Depreciation: Overrated or misunderstood?

The important role of depreciation in a successful portfolio-building strategy is widely misunderstood. In fact, some investors miss out on valuable financial benefits and this reduces the profitability of their investments

I am often asked questions about the 'right' way to invest in property. In fact, one of the most common queries I field is: "Should I buy for cash flow or capital growth?"

In reality, this is not the right question as these go hand in hand in creating long-term wealth. The trick is to invest in a property with great capital growth potential but which has an 'acceptable' cash flow. In today's market, it is likely that such a property would be somewhat cash flow positive depending on how much you borrow and the age of the property. However, if interest rates continue to rise, this same property will become somewhat cash flow negative, and this should be included in any risk management plan.

The most powerful tool to help any investor with maximising their cash flow, especially during the first 10 years of a property's life, is depreciation. After that, although depreciation still goes on for many years, successive rent increases over the period will help improve cash flow.

By focusing on the numbers you can get a clearer idea of the exact type of asset you need to buy. And, right now, the best investment for most investors tends to be a new property.

OUR EXPERT

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Why new properties?

We are all aware by now that depreciation rules have changed. Following the federal budget in May, it has been confirmed that investors buying second-hand properties (post 9 May 2017) will no longer have access to depreciation on plant and equipment items included in these properties (carpets, blinds, etc).

This announcement has rattled many landlords and would-be investors but, in my view, it has simply confirmed something I already believed to be true: investing in property is all about the numbers, rather than the real estate.

In the current marketplace, the numbers are clearly directing investors towards new properties, for several reasons:

• Higher depreciation

New investment properties attract full depreciation benefits. As a guide, if you decide to buy a townhouse today that was built in 2014 with medium-quality finishes, it will deliver depreciation benefits (capital works) of around \$5,000–\$6,000 per year. The same property bought brand new in 2017 will attract depreciation (capital works and plant and equipment) of \$10,000–\$12,000 – around double.

• Better cash flow

As a result of these higher depreciation benefits, landlords who own new properties have better cash flow, particularly in the first 10 years of ownership. Let's say your tax rate is currently 39% (37% plus 2% Medicare levy). Your depreciation-related tax refund on the 2014 property will be around \$2,000–\$2,350. On the 2017 property, it jumps up to \$4,000–\$4,500.

• Less maintenance

In addition to the depreciation benefits, a new property generally requires less maintenance, saving you costs.

These are the kinds of facts and figures I encourage my clients to focus on when deciding what type of property to invest in, and more often than not they lead investors towards new rather than second-hand properties.

By adopting a 'bigger picture' view, you can see the positive impact your investments could have on your lifestyle, not only in retirement but also right now. YIP

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