



WEEKLY COMMENT: FRIDAY 19 OCTOBER 2012

CANTERBURY EARTHQUAKES BUSINESS INTERRUPTION, DISPOSALS, AND DEPRECIATION RELIEF MEASURES – PART 1

1. This week and next 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. This week I look at the first four of the categories listed above. Next week I look at the last four categories.

I. Relief from the 10-year rule for income from land sales

4. Under ss. CB 9 to CB 12 of the *Income Tax Act 2007* (“the Act”), an amount that person derives from disposing of land is income if, providing other specified conditions are met:
 - (a) They dispose of the land within 10 years of acquiring it (ss. CB 9 & CB 10); or
 - (b) They dispose of the land within 10 years of completing improvements to it (s. CB 11); or
 - (c) They dispose of land in relation to which an undertaking or scheme was begun within 10 years of the date on which the person acquired the land (s. CB 12).
5. Persons affected by compulsory acquisitions by the government due to the Canterbury earthquakes could be inadvertently adversely affected by these rules. New s. **CZ 26** addresses this problem.

6. Under new s. **CZ 26**, which will apply from 4 September 2010, ss. CB 9 to CB 12 (which relate to disposals within 10 years of acquisition) do not apply to a person and land or buildings purchased by the Government from the person under section 53(1) of the *Canterbury Earthquake Recovery Act 2011*.

II. Deferred deductions for interruption expenditure

7. Where a person has an income-earning activity in greater Christchurch that is interrupted by the Canterbury earthquake, the person is allowed a deduction, under new s. **DZ 20**, for expenditure incurred in an income year before the 2016-17 income year during the period of interruption. The deduction is deferred to the year in which the income-earning activity resumes, providing the year the activity resumes is before the 2016-17 income year.
8. The specific requirements for the deferral and deduction in s. **DZ 20** are as follows:
- (a) The expenditure must be incurred in an income year (the current year) before the 2016-17 income year; and
 - (b) The person must have an income-earning activity in greater Christchurch (as defined in section 4 of the *Canterbury Earthquake Recovery Act 2011*) immediately before a Canterbury earthquake (as defined in that section); and
 - (c) The activity must be interrupted for a period (the period of interruption) as a result of the Canterbury earthquake; and
 - (d) In the current year, during the period of interruption, the person incurs expenditure or loss (the interruption expenditure) in meeting an obligation relating to the income-earning activity; and
 - (e) The interruption expenditure does not meet the requirements of the general permission for the person and the income-earning activity but would do so but for the interruption; and
 - (f) The person resumes the income-earning activity in an income year (the resumption year) before the 2016-17 income year.
9. New s. **DZ 20** will apply from 4 September 2010 for the 2010-11 to the 2015-16 income years.

III. Deemed availability for use for depreciation purposes while access is restricted

10. Under s. **EE 1(2)(c)** of the Act, one of the requirements for a person to have an amount of depreciation loss for an item for an income year is that the item is used, or is available for use, by the person in the income year.
11. Due to the Canterbury earthquakes it is likely that some items may not be available for use due to restricted access. New s. **EZ 23E**, which applies for the 2010-11 to the 2015-16 income years, addresses this problem. An item of depreciable property is treated for an income year as being available for use while access to the item is restricted if:
- (a) The access is affected by a restriction imposed due to the effects of a Canterbury earthquake (as defined in section 4 of the *Canterbury Earthquake Recovery Act 2011*); and
 - (b) The item was used or available for use immediately before the restriction was imposed; and
 - (c) The item would be used or available for use in the absence of the restriction; and

(d) The income year is the 2015–16 or an earlier income year.

IV. Depreciation recovery income and depreciation loss relief measures

12. The relief measures relating to depreciation recovery income and depreciation loss need to be considered under a number of sub-headings:

- (a) Modifications to the general rules on deemed disposals.
- (b) Modifications to the general rules defining ‘consideration’ for a disposal.
- (c) Consideration includes proceeds from disposal of irreparably damaged property or building rendered useless.
- (d) Modifications to the general rules on depreciation recovery income.
- (e) Rollover relief when depreciable assets are replaced.
- (f) Optional timing rule for depreciation recovery income and depreciation loss.

(a) Modifications to the general rules on deemed disposals

13. Depreciation recovery or loss on disposal can be triggered by:

- A disposal of depreciable property set out in **s. EE 46** of the Act; or
- An event (i.e. a deemed disposal); the events that are treated as disposals are set out in **s. EE 47** of the Act.

14. As a result of an amendment to **s. EE 47(4)** by **s. 26** of the *Taxation (Tax Administration and Remedial Matters) Act 2011* the definition of a disposal event that arises from irreparable damage to property has changed so as to include a building affected by neighbourhood damage (even if the building itself was relatively undamaged or repairable). A disposal event now includes:

- (a) The irreparable damage of an item of property that is not a building or grandparented structure. [s. EE 47(4)(a)]
- (b) The damage of an item of property that is a building or grandparented structure, or of the neighbourhood of the building or grandparented structure, causing the building or grandparented structure to be:
 - (i) Useless for the purpose of deriving income; and
 - (ii) Demolished or abandoned for later demolition. [s. EE 47(4)(b)]

(b) Modifications to the general rules defining ‘consideration’ for a disposal

15. Section **EE 45** of the Act has been amended so that ‘consideration’ now specifically includes a deduction for disposal costs.

16. Effective from 1 April 2008, ‘consideration’ from the disposal of an item, or from an event involving an item, equals “the amount that a person derives”, excluding output GST charged, minus the amount (the “disposal cost”) incurred in deriving that amount, to the extent to which the disposal cost:

- (a) Is not allowed as a deduction other than as a deduction for depreciation loss; and
- (b) Is not counted in “the amount that a person derives”.

17. 'Consideration' is therefore now clearly a net amount – the amount derived less disposal costs. The consideration may be zero or a negative amount.
18. Insurance proceeds and other amounts received are now referred to as “the amount that a person derives” whereas they were previously referred to as “consideration that a person derives”. The amount that a person derives from an event described in s. **EE 47(4)** (see (a) above) is the amount of insurance, indemnity, or compensation they receive for the affected item.
19. This clarifies that disposal costs are separately deducted when determining the “consideration”.
20. Earthquake disposal and demolition costs are deductible. This change is consistent with the Minister of Revenue’s announcement in October 2010 “that disposal and demolition costs incurred in relation to insured buildings irreparably damaged by the Christchurch earthquake would be dealt with as part of the disposal of the asset...The change ensures that the disposal and demolition cost of an insured earthquake damaged building are in effect deductible.” (IRD *Fact sheet – Earthquake Depreciation Issues* April 2011)

(c) Consideration includes proceeds from disposal for irreparably damaged property or building rendered useless

21. From the 2011-12 income year onwards, the amount that a person derives for irreparable damage to property other than a building, or damage to a building rendering it useless includes the total of the amount of insurance, indemnity, or compensation, and the amount of proceeds from the disposal. Previously, the amount of proceeds from the disposal was not specifically included. [Amendment to s. **EE 45(8)** inserted by **Clause 21CC** 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.]

(d) Modifications to the general rules on depreciation recovery income

22. Effective from 4 September 2010, the rules regarding when depreciation recovery income is derived and when a depreciation loss must be claimed have been amended. The changes apply generally, and not just to assets affected by the Christchurch earthquakes:
 - (a) The rule that depreciation recovery income is derived in the income year in which the disposal or the disposal event occurs has been repealed.
 - (b) Depreciation recovery income is derived in the earliest income year in which the consideration can be reasonably estimated (the ‘estimate year’).
 - (c) The rule that a person has a depreciation loss in the income year in which the disposal or the disposal event occurs has been repealed.

[Sections **EE 48(1) & 48(2)** as amended and s. **EE 48(2B)** as inserted by **ss. 27(1) to 27(3)** of the *Taxation (Tax Administration and Remedial Matters) Act 2011*]

23. Effective from 4 September 2010, the very specific exceptional circumstances in which a depreciation loss may be claimed on a building have also been changed, primarily to include buildings affected by the Christchurch earthquakes, but the changes could also apply in other very similar circumstances.

24. A depreciation loss can now be claimed on certain buildings. A person will have a depreciation loss for a building if:

- (a) The building or grandparented structure has been rendered useless for the purpose of deriving income, and demolished or abandoned for later demolition as a result of damage to the building or grandparented structure or of the neighbourhood of the building or grandparented structure; and
- (b) The damage is caused –
 - (i) By a natural event not under the control of the person, an agent of the person, or an associated person; and
 - (ii) Other than as a result of the action or failure to act of the person, an agent of the person, or an associated person.

[s. **EE 48(3)** as amended by ss. **27(4) to 27(7)** of the *Taxation (Tax Administration and Remedial Matters) Act 2011*]

(e) Rollover relief when depreciable assets are replaced

25. Effective from 4 September 2010, rollover relief was available under s. **EZ 23B** for assets affected by the Canterbury earthquakes in respect of depreciation recovery income, when there are plans to acquire replacement depreciable property before the end of the 2015-16 income year.

26. The following requirements must be met:

- (a) There must be net depreciation recovery income: (i.e. depreciation recovery income exceeding depreciation loss) for any of 4 classes of affected property:
 - (i) A building or grandparented structure (not depreciated in a pool);
 - (ii) Commercial fit-out (not depreciated in a pool);
 - (iii) Depreciable property for which the pool method of depreciation is used;
 - (iv) Other depreciable property;
- (b) Insurance receipts or compensation giving rise to an 'excess recovery' must be received in an income year before the 2016-17 income year, in relation to items of depreciable property that, as a result of the Canterbury earthquakes, are:
 - (i) If not a building or a grandparented structure, irreparably damaged.
 - (ii) If a building or grandparented structure, rendered useless for the purpose of deriving income, and demolished or abandoned for later demolition as a result of damage to the building or grandparented structure or of the neighbourhood of the building or grandparented structure.
 - (iii) If not irreparably damaged, assessed as uneconomic to repair so that the property is deemed to be disposed of and reacquired under 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.)
- (c) There must be plans to acquire replacement depreciable property in or before the 2015-16 income year, that:
 - (i) Is not depreciable intangible property; and

- (ii) If it replaces a building, grandparented structure or commercial fitout (other than pool-depreciated property), is a replacement building, grandparented structure or commercial fit-out and is located in greater Christchurch.
- (d) A written election notice must be given to the Commissioner every year beginning with the first year in which an excess recovery is realised (the 'estimate year'), by the later of 31 January 2012 or the date on which the return of income is filed for the year:
- (i) Specifying the affected property; and
 - (ii) Linking each item of acquired replacement property with one of the 'affected classes' (see (a) above); and
 - (iii) Giving details of each item of replacement property acquired in the year and the affected class to which the item is linked; and
 - (iv) Stating the amount of expenditure on each replacement item and the reduction of that expenditure for the purposes of determining adjusted tax value or depreciation loss; and
 - (v) Stating the amount, for the affected class of the suspended depreciation recovery income at the end of the year.
27. For each 'affected class' of depreciable property, the method for allocating depreciation recovery income against the depreciable cost of replacement assets and for returning any remaining depreciation recovery income (the 'suspended recovery income') is as follows:
- (a) Determine the net depreciation recovery income – i.e. the excess of depreciation recovery income over depreciation loss for the affected class. This is the 'excess recovery'. The excess recovery is the starting 'suspended recovery income' (i.e. the potential depreciation recovery income if a decision is made not to replace any assets in the affected class).
 - (b) Apply the excess recovery towards a reduction of the depreciable cost of replacement assets, using a specified formula approach. The excess recovery for an affected class of depreciable property is progressively applied to reduce the cost for depreciation purposes of replacement assets that are linked with the affected class of depreciable property:
$$[\text{Depreciable cost of replacement asset}] = [\text{replacement cost}] - [\text{cost reduction}]$$
 - (i) The 'cost reduction' is the portion of the excess recovery that is allocated to assets and consequently reduces the depreciable cost of those assets.
 - (ii) For property replaced that was not depreciated in a pool:
 - If the replacement cost exceeds the original cost, the cost reduction is the excess recovery;
 - If the replacement cost is less than the original cost, the cost reduction is a proportion of the excess recovery, that proportion being the portion of the original cost that is the replacement cost.
 - (iii) For property replaced that was depreciated in a pool the cost reduction is the cumulative replacement cost up to a maximum of the excess recovery.
 - (c) Return as depreciation recovery income (the suspended recovery income) any excess recovery that remains at the end of each income year after cost reduction of assets in the affected class.

28. An annual written notice of election to the Commissioner specifying the suspended recovery income at the end of each year, must be filed with the return of income for each year beginning from the estimate year and ending with:
- (a) The year in which there is no more suspended recovery income because the excess recovery has been completely allocated to replacement assets; or
 - (b) The year in which a decision is made not to acquire any more replacement property and there is suspended recovery income because the excess recovery has not been completely allocated to replacement assets; or
 - (c) The year in which the person making the election goes into liquidation or becomes bankrupt while there is suspended recovery income because the excess recovery has not been completely allocated to replacement assets; or
 - (d) The 2015-16 income year if any suspended recovery income remains at that time.
29. Any suspended recovery income remaining at the end of the 2015-16 income year must be returned as income for that year. There can be no allocation of any excess recovery towards cost reduction of replacement assets after the end of the 2015-16 income year.
30. When a replacement item that has had a cost reduction is disposed of, the cost reduction is treated as an amount of depreciation loss for the item for which a deduction was allowed. The depreciation recovery rules will therefore apply to the amount of the cost reduction as if it was depreciation claimed on the replacement item.

(f) Optional timing rule for depreciation recovery income and depreciation loss

31. New s. **EZ 23F**, contained in **Clause 27F** of the *Taxation (Annual Rates, Returns Filing, and Remedial Matters) Bill*, will apply to the 2010-11 to the 2015-16 income years. It allows for an optional deferral of depreciation recovery income and disposal costs, upon a deemed disposal, to 2015-16 if disposal costs are not incurred or able to be estimated until then.
32. The calculation and allocation rules in s. EE 48 for depreciation recovery income and depreciation loss will not apply, and the income from insurance and disposal, and the deductions for disposal costs and depreciation loss are allocated to income years according to new s. EZ 23F if:
- (a) An item of depreciable property is damaged by a Canterbury earthquake as that term is defined in s. 4 of the *Canterbury Earthquake Recovery Act 2011*; and
 - (b) The damage:
 - (i) Results in a deemed disposal and reacquisition under new s. **EZ 23C** because of property being uneconomic to repair; or
 - (ii) Results in a deemed disposal under s. EE 47(4) due to irreparable damage to non-building property or a building 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 s. EZ 23F for all items of depreciable property meeting the above requirements of paragraphs (a) to (c).

33. The optional deferral applies if:

- (a) 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; or
- (b) The disposal cost is incurred or able to be reasonably estimated before the end of the 2015–16 income year.

34. The person's income and consideration from the disposal and/or disposal cost and depreciation loss is attributed to the earlier of:

- (a) The 2015–16 income year; or
- (b) The first income year in which:
 - (i) The cost of disposing of the item (the disposal 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; and
 - (iii) The consideration from the disposal of the item is or has been derived or able to be reasonably estimated.

35. New s. EZ 23F overrides sections EE 1, EE 22, and EE 52 in relation to the timing of a person's income from the insurance receipt and consideration from the disposal of the item, and deductions for the disposal cost and depreciation loss.



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