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BARRISTERS & SOLICITORS

TAX UP-DATE

Earthquake Depreciation Issues

In response to the Canterbury Earthquake the Minister of Revenue recently announced changes to the existing tax laws relating to depreciation. These changes are aimed at amending the current rules relating to:

- depreciation recovered (when the insurance proceeds exceed the tax book value of the destroyed asset);
- the timing of the "deemed sale of destroyed assets"; and
- the deductibility treatment of the loss of a building not destroyed by an event beyond the owner's control, but subsequently destroyed as a consequence of such an event.

Depreciation Recovered Rollover

Under the existing tax laws when the insurance proceeds of a destroyed asset exceed the tax book value of the asset, the owner is taxed on depreciation recovered. This creates a funding problem for a business owner who needs to use the insurance funds to cover the cost of the replacement building but also has to fund the tax cost of the depreciation recovered. The Government in recognition that it is not appropriate that it should collect a windfall gain from depreciation recovered has proposed the following amendments to ensure that depreciation recovery is deferred to a later period in time.

The Government has proposed that where an asset owner has suffered damage to a depreciable fixed asset and claimed insurance to replace that asset, the asset owner be entitled to make an election to roll qualifying depreciation recovered over into the tax value of the replacement asset acquired.

The proposed legislation intends to implement roll-over relief for two classes of depreciable fixed assets being:

- buildings (together with fit out); and
- plant and equipment.

If the fixed asset is a building, the replacement building must be located within the Canterbury Earthquake Recovery Authority Zone, being the areas covered by the territorial authorities of the Christchurch City Council, the Selwyn District Council and the Waimakariri District Council (the CERA Zone).

If the fixed asset is plant and equipment, no restrictions apply to the location of the replaced plant and equipment.

How will it work?

The roll-over relief process will require the asset owner to make an election in writing to the Inland Revenue. The election will state that the asset owner has qualifying depreciation recovered and that they intend to defer payment of that deprecation recovered on the basis of their reasonable expectation that the fixed asset will be replaced by the end of 2015/2016 income tax year.

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The election must be sent to the Inland Revenue by the later of:

- the date the tax return is filed for the year the depreciation recovered would otherwise be recorded in; or
- 30 September 2011.

Once an election has been made, the owner must apply the roll-over relief against the next relevant replacement asset purchased in subsequent years. When the replacement asset has been acquired the asset owner must notify the Inland Revenue in writing that the asset has been acquired and that the deferred depreciation recovered has been offset into the adjusted tax value of that replacement asset.

Example

X Limited owns a building in the CERA Zone. The building was originally acquired at a cost of $3 million. The building is destroyed in the Canterbury Earthquake. The book value of the building at the time of the Canterbury Earthquake is $2 million reflecting accumulated depreciation of $1 million.

X Limited insured the building for replacement cover. In June 2011 X Limited insurers agree to pay insurance proceeds of $6 million to cover the cost of a replacement building. The replacement building is completed on 15 June 2014.

Under the existing laws (i.e. prior to roll-over relief being available) X Limited would have to pay tax on depreciation recovered taxable income of $1 million. At a company tax rate of 28%, X Limited would have a tax liability of $280,000 on the $1 million depreciation recovered.

Applying the new proposed roll-over relief provisions X Limited would specify in its 31 March 2012 tax return that it elects to defer the depreciation recovered pending the acquisition of the replacement building. Depreciation recovered income is therefore suspended for taxation purposes.

When the replacement building is delivered on 15 June 2014 X Limited would include in its 31 March 2015 tax return, the replacement building at a cost of $6 million and immediately record the replacement buildings adjusted tax value as $5 million.

Eventually, if the building is sold in excess of $6 million, the difference between the adjusted tax value and the building cost (in this case $1 million) will be clawed-back as depreciation recovery income. Therefore, the tax liability associated with disposal of the destroyed building has been rolled-over until disposal of the replacement building by way of sale.

What happens if the asset is not actually replaced?

If the destroyed asset is not actually replaced, then to the extent that deferred depreciation recovered has arisen, it is brought to account as income at the earlier of:

- the asset owner's 2015/2016 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.

Timing of Deemed "Sale of Destroyed Assets

When an insured asset is written off, depreciation recovered results when the insurance proceeds exceed the asset's tax book value. This is because when the asset is written off it is treated as if it has been sold.

Under the existing tax laws this deemed "sale" occurs at the date of the event that gave rise to the write off (e.g. the Canterbury Earthquake). In most cases however the insurance proceeds will not be quantifiable until months, sometime years after the event meaning that the asset owner has a retrospective tax liability.

In response to this issue the Government has proposed that a deemed sale should not be treated as having occurred until such a time as the insurance proceeds from the destroyed asset can be reasonably estimated. This amendment is to be a general amendment and not just limited to the Canterbury Earthquake. It is however intended to be effective from 4 September 2010.

Losses on Buildings

Current legislation allows a write-off for the loss of a building when that building is destroyed by an event such as an earthquake. However it does not allow a deduction for a building which has to be destroyed as a result of such an event, for example a building which is relatively unharmed by the event has to be demolished to allow a neighbouring building to be properly demolished.

Legislation will be amended to allow a building that has to be demolished as a result of the event, even if the building itself is not irreparably damaged by the event itself, to be written off.

Timing

The proposed amending legislation is expected to be enacted in July or early August this year. It is intended, however, to be retrospectively effective from 4 September 2010.

The information contained in this document is of a general nature and should be used as a guide only. All references to law and legislation apply to New Zealand law and legislation only. We recommend that before acting on it, you consult your legal professional.