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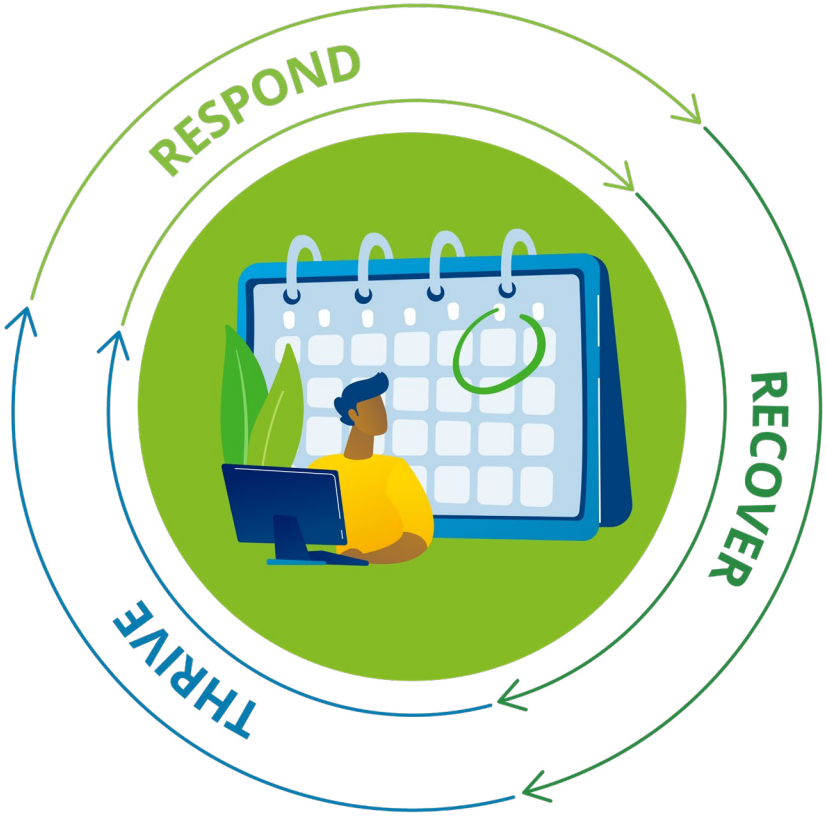

COVID-19: Reintroduction of tax depreciation on certain buildings

On 17 March 2020, the Government announced a package of measures to support businesses through the impact of COVID-19. One of the measures introduced was the reintroduction of tax depreciation on commercial and industrial buildings. This change was swiftly put through Parliament and it received Royal Assent on 25 March 2020.

When tax depreciation on buildings with an estimated useful life of 50 years or more was removed in the Budget of 2010, there was a significant tax and accounting impact as a result. This article provides detail on the relevant tax legislation and the accounting impact of the reinstatement of tax depreciation on certain buildings.

Reintroduction of tax depreciation on certain buildings

In the 2010 Budget, the Government introduced legislation to remove tax depreciation on commercial, industrial and residential buildings (with very few exceptions); this came into force for the 2012 income year.

The changes enacted in the COVID-19 Response (Taxation and Social Assistance Urgent Measures) Act ('COVID-19 Act') reintroduce tax depreciation on non residential buildings. The definition of non-residential buildings outlined in the COVID-19 Act is intended to include commercial and industrial buildings as well as motels and hotels. It does not include any other dwelling, including those where the intention is to provide accommodation for less than 28 days but where there are less than four separate accommodation units on the same site.

For non-residential buildings, tax depreciation can be claimed at 2% per annum diminishing value or 1.5% per annum straight line. Tax losses on the disposal of a building will remain non-deductible and should a building be sold for more than its tax book value, tax depreciation previously claimed will be recoverable.

Where applicable, items separately identified as fit-out will continue to be tax depreciable at the rate applied post 2010. Likewise, the tax treatment of any repairs and maintenance expenditure on a non-residential building remains unchanged.

Accounting issues – deferred tax implications of tax depreciation on buildings

Background

The removal of tax depreciation on buildings in 2010 gave rise to a significant issue in relation to accounting for deferred tax for those entities preparing financial statements in accordance with generally accepted accounting practice in New Zealand (NZ GAAP). This change resulted in differing deferred tax treatments depending on:

- The original acquisition date of the building (be it pre or post May 2010);
- The classification of the building as Property, Plant and Equipment (under NZ IAS 16 Property, Plant and Equipment) or Investment Property (under NZ IAS 40 Investment Property);
- If the building was held for sale or held for use; and
- If there were revaluations to the building.

The tax base of an asset for deferred tax purposes is defined by NZ IAS 12 Income Taxes ('NZ IAS 12') as the amount that will be deductible for tax purposes against any taxable economic benefits that will flow to the entity when it recovers the carrying amount of the assets. Provided a non-residential building is held for use in the business, the carrying amount of the asset should be recovered over the economic useful life of the building.

The reintroduction of tax depreciation on non-residential buildings could have a significant impact on the recognition of deferred tax as the tax base will increase to reflect the future tax deductions that are now available. The extent of the impact, be it the recognition of a deferred tax asset/liability or the reduction in an existing deferred tax liability, and the corresponding adjustment to tax expense in the income statement, will depend on the deferred tax treatment previously applied and the calculation of the adjusted tax base. The calculation of the adjusted tax base of a non-residential building may not be straight forward and will depend on a number of factors.

Pre-May 2010 buildings held for use in the business

Generally, a deferred tax liability exists on held for use buildings acquired pre May 2010 as the tax base was reduced to nil when tax depreciation on buildings was removed. The reintroduction of tax depreciation on buildings will reinstate a tax base for these non-residential buildings. The quantum of the tax base going forward should reflect tax depreciation deductions available over the remaining accounting economic useful life of the building, which will depend on a number of factors, including the tax depreciation rate and method expected to be applied to the building.

Determining the tax base should be done on a building-by-building basis and care should be taken when there have been additions to the building in later years.

Post-May 2010 buildings held for use in the business

For held for use buildings acquired post-May 2010 and subsequent additions to those buildings, it is likely that the initial recognition exception available under NZ IAS 12 was applied such that no deferred tax was recognised on these buildings. This would have been because on initial recognition it was not part of a business combination and there was a difference in the tax base and accounting carrying value that did not impact the income statement.

For these buildings, although the initial recognition exception had previously been applied, the change in tax legislation

results in the reinstatement of a tax base and consideration should be given as to whether this would result in a deferred tax asset or liability depending on the tax and accounting depreciation profile of the building and any additions.

As above, the tax base of these buildings would need to be calculated by reference to the future tax depreciation deductions available over the remaining accounting economic useful life of the buildings.

Revaluations to buildings held for use

We would not anticipate the reintroduction of tax depreciation on non residential buildings to have an impact on the deferred tax liabilities arising from the revaluation element of the carrying value of the building under NZ IAS 16.

Building held for sale

Where a building is held for sale, including Investment Property under NZ IAS 40 where the assumption that it is held for sale has not been rebutted (see NZ IAS 12 paragraph 51C), deferred tax has been recognised based on the tax consequences of sale. Provided the building is held on capital account, this means that deferred tax is only recognised based on any tax depreciation that would be clawed back on sale.

The reintroduction of tax depreciation on non-residential buildings should result in the deferred tax liability increasing each year by the tax effect of the tax depreciation claimed on that building going forward.

For investment property where the assumption that it is held for sale has been rebutted (i.e. it is held for use), the deferred tax treatment will change depending on the acquisition date of the building and the treatment will fall under one of the scenarios discussed above.

Future building acquisitions

For residential building acquisitions, deferred tax would continue to be applied as it was prior to the reintroduction of tax depreciation on non-residential buildings.

For non-residential building acquisitions, if the accounting carrying value and tax base are not equal on acquisition then the initial recognition exception should be considered.

Recognition of deferred tax asset

The recognition of any deferred tax asset resulting from these changes would need to be considered. NZ IAS 12 only permits a deferred tax asset to be recognised to the extent it is probable that taxable profits will be available to offset the tax deductions giving rise to the deductible temporary difference.

Given the current economic climate, greater scrutiny will be placed on the assessment of whether it is probable that there will be sufficient taxable profits to offset the tax deductions, especially if a deferred tax asset already exists in relation to unused tax losses or other temporary differences.

Timing of impact

Deferred tax under NZ IAS 12 is required to be accounted for based on tax legislation that has been substantively enacted by the end of the relevant financial reporting period. The COVID-19 Act received Royal Assent on 25 March 2020. Entities with a 31 March 2020 financial year end and later will need to reflect these changes when calculating deferred tax on buildings. For entities with an earlier financial year end, e.g. 31 December 2019, note disclosure could be made outlining the nature of the change and the estimated impact, if that impact is considered material.

For 31 March 2020 and later financial reporting periods, the impact of the change should be reflected through tax expense, rather than as an adjustment to opening retained earnings.

That adjustment through tax expense should be made in the financial reporting period in which the reintroduction of tax depreciation on non-residential buildings was enacted.

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