April 2011

Fact sheet – Earthquake depreciation issues

The Canterbury earthquake and its aftershocks have resulted in the destruction of buildings, plant and equipment. This has given rise to three issues with the application of the depreciation rules.

This fact sheet provides detail on proposed changes to depreciation rules announced by Government:

- Depreciation recovered when the insurance proceeds exceed the tax book value of the destroyed asset
- The timing of "deemed" sale of destroyed assets, and
- The deductibility of any loss when a building is not destroyed by an event beyond the owner's control, but has to subsequently be destroyed as a consequence of such an event.

The proposed amending legislation is expected to be enacted in July or early August this year and will be effective from 4 September 2010. Accordingly affected businesses should confirm the amending legislation before finalising their income tax positions.

Depreciation recovered rollover

There can often be a cash flow issue caused by depreciation recovered where insurance proceeds[1] exceed the tax book value of destroyed depreciable fixed assets where there is an intention to replace those assets. This is particularly the case when the assets are insured for replacement.

In the context of the Canterbury earthquakes and insurance recoveries, the Government has decided that it is appropriate to provide an election to roll qualifying depreciation recovered over into the tax value of the replacement asset. The proposed details are:

- Rollover relief will be allowed on depreciation recovered arising from insurance proceeds in respect of the Canterbury earthquake and its aftershocks;
- The election is on a class basis. There are two classes of depreciable fixed assets:
    1. buildings together with fit-out; and
    2. "other" (i.e., plant and equipment);
- The fixed asset is replaced by new or second hand assets (the rollover assets) in the same class by the end of the taxpayer's 2015–16 income year; and

[1] Insurance includes an amount of insurance, indemnity or compensation received for the loss or destruction of a business asset.

- If the insured fixed asset was a building, the replacement building is located inside the zone of responsibility of the Canterbury Earthquake Recovery Agency, which is currently envisaged to encompass the area covered by three territorial authorities – Christchurch City Council, Selwyn District Council, and Waimakariri District Council.

The amount of rollover relief available depends on the degree to which assets are replaced. This is to be determined by comparing the cost of the destroyed assets with the cost of the replacement assets.

The first step in this process is to ascertain the ratio (on a per class basis) of net depreciation recovered for that class to the total cost of destroyed assets in that class. (Net depreciation is the residual amount after deducting from gross depreciation recovered of that class any amount of loss on disposal of that class as a result of the earthquake). This ratio is then applied to the cost of the replacement asset to ascertain how much depreciation recovered can be incorporated into the adjusted tax value of that new asset.

Example 1

Non-building fixed assets destroyed by the earthquake had a cost of $1 million, and the net depreciation recovered was $300,000. The replacement assets were acquired over two years at a cost $400,000 per year, and then only $800,000 of replacement assets were acquired (even though the taxpayer originally expected to spend well over $1 million on the replacement assets).

Rollover into the first $400,000 of assets acquired is 400,000 x 300,000 / 1,000,000 = $120,000. Likewise rollover in the next year is another $120,000, making a total of $240,000. The balance of $60,000 is brought to income as explained below.

Process

The asset owner elects to use the rollover relief by advising Inland Revenue in writing that they have qualifying depreciation recovered that they are deferring pending their reasonable expectation of replacing the fixed asset by the end of the 2015–16 income year. This election must be sent to Inland Revenue by the later of:

- the date the tax return is filed for the year that the depreciation recovered would otherwise have been recorded in, using the new timing rule below, or
- 30 September 2011

Once an election has been made, the owner must use the rollover relief against the next relevant replacement assets purchased in subsequent years.

The owner also has to advise, again in writing with their income tax return, when the replacement asset(s) have been acquired and the deferred depreciation recovery offset into their adjusted tax values.

If the owner chooses to apply the rollover relief, the rollover asset's "total deductions" are increased by the amount of depreciation recovered that has been rolled-over into that asset and therefore its "adjusted tax value" is reduced by the amount.

Further, where straight line depreciation is used for the rollover asset, "cost" for this depreciation calculation is the actual cost less any depreciation rolled-over (by reducing the "adjusted tax value" the correct basis will already have been ascertained for diminishing value depreciation). This will require a specific legislative override.

If the destroyed asset is not actually replaced, then to the extent that deferred depreciation recovered has arisen (see the proposed new timing rule below) it is brought to account as income at the earlier of:

- The asset owner's 2015–16 income year
- The income year in which the owner made a decision not to replace the destroyed asset, or
- Any year in which the owner goes into liquidation or bankruptcy.

Example 2

In February 2011, a 31 March balance date firm's building is destroyed in the earthquake. The building originally cost $3 million. The book value is $2 million, reflecting accumulated depreciation of $1 million. The replacement insurance proceeds are $6 million and the insurance company "delivers" the replacement building on 15 June 2014.

In the absence of any rollover relief the building owner will have depreciation recovered taxable income of $1 million (see below for the timing of this). The insurance proceeds over the $3 million cost price are still a tax free capital gain. The difficulty is that the building owner has received insurance proceeds of $6 million to rebuild but at a 28 percent company tax rate has a $0.28 million tax liability on the $1 million depreciation recovered. The building owner is left with $5.72 million to meet the reconstruction cost of $6 million. Extra funds are required to meet the cost of the building.

This proposal will allow the owner to roll the depreciation recovered into the replacement building. Presuming that the insurance proceeds became, as a result of negotiations, capable of being reasonably estimated on 30 June 2011, the new rule (again see below) would time the depreciation recovered into the year ended 31 March 2012.

However, with the tax return for this 31 March 2012 year the taxpayer files a written election to defer the depreciation recovered pending acquiring the replacement building. Therefore the depreciation recovered income is suspended for taxation purposes. For the 31 March 2013 and 2014 years this income stays suspended.

The replacement building is delivered on 15 June 2014. The 31 March 2015 tax return will include this new building at a cost of $6 million, and, immediately upon acquisition, it will have an adjusted tax value of $5 million. However, for straight line depreciation purposes, its cost will be $5 million. If the building is depreciable, the usual months in the year formula applies.

Again notice will have to be filed with the 31 March 2015 tax return advising that the deferred depreciation recovered income has been rolled into the tax base for the replacement asset.

When the replacement asset is sold the difference between the adjusted tax value and building cost, in this case $1 million, will be clawed back as depreciation recovery income (provided it is sold for at least $6 million). Therefore the tax liability associated with disposal of the destroyed building has been rolled forward until disposal of the replacement building.

Timing of deemed "sale" of destroyed assets

There is also concern around the timing of the "deemed sale" when an insured asset is written off and that results in depreciation recovered because the insurance proceeds exceed the asset's tax book value (cost less accumulated depreciation). Presently this "sale" arguably occurs at the date of the event that gave rise to the write-off.

However, the insurance proceeds may not be quantifiable until months or even a year later and, quite likely, especially in the case of the Christchurch earthquake, in a different tax year. This presents compliance and administration problems, and potentially cause a taxing event retrospectively once the insurance proceeds can be quantified.

Following more general tax and accounting practice, the Government proposes that this "deemed sale" occurs when the insurance proceeds can be reasonably estimated. Although this is proposed to be effective from 4 September 2010, this is a general amendment to the underlying generic legislation, and is not limited to the Canterbury earthquakes.

Losses on buildings

After the central New Zealand floods of 2004 the Income Tax Act was amended to allow a generic write off for any loss on buildings that were destroyed by an event beyond the owner's control (and floods and earthquakes are good examples of such events).

After the 4 September 2010 Canterbury earthquake submissions were received that this provision should be extended to cover the situation where the building has to be destroyed as a result of such an event, even if the building itself was relatively undamaged or repairable. Examples include where the building has to be demolished to allow the land underneath the building to be remediated, or to allow for another building to be demolished. The Government agrees with these submissions and will table an amendment to achieve this.

Again, although this proposed amendment is expected to be effective from 4 September 2010, this is a general amendment to the underlying generic legislation, and is not limited to the Canterbury earthquakes.

Demolition costs

In October 2010 the Minister of Revenue announced that the law would be clarified so that disposal and demolition costs incurred in relation to insured buildings irreparably damaged by the earthquake would be dealt with as part of the disposal of the asset.

These changes were made by way of Supplementary Order Paper 187 to the Taxation (GST and Remedial Matters) Bill 2010 which was enacted on 20 December 2010.

The changes ensure that the disposal and demolition costs of an insured earthquake damaged building are in effect deductible.

Revenue account buildings
Rollover relief will also be provided in respect of insurance proceeds for buildings held on revenue account when these are replaced with buildings inside the zone of responsibility of the Canterbury Earthquake Recovery Agency. Similar rules to those detailed above for depreciation recovered rollover for buildings will apply.