



# real estate

## Tax Depreciation

Global Cost Segregation Services

Autumn 2008

**An international perspective on the benefits of cost segregation for real estate will allow you to reduce your global tax liabilities. Our dedicated team of specialists understand the complexities of tax depreciation and are committed to delivering you a successful outcome.**

The Banking Tax and Finance team at Davis Langdon LLP, a leading international construction and property consultancy, delivers managed solutions for clients investing in construction, infrastructure and real estate, independently representing client's interests, reducing risk and maximising value.



The tax depreciation team at Davis Langdon is based upon the specialist expertise and experience of Croser & James, for many years the UK's leading independent Capital Allowances consultants prior to the merger in 2001.

Tax depreciation rules vary from one country to the next. Whether any kind of deduction for real estate tax depreciation is available also varies from country to country. All require some degree of interpretation.

### Benefits of a Cost Segregation Study

Our experience and procedures allow us to optimise the outcome of cost segregation studies to produce real benefits through the acceleration of the tax deductions. We work with local tax partners on technical regulation and compliance issues within a particular domain.

A variety of depreciation methods can be used to allocate the depreciable amount of an asset; some regimes use a systematic basis over the useful life of the asset and others have prescribed methods spreading cost over a statutory period, not always equating to the asset's useful life. Some regimes have prescribed statutory rates, whilst others have rates which have become acceptable to the tax authorities through practice.

The correct allocation of costs between equipment, buildings and land is essential to realise the full benefit of the available deductions and specialist advice is essential.

### Our Services

Our approach to completing a cost segregation study for tax depreciation purposes, using project costs and accounting records, will include everything listed below:

- Programme - agree a programme and completion date with the client around statutory and other deadlines.
- Planning - identify potential problems or restrictions and propose solutions during initial research stage.
- Forecast - prepare a forecast of the benefits, so the value of our input can be measured.
- Due diligence - collate and review documentation, inspect the property taking photographs and making notes of specific items for reference, to establish design intent and justification for the claim on all items in accordance with the relevant legislation.
- Classification - prepare a detailed analysis classifying the expenditure into asset classes and produce a claim document for the client, the client's accountants and the tax authorities.
- Agreement - provide a complete service in support including direct negotiation and legal justification with the tax authorities.



## First Steps

In each country, the relative benefits of the particular tax depreciation regime will only become clear through experience and detailed analysis of different project types.

Our early involvement will mean that the issue of tax depreciation can be considered in sufficient time to make an informed decision about a particular property, whether it is new build, refurbishment or acquisition of an existing building.

In some jurisdictions the cost segregation study must be completed prior to contract completion, or when the asset is placed in service. The scope of our service can include advice upon the property investment structure, due diligence, negotiation, estimates of potential tax depreciation for use in cash flow forecasts and modelling, preparing a fully substantiated claim and advice on disposal of the asset.

## Points to Consider

Some of the issues affecting the successful outcome are listed below:

- Is there a statutory tax depreciation regime?
- Is a tax deduction available for capital expenditure on real estate?
- Is cost segregation feasible?
- Is cost segregation only possible on construction projects?
- Is cost segregation possible on property acquisitions and is there an accepted method for allocating costs to equipment, buildings and land?
- Is a deduction for tax depreciation allowed for leased property?
- What are the definitions of 'plant', 'equipment', 'structure' and 'building'? For instance, some regimes give the widest possible meaning to the term plant, whilst other regimes clearly define the meaning.
- When should tax depreciation be calculated; when the asset is acquired, or when it is placed in service?
- Should the deductions for accounting and tax depreciation be the same?
- Are a range of depreciation rates specified for certain assets and how is the rate within that range determined, by the tax authority or the taxpayer?
- Can tax depreciation be deferred if it is not required, for example, due to losses?
- What does the depreciable cost include; acquisition costs, delivery costs, installation, preliminaries, professional fees, taxes?
- Are there incentives for energy efficient or environmentally friendly assets?
- Is there is a negative adjustment on disposal?
- What is the procedure for making a claim? Can a ruling be obtained in advance of an issue? What are the filing deadlines and what is the timescale for agreeing the claim?

**"Our tax team will optimise your tax position - HMRC have stated that more than 50% of the claims for UK Capital Allowances which they receive on commercial property are sourced from our team".**

## Caveat

Our commitment to customer care and our client's business is taken very seriously. We have worked in partnership with a diverse portfolio of clients from small owner-occupiers to major multi-national corporations.

The information is provided solely to give an illustration of the potential deductions for tax depreciation for capital expenditure on real estate. Legislation and other issues must always be thoroughly investigated in each location. Restrictions, qualifications and elections may apply. Specialist professional advice should be obtained where appropriate.

## Contrasting Tax Depreciation Regimes Around the World

### Australia

In Australia, Capital Allowances are available under the legislative changes and interpretive decisions made in the New Business Tax Systems (Capital Allowances) Act 2001. Since July 2001, a Uniform Capital Allowances system (UCA), based on the effective life of assets, applies to all depreciable assets. Taxpayers can either self-assess the effective life of plant, or use the Tax Commissioner's published schedules of effective life, which provides statutory limits on the effective lives of certain assets. The Capital Allowance regime in Australia applies to all capital investments, including buildings and depreciation is available on all property regardless of age.

### Belgium

The Belgium current ruling practice was substantially reformed by the Program Law of 22 December 2002. Depreciation of an asset is tax deductible based on its historic cost and the straight-line method is normally used. Permission is needed from the tax authorities to use the double declining method. Depreciation rates are based on the estimated lifetime of the assets concerned. Taxpayers can agree non standard depreciation rates with the tax authorities, but most use the standard rates of depreciation. First year depreciation is based on the number of days an asset has been held. Short life assets can be revalued at replacement cost.

Belgian tax residents can claim an investment deduction which corresponds to a part of the acquisition or investment value in new fixed assets. The deduction equals a percentage of the investment which can be 4.50%, 14.50% or 21.50% and depends on the nature of the investment and on the entity claiming the deduction. An advanced tax ruling can be requested on a wide range of subjects; the Ruling Office is autonomous from the Belgian tax authorities and has the legal authority to issue decisions which are binding upon the Belgian tax authorities.

### Canada

Canadian tax law provides for the Capital Cost Allowance system (CCA), which allows a business to claim a calculated portion of the cost of equipment and property as a deduction from income tax over a period of years for the loss in value of the capital asset due to wear and tear or obsolescence. The amount of CCA that can be claimed each year depends on when the property was acquired and to which CCA class it belongs. The Canada Revenue Agency has assigned classes to particular types of depreciable property and assigned rates for each class. Annual allowances are determined by applying the prescribed rate to each class using the declining balance method. For example, most buildings are prescribed an annual rate between 4% and 10% and most machinery and equipment are at the rate of 20%. Generally, the CCA is computed on a pool basis with only a few separate asset pools of property for tax depreciation purposes.

### France

The French accounting regulation authority (Comité de Réglementation Comptable) issued new rules that substantially modify the French depreciation and amortisation accounting regimes. Whilst under the French system tangible fixed assets are, in principle, depreciable, French tax law includes a strict definition of permissible depreciation practices. A taxpayer can, however, also submit to the Revenue a supportable, logical and consistent approach, if the rules for calculating tax depreciation on real estate are not used.



The depreciation of fixed assets has to be carried out component by component and the components of a fixed asset have to be depreciated separately according to the lifetime of each component. Straight-line depreciation is normally used; the declining-balance method is restricted to specific new assets. Specific assets include industrial maintenance equipment, water and air-purification systems, security and safety equipment, medical or social installations, most office machinery, research equipment, hotels and hotel-related equipment, warehousing facilities and industrial buildings with a useful life of less than fifteen years.

### India

Tax depreciation is detailed in Section 32 of the Income Tax Act 1961 and Income Tax Rules 1962. Depreciation of assets is based on actual cost and is usually calculated on the declining-balance method. Residential buildings and other buildings such as offices, factories and hotels are depreciated at 5% to 10%. This depreciation rate, however, can be accelerated on plant and machinery at 15%. Depreciation on new plant and machinery acquired on or after 1st April 2005 may be available at 20% of the actual cost, subject to certain conditions. Furthermore, the environmental design elements of a building can be depreciated at 80% and 100%. New buildings of a higher specification will benefit from a cost segregation service. Depreciation is allowed at 100% after 1st September 2002 for water-supply projects or water-treatment systems put to use as infrastructure facilities. Depreciation is 50% of normal rates if an asset is used for less than six months per year. Capital assets purchased for scientific research may be written off in the year in which the expenditure is incurred.

## Ireland

Ireland has a similar regime to the UK under its Taxes Consolidation Act 1997 as amended. Wear and tear allowances on plant and machinery are given on a straight-line, rather than a reducing balance basis. Allowances are also given on industrial buildings and hotels. The incentives previously available for investment in designated areas have now been largely withdrawn. One major difference between the regime in Ireland and that in the UK is the restriction of the availability of allowances to property investors. The landlord will be denied allowances where the terms of the lease transfer the burden of wear and tear wholly onto the tenant.

Expenditure on plant and machinery incurred after December 2002 is subject to an annual 12.5% straight-line allowance over eight years. On disposal, the amount received for the plant and machinery has to be taken into account. Industrial buildings and hotels are written down at 4% per annum on a straight-line basis over the tax life of the building and a 10% rate is allowed for some types of buildings. In tax designated areas, some buildings are treated as industrial buildings.

## Italy

All fixed assets, except land, are depreciable for tax purposes. Maximum depreciation rates of fixed assets are determined in accordance with a Ministerial Decree for state corporate income tax purposes. The basis of valuation is the historical cost. Depreciation is deductible starting from the first tax period in which the asset was used and in the first period, the assets must be depreciated at a rate that does not exceed one-half of normal rates.

Accelerated depreciation is no longer possible from 2008. Deductions previously allowed for tax purposes only (i.e. regardless of the accounting treatment of the related cost in the profit and loss account) are no longer available; only accounting costs are deductible for financial years starting after 31 December 2007. A substitute tax (ranging from 12% to 16% rate) may be paid in order to obtain tax relief for differences between book and tax values; this will result in higher depreciations, lower capital gains and higher capital losses. When land and buildings are valued together, established rates separate the cost of the land which is not depreciable.

## Malaysia

Davis Langdon has been providing Capital Allowances services to clients in Singapore and Malaysia for over 20 years. In that time we have obtained the experience and understanding required to deal with the Inland Revenue Board of Malaysia and the Inland Revenue Authority of Singapore.

The regimes in both countries have similarities to the system in the UK. Allowances may be claimed on the purchase of existing buildings as well as new construction projects.

In Malaysia a 20% initial allowance is given on plant and machinery. A 10% initial allowance is given on industrial buildings, followed by a 3% allowance in subsequent years. A 10% special annual allowance is also available on certain other building types used for specified purposes.



## Netherlands

Special provisions were introduced in 1 January 2007, in principle limiting depreciation for immovable property. A distinction is made between real estate held for investment purposes and property used in a trade or business. For tax purposes, an investment property cannot be depreciated to an amount less than the property's fair market value. The value is determined annually by the municipal tax authorities. The depreciation of buildings employed in a trade or business is limited to 50% of the property's value for tax purposes. The straight line method of depreciation is most commonly used, although the declining balance is sometimes chosen. Tangible assets used by a company for the purposes of a trade can be depreciated if their values diminish over time. Depreciation begins on the first day an asset is used.

Under the new rules from 1 January 2007, the depreciation of some fixed assets is minimized to five years. The new rules also affect fixed assets acquired before 1 January 2007 and transitional rules are applicable. A limited transitional provision for recent investments in buildings allows depreciation according to current rules for a period of three years. The law, however, provides for accelerated depreciation of specific assets, for example, assets at least 30% of which environment-improving results accrue to the Netherlands and that appear on the special VAMIL (Vervroegde Afschrijving Milieu Investeringsen) list.

## Poland

Depreciation is treated as a tax deductible cost. The maximum rates are provided by law; the allocation should be made in accordance with the Ministry of Finance Decree and the Classification of Fixed Assets, which includes descriptions of the rules regarding the allocation of items to asset codes. The taxpayer cannot arbitrarily allocate items to other asset codes, but can apply to the Statistical Office for interpretation.

Polish legislation provides investment incentives in fourteen Special Economic Zones, which offer income tax exemption up to 65% of investment expenditure and if the amount available for deduction exceeds the annual Corporate Income Tax due, the excess can be utilised in the following years. It is possible for businesses which run activities in the Special Economic Zones to enjoy total income tax exemption for a considerable period.

## Singapore

The relevant statute is the Singapore Income Taxes Act 1967 and the law is relatively simply structured, allowing claims for plant and machinery, as well as industrial buildings allowances. Local relevant Capital Allowances case law has only existed since 2004. In Singapore, Capital Allowances include an initial allowance in the year of acquisition, plus an annual allowance. The initial allowance for plant and machinery is 20%, with annual allowances of 13.3% on a straight-line basis for manufacturing and industrial processing plant and machinery, 8% for furniture, fixtures and telecommunications equipment and 10% for data handling equipment. Industrial buildings are granted a 25% initial allowance and annual allowances of 3% of qualifying cost on a straight-line basis.

Accelerated annual allowances of 33.33% are granted to all qualifying plant and machinery and 100% allowances are granted on all computer and prescribed automation equipment, generators, robots, pollution control equipment and energy efficient or energy saving or noise controlling or chemical risk producing equipment. The Inland Revenue Authority of Singapore provides examples of plant for Capital Allowances purposes and has, for example, only recently published a concession allowing for carpets and venetian blinds in office buildings.

## South Africa

In South Africa the Income Tax Act 1962 as amended provides for Capital Allowances as a deduction against taxable income. Depreciation may be claimed in respect of the cost of the asset used for the purpose of trade.

The allowance generally consists of the amount by which the value of the asset has diminished by reason of wear and tear or depreciation during the year and is calculated according to the declining balance method.

Capital Allowances for machinery and equipment used for the first time in a manufacturing or similar process can be claimed over five years at 20% per annum on a straight-line basis. In respect of non-manufacturing plant and machinery, the rate is 10%. A depreciation allowance of 5% is allowed annually on the cost of buildings and improvements, where the building is used in a manufacturing or similar process and the building, or improvement is commenced after 1 January 1989. Special depreciation allowances apply to hotel buildings and equipment.

## Sweden

The Swedish system of depreciation shares many features common with other European countries, but is more prescriptive in allowing companies to decide what is classed as fixtures and fittings. Buildings can be depreciated on a straight-line basis over their expected life generally between 1.5% and 5% annually depending on the type and usage, with a maximum allowance of 100%. The depreciation rate for fixtures is up to 25% on a declining balance basis, however, immovable plant that is integral to the building, e.g. heating and elevator systems, is depreciated as part of the building.

## United States of America

The allocation of acquisition or construction costs of a building between real and personal property is based on legislation, case law and Internal Revenue Service guidance.

Capital costs must be recovered by using the Modified Accelerated Cost Recovery System. The system is designed to match asset class lives with the economic or useful life of assets and is defined by a series of tables in the legislation.

The correct classification of capital expenditure on a building or facility between structural and non-structural components allows investors to claim accelerated tax depreciation and defer income taxes. Typically a building will be depreciated over 39 years (commercial real property), or 27.5 years (residential real property). Cash flow can be maximised by reclassifying items to either 5 or 7 year personal property, or 15 year land improvement property, using either an invoice or engineering approach. Longer recovery periods apply to property outside the USA.

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