ATO deals another low blow to property investors

Many millions of dollars are certain to be lost by property investors following a recent ATO backflip on its definition of plant. By JAMES HANNAH, DEPpro

In a recent landmark decision a Brisbane property investor's claim for depreciation deductions for various items of plant was rejected by the Administrative Appeals Tribunal, sitting as the Small Taxation Claims Tribunal on behalf of the Commissioner of Taxation. The Tribunal stated that the items were not plant and therefore had to be treated as part of the building.

The items under review were:

- Electrical switchboards, mains and sub-mains cables, gas and telephone installations were an integral part of the structure of the building.
- Kitchen counter fittings, the bathroom mirror, glass shower screen, wardrobe shelving and mirrored doors were part of the fabric of the apartment.
- Sliding security screens, security floodlights, gates, deadlocks and the letter box were also part of the structure of the building.
- Pool and spa were entertainment or leisure items, which were not integral to the rental income-earning process.
- Protective bollards or vehicle control equipment also formed part of the structure of the building.

This result appears to be contrary to what the ATO has previously allowed and to what has been recorded and defined as plant in the tax ruling TR 2000/18.

In deriving their decision, the Tribunal applied several tests to determine whether or not an item meets the definition of plant and the function of the item in relation to the income earning activities.

"(a) A rental property itself is not "plant"…. It is the "setting" for the income earning activities.

(b) That which forms a part of the fabric of the property, in a metaphorical sense, or in other words, that which is an "integral part of the structure of the premises" is therefore also not plant… and is to be regarded as a part of the "setting" of the income earning activity.

(c) A conclusion that some item forms "part of the fabric" of a rental property is an issue of the fact,arrived at by considering whether the rental property may still be regarded as a complete entity for the purposes which it serves (in an income earning sense) even if the item were absent. If the property would be regarded as incomplete without the item, the item is a part of the fabric.

(d) If the item is properly regarded as NOT forming part of the 'setting', there is a need to consider (positively) its function in the context of the income-earning activities. If it can be said to be related to those activities in a sufficiently significant sense, it will be 'plant'. "

The Tribunal studied past cases and rulings in order to make their interpretation of what constitutes plant. The Tribunal is of the view that the disputed items do not come within the meaning of plant under section 42-18 of the Act. Therefore, the Applicant is not entitled to any further deductions for depreciation of plant under sections 42-18 of the Act.

The ramifications of the ruling are yet to be analysed, but from the latest statistics it would certainly contribute to many millions of dollars lost by property investors. Most large developers and mortgage originators are employing the tax advantages of depreciation as a selling tool, and property investors factor depreciation into their cash flow equations when purchasing property.

The underlying question remains as to what is considered plant and what constitutes a building. This case illustrates the confusion that exists when analysing investment property for depreciation purposes.

The guide to depreciation by The Australian Taxation Office states the following:

What is depreciation? The value of an asset gradually reduces over time as they approach the end of their useful life. Assets which lose value in this way are said to depreciate. In recognition of this fact, the cost of capital assets used in producing assessable income can be written off over a period of time as a tax deduction. Under income tax law, the term 'Deprecation' is applied to plant – for example, motor cars and machinery.

Which items can you depreciate? The depreciation provisions apply to plant that is used to produce assessable income or is installed ready for use to produce assessable income and is held in reserve. Depreciation is not allowed on plant used for private purposes or where income producing activity has not yet commenced. Plant includes:

- computers
- electric tools
- furniture and fittings
- furnishing – carpets and curtains
- manufacturing machinery
- motor vehicles.

In some situations, various other assets, which are generally not regarded as plant, are also depreciable under income tax law. They include:

- working animals – for example, racehorses – not used in primary production
- structural improvements – for example, fences and dams – on land used for agricultural or pastoral operations, or in a primary production business
- plumbing fixtures and fittings in premises mainly for the use of employees or for the care of the children of employees
- software, including a licence to use it.

Buildings are not generally plant or included in plant, but a deduction similar to depreciation may be available under the separate deduction provisions for capital works. Various deductions for non-depreciable capital expenditure are available under the primary production provisions.

In most instances, it will be clear whether or not something is an item of plant. However, if you're not sure whether an item qualifies for depreciation, contact your professional tax adviser or the Australian Taxation Office (ATO).

How are the rates of depreciation set? Depreciation rates are fixed by reference to the effective life of each asset. The effective life of a depreciating asset is the estimated period over which it can be used to produce income if it's maintained in good order and condition and subject to normal wear and tear. The longer the effective life of an item, the lower its depreciation rate; for example, if the

estimated effective life of an asset is 20 years, its basic rate of depreciation would be 5 percent. If the effective life is 10 years, the basic rate is 10 percent.

Effective life of an asset is used to decide the rate of depreciation. You can either make your own estimate of the effective life of assets acquired during the year or adopt the effective life determined by the Commissioner.

If you decide to make your own estimate of effective life, you need to take into account:

- how long you expect the asset to last
- how you expect to use it
- whether it's likely to become obsolete
- whether the effective life is limited to the life of a particular project.

The sort of information you could use to make an estimate includes:

- manufacturer's specifications
- independent engineering information
- your own past experience with similar assets
- the past experience of other users of similar assets.

Another important change that applies after this time is that you have the option to work out a new effective life depreciation rate for plant if you conclude that the effective life you've been using is no longer accurate because of changed circumstances. This does not apply to certain small business taxpayers, who will retain access to accelerated depreciated under the proposed Simplified Tax System.

Examples of changes in circumstances are:

- changes in technology that make the plant redundant
- changing market developments that result in the plant being scrapped at a different time than had been determined
- use of the plant turns out to be more or less rigorous than you expected
- other factors connected with usage that prevent the plant's continued use.

A reassessed effective life to the plant will mean either an increased or decreased rate of deduction. You can vary an effective life estimate regardless of whether you originally assessed the asset's effective life or adopted the effective life determined by the Commissioner.

The Australian Property Institute define depreciation thus: Depreciation in the valuation context includes not only depreciation of assets through wear and tear, but also includes loss in value due to functional, economic and technological obsolescence.

It's important to note that depreciation is a factor of either one or several of the following – (1) Wear and tear through physical use, in excess of that which maintenance can restore. (2) Functionality; e.g. economic and technical obsolescence. This is the process of becoming increasingly out of date and comparatively inefficient as a result of technological advances and improvements. (3) Commercial obsolescence, which can be defined as the process of becoming redundant through a fall in market demand for goods or services which the respective assets are being used to produce.

It's therefore important to understand why any property investor would take it upon themselves to spend additional capital funds to replace kitchen cupboards, shower cubicles and screens, switchboards and cabling… is it that the property may be