[Insert DD Month YYYY]

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[Insert Client Name]

[Insert Client Position]

[Insert Company Name]

[Insert Client Address]

[Suburb State Post Code]

Dear [Insert Client Name]

**Re:** **Depreciation deductions for residential rental properties**

Depreciation deductions can be claimed under Division 40 of the *Income Tax Assessment Act 1997* **(*ITAA 1997****)* in respect of depreciating assets used in deriving assessable rental income. For assets acquired during the year ended 30 June 2022 such deductions will be calculated based on the effective lives as set out in Taxation Ruling TR 2021/3.

Relevant considerations when determining depreciation deductions in relation to residential rental properties are discussed below.

**No depreciation of second-hand depreciating assets**

From 1 July 2017, certain investors are prevented from claiming deductions for the decline in value of second-hand depreciating assets (e.g. furniture and fittings) installed in residential premises used to derive rental income.

Deductions are disallowed under section 40-27 of the *ITAA 1997* in respect of second-hand assets where the assets were acquired on or after 9 May 2017 or where they had been previously held by the investor and used for private purposes. Accordingly, residential rental property investors will typically only be able to claim deductions for the decline in value of new assets which have been acquired for use in such premises.

The purpose of section 40-27 is to deny tax depreciation deductions in respect of second-hand assets whose value may have been refreshed or overstated on acquisition.

Instead the decline in value of such a depreciating asset may result in a capital loss (or in certain circumstances a capital gain) on any subsequent disposal of the asset under CGT Event K7 for the difference between the termination value of the asset and its cost.

The practical effect of these amendments is that certain entities can therefore only deduct the decline in value of depreciating assets used in gaining or producing assessable income for residential premises if the asset is acquired new for that purpose.

Importantly, there is no reduction to the capital works deduction in respect of eligible building expenditure which may be written off under Division 43 of the *ITAA 1997*, which is often the most material tax depreciation deduction claimable in respect of any acquired residential investment property.

The reduction in the decline in value of any depreciating asset will only apply if the relevant asset has been ‘previously used’ in that:

* the entity is not the first entity that has used the asset or installed the asset ready for use within the meaning of Division 40
* the asset is used or installed ready for use during the tax year in residential premises that has been formerly used in a dwelling that was a residence of the taxpayer when the asset was first used or installed or
* the asset is used or installed ready for use during any income year for a purpose that is not a taxable purpose, unless the use for that purpose is occasional. For example, allowing relatives to stay one weekend free of charge in rental accommodation that is usually used to derive rent would be regarded as occasional use and therefore any depreciating assets used in those circumstances would not be for a non-taxable purpose.

It should be noted that the restriction on claiming deductions for used depreciating assets in a residential rental property does not apply if the entity is either a corporate tax entity, a superannuation plan that is not a self-managed superannuation fund (**SMSF**), a public unit trust, a managed investment trust, or a partnership or unit trust where each member of the partnership or unit trust is one of the aforementioned excluded entities.

In addition, the reduction also does not apply if the depreciating asset is used in carrying on a business. That is, the reduction is aimed at residential property investors who are deriving passive investment income.

Furthermore, the amendments do not apply to a depreciating asset installed in new residential premises (including substantially renovated premises) if no entity has previously been entitled to any deduction for the decline in value of the asset and no one has resided in the premises in which the asset has been used. For example, a developer would not have claimed a deduction for the decline in value of any depreciating asset as such a property would have been regarded as trading stock of the developer and no other person would have previously lived in the premises.

For these purposes, the term ‘new residential premises’ has the same meaning as that term has under section 40-75 of *A New Tax System (Goods and Services Tax) Act* 1999 (***GST Act***). Section 40-75 of the *GST Act* defines new residential premises as premises that have not been previously sold or subject to a long-term lease as residential premises or have been subject to a substantial renovation or replacement of existing premises. For these purposes ‘substantial renovations’ is also defined under the *GST Act* as being renovations in which substantially all of a building is removed and replaced (although it does not always need to involve structural alterations).

In all other respects depreciating assets acquired before 9 May 2017 will continue to be depreciable under the general depreciation rules until they are either written off or are on-sold.

**Calculating the effective life of residential rental property assets**

As an owner of a residential rental property is not generally regarded as carrying on a business, it cannot rely on the concessional depreciation rates available under the small business entity capital allowance rules contained in Subdivision 328-D of the *ITAA 1997*. Accordingly, it is necessary to apply the general capital allowance rules in Division 40 in calculating the decline in value of rental property depreciable assets.

Such taxpayers will be able to claim an immediate deduction for a depreciating asset costing $300 or less to the extent it is used for a taxable purpose, i.e. if the asset is used predominantly to derive rental income. However, reference must generally be made to the Commissioner of Taxation’s estimate of effective lives under section 40-100(1) in calculating the depreciation of depreciating assets whose cost is more than $300.

**Effective life of depreciating assets under Taxation Ruling TR 2021/3**

The Australian Taxation Office (**ATO**) annually reviews its determination of the effective lives of depreciating assets, including plant included in residential rental properties.

This determination is set out in in Taxation Ruling TR 2021/3 in respect of depreciating assets which were acquired during the year ended 30 June 2022.

This ruling provides taxpayers with, amongst other things, a comprehensive guide to the effective lives of depreciable assets typically contained in residential rental properties.

The effective life of an asset forms the basis of the prime cost depreciation rate, as it reflects the term over which the asset is to be written-off in equal proportionate instalments. To obtain an accelerated rate of depreciation, assets can be alternatively written off at a diminishing value rate which for depreciating assets acquired after 9 May 2006 is 200% of the prime cost rate.

## What does the Ruling say?

Table A and Table B in Taxation Ruling TR 2021/3 outline the ATO’s view on the effective lives of various depreciating assets.

Table A contains categories of assets under industry headings and may only be used by members of the specified industry, which includes residential property operators. Where Table A does not apply to a particular depreciating asset, reference should be made to the list of effective lives that apply to depreciating assets generally which is set out under Table B.

It should be noted that residential property includes houses, units or flats commonly used as residential properties. The effective lives of depreciating assets held by residential property operators listed in Table A does not, therefore, cover assets generally found in commercial, industrial or retail properties. For these assets, it is necessary to refer to other categories of industries listed in Table A which refer to depreciating assets (e.g. the effective lives of certain commercial and office building assets listed in relation to non-residential property owners). If it is not possible to identify the effective life of particular assets under Table A the general rates listed under Table B must be applied, unless a choice is made to self-assess the effective lives of the relevant assets.

# Table A - Industry Specific Effective Lives

Taxation Ruling TR 2021/3 contains a comprehensive list of the effective lives of various assets typically contained in residential rental properties. Some of the assets contained in the ruling include:

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| **Asset** | Effective Life | Prime Cost | Diminishing Value (for assets acquired after 9 May 2006) |
| Automatic garage door control | 5 | 20% | 40% |
| Automatic garage door motor | 10 | 10% | 20% |
| Carpets | 8 | 12.5% | 25% |
| Ceiling fans | 5 | 20% | 40% |
| Cook tops and range hoods | 12 | 8.33% | 16.67% |
| Dishwashers | 8 | 12.5% | 25% |
| Ducted heaters - gas | 20 | 5% | 10% |
| Fire alarms | 6 | 16.67% | 33.33% |
| Light fittings | 10 | 10% | 20% |
| Fire extinguishers | 15 | 6.67% | 13.33% |
| Fire hoses and nozzles | 10 | 10% | 20% |
| Hot water units - electric/gas | 12 | 8.33% | 16.67% |
| Hot water units - solar | 15 | 6.67% | 13.33 |
| Ovens | 12 | 8.33% | 16.67% |
| Refrigerators | 10 | 10% | 20% |
| Washing machines | 6 | 16.67% | 33.33% |

A comprehensive list of assets and effective lives are available in *TR 2021/3: Income tax: effective life of depreciating assets* (applicable from 1 July 2021)*.*

#### Self-assessment of effective life

Alternatively, a taxpayer can choose to self-assess the effective life in accordance with section 40-105 of the *ITAA 1997*.

Taxpayers choosing to self-assess the effective life of an asset must remember that their self-assessment determination may be subject to ATO review. As such, the advantage in using the ATO’s determination of the effective life of a depreciating asset is that the ATO’s rate represents a ‘safe harbour’ rate that will not be challenged in any audit process undertaken by the ATO.

Where a taxpayer chooses to self-assess an effective life rate that is different to that outlined by the ATO, the taxpayer will be required to have sufficient evidence to demonstrate why the ATO’s effective life rates are not appropriate in the particular circumstances.

If you would like to discuss any matters in relation to the above in respect of your particular circumstances, please do not hesitate to contact me on [insert telephone number].

Yours faithfully

**[Insert Partner name]**

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| Encl. |