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Depreciation - what you need to know about the tax and accounting implications

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As predicted, Budget 2010 announced significant changes to the tax depreciation rules as follows:

- The removal of the ability to claim depreciation on buildings from the 2012 income year, with "grandparenting" of the existing treatment for some buildings
- The removal of the 1.2 loading factor to depreciation rates on certain new assets
- A change in the tax treatment of certain capital contributions

Not only are these big tax changes, but the removal of depreciation on buildings has given rise to a significant deferred tax issue. In this special alert we look at these changes in more detail and set out the implications from a tax and accounting point of view.

Removal of tax depreciation on buildings

The Government's analysis suggests that on average long-lived buildings have been appreciating since 1993 and a 2% depreciation rate is not appropriate. Therefore, with effect from the 2012 income year, a 0% tax depreciation rate will apply to "buildings" that have an estimated useful life [EUL] of 50 years or more. This means, that from the beginning of the 2012 income year, no further tax depreciation can be claimed. Tax losses arising on the disposal of buildings will remain non-deductible. Because, under these new rules buildings remain depreciable property for tax purposes, should a building be sold for more than its tax book value, depreciation previously claimed will be recoverable.

The meaning of a building

In light of these changes, the definition of a building will become important as taxpayers seek to see what structures can be excluded from being buildings. Reference should be made to the recently released Inland Revenue's Interpretation Statement (IS 10/02) regarding the meaning of the term "building". This statement, which is applicable from 30 July 2009, concludes that a building is an item within the ordinary or conventional meaning of the term "building" and will generally have the following characteristics:

- A building is a structure of considerable size
- A building is permanent in the sense that it is intended to last a considerable time
- A building is permanent in the sense that it is designed to be located permanently on the site where it stands. A building is fixed to the land on which it stands. However, a building need not be legally part of the land on which it stands

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- A building is enclosed by walls and a roof
- A building can function independently of any other structure. However, a building is not necessarily a physically separate structure

Certain buildings have "grandparented" treatment

Certain "grandparented structures" which are considered buildings under the Commissioner's interpretation statement will still be able to be depreciated as the existing treatment has been "grandparented". This specific list of assets includes barns (including drying barns), carparks (buildings), chemical works, fertilizer works, powder drying buildings and site huts which were acquired on or before 30 July 2009. Improvements to these assets post 30 July 2009 will not qualify for grandparented treatment and will have a 0% depreciation rate from the 2012 income year.

Assets within buildings

Items within a building but which are treated separately from the building, such as building fit-outs, can continue to be depreciated. However the Government has signalled that this area is to be the subject of a future review and if necessary the tax rules will be amended before 1 April 2011 to clarify the law.

For residential properties, reference should be made to the Inland Revenue's Interpretation Statement IS 10/01 regarding whether an item is part of a building or separately depreciable. The principles in this interpretation statement should also be relevant for non-residential properties.

Repairs and maintenance

Repairs and maintenance to buildings are likely to come under more scrutiny by Inland Revenue who may fear taxpayers will seek to class building improvements as deductible repairs and maintenance. Guidance has been issued reminding taxpayers of the Inland Revenue view of the correct approach in this regard. The guidance states that "repairing or replacing something that forms part of a building, provided it does not substantially improve or alter value or function of the building is likely to be deductible. If, on the other hand, a substantial amount of work is involved, or the building is improved in some way, it is likely that this will be non-deductible capital expenditure" (for which no depreciation can be claimed).

Interpretation of useful lives and applying for special rates

If you have already thought about applying for a special rate for your particular building because you believe it has a useful life of less than 50 years or does depreciate rather than appreciate, then the news is not good. Special rates are granted in situations where the specific economic depreciation rate is either faster or slower than the Commissioner's rate. However with effect from 20 May 2010, it will not be possible to apply for a "special rate" for a building because the general view is that buildings on average do not decline in value. This seems particularly harsh for a building which is built on leasehold land which clearly does lose value, particularly if at the expiry of the lease the building transfers to the lessor or land owner for no consideration or compensation. There appears to be no avenue to apply for dispensation for such situations other than seeking a legislative change.

It will also not be possible to argue, for example, that a secondhand building doesn't have an economic useful life [EUL] of 50 years because the guidance states that, a "whole of life" approach is taken. Therefore, if a person purchases a secondhand item with an EUL of 50 years, its EUL will still be 50 years regardless of how old the item is.

It is still possible to apply for a "provisional rate" where you can establish that the building does not come within an existing asset category (other than then the default class).

Accounting issues - deferred tax implications of removal of tax depreciation on buildings

The removal of tax depreciation on buildings has given rise to a significant issue in relation to accounting for deferred tax. There will be a substantial increase in the deferred tax liability associated with certain buildings. Whether or not there is an increase depends on whether the building was owned at the time of the change or was purchased subsequently and on the expected manner of recovery of the carrying value of the building (i.e. through use and/or sale).

New Buildings

If a building is acquired in a separate transaction that is not the acquisition of a business then the initial recognition exemption under NZ IAS 12 *Income Taxes* will apply and no deferred tax will arise. If the building

is subsequently revalued however, then deferred tax will arise on the revaluation increase. This will be recognised in the revaluation reserve as per usual.

If the building is acquired in a business combination then the initial recognition exemption will not apply and the deferred tax will arise and affect the calculation of goodwill. Investment property acquisitions will need to be carefully analysed to determine whether they are acquisitions of an asset or a business. If an acquirer will provide significant services in operating the property it could well be a business combination.

Existing Buildings

The expected manner of recovery of the carrying value of existing buildings (i.e. through use and/or sale) will determine the amount of deferred tax recognised. For May balance dates onwards deferred tax must be recalculated to take account of the change in the tax law. If the carrying value of the building is expected to be recovered through use, the deferred tax liability will increase because the tax base will be reduced to the remaining tax depreciation able to be claimed for periods up to the end of the 2011 income year. The temporary difference on which deferred tax will be calculated, being the difference between the carrying amount for accounting purposes and the tax base, will therefore increase substantially, equating effectively to the carrying value of the building. The change in the deferred tax liability will be recognised in the profit or loss.

Example:
Entity A has, at the date the tax law changes are substantively enacted, an existing building with a cost of $100, a carrying value of $90 and a tax book value of $80. It expects to recover the carrying value of the building through use. The tax depreciation for the 2011 income year will be $2. The following table demonstrates the calculation before and after the change to the tax rate and the tax depreciation rules.

	Carrying value	Tax base	Temporary difference	Deferred tax liability
Before change	$90	$80	$10	$3 (@ 30c)
After change	$90	$2	$88	$24.64 (@ 28c)

If the carrying value of the building is expected to be recovered through sale then the deferred tax will equate to the tax on depreciation recovered assuming that the entity is not subject to tax on capital gains. This is unlikely to change on adopting the new tax rules.

The above applies whether the buildings are owner occupied or investment properties for accounting purposes. Note that if the expected manner of recovery subsequently changes, deferred tax must be recalculated.

Other tax depreciation issues

Removal of 1.2 loading factor for certain new assets

Prior to the budget announcements, the base tax depreciation rate for certain new assets acquired could be multiplied by a loading factor of 1.2. This incentive was originally introduced to encourage New Zealand businesses to invest in new capital equipment. The types of assets that qualified for the loading were new assets, which had not been used or held for use in New Zealand, not being a building, used imported car or international aircraft.

As a result of the budget announcements, if a person acquires or enters into a binding contract for the purchase or construction of an item of depreciable property after 20 May 2010, the loading factor cannot be applied. For example:

Asset (Assume new assets)	DV rate + 20% loading if acquired on or before 20 May 2010	DV rate if acquired post 20 May 2010	SL rate + 20% loading if acquired on or before 20 May 2010	SL rate if acquired post 20 May 2010
Office equipment (Default class)	48	40	36	30
Motor vehicles (for transporting people up to and including 12 seats)	36	30	25.2	21

The loading factor can continue to be applied to those qualifying assets which were acquired on or before 20 May 2010. However it should be noted that improvements (including entering into a binding

contract for the purchase or construction of an improvement) to qualifying assets after 20 May 2010 must compulsorily be treated as a separate item of depreciable property and will not qualify for the loading.

Businesses may like to consider amending the rates now within their tax depreciation systems for depreciable assets acquired after 20 May 2010 rather than wait until year end to sort out which rate applies.

Capital contributions

The tax treatment of "capital contributions" has been changed. A capital contribution is a subsidy or similar payment made to a person that compensates them for some capital expenditure. For example, it is fairly common for a landlord to contribute towards the cost of a building fit out incurred by a lessee. Capital contributions may be capital in nature and so not taxable in the hands of the recipient. In addition, the base cost of the depreciable asset acquired would generally not need to be reduced for the contribution. However with effect from 20 May 2010, a "capital contribution" amount received will be treated as income and must be spread over 10 years. Alternatively the recipient can elect to reduce the tax value of the asset by the amount of the contribution. A new definition of "capital contribution" has been inserted for these new rules. Clients who contemplate receipt of capital contributions from here on should speak to their Deloitte tax advisor accordingly.

For more information please contact your usual Deloitte tax advisor or one of the following partners.

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