deductions will no longer be allowed for buildings with "an estimated useful life of 50 years or more."

Leading property investment and property depreciation expert John Freeman from Bayleys Valuations Limited in Wellington said the Budget specifically voiced the Government's belief that this would apply to such properties as rental houses and offices.

"As signaled for quite some time now, the Government has embarked on a path to abolish building depreciation on virtually every building type, and potentially looking over the coming months into reducing the categories of assets within commercial properties that currently attract depreciation claims, must have an effect on the property market in New Zealand," Mr Freeman said.

"Treasury, according to Finance Minister Bill English, is predicting already that levels of rent - both in the commercial and residential arenas - will probably rise as a result of this over the next few years.

"I believe that property investors and owners will not be happy to, or indeed in many cases able to, absorb the changes in depreciation expense claims on their properties. That will probably reduce net income from the investment so there will have to be movement on rental levels, and the only way investors can maintain yield margins is by increasing rents."

Mr Freeman said the Government's firm view was that: "New Zealand buildings do not drop in value over time, thus giving property owners tax preferences."

"The tax depreciation rate basically effective for most property investors on buildings from April 1, 2011 will therefore be reset to zero," Mr Freeman said.

"That is unless of course in accordance with IR 265 (the IRD's tax depreciation rate guide) you own a portable building or one with prefabricated stressed-skin insulation panels. If you currently do have a building that meets this 'less than 50 year useful life' criteria, you can continue to depreciate it at the current rate.

"The Government acknowledges that some property owners may feel their properties are in a class that has useful life of less than 50 years. The option for property owners to apply to the IRD for a provisional depreciation rate in such cases is available, and given the very limited

exclusions applicable, there may be quite a few of these rulings applied for by commercial real estate owners.”

The Budget outlined that repairs and maintenance costs to keep properties in good condition to maintain their value would still be allowed.

“Nothing seems to have changed in this respect in the Budget,” Mr Freeman said. “For the time being, depreciation claims on building fitout and services not currently designated as buildings will be allowed.

“However, the Budget clearly stated that the Government will review the treatment of commercial property fitouts in the next period, and, if necessary amend the rules on such allowances prior to 1 April 2011. It is thought this will clarify any uncertainty as to what property owners can or cannot claim in terms of asset tax depreciation.

“This intention was signaled by the IRD in late March this year when the IRD announced that the treatment of commercial property fitouts and services may well follow the treatment of its residential counterparts in the future.

“A lot of what is currently claimed by commercial property investors could be denied by IRD in the future. The IRD had listed 16 examples of fitout applications, of which, for residential property, only three or four may now be claimed as depreciable assets and not part of the building.”

Meanwhile, the 20 percent loading to the tax depreciation rates currently available if investors purchase a brand new asset is being removed from today. Assets currently attracting this loading will be allowed to continue.

The Budget estimates that these actions on property investment will raise \$685million in 2011/12 rising to \$690 million in 2013/14.

Mr Freeman said that interestingly within the Budget, the IRD had been allocated a “significant boost in funding” to assist with audits of property transactions, and to increase its activity in respect of “debt collection and the hidden economy.”

The activities of Loss Attributing Qualifying Companies or LAQCs – the corporate vehicle used by many residential property investors – will also be treated differently from next year.

“The 2010 Budget has signaled legislation is to be proposed that from April 2011, all LACQs will be taxed as limited partnerships. Laws will be tightened from April next year to prevent investors choosing to have losses deducted at their marginal personal tax rate, but profits taxed at the lower company tax rate.

“The Government feels this will ensure both profits and losses incurred are calculated at the same marginal tax rate as that of the investor. Investors should review these changes in conjunction with taxation specialists to determine the personal effect of these changes upon them and their investments vehicles.”

Case scenarios....what does today's Budget mean to property investors' bottom lines?

Currently if an investor purchases a commercial property, such as an office block, with a cost (excluding the land component) of \$3.5million, without segregating it any further for tax depreciation purposes, then the first year's claim is in the region of \$105,000. Segregated further into the buildings and services categories increases the current claim levels to approximately \$164,000.

The Budget action in removing building depreciation claims means an investor's first year's depreciation claim could be a maximum of \$115,000. However if fitout allowances are - as is being signaled - reduced or disallowed altogether, this estimate would reduce dramatically.

Investors who fail to segregate assets into their correct depreciation categories of buildings and services will see all their depreciation claims disappear from 1 April 2011.

For a residential property investor purchasing a rental property for a cost of \$300,000 (again excluding land) basic tax depreciation claims allowable now are between \$6000 and \$9000 for the first year of ownership depending on the rate chosen.

From April 1, 2011, most residential property investors - even allowing for segregating of assets into building and fitout/chattels categories - the figures will almost certainly disappear, and depreciation allowable claims will be significantly reduced.

Investors buying and/or selling property in the future should be conscious that the IRD has more money and resources to spend on investigating the transaction to ensure the process is completed in total accordance with the all rules.

Caption: Commercial property valuations and tax specialist John Freeman.

For further explanation or commentary, contact Bayleys Valuations Limited director John Freeman (FPINZ MRICS MACostE). Telephone 04 499 6414 or mobile 021 427 054