

# Accountants News

INFORMATION FOR PRACTISING ACCOUNTANTS

## Review That Schedule!

Over the past months we have been contacted constantly by taxpayers and accountants asking "I know this is not one of your schedules - but can you check the rates for us?". In this edition of the Accountants News we share our tips on how to review a recently prepared depreciation schedule for rate compliance.

### Incorrect rates—an ongoing problem

It is almost two years since the depreciation system was changed but we are still seeing depreciation schedules prepared for newly acquired properties using accelerated depreciation rates.

Using the depreciation deductions calculated in these schedules creates an audit risk for the taxpayer - as well as a potential liability time bomb for any accountant who assists in preparing the tax return.

Most transitional style scheduling errors are relatively simple to identify and correct (particularly as you should be able to ask the party who prepared the schedule to fix the calculations).

Ironically, the ease with which these erroneous claims can be avoided is a two edged sword for accountants. On the positive side, you have the opportunity to assess and limit your client's risk of non-compliance (something not always possible with other forms of scheduling error). On the negative side, a client may have good legal grounds to argue that (particularly in a transitional period such as this) they expected you to make these basic checks and that failing to do so constituted professional negligence. Your duty of care to the client is not negated just because the party preparing the schedule also owes the client a similar duty.

Most of the recently produced 'mis-schedules' we have been shown were provided by builders or property marketers. However, a significant number of quantity surveyors were also initially slow to realise that the system had changed.

Finally, even if your client's schedule was prepared using the best information available at the time, it may still need adjusting in a few specific areas. While the 21 September 1999 announcement provided a general overview of the changes

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to the law, some of the details were not supplied until much later. For example, the decrease in the depreciation rates for certain employees amenities was not discussed in any Government or ATO documentation prior to the release of Draft Taxation Ruling 2000/D7 on 17 May 2000. In the interim, most schedules (including ours) will have used the existing statutory rates.

#### *Three common transitional errors*

At minimum, we recommend you check your client's schedules for the three common flaws listed below.

We have provided some simple 'quick checks' which may identify obvious cases of mis-scheduling. However, to be safe, you should check each schedule item individually.

1. Failing to correctly identify whether accelerated or non accelerated rates apply.

▶ Quick check - A substantial number of the items in the schedule are depreciated at the diminishing value rate of 20%. This was the old default rate and is now only rarely used.

Accelerated depreciation rates ceased to be available to standard taxpayers for items acquired under a contract entered into after 11:45 am on the 21 September 1999.

Where depreciable items are purchased as part of a standard property transaction or building contract, 'entered into' will normally refer to the date on which the contract is initially signed, rather than the date on which settlement occurs. This means that accelerated rates will apply for some items on which depreciation did

not actually commence until after the 21 September. For example, there may be an extended eligibility period if an investor purchases a property off the plan.

It is important to check whether any of the items associated with a pre 21 September property acquisition were purchased at a separate and subsequent date. For example, it is not unusual for a party entering a building contract to be responsible for supplying the builder with certain items (such as carpet or white goods) or to arrange for certain sections of the work (such as air conditioning installation or office fitout) to be done separately under an independent contract.

Similarly, it is common for people purchasing a completed house to make minor additions or replace existing furnishings before renting the property.

2. Failing to correctly identify whether a 100% deduction is available.

▶ Quick check - Either light fittings are depreciated at 100% or there is no separate listing for light fittings. As a property will normally have 2 or more similar light fittings, the 100% rate will not apply under the new legislation.

The original 100% deduction for individual items valued at \$300 or less ceased to be available to standard taxpayers for purchases after 30 June 2000. A more limited version of this deduction has recently been reintroduced for investment owners. However, the change in eligibility criteria means that many items which were eligible under the old law no longer qualify.

If a transitional schedule contains items depreciated at 100%, there is a high risk it does so in error.

If items worth \$300 or less have been grouped or described in only vague terms, it may be necessary for you to ask the

schedule provider to supply an itemised and costed list before you can determine to what extent an adjustment is necessary.

3. Failing to use the correct rates for amenities for employees

▶ Quick check - diminishing value depreciation rates of 50% were used

The special employee amenities depreciation rates contained in section 42-150 of the ITAA 1997 ceased to be available to standard taxpayers for items acquired under a contract entered into after 11:45 am on the 21 September 1999.

As previously noted, this change was not specifically announced until May 2000. Because the rates for these items were set in the Act and had not been adjusted following the introduction of loadings or broad banding, it was widely anticipated that they would remain unchanged. We believe there is a high risk that inappropriate rates will be used in even the most recent schedules, as our experience suggests many schedule suppliers are still unaware of this change.

#### *Property Marketing Prospectuses*

Taxpayers should also take extra care when considering indicative depreciation allowances contained in marketing prospectuses. Our experience is that a substantial percentage of these forecasts have yet to be adjusted to take into account the new lower depreciation rates. Given that indicative depreciation forecasts are traditionally 'optimistic', this additional over-allowance may result in grossly misleading projections.

It is always worth asking who prepared the indicative schedule. Builders and real estate agents appear more likely to rely on standard templates or 'rule of thumb' allowances which may be out of date. We recommend that if an indicative depreciation statement does not contain a list of the items depreciated and the rates used, you request these before placing any reliance on the deductions indicated.

After-purchase feedback from our clients suggests that if a potential investment is no longer attractive once you reduce the promised depreciation deductions by at least twenty percent, insisting on a detail breakdown of the depreciation calculation is critical. Many potential investors are unaware that a substantial percentage of indicative depreciation schedules are based on nothing more than the property sales price and a set of average depreciation

percentage guides - with little or no reference to the actual property features.

Of course, any analysis of the investment potential of a property should also take into account the potential effects at sale of the balancing adjustments on plant and equipment, as well as the special building write-off capital gains tax claw back. These are rarely mentioned in the marketing prospectus.

#### **Accounting for the Full Cost of Property Acquisition**

Purchasing a major building asset, whether as an investment or for business premises, involves a long term commitment of funds. It is important that the prospective owner has a realistic understanding of the costs involved in maintaining the property in good condition.

Many owners are surprised to discover just how expensive the physical upkeep of a large property can be. While most prospective owners insist on obtaining a building condition report to ascertain the current condition of the building, very few complete the investigative process by ascertaining the maintenance and repair costs associated with the ongoing ownership of the property.

An assessment of the potential accrued maintenance costs for a building can establish:

- a) what items will require repair or replacement during a set time period (e.g. 10 years),
- b) when each repair or replacement is likely to be required, and
- c) approximately what each repair or replacement is likely to cost.

Armed with this information, a potential purchaser can make a genuine assessment of the cost of acquiring the building. How these costs impact on a business's or investor's long term budget may be the deciding factor to determine whether a purchase is economically viable or not.

For some high risk purchasers, obtaining accurate accrued maintenance costs prior to purchase should be considered mandatory. These include: people acquiring business premises in order to establish a new business venture and people acquiring substantial property assets under negative gearing arrangements which include the use of predominately external financing. These people are likely to have only a limited ability to absorb unexpected expenses. They are also more likely to have used personal assets such as the family home as security - thus limiting their ability to obtain additional credit. As a result, a higher than expected level of maintenance costs, or the unexpected conjunction of several unavoidable costs at the one time, may result in cash flow problems with potentially disastrous results.

People purchasing older buildings should also give priority to obtaining an accrued maintenance report, as such buildings are more likely to require non-standard repair or replacement work as elements of the building fail.

If you are assisting clients with the preparation of business plans for new ventures, or with the preparation of finance application reports, we recommend you consider advising your clients to obtain an Accrued Maintenance Cost Report as part of this process.

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