Regulatory Impact Statement

Tax relief for depreciation clawback – Canterbury earthquake

Agency Disclosure Statement

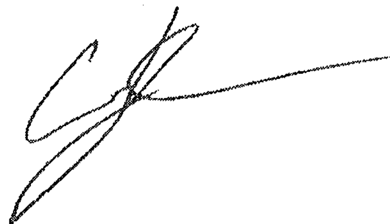
This Regulatory Impact Statement has been prepared by Inland Revenue.

It provides an analysis of options to provide tax relief for firms facing a depreciation recovery liability because of insurance proceeds on assets lost or destroyed as a consequence of the Canterbury earthquake and its aftershocks, including the 22 February event.

The analysis has been undertaken in a very constrained timeframe, due to the urgency of the Government decisions that are required. This has limited the depth of research and analysis able to be undertaken. Where fiscal cost estimates have been made there is a significant degree of uncertainty involved due to difficulties in accurately estimating the quantum of depreciation recovery income.

As a result of the urgency of the Government decisions that need to be made in relation in this problem, consultation has been limited. Further consultation, with the private sector is planned as this measure is finalised.

None of the policy options would impair private property rights, restrict market competition, reduce the incentives for businesses to innovate and invest, or override fundamental common law principles. The preferred option has the potential to increase compliance costs, but only for firms claiming rollover relief. This trade-off would be necessary for equity purposes.



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STATUS QUO AND PROBLEM DEFINITION

1. The policy problem is whether the current depreciation clawback rules produce the correct policy result for firms facing a depreciation recovery liability, due to receiving insurance proceeds on assets lost or destroyed as a consequence of the Canterbury earthquake and its aftershocks.[1] Many firms in Canterbury face serious destruction or loss of business assets. The consequent insurance payments may result in these firms facing a depreciation clawback liability.

2. When capital assets (buildings and plant and machinery) are purchased there is no income tax deduction for that expenditure. However, depreciation is deductible while the asset is available for business use. Depreciation is an estimate of the decline in value of an asset as it is used to earn income. When an asset is sold or destroyed the actual decline in value of the asset becomes clear. If the asset is sold for less than its depreciated tax value (book value) that loss is generally deductible since it demonstrates that depreciation was underestimated. If an asset is sold for more than its book value, then the depreciation deducted over the life of the asset was overestimated and the excess depreciation (the difference between the book value and the sales proceeds) is included as income. This is a clawing back of excess depreciation previously allowed and is known as "depreciation clawback" or "depreciation recovery".

3. If an asset is destroyed by an earthquake, the general rule is that the book value of the asset is a deductible loss. However, many income producing assets are insured. In these cases, assets are deemed to be sold for the value of the insurance proceeds. If the insurance proceeds exceed an item's book value, any excess depreciation is clawed back as income.

4. The depreciation rules for buildings and plant and equipment are similar, except that no deduction is allowed if a building is sold for less than its book value. However, if the building is destroyed, by a natural disaster, the loss is deductible to the extent that any insurance proceeds are less than its book value. Most buildings will be insured, often for more than their book value. Budget 2010 made the depreciation rate on most buildings zero. However, many will have had prior depreciation so that their book value will be lower than any insurance proceeds. In these cases, past depreciation will be fully or partially clawed back.

5. <u>An example</u>: In February 2011, a firm's building is destroyed in an earthquake. The building originally cost $3 million. The building would cost $6 million to replace. However, the book value is $2 million, reflecting prior depreciation of $1 million. The insurance proceeds are $6 million (the replacement cost). In the absence of any rollover relief, the building owner will have depreciation clawback of $1 million since instead of depreciating, the building has been going up in value. The insurance proceeds over and above 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 30 percent tax rate has a $0.3 million tax liability on the $1 million depreciation clawback. The building owner is left with $5.7 million to meet the reconstruction cost of $6 million.

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

6. A gap in our analysis is that we know very little about the value and nature of the assets destroyed, nor do we have a good understanding of whether these assets are insured.

OBJECTIVES

7. The desired Government outcomes are to:

- uphold the general direction of tax law while ensuring the current rules do not unnecessarily bring forward future tax liabilities, or produce results that may be seem as unfair and assist firms recovery from the Canterbury earthquake and it aftershocks, and assist rebuilding in the Canterbury region;
- ensure that the revenue base remains sufficiently protected; and
- provide certainty to those firms with potential depreciation clawback income liabilities as a result of the earthquake and its aftershocks.

8. The desired Government outcomes must be achieved within a short timeframe. This is because they are a response to a devastating event that has already occurred. Ideally, people should have certainty about what the tax treatment will be in respect of certain things they have done or are contemplating doing as soon as practically possible. This is certainly the case where the consequence is an exposure to income taxes.

9. Depreciation clawback is not a capital gains tax or a tax penalty but simply recognition that past depreciation deductions at the time of the event have been excessive. If it had been known in advance that the building owner would eventually receive insurance proceeds in excess of the the building's cost, then no depreciation should have been allowed. Therefore, depreciation clawback is generally the correct tax result.

10. However, in the context of the Canterbury earthquake there are grounds to support rollover relief as this may help achieve the Government's desired outcomes. These include:

- There is likely to be substantial clawback of depreciation on destroyed buildings and some depreciation clawback for plant and equipment. This would hinder reconstruction in Canterbury since firms will have fewer funds to rebuild (assuming that they have already spent the tax value of the previous excess depreciation deductions).

- Had the earthquake not happened, then buildings, plant and equipment may have been retained for a number of years in which case depreciation clawback may have been deferred into the future or indefinitely.

- Depreciation clawback may also be seen as unfair, as taxpayers only face the prospect of depreciation clawback if depreciable assets have been totally destroyed, when lesser-affected firms will not face that tax liability until they ultimately sell the depreciable asset, perhaps in many years time.

REGULATORY IMPACT ANALYSIS

11. Several different options have been considered to address the problem and achieve the desired Government outcomes.

12. Option 1 addresses the concern that depreciation clawback may produce an incorrect policy result, given the Government's tax policy objective regarding the Canterbury earthquake and its aftershocks. Options 2 – 5 do not directly target this concern, but may meet some of the government's broader objectives.

Option 1: Depreciation clawback rollover relief (officials preferred option)

13. The proposal is that depreciation clawback rollover relief should apply to allow the owner to rollover prior depreciation so that there is no immediate tax payable. This is often referred to as rollover relief. In the example above, the building destroyed is replaced by a new $6 million building. The $1 million of earlier depreciation is rolled over to the replacement building which although costing $6 million has an immediate book value of $5 million. If the building is subsequently sold for $6 million the $1 million excess depreciation would be clawed back as a tax liability for the vendor.

14. There are standard policy grounds for depreciation clawback. However, in the context of the Canterbury earthquake and its aftershocks there are strong grounds for providing rollover relief for depreciation clawback for destroyed buildings and destroyed or lost plant and equipment. Rollover relief on insurance proceeds invested in replacing assets lost or destroyed in the earthquake would have the following advantages:

- it targets those firms with depreciation clawback liabilities;
- depreciation clawback would be deferred until such time as the relevant asset is sold;
- allowing insurance proceeds to be applied without imposing tax would assist firms affected by the Canterbury earthquake to recover;
- it would address concerns about the depreciation clawback rules producing unfair results; and
- it could also encourage rebuilding in Canterbury in a cost effective manner.

15. This option will increase compliance costs, which cannot be quantified because of poor data, for firms that apply rollover relief to newly acquired assets. The compliance costs arise because firms will need to separately track and account for assets where rollover relief has been taken. However, applying rollover relief is optional, so firms can make informed decisions on whether to access any rollover relief.

16. Fiscally, the government is forgoing a windfall gain (this was not an expected revenue stream). Further, with rollover relief being limited to insurance proceeds there are integrity advantages because insurance companies have incentives to check that each claim is legitimate.

17. Within the time available, it has not been possible to determine the social, environmental or cultural impacts of this option.

Option 2: No relief

18. The case for no relief was considered. As noted, depreciation clawback is not a capital gains tax or a tax penalty, but simply recognition that past depreciation deductions at the time of the event have been excessive. In this instance, if it had been known before the earthquake that an earthquake was going to take place and that the building owner would receive insurance in excess of the building's cost, then no depreciation should have been allowed. Depreciation clawback in this case is the correct tax result.

19. However, in the context of the Canterbury earthquake and its aftershocks we believe that there are stronger policy grounds for providing rollover relief.

Option 3: Provide expensing

20. Expensing means a firm is allowed an immediate deduction for the costs of a capital asset. Expensing would reduce the costs of building or purchasing replacement assets for those destroyed in the Canterbury earthquake and its aftershocks since the costs of rebuilding would give rise to immediate deductions. Expensing could also be targeted to encourage rebuilding in areas that have been particularly badly affected by the earthquake.

21. Expensing is not preferred because in order to target reconstruction it would require a range of design issues to be resolved, including defining qualifying assets, regional boundaries, and refundibility. In addition, expensing is costly. The initial estimate on allowing expensing for buildings was $800 million. Allowing expensing for other assets would increase this cost.

Option 4: Reducing income taxes for firms in Canterbury

22. This option involves cutting the tax rate for firms located in Canterbury or specific locations within the Canterbury region. It was not preferred because reducing all tax rates in Canterbury would be fiscally expensive and it is not possible to effectively target tax cuts to those firms with depreciation clawback liabilities.

23. Lowering tax rates on firms located in Canterbury could encourage firms to locate into the region. However, this measure would not advantage the many firms operating in Canterbury in tax loss. Moreover, cutting the company tax rate would give rise to a set of complex issues. Given our imputation system, company tax for New Zealand taxpaying shareholders is only a withholding tax until tax payments are made to top up this amount to the shareholder's marginal rate when dividends are paid. This makes cuts in the company tax rate relatively ineffective as a way of aiding reconstruction.

24. If company tax rates were reduced in Canterbury there would also be incentives for corporate groups to use interest, royalty or service fee payments to allocate income to Canterbury operations even if the actual economic activity was performed in other parts of New Zealand. Businesses also operate through trusts, partnerships or as sole-traders and in these cases trustee and personal tax rates generally apply. Our tax rules do not differentiate between business income and other income (such as employment or investment income).

Option 5: Allowing losses to be carried back

25. Allowing businesses to carry back losses so that they could be used to reduce tax on income earned in previous years could help some businesses deal with cash-flow issues which may allow them to rebuild or recover more quickly. Loss carry-back would effectively cash out losses to the extent that businesses were in profit in the years prior to the earthquake.

26. Loss carry-back would be ineffective for businesses that were already in loss due to the general economic downturn. Another drawback of loss carry-back is that it would cancel imputation credits earned in previous years. This means that for businesses that have already paid out their prior year income as imputed dividends, there would be no benefit, as the amount of tax that could be refunded would be limited by the amount of credits that had not been distributed to shareholders. Finally, there would be complexities in working out how businesses would apportion losses in cases where they operate not only in Canterbury but also in other areas. It is clear that loss carry-back would be much less closely associated with reconstruction than expensing or partial expensing.

27. For these reasons loss carry-back was not the preferred option.

CONSULTATION

28. The urgency of the Government decisions that need to be made in relation to this problem has meant that consultation has been limited. Consideration has been given to correspondence received by Ministers and officials in connection with the issue. Consultation has been undertaken with the Treasury.

29. However, there will be a period for feedback after the announcement and we propose to consult on the draft legislation with a number of organisations that are involved in tax policy development, including the New Zealand Institute of Chartered Accountants and the New Zealand Law Society. This provides an opportunity for the rollover relief proposal to be tested and modified as appropriate.

CONCLUSIONS AND RECOMMENDATIONS

30. Officials have considered the options outlined above. Officials consider that rollover relief (option 1 above) is appropriate and best addresses the problem in a way that meets the desired Government outcomes. This solution limits the potential cost and risks associated with providing tax relief. It provides more appropriate tax results, given the magnitude of the Canterbury earthquake, whilst providing the necessary degree of protection to the revenue base.

31. Further, it has been agreed by Ministers that, for equity reasons, these options would also apply to the 4 September 2010 Canterbury earthquake.

IMPLEMENTATION

32. Amendments to the Income Tax Act would be needed to give effect to rollover relief. The amendments could apply to firms with lost or destroyed assets because of the Canterbury earthquake and its aftershocks, provided the insurance proceeds exceed the book value of the relevant assets, and the firm reinvests. There are a range of legislative vehicles to give effect to the necessary amendments.

33. Any new rules will be administered by Inland Revenue through existing channels. Overall compliance costs are reduced by making rollover relief optional.

MONITORING, EVALUATION AND REVIEW

34. Inland Revenue will monitor the outcomes pursuant to the Generic Tax Policy Process ("GTPP") to confirm they meet the policy objectives.

35. The GTPP is a multi-stage tax policy process that has been used to design tax policy in New Zealand since 1995. The final stage in the GTPP is the implementation and review stage, which involves post-implementation review of the legislation, and the identification of any remedial issues. Opportunities for external consultation are also built into this stage. In practice, any changes identified following the proposed amendments would be added to the tax policy work programme. New proposal would go through the normal GTPP.