



## WEEKLY COMMENT: FRIDAY 26 OCTOBER 2012

### CANTERBURY EARTHQUAKES BUSINESS INTERRUPTION, DISPOSALS, AND DEPRECIATION RELIEF MEASURES – PART 2

1. Last week and this week I look at the business interruption, asset disposals, and depreciation relief measures relating to the Canterbury earthquakes, some of which were legislated in the *Taxation (Tax Administration and Remedial Matters) Act 2011*, and a number of which are in the process of being legislated and are currently contained in the *Taxation (Annual Rates, Returns Filing, and Remedial Matters) Bill* (“the Bill”) and the *Supplementary Order Paper No 98* (“the SOP”) to that Bill.
2. The relief measures can be broadly divided into the following categories:
  - I. Relief from the 10-year rule for income from land sales.
  - II. Deferred deductions for interruption expenditure.
  - III. Deemed availability for use for depreciation purposes while access is restricted.
  - IV. Depreciation recovery income and depreciation loss relief measures.
  - V. Relief from atv adjustments when compensation is received for depreciable property.
  - VI. Relief measures for depreciation recovery income for items depreciated in a pool.
  - VII. Relief measures relating to income from insurance receipts.
  - VIII. Relief measure relating to the thin capitalisation debt percentage.
3. Last week I looked at the first four of the categories listed above. This week I look at the last four categories.

#### **V. Relief from atv adjustments when compensation is received for depreciable property**

4. Under s. **EE 52**, when a person receives insurance, indemnity, or compensation for depreciable property (other than for an item that is lost, stolen or irreparably damaged), the amount by which the compensation exceeds the expenditure that the person incurs because of the event for which the person receives the compensation must be subtracted from the item’s adjusted tax value.
5. If the item’s adjusted tax value becomes negative in an income year because of the amount subtracted from the adjusted tax value, the negative amount is an amount of depreciation recovery income derived by the person in the income year.

6. This rule is overridden in two situations:
- (a) When compensation is received in relation to Canterbury earthquake-damaged property assessed as uneconomic to repair; and
  - (b) When compensation is received in relation to Canterbury earthquake-damaged property that is not irreparably damaged.
- (a) New s. EZ 23C: Deemed disposal of Canterbury property assessed as uneconomic to repair***
7. A person is treated as, on the date of the Canterbury earthquake, as disposing of an item of depreciable property for the amount of insurance or compensation, and reacquiring the item for zero consideration, if:
- (a) The income year (the current year) is before the 2016–17 income year; and
  - (b) The item is damaged by a Canterbury earthquake as that term is defined in s. 4 of the *Canterbury Earthquake Recovery Act 2011*; and
  - (c) The person is entitled to an amount of insurance or compensation for the damage to the item; and
  - (d) The item is assessed by the payer of the insurance or compensation (the insurer) as uneconomic to repair; and
  - (e) The damage does not meet the requirements of section EE 47(4) (i.e. the property is not a building and is not irreparably damaged, and if it is a building, it is not useless and abandoned for later demolition).
- [New s. **EZ 23C** inserted by **Clause 27C** of the *Taxation (Annual Rates, Returns Filing, and Remedial Matters) Bill*, applying for the 2010–11 to the 2015–16 income years.]
- (b) New s. EZ 23D: Depreciation recovery income limited to depreciation loss for Canterbury property damaged but not assessed as uneconomic to repair***
8. A person who would, for an item in an income year, ordinarily derive depreciation recovery income under s. EE 52, derives as depreciation recovery income the lesser of: the s. EE 52 depreciation recovery income and the total depreciation loss allowed for the item, if the following conditions are met:
- (a) The income year (the current year) is before the 2016–17 income year; and
  - (b) The item is damaged by a Canterbury earthquake as that term is defined in section 4 of the *Canterbury Earthquake Recovery Act 2011*; and
  - (c) The person is entitled to an amount of insurance or compensation for the damage to the item; and
  - (d) S. **EZ 23C** (see **(a)** above) does not apply (i.e. the item is not assessed by the payer of the insurance or compensation (the insurer) as uneconomic to repair; and
  - (e) The damage does not meet the requirements of s. **EE 47(4)** (i.e. the property is not a building and is not irreparably damaged, and if it is a building, it is not useless and abandoned for later demolition).

[New s. **EZ 23D** inserted by **Clause 27D** of the *Taxation (Annual Rates, Returns Filing, and Remedial Matters) Bill*, applying for the 2010–11 to the 2015–16 income years.]

#### **VI. Relief measures for depreciation recovery income for items depreciated in a pool**

9. An excess recovery is subtracted from a pool's adjusted tax value at the end of an income year if:
- (a) An item that has been damaged is in a pool at the end of an income year; and
  - (b) A person in the income year derives an amount of insurance, indemnity, or compensation (the **compensation amount**) for damage to that item; and
  - (c) The compensation amount exceeds the expenditure or loss that the person incurs because of the damage.

[New s. **EE 22(2B)** inserted by **Clause 21CB(1)** of the *Taxation (Annual Rates, Returns Filing, and Remedial Matters) Bill*, effective from the 2011-12 income year onwards, except if a return has not been filed for 2010-11 under a Canterbury Earthquake extension of time.]

10. An excess recovery relating to a pool depreciated item that is disposed of is deducted from a pool's adjusted tax value on the date of disposal if:
- (a) The damaged item that is disposed of was depreciated in a pool; and
  - (b) A person derives an amount of insurance, indemnity, or compensation to which s. EE 22(2B) does not apply for damage to the item occurring before the disposal.
  - (c) Any excess of insurance, indemnity or compensation over expenditure or loss incurred in deriving the insurance or compensation, is deducted from the pool's adjusted tax value on the date of disposal.

[Amended s. **EE 22(3)** amended by **Clause 21CB(2)** of the *Taxation (Annual Rates, Returns Filing, and Remedial Matters) Bill*, effective from the 2011-12 income year onwards, except if a return has not been filed for 2010-11 under a Canterbury Earthquake extension of time.]

11. Under new s. **EZ 23G**, there is the option of deferring to 2015-16 any insurance income upon disposal of items depreciated in a pool. As this rule also applies to non-pool items, I have dealt with it under **section VII (d)** below.

#### **VII. Relief measures relating to income from insurance receipts**

12. The relief measures relating to income from insurance receipts need to be considered under a few sub-headings:
- (a) Insurance receipts allocated to earlier of year of derivation or year expenditure is incurred.
  - (b) Replacement income allocated to later of year of interruption or year received or estimated.
  - (c) When excess recoveries for Christchurch revenue account property can be suspended.
  - (d) Optional deferral to 2015-16 of insurance income and repair costs.

**(a) Insurance receipts allocated to earlier of year of derivation or year expenditure is incurred.**

13. Section CG 4 which dealt with “recovered expenditure or loss” is being replaced by a new s. CG 4 which deals with “Receipts for expenditure or loss, from insurance, indemnity, or otherwise”.
14. Under the new s. CG 4, an amount that a person derives, to the extent of the deduction allowed for any expenditure or loss, is income of the person, where:
  - (a) The person is allowed a deduction for expenditure or loss; and
  - (b) The person derives an amount relating to the expenditure or loss, whether through insurance, indemnity, or otherwise; and
  - (c) The amount, to the extent of the deduction, is not income of the person under any other provision in the Income Tax Act 2007.
15. Under new s. CG 4, the income is allocated to the later of:
  - (a) The income year in which the expenditure or loss is incurred; or
  - (b) The income year in which the amount is derived.
16. New s. CG 4 applies for:
  - (a) The 2011-12 and later income years; or
  - (b) 2010-11 and later income years for a person who is granted an extension of time for filing a return for the 2010-11 income year under the Canterbury Earthquake (Inland Revenue Acts) Order 2011.
17. New s. CG 4 differs from the previous s. CG 4 in 2 important respects:
  - (a) New s. CG 4 refers to an “amount derived” relating to an expenditure or loss, whereas the previous reference was to a “recovery” of some or all of any expenditure or loss.
  - (b) New s. CG 4 provides for income to be allocated to the later of the year of derivation or the year the expenditure was incurred, whereas the previously the income was allocated to the income year in which “the amount was recovered”.

[s. CG 4 as replaced by **Clause 11B** of the *Taxation (Annual Rates, Returns Filing, and Remedial Matters) Bill*, effective from the 2011-12 income year onwards, except if a return has not been filed for 2010-11 under a Canterbury Earthquake extension of time.]

***(b) Receipts from insurance, indemnity, or compensation for interruption or impairment of business activities***
18. Section **CG 5B** applies from the date of the first Canterbury Earthquake, 4 September 2010, when a person receives an amount of insurance, indemnity, or compensation for an interruption or impairment of business activities resulting from an event.
19. An amendment contained in the Annual Rates Tax Bill is aimed at ensuring that any replacement income is not allocated to an income year earlier than the year in which the income that is replaced would have been derived.
20. Under s. **CG 5B(2)**: The part of the insurance, indemnity, or compensation attributable to income that the person would have derived (the replaced income) if not for the event is income of the person.
21. Under new s. CG 5B(3) the income under s. CG 5B(2) is allocated to the later of:

- (a) The income year to which the replaced income relates; or
- (b) The earlier of:
  - (i) The income year in which the amount is received; or
  - (ii) The income year in which the amount is reasonable able to be estimated.

22. The amended s. CG 5B applies for:

- The 2011-12 and later income years; or
- 2010-11 and later income years for a person who is granted an extension of time for filing a return for the 2010-11 income year under the Canterbury Earthquake (Inland Revenue Acts) Order 2011.

[s. **CG 5B** as amended by **Clause 11C** of the *Taxation (Annual Rates, Returns Filing, and Remedial Matters) Bill*, effective from the 2011-12 income year onwards, except if a return has not been filed for 2010-11 under a Canterbury Earthquake extension of time.]

***(c) When excess recoveries for Christchurch revenue account property can be suspended***

23. Under ordinary circumstances, any insurance or compensation received for loss or damage to revenue account property is taxable under s. **CG 6** and a deduction is available for the cost of the property under s. **DB 23**.
24. New s. **CZ 25** (previously enacted as s. CZ 23) overrides s. **CG 6** and provides for excess insurance or compensation recoveries from Christchurch revenue account property to be suspended in specified circumstances.
25. Under new s. **CZ 25**, certain **excess recoveries** – amounts received by a person that would normally be taxable under s. CG 6, less the deductions under s. DB 23 - for buildings or land (the **affected property**) all of which is revenue account property, may be suspended in an income year (the current year) before the 2016–17 income year, when the person plans in the current year to acquire, in or before the 2015-16 income year and located in greater Christchurch, property (the **replacement property**) replacing affected property.
26. Following the example on the *IRD website*, a person's building that is revenue account property cost \$3m and is demolished by the earthquake in February 2011. The insurance proceeds to rebuild the building are reasonably able to be estimated at \$6m by June 2011. In the tax return to 31 March 2012, there would ordinarily be income under s. CG 6 of \$3m (the \$6m insurance proceeds less the cost of \$3m). The taxpayer intends to replace the property and elects to 'suspend' the income recognition. The 'suspended recovery income' at the end of 2011-12 is therefore \$3m.
27. Some requirements are as follows:
- (a) As in the case of the above example, the excess recoveries must arise from:
    - (i) Insurance or compensation because a Canterbury earthquake damages the land and damages each building, or the neighbourhood of the building, causing the building to be useless for the purpose of deriving income and consequently to be abolished or abandoned for later demolition; or
    - (ii) A purchase by the Government from the person; and

- (b) Written notice must be given to the Commissioner every year until the property is replaced and any remaining suspended recovery income is returned. Any remaining suspended recovery income at the end of the 2015-16 income year must be returned.
28. When the property is replaced, the 'suspended recovery income' is reduced or eliminated by the replacement cost (the "rollover" adjustment). The replacement cost, for the purposes of subsequent tax deductions upon the eventual disposal of the property, is correspondingly reduced.
29. The cost reduction is calculated as follows:
- $$(\text{Excess recovery}) \times (\text{replacement cost to a maximum of original cost}) / (\text{original cost})$$
30. Original cost is the deductions available under s. DB 23 for the original affected property. Any replacement cost in excess of the original cost does not feature in the formula. Hence the maximum cost reduction will be the 'excess recovery' (i.e. the suspended recovery income).
31. Continuing with the example on the IRD website, the replacement cost is \$6m, but replacement cost in the cost reduction formula will be limited to \$3m, because that was the original cost. The cost reduction will therefore be the excess recovery of \$3m. The cost of the building for future tax purposes is \$3m (and not the replacement cost of \$6m), and the suspended recovery income of \$3m is reduced to zero.
32. A person choosing to rely on s. CZ 25 to suspend the recognition of suspended recovery income must, starting from the year when the insurance can be reasonably estimated (the estimate year - the 2011-12 income year in the case of the above example), give written notice to the Commissioner every year by the date the return of income for the year is filed:
- (a) Describing the affected property; and
  - (b) Giving details of replacement property acquired in the current year to replace, in full or in part, the affected property; and
  - (c) Giving the cost of the replacement property and the reduction of that cost; and
  - (d) Any remaining suspended recovery income for the affected property at the end of the current year.
- [s. CZ 25 inserted by **Clause 16C** of the *Taxation (Annual Rates, Returns Filing, and Remedial Matters) Bill*, effective from the date of enactment.]
- (d) Optional deferral to 2015-16 of insurance income and repair costs**
33. New s. **EZ 23G** allows for an optional deferral to 2015-16 of insurance income received:
- (a) For the disposal of pool depreciated items; and
  - (b) For repair costs of non-pool items when there is no deemed disposal and the repair expenditure is not incurred and not able to be estimated.
34. The calculation and allocation rules in ss. **CG 4**, **EE 22** and **EE 52** for insurance receipts in excess of repair expenditure will not apply, and the income from insurance, and the deductions for repair costs are allocated to income years under s. **EZ 23G** if:
- (a) An item of depreciable property is damaged by a Canterbury earthquake; and
  - (b) The damage:

- (i) Does not result in a deemed disposal and reacquisition under s. EZ 23C because property is not uneconomic to repair; or
  - (ii) Does not result in a deemed disposal under s. EE 47(4) due to non-building property being repairable or a building not being rendered useless and demolished or abandoned; and
- (c) The person is entitled to insurance or compensation for damage to the item; and
- (d) The person chooses to apply the optional deferral under s. EZ 23G for all items of depreciable property meeting the above requirements of paragraphs (a) to (c).
35. If the insurance or compensation for the damage (the insurance receipt) is derived or able to be reasonably estimated before the end of the 2015–16 income year, the person's insurance income is attributed to the earlier of:
- (a) The 2015–16 income year; or
  - (b) The first income year in which:
    - (i) The repair cost is or has been incurred or able to be reasonably estimated; and
    - (ii) The insurance receipt is or has been derived or able to be reasonably estimated.
36. Similarly, if the repair cost is incurred or able to be reasonably estimated before the end of the 2015–16 income year, the person's deductions for the repair cost are attributed to the earlier of:
- (a) The 2015–16 income year; or
  - (b) The first income year in which:
    - (i) The repair cost is or has been incurred or able to be reasonably estimated; and
    - (ii) The insurance receipt is or has been derived or able to be reasonably estimated.
37. Section **EZ 23G** overrides sections **CG 4**, **EE 22**, and **EE 52** in relation to the timing of the person's income from the insurance receipt and deductions for the repair cost.

[New s. **EZ 23G** inserted by **Clause 27G** of the *Taxation (Annual Rates, Returns Filing, and Remedial Matters) Bill*, applying for the 2010–11 to the 2015–16 income years.]

### **VIII. Relief measure relating to the thin capitalisation debt percentage**

38. New s. **FZ 7** applies when an asset is treated as impaired or is derecognised under generally accepted accounting practice so that the value of assets is reduced when measuring the debt percentage. It allows any insurance or compensation to be included in the value of assets.
39. More specifically, for the purposes of sections **FE 16** and **FE 18** (which relate to the valuation of the assets of a person's New Zealand group and worldwide group for thin capitalisation purposes) the person may, if certain requirements are met, choose to include an amount of the insurance, corresponding to the amount of the impairment or the derecognised value of an asset, in the value of the total group assets of the person's New Zealand group during the period:
- (a) Beginning with the impairment or derecognition of the asset; and
  - (b) Ending before the earlier of:

- (i) The recognition of the amount of insurance; or
  - (ii) The beginning of the 2016–17 income year.
40. If a person includes an amount of insurance in the value of the total group assets of the person's New Zealand group for a period, the person must also include the amount in the value of the total group assets of the person's worldwide group for the period.
41. The following requirements must be met in order to include any insurance earlier than it would otherwise be included under generally accepted accounting practice:
- (a) An asset of the person's New Zealand group must be damaged as a result of a Canterbury earthquake; and
  - (b) The asset must be impaired, or derecognised, under generally accepted accounting practice as a result of the damage; and
  - (c) Insurance for the damage must be recognised at a later date under generally accepted accounting practice; and
  - (d) Notice must be given to the Commissioner, in the form and by the means prescribed by the Commissioner, no later than the later of 30 November 2012 and the day by which the person is required to make a return of income for the corresponding tax year, that the person has applied s. FZ 7 for the income year, specifying:
    - (i) The amount of income that would arise under s. **CH 9** (Interest apportionment: excess debt entity) for the income year before application of this section; and
    - (ii) The amount of income that arises under s. **CH 9** for the income year after the application of this section; and
    - (iii) Further information required by the Commissioner.

[New s. FZ 7 inserted by **Clause 32BA** of the *Taxation (Annual Rates, Returns Filing, and Remedial Matters) Bill*, applying for income years ending after 4 September 2010 and before the 2016-17 income year]



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