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WEEKLY COMMENT: FRIDAY 13 SEPTEMBER 2013

1. I last looked at the Canterbury earthquakes tax relief measures in *Weekly Comment* 19 October and *Weekly Comment* 26 October 2012. There are a number of additional changes that are proposed in *Supplementary Order Paper No. 257* ("the SOP") to the *Taxation (Annual Rates, Foreign Superannuation, and Remedial Matters) Bill* ("the Bill"). In addition, Inland Revenue have released draft Question We've Been Asked QWB00129 *Income tax – Depreciation roll-over relief for Canterbury* ("the draft QWBA"), with a deadline for comment of 11 October 2013.

2. The SOP:

   (a) Generally extends the roll-over relief measures from the 2015-16 income year to the 2018-19 income year;

   (b) Removes the exemption for Crown purchases of land where the profits would be taxable under s. CB 12 (undertaking or scheme where development or division work is not minor) currently contained in s. CZ 26, effective from when the new Act receives the Royal assent**;**

   (c) Extends the operation of sections EZ 23C to EZ 23G to the 2018-19 income year and changes the numbering of the sections to s. EZ 65 to EZ 69 effective from 1 April 2016 (i.e. from the date of the extension);

   (d) Extends the depreciation roll-over relief for replacement property to 2018-19 providing that, in the case of a building, a replacement has been acquired or a construction consent applied for before the end of the 2015-16 income year;

   (e) Introduces additional depreciation roll-over relief for replacement property acquired through an owned company ("a replacement interest") subject again to the proviso that, in the case of a building, a replacement has been acquired or a construction consent applied for before the end of the 2015-16 income year;

   (f) Extends the revenue account property roll-over relief so as to include property from which profits would be taxable under s. CB 6, CB 7, CB 12 and CB 13 – i.e. various land taxing provisions - (as well as s. CG 6) and extends the roll-over measures to the 2018-19 income year; and

   (g) Extends the operation of the thin-capitalisation asset valuation concession to the 2018-19 income year.

3. The draft QWBA contains 3 detailed examples of how existing s. EZ 23B operates – i.e. depreciation roll-over relief when replacement property is to be acquired.

4. Section EZ 23B has been tidied up in the SOP so that the legislation operates as intended, and the examples in the draft QWBA explain how the section operates.

Replacement property acquired through an owned company: new s. EZ 23BB

5. The new s. EZ 23BB introduced in the SOP extends the roll-over relief to replacement property acquired through a company in which a person has an ownership interest (referred to as the "*replacement interest*"). Section EZ 23BB operates by applying a person's *fractional interest* in the acquiring company to the cost of the company's replacement property so as to determine the person's *fractional interest value* in the company's replacement property. The person's excess recovery is then applied to reduce the cost of the replacement property to the acquiring company up to the amount of the person's *fractional interest value*.

6. Where the company that acquires the replacement property is owned through a trust, the relevant *fractional interest* in the company of the person with the excess recovery is the proportion of the trust's corpus that was settled by the person multiplied by the trust's voting interest in the company. That fractional interest is then multiplied by the company's expenditure on replacement property to determine the person's *fractional interest value* in the replacement property. The person's excess recovery can then be used to reduce the depreciable cost of the company's replacement property up to a maximum of the person's fractional interest value.

7. The main aspects of s. EZ 23BB are:
   (a) It does not apply to depreciable intangible property or to pool depreciated property.
   (b) There are 3 classes of property it applies to: buildings (or grandparented structures), commercial fit-out, and other depreciable property.
   (c) The insurance or compensation must relate to:
      (i) Property that is irreparably damaged; or
      (ii) Damage to a building or its neighbourhood that precludes further use; or
      (iii) Property that is assessed as uneconomic to repair and deemed to be disposed of and reacquired under s. EZ 23C.
   (d) The replacement property must be acquired by a company in which a voting interest is held by:
      (i) The person who received the compensation; or
      (ii) A trustee of a trust settled by the person who received the compensation.

8. The other requirements more or less parallel the existing s. EZ 23B. As noted above, the draft QWBA sets out 3 examples of hoe s. EZ 23B is meant to operate. So I thought I would extend the examples in the draft QWBA to a scenario where the person has a voting interest in the company that acquires the replacement property, or has settled a trust that has a voting interest in the company that acquires the property.

Example 1: Fractional interest value in replacement building exceeds the cost of the destroyed building

9. Tom receives insurance proceeds of $10 million for a building destroyed in a Canterbury earthquake. The original cost of the building was $10 million and its adjusted tax value was $9 million. *Tom has a 100% interest in a company, KiwiCo, that plans to acquire a replacement building* costing $12 million.

10. The insurance proceeds exceed the building's adjusted tax value by $1 million. Therefore, Tom has an **excess recovery of $1 million**. This is Tom's **opening depreciation recovery income**.

11. ***Step 1: Determine Tom's fractional interest value in the replacement property:***

    (a) Tom's fractional interest value = (Tom's voting interest in KiwiCo) x (KiwiCo's expenditure on replacement property).

    (b) Tom's fractional interest value = 100% x 12 million = $12 million.

    (c) Because Tom's fractional interest value in KiwiCo's replacement building is equal to or greater than the cost of the affected property (i.e. the cost of Tom's building that was damaged), the whole of Tom's opening depreciation recovery income should be available to be rolled-over against the cost of KiwiCo's replacement building.

12. ***Step 2: Calculate the suspended recovery income:***

    (a) Tom now has to calculate the suspended recovery income by applying the following formula:

    $$\frac{\textbf{limited replacement cost} \ \ \textbf{x} \ \ \textbf{excess recovery}}{\textbf{affected cost}}$$

    (b) The *limited replacement cost* is the lesser of:

    (i) The amount by which the *cost* of the affected property (i.e. Tom's building that was damaged) *exceeds* the *total fractional interest value of expenditure in acquiring other replacement property*, with or before the replacement item; as no other replacement property has been acquired with or before the $12 million replacement building, the amount is: $10 million – $0 = $10 million; or

    (ii) The fractional interest value of the replacement interest calculated under Step 1, which in this case is $12 million.

    (c) The limited replacement cost is the lesser of the above two amounts, which is $10 million.

    (d) The *affected cost* is the total cost of the affected property (i.e. Tom's building that was damaged), which is $10 million.

    (e) Tom's suspended recovery income can now be calculated using the following amounts in the above formula:

    $$\frac{\textbf{\$10million x \$1million}}{\textbf{\$10million}} = \textbf{\$1million}$$

13. ***Step 3: Reduce Tom's opening depreciation recovery income by Tom's suspended recovery income (the amount calculated under the formula):***

    Under s. EZ 23BB(3), the calculated amount of $1 million is:

    (a) Tom's suspended recovery income for the replacement interest in KiwiCo; and

    (b) A reduction in Tom's depreciation recovery income for the affected class (buildings, in this case):

    ($1 million: Tom's opening depreciation recovery income) – ($1 million: Tom's suspended recovery income) = $0.

14. ***Step 4: Return in the current year any remaining depreciation recovery income:***

    Since Tom's opening depreciation recovery income has been reduced to zero, Tom has no liability to return any depreciation recovery income.

15. ***Step 5: When Tom will have to return depreciation recovery income in future:***

    Tom will have to return the suspended recovery income as depreciation recovery income upon the occurrence of the earliest of a number of events listed in paragraph **24** below.

Example 2: Fractional interest value in replacement building is less than the cost of the destroyed building

16. Tom receives insurance proceeds of $20 million for a building destroyed in a Canterbury earthquake. The original cost of the building was $20 million and its adjusted tax value was $18 million. *Tom settled 50% of the corpus of a trust that has a 100% interest in KiwiCo, which plans to acquire a replacement building costing $30 million*.

17. The insurance proceeds exceed the building's adjusted tax value by $2 million. Therefore, Tom has an excess recovery, or opening depreciation recovery income, of $2 million.

18. ***Step 1: Determine Tom's fractional interest value in KiwiCo's replacement property:***

    (a) Tom's fractional interest value = (Tom's settlement fraction of trust corpus) x (trustee's voting interest in KiwiCo) x (KiwiCo's expenditure on replacement property);

    (b) Tom's fractional interest value = 50% x 100% x 30 million = $15 million.

    (c) Because Tom's fractional interest value in KiwiCo's replacement building is less than the cost of the affected property (i.e. the cost of Tom's damaged building), only some of the excess recovery amount can be allocated against the cost of the replacement building.

19. ***Step 2: Calculate Tom's suspended recovery income:***

    (a) Tom calculates his suspended recovery income by applying the following formula:

$$\frac{\textbf{limited replacement cost} \ \ \textbf{x} \ \ \textbf{excess recovery}}{\textbf{affected cost}}$$

    (b) <u>The limited replacement cost</u> is $15 million, which is the lesser of:

(i) The amount by which the cost of the damaged asset (i.e. Tom's damaged building) exceeds Tom's total fractional interest value of expenditure in acquiring other replacement property, with or before KiwiCo's replacement building; no other replacement property has been acquired with or before KiwiCo's replacement building; therefore, the amount is: $20 million – $0 = $20 million (i.e. the cost of Tom's damaged asset); or

(ii) The amount spent on the replacement item, which is $15 million.

(c) The affected cost is the total cost of the affected property (i.e. Tom's damaged building), which is $20 million.

(d) Tom's suspended recovery income can now be calculated using the following amounts in the above formula:

$$\frac{\mathbf{\$15million\ x\ \$2million}}{\mathbf{\$20million}} = \mathbf{\$1.5million}$$

20. ***Step 3: Reduce Tom's opening depreciation recovery income by Tom's suspended recovery income (the amount calculated under the formula):***

Under s. EZ 23BB(3), the calculated amount of $1.5 million is:

(a) Tom's suspended recovery income for the replacement interest in KiwiCo; and

(b) A reduction in Tom's depreciation recovery income for the affected class (buildings, in this case):

($2 million: Tom's opening depreciation recovery income) – ($1.5 million: Tom's suspended recovery income) = $500,000.

21. ***Step 4: Return in the current year any remaining depreciation recovery income:***

Tom's remaining depreciation recovery income of $500,000 must be returned by Tom in the current year.

22. ***Step 5: When Tom will have to return depreciation recovery income in future:***

Tom will have to return the suspended recovery income as depreciation recovery income upon the occurrence of the earliest of a number of events listed in paragraph **24** below.

When Tom will have depreciation recovery income

23. Suspended recovery income for Tom's replacement interest is not depreciation recovery income for Tom arising from the replacement interest unless it is attributed to an income year by s. EZ 23BB(8) and (9).

24. Tom will have depreciation recovery income equal to his suspended recovery income upon the occurrence of the earliest of the following events:

(a) Because the replacement property is a building, if by the end of the 2015-16 income year, replacement property (the unconfirmed property) for the replacement interest has not been acquired by KiwiCo, and is not the subject of an application by the owning company to the appropriate authority for consent to construction, Tom will have depreciation recovery income equal for his replacement interest at the end of 2015-16 income year equal to the suspended recovery income corresponding to the unconfirmed property, and Tom's suspended recovery income will be correspondingly reduced.

(i) In Example 1: ($1 million: Tom's suspended recovery income) – ($1 million: Tom's depreciation recovery income) = ($0: Tom's remaining suspended recovery income).

(ii) In Example 2: ($1.5 million: Tom's suspended recovery income) – ($1.5 million: Tom's depreciation recovery income) = ($0: Tom's remaining suspended recovery income).

(b) If KiwiCo disposes of the replacement property in an income year, section EZ 23BB(8) currently states that Tom "will have depreciation recovery income equal to the "fractional interest value" of the replacement interest and the suspended recovery income will be correspondingly reduced". This is wrong – Tom will actually have depreciation recovery income equal to his suspended recovery income that corresponds to the fractional interest value in the building disposed of by KiwiCo.

(c) The income year in which Tom or the trustee of his trust disposes of the replacement interest – i.e. the shares in KiwiCo.

(d) The income year in which Tom goes into liquidation or becomes bankrupt.

(e) The 2018-19 income year if KiwiCo has not acquired the replacement property relating to the replacement interest and the affected property by the end of that year.

PDF attachment: Canterbury Earthquakes Tax Relief Measures

25. The PDF attachment *Canterbury Earthquakes Tax Relief Measures* contains all the details on all of the earthquakes tax relief measures enacted so far, and the other tax relief measures in the pipeline for enactment.

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