

EXPOSURE DRAFT – FOR COMMENT AND DISCUSSION ONLY

Deadline for comment: 11 October 2013. Please quote reference: QWB00129

Note to Submitters

The Minister of Revenue released Supplementary Order Paper No 257 to the Taxation (Annual Rates, Foreign Superannuation, and Remedial Matters) Bill on 25 June 2013. The paper proposes extending the time limit for the roll-over of depreciation relief for Canterbury from the 2015–16 income year to the 2018–19 income year. In addition, taxpayers will be required to demonstrate an appropriate level of commitment to rebuilding in Canterbury by the end of the 2015–16 income year to access roll-over relief to the end of the 2018–19 income year. The bill is before Parliament, and is expected to be enacted early in 2014. If the bill is enacted in its current form, the time limit will be extended to the 2018–19 income year. This Question We've Been Asked outlines the depreciation roll-over relief available to the 2015–16 income year. We will reconsider the impact of the proposed legislation after consultation and before the item is finalised for publication.

QUESTION WE'VE BEEN ASKED QWB00129

INCOME TAX – DEPRECIATION ROLL-OVER RELIEF FOR CANTERBURY

All legislative references are to the Income Tax Act 2007 unless otherwise stated.

This Question We've Been Asked is about s EZ 23B.

Question

1. How does the formula in s EZ 23B(4) allocate the excess recovery amount when an item of affected property is replaced with one or more items of replacement property?

Answer

2. The formula determines how much of the excess recovery amount is allocated against the cost of a particular replacement item. It does this by reference to the accumulated cost of **other** items of replacement property acquired with or before the particular replacement item (s EZ 23B(4) and (5)). This means that where only one replacement item is acquired, the cost of other items of replacement property acquired with or before the particular replacement item is zero.
3. Since the focus of this Question We've Been Asked is on the application and effect of the formula, it supplements the comprehensive analysis of s EZ 23B in "Canterbury earthquake relief measures" *Tax Information Bulletin* Vol 23, No 8 (November 2011) at 66–68.
4. The formula in s EZ 23B(4) applies to affected property not depreciated in a pool. Therefore, the scope of this Question We've Been Asked is limited to those classes of affected property not depreciated in a pool.

Explanation

5. Section EZ 23B provides roll-over relief in respect of depreciation recovery income for taxpayers affected by the Canterbury earthquakes. It applies when a person receives insurance or compensation that gives rise to depreciation recovery income for items of depreciable property (called the affected property) lost or irreparably damaged in the Canterbury earthquakes (s EZ 23B(1)). Provided

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certain conditions are met, the amount that would be depreciation recovery income is available to be allocated against the cost of replacement items (s EZ 23B(2) and (3)). Any amount of depreciation recovery income not allocated to replacement items by the end of the 2015–16 income year at the latest is taxable as depreciation recovery income (s EZ 23B(8)).

6. This Question We've Been Asked clarifies the effect of the formula in s EZ 23B(4). The formula calculates the amount of the depreciation recovery income that can be allocated against the cost of the replacement property. There has been some confusion about how the formula works. The confusion appears to arise because one of the alternatives in the formula uses the expenditure incurred in acquiring **other** items of replacement property instead of using the expenditure in acquiring the particular item of replacement property. This is necessary to ensure that the depreciation recovery income is not over-allocated to the particular replacement item.
7. The purpose of the depreciation roll-over relief provisions (s EZ 23B) is to provide affected taxpayers with options in relation to the potential tax liability on the depreciation recovery income arising from the insurance or compensation received. In addition to the option of simply returning the depreciation recovery income, taxpayers can elect to use the depreciation roll-over relief provisions. This election gives taxpayers the further option to defer or "suspend" the recognition of the depreciation recovery income to a later income year (with the latest income year being the 2015–16 income year) or to suspend and "roll-over" the depreciation recovery income into the cost of the replacement item.
8. If the total cost of the replacement item or items equals or is more than the cost of the affected property, then the whole amount of depreciation recovery should be available to be rolled-over into the cost of the replacement item or items (s EZ 23B(4)).
9. If the total cost of the replacement item or items is less than the cost of the affected property, only a proportion of the depreciation recovery amount can be rolled-over into the cost of the replacement items. The balance of the depreciation recovered is recognised as income at or before the end of the 2015–16 income year (s EZ 23B(8)).
10. Any amount rolled-over to a replacement item effectively reduces the adjusted tax value of the replacement item (s EZ 23B(3)(a) and (11)). This means that when the replacement item is eventually sold, the amount that was rolled-over to the replacement item will be fully taxable as depreciation recovery income provided the replacement item is sold for more than its adjusted tax value. The tax liability associated with disposal of the affected property has effectively been rolled forward until disposal of the replacement property.
11. If the affected property is not actually replaced, then any depreciation recovery income arising from the insurance or compensation received is brought into account as income in the earlier of:
 - the 2015–16 income year;
 - the income year in which the person decides not to replace the affected property; or
 - the income year in which the person goes into liquidation or bankruptcy (s EZ 23B(8)).

How the formula works

12. The formula applies to the following groups or classes of affected property:

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- a building or grandparented structure (not depreciated in a pool);
 - commercial fit-out (not depreciated in a pool);
 - other depreciable property (not depreciated in a pool) (s EZ 23B(10)).
13. The following steps must be taken for each of these affected classes of depreciable property:
- Step 1:* Calculate the depreciation recovery income (called the excess recovery).
- Step 2:* Calculate, using the formula, how much of the excess recovery is available to be deferred (called the suspended recovery income) or deferred and allocated against the cost of the replacement item, or both.
- Step 3:* Reduce the adjusted tax value of the replacement item by the amount calculated under the formula.
- Step 4:* Reduce the suspended recovery income by the amount calculated under the formula.
- Repeat steps 2–4,* if more than one replacement item is purchased.
- Step 5:* Return any unallocated suspended recovery income.

Examples demonstrating how the formula works

14. The following three examples demonstrate how the formula works using the steps set out above. Examples 1 and 2 apply the formula to different scenarios where only one replacement item is acquired. Example 3 applies the formula to the situation where multiple replacement items are acquired.

Example 1: Acquisition of a replacement building costing more than the destroyed building

15. 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 plans to acquire a replacement building costing \$12 million.
16. Because the cost of the replacement building is equal to or greater than the cost of the affected property, the whole excess recovery amount should be available to be rolled-over against the cost of the replacement building.

Step 1: Calculate the excess recovery

17. The insurance proceeds exceed the building's adjusted tax value by \$1 million. Therefore, Tom has an excess recovery of \$1 million.

Step 2: Calculate the suspended recovery income

18. Tom now has to calculate the suspended recovery income by applying the following formula:

$$\frac{\text{limited replacement cost} \times \text{excess}}{\text{affected cost}}$$

19. The limited replacement cost is the lesser of:
- (i) the amount by which the cost of the affected property exceeds the total expenditure in acquiring other replacement property, with or before the replacement item; or
 - (ii) the amount spent on the replacement item.

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20. The affected cost is the total cost of the affected property.
21. No other replacement property has been acquired with or before the \$12 million replacement building. Therefore, the amount under (i) above is:
- $$\$10 \text{ million} - \$0 = \$10 \text{ million}$$
22. The amount spent on the replacement building under (ii) above is \$12 million.
23. As the limited replacement cost is the lesser of these two amounts, the “limited replacement cost” is \$10 million. The suspended recovery income can now be calculated using the following amounts in the above formula:

$$\frac{\$10 \text{ million} \times \$1 \text{ million}}{\$10 \text{ million}} = \$1 \text{ million}$$

Step 3: Reduce the adjusted tax value of the replacement item by the amount calculated under the formula

24. The suspended recovery income of \$1 million is now available to roll-over into the adjusted tax value of the replacement building as follows:
- $$\$12 \text{ million (cost of replacement property)} - \$1 \text{ million (suspended recovery income)} = \$11 \text{ million (adjusted tax value)}$$

Step 4: Reduce the suspended recovery income by the amount calculated under the formula

25. The suspended recovery income of \$1 million is now also available to reduce the starting suspended recovery income:
- $$\$1 \text{ million (excess recovery)} - \$1 \text{ million (suspended recovery income)} = \$0$$

Step 5: Return any unallocated suspended recovery income

26. Since the suspended recovery income has been reduced to zero, Tom has no liability to return any unallocated suspended recovery income.

Summary of example 1

27. In this example, the depreciation roll-over relief provisions act to:
- (a) fully allocate the depreciation recovery income of \$1 million against the cost of the replacement building;
 - (b) reduce the adjusted tax value of the replacement building to \$11 million;
 - (c) defer the recognition of depreciation recovery income of \$1 million until the subsequent sale of the replacement building (assuming the building is sold for more than its adjusted tax value).

Example 2: Acquisition of a replacement building costing less than the destroyed building

28. Kiwico Ltd 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. Kiwico Ltd plans to acquire a replacement building costing \$15 million.
29. Because the cost of the replacement building is less than the cost of the affected property, only some of the excess recovery amount can be allocated against the cost of the replacement building.

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Step 1: Calculate the excess recovery

30. The insurance proceeds exceed the building's adjusted tax value by \$2 million. Therefore, Kiwico Ltd has an excess recovery of \$2 million.

Step 2: Calculate the suspended recovery income

31. Kiwico Ltd now has to calculate the suspended recovery income by applying the following formula:

$$\frac{\text{limited replacement cost} \times \text{excess}}{\text{affected cost}}$$

32. The limited replacement cost is the lesser of:

- (i) the amount by which the cost of the damaged asset exceeds the total expenditure in acquiring other replacement property, with or before the replacement item; or
- (ii) the amount spent on the replacement item.

33. The affected cost is the total cost of the affected property.

34. No other replacement property has been acquired with or before the \$15 million replacement building. Therefore, the amount under (i) above is:

$$\$20 \text{ million} - \$0 = \$20 \text{ million}$$

35. The amount spent on the replacement building under (ii) above is \$15 million.

36. As the limited replacement cost is the lesser of these two amounts, the "limited replacement cost" is \$15 million. The suspended recovery income can now be calculated using the following amounts in the above formula:

$$\frac{\$15 \text{ million} \times \$2 \text{ million}}{\$20 \text{ million}} = \$1.5 \text{ million}$$

Step 3: Reduce the adjusted tax value of the replacement item by the amount calculated under the formula

37. The suspended recovery income of \$1.5 million is now available to roll-over into the cost of the replacement building:

$$\$15 \text{ million (cost of replacement property)} - \$1.5 \text{ million (suspended recovery income)} = \$13.5 \text{ million (adjusted tax value)}$$

Step 4: Reduce the suspended recovery income by the amount calculated under the formula

38. The suspended recovery income of \$1.5 million is now also available to reduce the suspended recovery income:

$$\$2 \text{ million (excess recovery)} - \$1.5 \text{ million (suspended recovery income)} = \$500,000$$

Step 5: Return any unallocated suspended recovery income

39. The unallocated suspended recovery income of \$500,000 must be returned as depreciation recovery income in the income year in which Kiwico decides not to acquire any more replacement property in this class or at the end of the 2015–16 income year (whichever comes first).

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Summary of example 2

40. In this example, the depreciation roll-over relief provisions act to:
- (a) roll-over \$1.5 million of the depreciation recovery income of \$2 million into the cost of the replacement building;
 - (b) reduce the adjusted tax value of the replacement building to \$13.5 million;
 - (c) defer the recognition of the suspended recovery income of \$500,000 to the income year in which Kiwico decides not to acquire any more replacement property in this class or the end of the 2015–16 income year (whichever comes first);
 - (d) defer the recognition of the depreciation recovery income of \$1.5 million until the subsequent sale of the replacement building (assuming the building is sold for more than its adjusted tax value).

Example 3: Multiple replacement items

41. The following example demonstrates how the formula works where more than one item of replacement property is acquired.
42. Linda receives insurance proceeds of \$1 million for plant and equipment (not previously depreciated under the pool method) destroyed in a Canterbury earthquake. The original cost of the plant and equipment was \$1 million and its adjusted tax value was \$700,000. Linda acquires a replacement item in each of years 1, 2 and 3, at a cost of \$400,000 each, and a final replacement item costing \$10,000 in year 4.

Step 1: Calculate the excess recovery

43. The insurance proceeds exceed the adjusted tax value of the plant and equipment by \$300,000. Therefore, Linda has an excess recovery of \$300,000.

Year 1 – Step 2: Calculate the suspended recovery income

44. Linda now has to calculate the suspended recovery income for year 1 by applying the following formula:

$$\frac{\text{limited replacement cost} \times \text{excess}}{\text{affected cost}}$$

45. The limited replacement cost is the lesser of:
- (i) the amount by which the cost of the affected property exceeds the total expenditure in acquiring other replacement property, with or before the replacement item; or
 - (ii) the amount spent on the replacement item.
46. The affected cost is the total cost of the affected property.
47. No other replacement property has been acquired with or before the first replacement item of \$400,000. Therefore, the amount under (i) above is:
- $$\$1 \text{ million} - \$0 = \$1 \text{ million}$$
48. The amount spent on the replacement item under (ii) above is \$400,000.
49. This means the “limited replacement cost” is \$400,000. The suspended recovery income for year 1 can now be calculated using the following amounts in the above formula:

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$$\frac{\$400,000 \times \$300,000}{\$1 \text{ million}} = \$120,000$$

Year 1 – Step 3: Reduce the adjusted tax value of the replacement item by the amount calculated under the formula

50. The suspended recovery income of \$120,000 is now available to roll-over into the adjusted tax value of the replacement item:

$$\$400,000 \text{ (cost of replacement property)} - \$120,000 \text{ (suspended recovery income)} = \$280,000 \text{ (adjusted tax value)}$$

Year 1 – Step 4: Reduce the suspended recovery income by the amount calculated under the formula

51. The suspended recovery income of \$120,000 is now also available to reduce the suspended recovery income:

$$\$300,000 \text{ (excess recovery)} - \$120,000 \text{ (suspended recovery income)} = \$180,000$$

Year 2 – Step 2: Calculate the suspended recovery income

52. For year 2, Linda applies the formula as follows.

53. Total expenditure in acquiring other replacement property with or before the second replacement item is \$400,000 (being the cost of the first replacement item). Therefore, the amount under (i) above is:

$$\$1 \text{ million} - \$400,000 = \$600,000$$

54. The amount spent on the replacement item in year 2 under (ii) above is \$400,000.

55. This means the “limited replacement cost” is \$400,000 (the lesser of \$600,000 calculated under (i) and \$400,000 calculated under (ii)). The suspended recovery income for year 2 can now be calculated using the formula:

$$\frac{\$400,000 \times \$300,000}{\$1 \text{ million}} = \$120,000$$

Year 2 – Step 3: Reduce the adjusted tax value of the replacement item by the amount calculated under the formula

56. The suspended recovery income of \$120,000 is now available to roll-over into the adjusted tax value of the replacement item:

$$\$400,000 \text{ (cost of replacement property)} - \$120,000 \text{ (suspended recovery income)} = \$280,000 \text{ (adjusted tax value)}$$

Year 2 – Step 4: Reduce the suspended recovery income by the amount calculated under the formula

57. The suspended recovery income of \$120,000 is now also available to reduce the suspended recovery income:

$$\$180,000 \text{ (excess recovery as reduced in year 1)} - \$120,000 \text{ (suspended recovery income)} = \$60,000$$

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Year 3 – Step 2: Calculate the suspended recovery income

58. For year 3, Linda applies the formula as follows.
59. Total expenditure in acquiring other replacement property with or before the third replacement item is \$800,000 (\$400,000 for each of the first and second replacement items). Therefore, the amount under (i) above is:

$$\$1 \text{ million} - \$800,000 = \$200,000$$

60. The amount spent on the replacement item in year 3 under (ii) above is \$400,000.
61. This means the “limited replacement cost” is \$200,000 (the lesser of \$200,000 calculated under (i) and \$400,000 calculated under (ii)). The suspended recovery income for year 3 can now be calculated using the formula:

$$\frac{\$200,000 \times \$300,000}{\$1 \text{ million}} = \$60,000$$

Year 3 – Step 3: Reduce the adjusted tax value of the replacement item by the amount calculated under the formula

62. The suspended recovery income of \$60,000 is now available to roll-over into the adjusted tax value of the replacement item:

$$\$400,000 \text{ (cost of replacement property)} - \$60,000 \text{ (suspended recovery income)} = \$340,000 \text{ adjusted tax value}$$

Year 3 – Step 4: Reduce the suspended recovery income by the amount calculated under the formula

63. The suspended recovery income of \$60,000 is now also available to reduce the suspended recovery income:

$$\$60,000 \text{ (excess recovery as reduced in year 2)} - \$60,000 \text{ (suspended recovery income)} = \$0$$

64. At the end of year 3, the combined cost of the replacement items is reduced by a total of \$300,000 from \$1.2 million to \$900,000. Therefore, the depreciation recovery income of \$300,000 is fully rolled into the adjusted tax value of the replacement property. This is what would be expected, because the total cost of the replacement items exceeds the cost of the affected property.

Year 4

65. Because the cost of other replacement items (\$1.2 million, being \$400,000 in each of years 1–3) exceeds the cost of the affected property (\$1 million) no further reductions are available (s EZ 23B(4)(a)). This makes sense, because the full amount of the excess recovery has already been allocated against replacement items.

Step 5: Return any unallocated suspended recovery income

66. Since the suspended recovery income has been reduced to zero, Linda has no liability to return any unallocated suspended recovery income.

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Summary of example 3

67. In this example, the depreciation roll-over relief provisions act to:
- (a) fully allocate the depreciation recovery income of \$300,000 against the cost of the replacement items;
 - (b) reduce the adjusted tax values of the replacement items from \$1.2 million to \$900,000.

Other requirements for depreciation roll-over relief

68. To qualify for the depreciation roll-over relief, the replacement asset must be:
- depreciable property (that is not depreciable intangible property) in the same class as the affected property; and
 - acquired before the end of the 2015–16 income year (s EZ 23B(7)).
69. In addition, any replacement building, grandparented structure or commercial fit-out must be located in greater Christchurch (s EZ 23B(7)).
70. Taxpayers who wish to make use of the depreciation roll-over relief provisions must elect to do so by giving written notice to the Commissioner specifying the affected property and linking each item of replacement property with an affected class. This notice must be given by the later of 31 January 2012 or when the income tax return is filed for the income year in which the insurance pay-out can be reasonably estimated. Written notice must also be given in each subsequent year in which the depreciation recovery income is suspended (s EZ 23B(1)(d) and (9)).

Draft items produced by the Office of the Chief Tax Counsel represent the preliminary, though considered, views of the Commissioner of Inland Revenue.

In draft form these items may not be relied on by taxation officers, taxpayers, and practitioners. Only finalised items represent authoritative statements by Inland Revenue of its stance on the particular issues covered.

References

Related rulings/statements

“Canterbury earthquake relief measures” *Tax Information Bulletin* Vol 23, No 8 (October 2011)

Subject references

Income tax
Depreciation

Depreciation roll-over relief

Canterbury earthquakes

Legislative references

Income Tax Act 2007, s EZ 23B