



WEEKLY COMMENT: FRIDAY 12 OCTOBER 2012

1. From the beginning of the 2011-12 income year, the tax depreciation rate for buildings has been 0% - i.e. buildings (apart from a few specified exceptions) are no longer depreciable. At the same time, new rules came into effect that allowed 'commercial fit-out' to be separately depreciated. As a starting point, 'commercial fit-out' is excluded from the definition in s. YA 1 of a "building", so that the 0% depreciation rate does not apply to items of 'commercial fit-out'.
2. The *Taxation (Livestock Valuation, Assets Expenditure, and Remedial Matters) Bill* ("the Bill") introduced on 13 September contains an amendment clarifying that expenditure on commercial fit-out must be capitalised and depreciated. So this week I thought I'd take the opportunity to review the tax depreciation rules relating to commercial fit-out.
3. I look at:
 - Meaning of commercial fit-out.
 - The first limb of the definition: 'Plant'.
 - How to determine if a mixed-use building is a commercial building.
 - The second limb: attached to a building and not structural or weatherproofing.
 - Dwelling within the building.
 - Treatment of expenditure on commercial fit-out.
 - No retrospective re-characterisation of building items as commercial fit-out.
 - Change of use: switching from being commercial to predominantly residential.
 - Commercial fit-out that was not previously separately depreciated: transitional rule.
 - Conclusions regarding the meaning of commercial fit-out.

Meaning of commercial fit-out

4. **Commercial fit-out** is defined in s. YA 1 as meaning an item to the extent to which it is—
 - (a) **Plant** attached to a **commercial building**, but not used inside a **dwelling** within the commercial building.
 - (b) Attached to, and nonstructural in relation to, a building, if the item is not used for weatherproofing the building and—
 - (i) Is not used in relation to, and is not part of, a dwelling within the building; or
 - (ii) Is used in relation to, but is not part of, a dwelling within the building, and the building is a commercial building.

The first limb of the definition: 'Plant'

5. The first limb of this definition requires examination of 3 other defined terms:
 - Plant;
 - Commercial building; and
 - Dwelling.
6. Plant attached to a commercial building is generally depreciable as 'commercial fit-out'. In s. YA 1: **Plant** does not include an item that is structural in relation to the building. This means that if an item of plant is integrated into the structure of a building, the building depreciation rate of 0% will apply to that item. The *IRD website* provides the example of a lift shaft as an item of plant that is structural: hence the lift shaft forms part of the building for tax depreciation purposes, and is not depreciable as being part of the lifts (that are separately depreciable).
7. In s. YA 1: **Commercial building** means a building that is not, in part or in whole, a dwelling, unless use as a dwelling is a secondary and minor use.
8. Therefore, a commercial building is one where the main use is non-residential. That is not to say that it cannot contain residences, provided that any residential premises within the building are of a secondary and minor use.

How to determine if a mixed-use building is a commercial building

9. It is stated in the *IRD website* that if it is not clear what the main use of a building is, taxpayers will need to take a position based on their particular circumstances:

"One method for determining the building's main use could be to compare the area of the building that is used or set aside exclusively for residential accommodation with the remaining area of the building. In making this assessment, the taxpayer would need to consider how to allocate the shared areas (for example, lobbies, hallways and entranceways that commercial and residential tenants can normally access). If commercial and residential tenants have equal access to shared areas, one approach would be to count the shared areas as appurtenant to the residential accommodation and again as part of the rest of the building. However, in working out the most appropriate apportionment approach the particular circumstances of each building will be important."
10. In the *IRD website* it is stated that the dominant purpose of the building determines the tax treatment of items of shared fit-out, as illustrated by the following examples.

Example 1: If the dominant or main purpose of a building is commercial, items of shared fit-out will be depreciable as commercial fit-out. For example, most of the floor area of a building is occupied by commercial tenants but the top floor has a residential apartment. The shared items of fit-out, such as electrical cabling, fire protection equipment, sewerage and water reticulation, and the fit-out of lobbies that are not part of the residential premises are depreciable. However, the fit-out within the apartment is generally not depreciable property, as per the Commissioner's interpretation statement *IS 10/01*.

Example 2: Most of the floor area of a building is used for residential purposes. The remainder is used for commercial purposes. Items of fit-out in the building that are used as a café and residential purposes will be mainly non-depreciable - as in the Commissioner's interpretation

statement *IS 10/01*. However, the fit-out of the café within the building will be depreciable as commercial fit-out because it is not used in relation to, and is not part of, a dwelling.”

The second limb: attached to a building and not structural or weather-proofing

11. The second limb of the definition applies to commercial buildings, and also to buildings that are not commercial buildings. The IRD website explanation is as follows:

“The second limb of the definition of commercial fit-out is intended to exclude items holding up the building or used to weather-proof the building (“building core”) from being a commercial fit-out. This makes the building core of certain buildings non-depreciable. For a building with an estimated life of 50 years or more, the non-depreciable building core includes foundations, the building frame, floors, external walls, cladding, windows, external doors, internal stairways, the roof and load-bearing structures associated with the building such as pillars and load-bearing internal walls. Further, under the new definition of commercial fit-out, items attached to the building used within residential premises are not commercial fit-out. However, attached items used in relation to a residential dwelling are commercial fit-out if the building is a commercial building.”

Dwelling within the building

12. Both limbs of the definition of ‘commercial fit-out’ contain exclusions for items relating to a “dwelling within the building”:
- (a) Under the first limb, plant that is used inside a dwelling within a commercial building is excluded from being ‘commercial fit-out’.
 - (b) Under the second limb, other (non-plant) items are excluded from being ‘commercial fit-out’ if:
 - (i) They are used in relation to, or are part of, a dwelling within a (non-commercial) building; or
 - (ii) They are used in relation to and part of a dwelling within a commercial building.
13. The first limb of the definition of **dwelling** in s. YA 1 is very broad and means “any place used predominantly as a place of residence or abode, including any appurtenances belonging to or enjoyed with the place”.
14. However, the second limb contains a number of listed exclusions, so that commercial buildings that provide residential-type accommodation are not treated as dwellings:
- (a) Hospitals;
 - (b) Hotels, motels, inns, hostels, or boarding houses;
 - (c) Certain serviced apartments, where additional services are provided and where the resident does not have quiet enjoyment;
 - (d) Convalescent homes, nursing homes, or hospices;
 - (e) Rest homes or retirement villages, except places that are characterised as places of residence for **independent living**; and
 - (f) Camping grounds.

15. Rest homes or retirement villages that are characterised as places of residence for independent living are classified as dwellings. In s. YA 1: **Independent living** means occupancy of a place under an arrangement that–

(a) Does not have a level of compulsory care.

(b) Has a level of compulsory care that is merely incidental to the occupancy.”

16. The IRD notes that in rest homes or retirement villages, a distinction has been drawn between serviced apartments and premises that provide residents with independent living arrangements. It is stated in the IRD website that:

“Fit-out associated with rest homes, hospitals, community centres and serviced apartments will generally continue to be depreciable whereas fit-out associated with premises that provide for independent living will generally be non-depreciable.

Serviced apartments are generally distinguishable from premises providing for independent living because the occupancy arrangements typically require the resident to purchase a bundle of care services (such as medical supplies, nursing care, meals, cleaning, provision of linen and laundry) in addition to a right of occupancy in order to be entitled to occupy the premises. In this situation, the fit-out of the serviced apartment will continue to be depreciable property.

However, if the only compulsory services supplied to the resident are merely incidental to the occupancy (such as gardening, maintenance, management and security services) the fit-out of the serviced apartment will not be depreciable.”

Treatment of expenditure on commercial fit-out

17. Clause 14 of the Bill contains a new s. DA 5 which applies to expenditure relating to commercial fit-out: when applying the capital limitation to expenditure, to the extent to which the expenditure relates to a building’s commercial fit-out, the expenditure is treated as relating to the commercial fit-out, and not to the building.

18. This means that in order to decide whether expenditure, for example, repairs and maintenance expenditure, is deductible outright or must be capitalised and depreciated, the expenditure is treated as relating to the commercial fit-out (and not, for example, to the building). Hence, the expenditure will not be deductible as R&M relating to the building. It must be capitalised and depreciated as commercial fit-out.

No retrospective re-characterisation of building items as commercial fit-out

19. The Commissioner expressed a viewpoint for comment and discussion only in a draft *Questions We’ve Been Asked* (QWBA ED 0140: *Depreciation Of Commercial Fit-out*) that was not issued in final form:

- That there can be no retrospective re-characterisation of part of a building into various items of fit-out in order to claim depreciation deductions on those items.
- The Commissioner contended that any retrospective re-characterisation and depreciation of fit-out would require the Commissioner to exercise his discretion under section 113 of the Tax Administration Act 1994 to adjust the depreciation deductions in previous assessments, based on the backdated valuations. However, the Commissioner cannot exercise section 113 in matters of “regretted choice” (as discussed in SPS 07/03 *Requests to amend assessments*).

- The Commissioner concedes, however, that if a taxpayer can sufficiently demonstrate that an error did occur in the assessment, the Commissioner may consider exercising section 113. The taxpayer must show that there was a genuine error in the tax return. For example, items of building fit-out were recorded separately in the taxpayer's books but for some reason that was not reflected in the depreciation deductions claimed in the tax return.
20. It should be noted that this draft QWBA was never issued in final form. Therefore the comments cannot be relied upon. However, it is likely that the IRD would challenge a retrospective re-characterisation of items into commercial fit-out.

Change of use: switching from being commercial to predominantly residential

21. From the 2011-12 income year onwards, the rules in s. EE 47(2), relating to depreciation recovery when there is a change of use have been adjusted to include:
- A change in use of an item for the purposes of the definition of commercial fit out.
 - A change in the status of a building related to an item for the purposes of the definition of commercial fit-out.
22. Therefore the following will constitute disposal events for the purposes of depreciation recovery:
- (a) Commercial fit-out that was not part of a place of residence in a commercial building becoming part of a place of residence in the building.
 - (b) A building that was a commercial building becoming predominantly residential.
23. In either of the above cases, any commercial fit out, or shared fit-out, as appropriate, that has been separately depreciated, will be treated as having been disposed of, for a consideration equal to its market value (less any output GST) on the first day of the income year following the change in status of the commercial fit-out or building.
24. The depreciation recovery income, under s. EE 48, if the consideration exceeds the adjusted tax value on the deemed disposal date, will be equal to the lesser of:
- (a) The amount by which the consideration exceeds the adjusted tax value; and
 - (b) The sum of the depreciation loss claimed on the commercial fit-out.

Commercial fit-out that was not previously separately depreciated: transitional rule

25. Where commercial fit-out has not previously been separately depreciated, a transitional rule in s. DB 65 applies to allow a small proportion of building depreciation to continue to be claimed in a year where:
- (a) A person owns a commercial building depreciable at 0% in the year; and
 - (b) The person had a depreciation deduction for the building in the 2010-11 income year and has not disposed of the building; and
 - (c) Commercial fit-out, for which the person has never had a depreciation deduction, was acquired at the same time as the building and relates to the building; and
 - (d) The building was acquired in the 2010/2011 income year or earlier; and
 - (e) The person has no other deduction in relation to the building for the income year.

26. The deduction is provided for the “starting pool” of deemed commercial fit-out in the building. The “starting pool is calculated as 15% of the 2010-11 closing adjusted tax value (“atv”) of the building, and this is reduced by the 2010-11 closing atv of previously separately depreciated commercial fit-out in the building.
27. The amount of the deduction is the lesser of 2% of the “starting pool” value or the residual value of the pool - taking into account all previous deductions taken under the transitional rule.
28. Any amount deducted under this transitional rule in s. D 65 is not “depreciation loss”, so the depreciation recovery rules will not apply when the building is disposed of.
29. The following example is provided in the IRD website:

“Example: Company ABC acquired a warehouse on 1 April 1999 for \$1 million. Items of commercial fit-out within the building were not separately identified and depreciated at the time the building was acquired. Twelve months later a refurbishment of the warehouse was completed. The refurbishment was itemised and depreciation was applied to the various items of commercial fit-out.

At the end of the 2010-11 income year the adjusted tax book value of the warehouse is \$640,000 and the adjusted tax book value of the associated commercial fit-out is \$64,000.

The starting pool value is: $(15\% \times 640,000) - 64,000 = \$32,000$

The annual deduction is: $\$32,000 \times 2\% \times 12/12 = \640

To reduce complexity and compliance costs there are no loss or recovery rules applying to the value of the pool when the relevant building or fit-out is disposed of. In the above example, the taxpayer is entitled to a deduction of up to \$640 a year provided they own the commercial building.

However, if the dominant purpose of a building changes from commercial to residential, no deduction is allowed under section DB 65, as subsection (1)(a) no longer applies to the building. However, the deductions would begin again if the building subsequently reverts to being a commercial building - provided the building ownership has been maintained.”

Conclusions regarding the meaning of ‘commercial fit-out’

30. Based on the foregoing, the following conclusions can be drawn, applying from the 2011-12 income year onwards:
- (a) Plant is commercial fit-out if it is non-structural and attached to a building whose use as a place of residence (if so used) is secondary and minor, provided the plant is not used within the portion of the building that is a place of residence.
 - (b) An item used for weatherproofing a building is not commercial fit-out.
 - (c) An item (other than plant) is commercial fit-out if it is attached to a building, but not structural, and it is not used in relation to, or part of, a place of residence within the building.
 - (d) An item (other than plant) is commercial fit-out if it is non-structural and attached to a building, even though it may be used in relation to a place of residence within the building, provided that the building’s use as a place of residence is secondary and minor and the item is not part of the place of residence within the building.

- (e) Plant that is non-structural and other non-structural items, that are attached to a type of building that is a listed exclusion from the definition of “dwelling”, will be commercial fit-out.
- (f) The level of compulsory care provided as part of an occupancy of a rest home or retirement village, will determine whether non-structural plant and other non-structural items used in relation to, or forming part of, that occupancy, can be depreciated as commercial fit-out.
- (g) Expenditure on items of commercial fit-out must be capitalised and depreciated, and cannot be treated as R&M relating to the building.
- (h) Retrospective re-characterisations of items as commercial fit-out are likely to be challenged by the Commissioner.
- (i) The normal depreciation recovery rules apply when there is a change in use of a building: the disposal date will be the beginning of the income year following the year in which the change occurred. Items of shared fit-out are deemed to be disposed of at their market value on the deemed disposal date.
- (j) Commercial fit-out that was originally acquired with a building but not previously separately depreciated may be depreciated under the transitional rule at 2% of the “starting pool” value (which will be 15% of the building’s closing adjusted tax value in 2010-11).



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