

## **Interpretation Statement IS 10/05**

### **DEPRECIATION – ESTIMATED USEFUL LIFE AND LEASE TERMS**

All legislative references are to the Income Tax Act 2007 ("ITA 2007") unless otherwise stated.

#### **Summary**

1. This Interpretation Statement addresses whether a lease term is a relevant factor in determining an item's estimated useful life ("EUL") for the purposes of setting a special depreciation rate.
2. The issue arises where the item to be depreciated by the taxpayer is owned by the taxpayer (or deemed to be owned by the taxpayer for the purposes of being entitled to depreciate the item), but is located in something leased where the taxpayer is the lessee. However, section EE 35(2) provides that special rates cannot be set for buildings, so the issue does not arise for those items that are part of a building.
3. The issue also arises where the item to be depreciated by the taxpayer is the item that is being leased and the taxpayer is either the lessee (in the case of a finance lease as defined in the ITA 2007) or the lessor (in the case of an operating lease).
4. In the above situations, the issue is whether taxpayers may get a special depreciation rate that is based on an EUL that is equal to the length of the lease.
5. It is concluded that the term of a lease is not a relevant factor in determining a special rate for an item of depreciable property under section 91AAG(2) of the Tax Administration Act 1994 ("TAA").
6. A special rate is determined by considering all factors that are relevant to the EUL, as defined in the ITA 2007. Section EE 63(1) defines EUL as the period over which an item of depreciable property might reasonably be expected to be useful in deriving assessable income or carrying on a business for the purpose of deriving assessable income, taking into account the passage of time, likely wear and tear, exhaustion, and obsolescence, and an assumption of normal and reasonable maintenance.
7. It is considered that "passage of time, likely wear and tear, exhaustion, and obsolescence" involves the consideration of deterioration, exhaustion, and external factors that cause the item to no longer be of use to any business. Therefore, an individual taxpayer's decision to abandon or demolish the item at the end of a lease term is irrelevant when determining the EUL of an item. This interpretation of EUL is supported by the provisions in the ITA 2007 that relate to loss on disposal and finance leases.

## **Legislation**

8. The following are the relevant sections from the ITA 2007.
9. Section EE 2 defines "own" for the purposes of owning depreciable property:

### **EE 2 Nature of ownership of item**

#### *Kinds of ownership*

- (1) **Own**, for the ownership of depreciable property,—
  - (a) means legal or equitable ownership; and
  - (b) includes ownership of the kinds described in sections EE 3 to EE 5.

#### *Shared ownership*

- (2) When more than 1 person owns an item of depreciable property, **own** means the interest that the person has in the item.

10. Sections EE 4 and EE 5 describe when a lessee is deemed to own a fixture or an improvement that is located on land that they are leasing:

### **EE 4 Ownership of lessee's improvements: lessee**

#### *When this section applies*

- (1) This section applies when—
  - (a) a lessee of land incurs expenditure during the period during which the land is leased to the lessee in erecting a fixture on the land or making an improvement to the land; and
  - (b) the lessor owns the fixture or improvement.

#### *Ownership of fixture or improvement*

- (2) The following apply to the ownership of the fixture or improvement:
  - (a) in the period during which the land is leased to the lessee,—
    - (i) the lessee is treated as owning the fixture or improvement; and
    - (ii) the lessor is treated as not owning the fixture or improvement; and
    - (iii) a person to whom the lessor disposes of the land during the period is treated as not owning the fixture or improvement; and
  - (b) after the period during which the land is leased to the lessee,—
    - (i) the lessor is treated as not owning the fixture or improvement, unless the lessor incurs a cost relating to it at the end of the period; and
    - (ii) a person to whom the lessor disposes of the land during the period is treated as not owning the fixture or improvement.

### **EE 5 Ownership of lessee's improvements: other person**

#### *When this section applies: first case*

- (1) This section applies when—
- (a) a lessee of land incurs expenditure during the term of the lease in erecting a fixture on the land or making an improvement to the land; and
  - (b) the lessee has been allowed a deduction for an amount of depreciation loss for the fixture or improvement; and
  - (c) the lessee disposes of their interest in the lease to another person; and
  - (d) the other person pays the lessee for the fixture or improvement.

*When this section applies: second case*

- (2) This section also applies when—
- (a) a lessee of land has been allowed a deduction for an amount of depreciation loss for a fixture on the land, or an improvement to the land, that a previous lessee erected or made; and
  - (b) the lessee disposes of their interest in the lease to another person; and
  - (c) the other person pays the lessee for the fixture or improvement.

*Other person treated as owner*

- (3) The other person is treated as owning the fixture or improvement from the time at which they pay the lessee for it.

11. Section EE 35 provides that a special rate is set under section 91AAG to 91AAJ of the TAA:

#### **EE 35 Special rate or provisional rate**

*Rate set for item of depreciable property*

- (1) A special rate or a provisional rate is set for an item of depreciable property under sections 91AAG to 91AAJ of the Tax Administration Act 1994.

*No special rate for excluded depreciable property, special excluded depreciable property, or building*

- (2) A special rate may not be set for an item of excluded depreciable property, an item of special excluded depreciable property, or a building.

...

12. Section EE 44 provides for when the loss on disposal provision (section EE 48(2)) applies.

#### **EE 44 Application of sections EE 48 to EE 52**

*When sections apply*

- (1) Sections EE 48 to EE 52 apply when a person derives consideration from the disposal of an item or from an event involving an item, if—
- (a) the consideration is consideration of a kind described in section EE 45; and
  - (b) either—
    - (i) the item is an item of a kind described in section EE 46; or

- (ii) the event is an event of a kind described in section EE 47.  
...
13. Section EE 46 describes the items to which the loss on disposal provision applies.

**EE 46 Items for purposes of section EE 44**

*Items to which sections EE 48 to EE 52 apply*

- (1) For the purposes of section EE 44, an item of property to which sections EE 48 to EE 52 apply is an item of depreciable property that a person owns, including—
- (a) an item for which the person has been allowed a deduction for an amount of depreciation loss they have had under section EE 33; and
- (b) an item to which section CZ 11 (Recovery of deductions for software acquired before 1 April 1993) applies.
- ...

14. Section EE 47 describes the events to which the loss on disposal provision applies:

**EE 47 Events for purposes of section EE 44**

*Events to which sections EE 48 to EE 52 apply*

- (1) For the purposes of section EE 44, this section describes the events to which sections EE 48 to EE 52 apply.

*Change of use or location of use*

- (2) The first event is the change of use, or change of location of use, of an item of property, as a result of which a person is denied a deduction for an amount of depreciation loss for the item for the next income year. The event is treated as occurring on the first day of the next income year.

*Loss or theft*

- (3) The second event is the loss or theft of an item of property, if the item is not recovered in the income year in which the loss or theft occurs.

*Irreparable damage*

- (4) The third event is the irreparable damage of an item of property.

...

*Cessation of ownership under section EE 4 or EE 5*

- (8) The seventh event is the cessation of ownership of a fixture or improvement—
- (a) that a lessee is treated as having under section EE 4(2); or
- (b) that a person is treated as having under section EE 5(3).

*Cessation of rights in intangible property*

- (9) The eighth event is an occurrence that has the effect that the owner of an item of intangible property is no longer able, and will never be able, to exercise the rights that constitute or are part of the item.

*Item leaving New Zealand permanently*

- (10) The ninth event is described in section EZ 21(2) (Sections EE 45 and EE 47: permanent removal: allowance before 1 April 1995).

15. Section EE 48(2) provides for loss on disposal:

**EE 48 Effect of disposal or event**

...

*Amount of depreciation loss*

- (2) For the purposes of section EE 44, if the consideration is less than the item's adjusted tax value on the date on which the disposal or the event occurs, the person has an amount of depreciation loss, for the income year in which the disposal or the event occurs, that is the amount by which the consideration is less than the item's adjusted tax value on that date.

...

16. Section EE 63 sets out the definition of estimated useful life:

**EE 63 Meaning of estimated useful life**

*Meaning for item of depreciable property, except for copyright in sound recording*

- (1) **Estimated useful life**, for an item of depreciable property, other than a copyright in a sound recording, means the period over which the item might reasonably be expected to be useful in deriving assessable income or carrying on a business for the purpose of deriving assessable income, taking into account—
- (a) the passage of time, likely wear and tear, exhaustion, and obsolescence; and
  - (b) an assumption of normal and reasonable maintenance.

...

17. Section FA 6 provides that for a finance lease the lease is treated as a sale of the leased item:

**FA 6 Recharacterisation of amounts derived under finance leases**

When a personal property lease asset is leased under a finance lease, the lease is treated as a sale of the lease asset by the lessor to the lessee on the date on which the term of the lease starts, and—

...

- (c) subpart EE (Depreciation), the financial arrangements rules, and the other provisions of this Act apply to the arrangement as recharacterised.

18. Section FA 8 provides that for a finance lease the lessee is the owner of the property for depreciation purposes:

**FA 8 Deductibility of expenditure under finance lease**

*Lessee treated as owner*

- (1) The lessee under a finance lease is treated as the owner of the personal property lease asset for the purposes of subpart EE (Depreciation).

*Lessor not treated as owner*

- (2) The lessor under a finance lease is not treated as the owner of the personal property lease asset for the purposes of subpart EE.

19. The definition of finance lease is set out in section YA 1:

**YA 1 Definitions**

**finance lease** means a lease of a personal property lease asset entered into by a person on or after 20 May 1999 that—

...

- (b) when the person enters the lease or from a later time, involves a term of the lease that is more than 75% of the asset's estimated useful life as defined in section EE 63 (Meaning of estimated useful life):

...

20. Section 91AAG of the TAA provides for the setting of special rates:

**91AAG Determination on special rates and provisional rates**

- (1) A person may apply, in writing, to the Commissioner for the issue of a determination allowing them to use for an item, for a specified income year or years,—
- (a) a special rate higher or lower than the economic rate set in a determination under section 91AAF; or
- ...
- (2) When determining whether or not to grant an application for a special rate or a provisional rate, the level of any such rate, and the income year or years to which it applies, the Commissioner may have regard to any factors that are relevant in determining the item's estimated useful life, including an estimate based on a depreciation method or on a valuer's report, or a rate of depreciation that the person uses for the item for financial reporting purposes.
- (3) The Commissioner may issue a determination setting a special rate using—
- (a) the formula in section EE 27 of the Income Tax Act 2007; or
- (b) the formula in section EE 28 of that Act; or
- (c) the formula in section EE 30 of that Act; or
- (cb) the formula in section EZ 23 of that Act; or
- (d) the straight-line method other than under paragraph (b).
- ...

**Analysis**

21. At issue is whether taxpayers may get a special depreciation rate that is based on an EUL that is equal to the length of a lease. This analysis sets out the situations in which the issue tends to arise. The analysis then looks at the process by which the Commissioner determines a special rate, and concludes that the process includes determining an item's EUL. It is concluded that factors that the Commissioner takes into account when determining a special rate are those that are relevant to determining the item's EUL. The definition of EUL is then analysed to determine whether a lease term is a factor the Commissioner should take into account when determining a special rate. It is concluded that the definition of EUL does not allow a lease term to be a factor the Commissioner is to take into account when determining a special rate. This interpretation of EUL is supported by the legislative provisions relating to loss on disposal and finance leases.

### ***Situations where the lease term issue arises***

22. The issue of whether the Commissioner may set a special depreciation rate for an item of depreciable property based on an EUL equal to the length of a lease to which the item is subject to, tends to arise in either of two situations:
  - The item to be depreciated by the taxpayer is owned by the taxpayer (or deemed to be owned by the taxpayer for the purposes of being entitled to depreciate the item) and is located in something leased where the taxpayer is the lessee.
  - The item to be depreciated by the taxpayer is the item that is being leased where the taxpayer is either the lessee (in the case of a finance lease as defined in the ITA 2007) or the lessor (in the case of an operating lease).
23. The above two situations exist because of the operation of the provisions in the ITA 2007 that relate to who is entitled to depreciate items of property. Section EE 1(2) provides that in order to claim depreciation, a person must own the item of depreciable property. "Own", for the purposes of ownership of depreciable property is defined in sections EE 2 to EE 5. Section EE 2(1) provides that "own" means legal or equitable ownership. Section EE 2(2) provides that "own" includes ownership of the kind described in sections EE 4 and EE 5.
24. The first situation exists where a person legally owns an item that is located in something leased, or, under section EE 4 or section EE 5, is deemed to own an item that is located on leased land (being a fixture or an improvement that is not considered part of a building).
25. The second situation exists where the item is the leased item. Such situations typically would involve personal property leases where only the lessee is allowed a depreciation deduction on the item. The definition of "finance lease" in section YA 1 includes leases of items of personal property, if the term of the lease of the item is more than 75 percent of the EUL for that item. Where the lease must be treated as a finance lease, section FA 6 deems that a sale of the property has occurred at the date that the lease term starts, and section FA 8(1) deems the lessee as the owner of the property for the purposes of being allowed a depreciation deduction for the property under subpart EE.

### ***How a special rate is determined***

26. Section EE 35(1) provides that a special rate or provisional rate is set under sections 91AAG to 91AAJ of the TAA.

#### **EE 35 Special rate or provisional rate**

##### *Rate set for item of depreciable property*

- (1) A special rate or a provisional rate is set for an item of depreciable property under sections 91AAG to 91AAJ of the Tax Administration Act 1994.  
...
27. Section 91AAG(1)(a) of the TAA provides that a person may apply to the Commissioner to set a special depreciation rate that is higher or lower

than the economic rate for the item, for the person to use for depreciating the item.

**91AAG Determination on special rates and provisional rates**

- (1) A person may apply, in writing, to the Commissioner for the issue of a determination allowing them to use for an item, for a specified income year or years,—
  - (a) a special rate higher or lower than the economic rate set in a determination under section 91AAF; or
  - ...

**Section 91AAG(2) of the Tax Administration Act 1994**

- 28. Section 91AAG(2) of the TAA provides that when determining a special rate, the Commissioner may have regard to any factors that are relevant in determining the item's EUL, including an estimate based on a depreciation method or valuer's report, or a rate of depreciation that the person uses for the item for financial reporting purposes.

**91AAG Determination on special rates and provisional rates**

- ...
- (2) When determining whether or not to grant an application for a special rate or a provisional rate, the level of any such rate, and the income year or years to which it applies, the Commissioner may have regard to any factors that are relevant in determining the item's estimated useful life, including an estimate based on a depreciation method or on a valuer's report, or a rate of depreciation that the person uses for the item for financial reporting purposes.

...

- 29. Having regard to section 91AAG(2), the EUL is the key component in determining a special rate. It is considered that the financial reporting treatment or "any [other] factors" are to be taken into regard in determining the EUL, rather than as separate considerations in determining a special rate.
- 30. The background to section 91AAG(2) of the TAA indicates that this interpretation is correct. The predecessor to section 91AAG(2) was section EG 10(2) of the Income Tax Act 1994. Section EG 10(2) provided that, in determining a special rate, the Commissioner must have regard to the basic economic rate formula set out in section EG 4(3) of the Income Tax Act 1994, and the rate of depreciation used by the taxpayer for financial reporting. The formula set out in section EG 4(3) included the EUL as a necessary factor in the equation.
- 31. As a result of the enactment of the Income Tax Act 2004, section 91AAG(2) of the TAA replaced section EG 10(2) of the Income Tax Act 1994. Section 91AAG(2) was virtually the same as section EG 10(2) until the section was amended in 2005 by the Taxation (Base Maintenance and Miscellaneous Provisions) Act 2005. Inland Revenue's Policy Advice Division discussed section 91AAG(2) in its commentary on the Taxation (Base Maintenance and Miscellaneous Provisions) Bill, which resulted in the 2005 amendment to that provision (Policy Advice Division, *Taxation (Base Maintenance and Miscellaneous Provisions) Bill* (Inland Revenue Department, Wellington, 2004) (at page 19)):

At present, the basis on which the Commissioner will issue special tax depreciation rates requires taxpayers to identify, for example, the actual economic life of

depreciable property with a high degree of certainty. This has led to concerns that this basis is too rigid. That is, if actual economic life cannot be clearly ascertained, a special tax depreciation rate will generally not be allowed.

**The changes will allow the Commissioner greater flexibility in considering special tax depreciation rate applications if he is reasonably satisfied that, in the circumstances, the actual economic life of depreciable property differs significantly to the estimate of economic life used to prescribe the general tax depreciation rate (estimated useful life).** This would include taking into account assessments of economic life based on valuers' reports and other available best estimates (for example, from different depreciation methods). However, the current legislation guiding the Commissioner on the factors that he may have regard to in this area is unclear. The changes are intended to clarify this.

At present, in section [91AAG(2)] of the Tax Administration Act 1994, the Commissioner is required to have regard to the formula in section EE 25(4) of the Income Tax Act 2004 and the rate of depreciation (if any) that the person uses for financial reporting purposes. How this provision is meant to be interpreted is unclear because financial reporting depreciation rates can differ significantly from tax depreciation rates, simply because of the differences in the underlying formula used or even the method - for example, diminishing value versus straight-line. In such cases **the more important piece of information is likely to be the estimate of useful life and how this is calculated. To that effect, section [91AAG(2)] is being amended to explicitly allow the Commissioner to have regard to any factors that are relevant in determining estimated useful life.** This will include, as noted above, estimates from independent valuers.

[Emphasis added]

32. The above commentary shows that the changes to section 91AAG(2) of the TAA appear to have been intended to clarify that the EUL of an item to which a special rate is sought should be determined on an assessment of a broad range of factors that provide a reasonable level of certainty, although it does not have to be an absolute certainty. Therefore, the section expresses that the relevant factors may include estimates.
33. The above commentary also emphasises that special rates are determined if the economic life of the particular item is expected to be different from the economic life estimated for the general economic depreciation rate applicable to items of the kind to which a special rate is sought. EUL is equated with economic life and is considered an important piece of information in considering a special rate. Therefore, the changes to section 91AAG(2) of the TAA also appear to have been intended to clarify that the EUL is the key component that must be considered when determining a special rate. This supports the view that the financial reporting treatment, estimates from valuers, and other factors are to be taken into regard if they are relevant to determining the item's EUL, rather than as separate considerations in determining a special rate.

#### ***Section 91AAG(3) of the Tax Administration Act 1994***

34. Section 91AAG(3) of the TAA sets out the methods the Commissioner may use to determine a special depreciation rate. It is considered that section 91AAG(3) is consistent with the view that the Commissioner must include the item's EUL as the key component in determining any special rate.
35. Section 91AAG(3) of the TAA provides that the Commissioner may set a special depreciation rate using a statutorily set formula or an alternative straight-line method. This ability to issue a special rate based on a straight-line method other than in accordance with the statutory formula was introduced as part of the amendments in the Taxation (Base Maintenance and Miscellaneous Provisions) Act 2005.

36. Before the 2005 amendments, section 91AAG(3) of the TAA provided that the Commissioner could issue a special depreciation rate after having regard to the factors in section 91AAG(2) of the TAA. Before the 2005 amendments, the factors in section 91AAG(2) were the economic rate formula set out in section EE 25(4) of the Income Tax Act 2004 and the rate of depreciation used for financial reporting purposes.
37. The reason for the 2005 amendments to section 91AAG(3) of the TAA was discussed in the Inland Revenue's Policy Advice Division 2004 commentary on the Taxation (Base Maintenance and Miscellaneous Provisions) Bill (at page 20):

Another concern is whether, under section [91AAG(3)], the Commissioner can prescribe a special tax depreciation rate that is not determined using the legislated diminishing value formula (the formula in EE 25(4)). This has implications when, for example, a taxpayer requests a straight-line rate to be calculated without reference to the diminishing value formula. Changes are therefore proposed to section [91AAG(3)] to allow the Commissioner to prescribe special tax depreciation rates using a straight-line method from the outset, instead of setting a diminishing value rate and then prescribing a straight-line equivalent.

38. Section 91AAG(3)(d) of the TAA provides for the alternative straight-line method, and section 91AAG(3)(a) to (cb) of the TAA provides for a statutory formula provided in section EE 27, section EE 28, section EE 30, or section EZ 23, which the Commissioner may use to determine a special rate:

#### **91AAG Determination on special rates and provisional rates**

- ...
- (3) The Commissioner may issue a determination setting a special rate using—
    - (a) the formula in section EE 27 of the Income Tax Act 2007; or
    - (b) the formula in section EE 28 of that Act; or
    - (c) the formula in section EE 30 of that Act; or
    - (cb) the formula in section EZ 23 of that Act; or
    - (d) the straight-line method other than under paragraph (b).
- ...
39. Each formula contained in sections EE 27, EE 28, EE 30, and EZ 23 includes the EUL as a component. Therefore, a statutory formula, which includes the EUL, must be used to determine a special rate unless an alternative straight-line method is chosen. The straight-line method is defined in section EE 67 as:

the method of calculating an amount of depreciation loss for an item of depreciable property by subtracting, in each income year, a constant percentage of the item's cost, to its owner, from the item's adjusted tax value

40. Whether the EUL must be used to determine a rate for an alternative straight-line method is unclear from the above definition of the straight-line method, and is not discussed in the above commentary on the amendment. However, as discussed above, section 91AAG(2) of the TAA appears to clarify that the EUL is the overriding factor that must be considered when determining a special rate. This effectively suggests that even though the EUL is not expressed as a requirement of calculating an amount of depreciation loss under the straight-line method defined in

section EE 67, in order to set a special rate the Commissioner must consider factors that are relevant in determining an item's EUL. This implies that the Commissioner must include the item's EUL as a component in determining any special rate.

41. Therefore, it is considered the correct interpretation is that in order to set a special rate, whether using a statutory formula or an alternative straight-line method, the Commissioner must consider factors that are relevant in determining the item's EUL and must include the item's EUL as a component in determining the special rate. This means the definition of EUL needs to be examined to determine whether a particular factor, such as a lease term, is relevant to determining the EUL required for setting special rates.

#### ***Estimated useful life defined***

42. Section EE 63(1) sets out the definition of EUL for an item of depreciable property, other than a copyright in a sound recording. This is the period over which the item might reasonably be expected to be useful in deriving assessable income or carrying on a business for the purpose of deriving assessable income, taking into account the passage of time, likely wear and tear, exhaustion, and obsolescence, and an assumption of normal and reasonable maintenance.

#### **EE 63 Meaning of estimated useful life**

*Meaning for item of depreciable property, except for copyright in sound recording*

- (1) **Estimated useful life**, for an item of depreciable property, other than a copyright in a sound recording, means the period over which the item might reasonably be expected to be useful in deriving assessable income or carrying on a business for the purpose of deriving assessable income, taking into account—
    - (a) the passage of time, likely wear and tear, exhaustion, and obsolescence; and
    - (b) an assumption of normal and reasonable maintenance.
43. The definition of EUL was introduced into section 107A of the Income Tax Act 1976 by section 2(1) of the Income Tax Amendment Act 1993 as part of the then new depreciation regime. The definition introduced into the Income Tax Act 1976 is substantially the same as the definition in the ITA 2007. The definition introduced into the Income Tax Act 1976 states:

**"Estimated useful life"** means, in respect of any depreciable property, the period over which such property might reasonably be expected to be useful in gaining or producing assessable income or in carrying on a business in New Zealand, having regard to such factors as likely wear and tear, the passage of time, exhaustion, and obsolescence and based upon an assumption of normal and reasonable maintenance:

44. The Consultative Committee on the Taxation of Income from Capital ("Valabh Committee") in a letter to the Government dated 14 November 1991 on the Committee's recommendations for the new depreciation regime (introduced by the Income Tax Amendment Act 1993), states that it is necessary to identify objective criteria for determining useful life (Consultative Committee on the Taxation of Income from Capital, *Final Report of the Consultative Committee on the Taxation of Income from Capital* (Consultative Committee, Wellington, 1992, Appendix A, point 6 "Definition of useful life")):

[The] definition [of EUL in the draft legislation] reflects our view that the useful life of an asset for depreciation purposes is not the life for which an asset could technically be used, but the life for which it is or will be useful in the income earning process. It is necessary to identify relevant objective criteria for determining useful life such as physical deterioration, technical obsolescence, obsolescence due to market factors and the average length of time for which an asset is held for income-earning or business purposes.

**However it is necessary to note that it is the useful life of the asset which is the important criteria for determining depreciation rates, not necessarily the length of time for which it will be used by any particular taxpayer.** This means that where an asset will be disposed of to another taxpayer for use by that taxpayer, the useful life of the asset needs to be calculated having regard to the entire period for which the asset will be used, not just the period for which the asset is first used by a taxpayer.

[Emphasis added]

45. Earlier in the Valabh Committee's letter (under point 4 "Schedular Versus Taxpayer-initiated Rate Setting"), the Committee recommended that individual taxpayers should be entitled to apply for a rate specific to their circumstances, although the same statutory criteria for determining useful life should be applied for setting all rates:

We continue to hold the view that the Commissioner should set a schedule of tax depreciation rates, and that taxpayers should be able to apply for higher rates where appropriate.

**Whether rates are calculated at the Commissioner's initiative or as a consequence of a taxpayer's request the same statutory criteria (ie determination of useful life and estimated residual value) should be applied. However, although the same criteria for determining useful life and estimated residual value would be used it does not follow that the rate determined should be the same.** Tax depreciation rates set by the Commissioner have to apply for all assets of a class and to all taxpayers who own such assets. Many taxpayers will lack the resources to determine accurately the tax depreciation rates applying to their assets. This means that there will inevitably be some inaccuracies in the rates set by the Commissioner when applied to individual taxpayers. We would expect that rates set as a consequence of application by taxpayers and using information in respect of their own circumstances would be considerably more accurate than those set by the Commissioner which need to have general application.

[Emphasis added]

46. It appears that the Valabh Committee envisaged a depreciation regime that would allow taxpayers to obtain special rates that are based on the useful life of the item in the specific conditions that the item is being used in the taxpayer's business. However, the useful life of an item is determined by an assessment of the item's usefulness, in the specific conditions, to any business rather than its usefulness to a particular taxpayer. The Valabh Committee envisaged objective criteria for determining an item's useful life.

#### ***Criteria for determining an item's estimated useful life***

47. In the Valabh Committee's letter to the Government dated 14 November 1991, the Committee envisaged objective criteria for determining an item's useful life, such as "physical deterioration, technical obsolescence, obsolescence due to market factors and the average length of time for which an asset is held for income-earning or business purposes". Criteria of "likely wear and tear, the passage of time, exhaustion, and obsolescence" were written into the definition of EUL from its introduction in 1993. These criteria are now provided in the definition of EUL in the ITA

2007, which provides that the Commissioner is to take them into account when determining the EUL of an item.

48. It is interesting to note as a preliminary observation that the term "the passage of time" seems rather vague in respect of its meaning in relation to considering EUL. It appears that the Valabh Committee's reference to "the average length of time for which an asset is held for income-earning or business purposes" may have been the basis for the term "passage of time". However, even if that is so, it is considered that it does not add any meaning to the term in the context of what should be considered in determining an EUL. This is because the phrase "average length of time for which an asset is held for income-earning or business purposes" appears to be another way of describing EUL, which the criteria are supposed to establish. That is, that phrase describes the outcome, but does not assist with determining what is required to be considered in determining an EUL.
49. The criteria of "likely wear and tear, the passage of time, exhaustion, and obsolescence" have remained in the definition of EUL, except that in the Income Tax Act 2004 the order was changed to "the passage of time, likely wear and tear, exhaustion, and obsolescence", and has remained in this order in the ITA 2007. There is no obvious reason for this change in order, and there appears to be no published background commentary on this. The meanings of these terms are discussed below, with "likely wear and tear", "exhaustion", and "obsolescence" discussed briefly before "passage of time".

#### *Likely wear and tear*

50. "Wear and tear" is defined in *Butterworths New Zealand Law Dictionary* (6<sup>th</sup> ed, LexisNexis New Zealand, Wellington, 2005) as the "deterioration or waste of any substance by the ordinary use of it". Therefore, the period over which an item is likely to become fully deteriorated is relevant in determining an EUL.

#### *Exhaustion*

51. The *Concise Oxford English Dictionary* (11th ed (revised), Oxford University Press, 2006) defines "exhaustion" as "the action or state of exhausting something or of being exhausted", and defines "exhaust" as "tire out completely" and "use up (resources or reserves) completely". It is considered that exhaustion in the definition of EUL means the using up of the item itself or the using up of things such as resources to cause an item to become useless. Therefore, exhaustion will be a consideration in determining an EUL for an item where after a period of time an item can no longer be used due to the item being functionally used up or deterioration of resources used by the item, or some external factor such as resources no longer available. To this degree, exhaustion has similarities with obsolescence in the definition of EUL.

#### *Obsolescence*

52. The *Concise Oxford English Dictionary* (11th ed (revised), Oxford University Press, 2006) defines "obsolescent" as "becoming obsolete" with "obsolescence" included as a derivative word, and defines "obsolete" as "no longer produced or used; out of date".

53. There are no New Zealand cases on the meaning of "obsolescence" in the context of the current depreciation provisions. However, the ordinary meaning of obsolescence has been considered in various cases (see: *Para Handkerchief & Textiles (1964) Ltd v CIR* (1992) 14 NZTC 9,125; *Anaconda Co v Property Tax Department of the State of New Mexico* App 94 NM 202; 608 P2d 514 (1979); *Real Estate-Land Title & Trust Co v United States*, 309 US 13 (1940); and *SS White Dental Manufacturing Co v United States* 38 F Supp 301; 93 Ct CL 469 (1941)). These cases tend to show that the meaning of obsolescence in the context of the definition of EUL is as follows:

- Obsolescence is the process whereby an item loses its economic usefulness through causes other than physical deterioration. It is a progressive reduction in the item's ability to function in the business of the taxpayer, such that it will become useless, before the end of its "normal" useful life.
- Obsolescence is where the uselessness arises from external forces that are generally outside the taxpayer's control.
- Obsolescence may exist where an item becomes outmoded by virtue of improved alternatives that make the item uneconomic or uncompetitive such that it must be replaced. However, obsolescence does not equate to something simply being suboptimal, or there simply being "better" or more modern alternatives. A substantial diminution in utility will be necessary, which (in the case of depreciable property used in business) would be likely to progressively contribute to the decline in business (due to the loss of the underlying item's utility).
- Obsolescence is not established by the abandonment or demolition of the item, or a decision to do so. The presence and impact of obsolescence must be determined having regard to the status of the item before its abandonment or demolition.

54. Therefore, obsolescence will be an objective consideration in determining an EUL for an item where after a period of time external factors have caused the item to become useless to any business, disregarding any decision by a particular taxpayer to abandon or demolish the item.

#### *Passage of time*

55. The term "passage of time" seems vague. It is not defined as a term in any of the dictionaries referred to above. However, given the ordinary meaning of "passage" is "the action or process of moving" (*Concise Oxford English Dictionary* (11th ed (revised), Oxford University Press, 2006)), it is possible to infer that "passage of time" means simply movement through time. This however provides little guidance on how "passage of time" is to be taken into consideration when determining an EUL. It merely indicates that the elapse of time is a consideration, which is already obvious from the nature of EUL, being inherently something that is a unit of time (a "life").

56. The statutory interpretation concept of *noscitur a sociis* provides that groups or lists of words should be read together and will take meaning from each other. Given the vagueness of the term "passage of time" in relation to how it relates to considering EUL, *noscitur a sociis* appears to

be an appropriate concept to apply in the interpretation of the phrase "passage of time". Under this concept, the words "likely wear and tear", "exhaustion", and "obsolescence" would add some meaning to "passage of time". As outlined above, "likely wear and tear" brings into consideration the deterioration normally expected of items during their use.

"Exhaustion" brings into consideration deterioration of resources used by the item and external factors such as resources no longer available, which cause the item to no longer be of use. "Obsolescence" brings into consideration external factors that cause the item to become useless to any business, disregarding any decision by a particular taxpayer to abandon or demolish the item. Therefore, "passage of time" will take on a meaning that is consistent with the considerations of deterioration of the item and resources used by the item, and external factors, which cause the item to no longer be of use to any business.

57. The above conclusion indicates that it is not the mere passage of time that can be taken into account when determining an EUL. This means any argument that the EUL should be equal to a lease term based on the fact that time has elapsed, would not withstand the interpretation of "passage of time" based on the *noscitur a sociis* concept. That is, something more than the passing of time to the end of the lease must occur for the EUL to be equal to the length of the lease. Something more would have to be the occurrence of deterioration or some external factor that causes the item to no longer be of use to any business. This interpretation is consistent with the objective criteria the Valabh Committee envisaged for determining an item's useful life. That is, the EUL of an item is determined by an assessment of the usefulness of the item being used in particular conditions, rather than necessarily the item's usefulness to a particular taxpayer.
58. An argument may be that if "passage of time" is to be interpreted with the same meaning as "likely wear and tear", "exhaustion", or "obsolescence", it would be unnecessary to include it in the list of criteria. The answer would appear to be that "likely wear and tear", "exhaustion", and "obsolescence" were not meant to be exhaustive, and instead were indicators of the kind of things to be taken into account. Such things would be of a kind that would cause the item to become no longer useful to any business. This interpretation follows closely the most descriptive part of the definition of EUL being; "the period over which the item might reasonably be expected to be useful in deriving assessable income or carrying on a business for the purpose of deriving assessable income".
59. It is also noted that there may be cases where items of property depreciate in value even when they are not used. In such cases, it may be considered that the passage of time would have some bearing on the item's EUL. However, it is considered that it is the deterioration over time caused by the lack of use of an item (for example, a car left idle) or the possible obsolescence of an item (for example, machinery unique to a particular situation) that would be relevant to determining the EUL.
60. The above interpretation that "passage of time" takes its meaning from the other terms in the list is also supported by consideration of the purpose of the 1993 amendments to the depreciation provisions. The February 1993 officials' report to the Finance and Expenditure Committee on Taxation Reform Bill (No 6) stated that one intention of the 1993 amendments was to establish legislative criteria for setting depreciation rates and require the Commissioner to follow the criteria. Therefore, it

seems that the definition of EUL was phrased so to secure the kind of deduction for taxpayers that already had been established under the earlier provisions (although previously subject to the Commissioner's discretion).

61. Before the 1993 amendments, the depreciation provisions (sections 74 and 108) in the Income Tax Act 1976 provided the Commissioner with a discretion to allow a deduction for depreciation of an item where the depreciation was caused by "fair wear and tear or by the fact of the asset becoming obsolete or useless" and the "depreciation cannot be made good by repair". Therefore, it seems the definition of EUL introduced by the 1993 amendments included some of the terms from the old depreciation provisions, as well as "exhaustion" and "passage of time". This tends to indicate that, to secure the same kind of deduction as established under the pre-1993 provisions, the term "passage of time" would take its meaning from the other terms in the list, which were seemingly provided for in the pre 1993 provisions.
62. Therefore, the above analysis of the terms "passage of time", "likely wear and tear", "exhaustion", and "obsolescence" tends to indicate that considerations of an item's EUL are not open to the mere passing of time, and instead are restricted to considerations of deterioration, exhaustion, and external factors that cause an item to no longer be of use to any business.

#### ***Interpretation of estimated useful life supported by other provisions***

##### *Loss on disposal*

63. A loss on disposal may be claimed under section EE 48(2).

##### **EE 48 Effect of disposal or event**

...

##### *Amount of depreciation loss*

- (2) For the purposes of section EE 44, if the consideration is less than the item's adjusted tax value on the date on which the disposal or the event occurs, the person has an amount of depreciation loss, for the income year in which the disposal or the event occurs, that is the amount by which the consideration is less than the item's adjusted tax value on that date.

...

64. Section EE 44(1) provides for when the above loss on disposal provision, section EE 48(2), applies. Section EE 44(1) provides for cases where there has been a "disposal of an item" that is "of a kind described in section EE 46" or where there has been an "event involving an item" where the event is "of a kind described in section EE 47".

##### **EE 44 Application of sections EE 48 to EE 52**

##### *When sections apply*

- (1) Sections EE 48 to EE 52 apply when a person derives consideration from the disposal of an item or from an event involving an item, if—
  - (a) the consideration is consideration of a kind described in section EE 45; and
  - (b) either—

- (i) the item is an item of a kind described in section EE 46; or
  - (ii) the event is an event of a kind described in section EE 47.
- ...
65. The term "disposal" for depreciation purposes takes its meaning from paragraph (f) of the definition of "dispose" in section YA 1, which provides that the word "dispose" "for depreciable property, includes destroy, withdraw, or let lapse". This definition is not exhaustive, so the term "disposal" for depreciation purposes also takes on its ordinary meaning. The *Concise Oxford English Dictionary* (11th ed (revised), Oxford University Press, 2006) defines "disposal" as "the action or process of disposing" and "the sale of assets", and "dispose" as "get rid of". Therefore, it is considered that the term "disposal" for depreciation purposes is wide enough to cover the abandonment of property after a lease.
66. Items described in section EE 46(1) are generally items of depreciable property that a person owns.

#### **EE 46 Items for purposes of section EE 44**

##### *Items to which sections EE 48 to EE 52 apply*

- (1) For the purposes of section EE 44, an item of property to which sections EE 48 to EE 52 apply is an item of depreciable property that a person owns ...
67. As seen, the word "own" is defined for depreciation purposes in sections EE 2 to EE 5. Section EE 2 provides that "own" means legal or equitable ownership, and includes ownership described in sections EE 3 to EE 5. Therefore, a taxpayer who legally owns an item that is being used in a lease situation (such as an item located in something leased, or machinery hired out) can apply the loss on disposal provision to that item on any disposal that may occur as a result of the termination of the lease. Also, as discussed above, a person can "own" an item for depreciation purposes under sections EE 4 to EE 5 in specific leasing situations involving deemed lessee ownership of fixtures or improvements, as well as finance lease situations under section FA 8. Therefore, the loss on disposal provision may be applied to the disposal of depreciable property as a result of the termination of a lease.
68. Therefore, section EE 48 specifically provides for an allowable deduction for loss on disposal where disposal is determined by the taxpayer's decision to abandon or otherwise dispose of an item, and can include specific circumstances to the taxpayer such as lease arrangements. This indicates that depreciation deductions in general (that is, without this specific loss on disposal provision) are meant to apply to the expected total useful life of an item to any business, without shortening the expected total useful life of the item due to a taxpayer's decision to dispose of the item in the future (for example, at the end of a lease term). Therefore, it is considered this indicates EUL is the estimated usefulness of the item to **any** business, which is consistent with the interpretation of EUL discussed above.

#### *Finance leases*

69. The definition of "finance lease" in section YA 1 includes leases of items of personal property, if the term of the lease of the item is more than 75

percent of the EUL for that item. Therefore, it is expressly envisaged in the legislation that the EULs of items will not necessarily coincide with lease terms. Although this inclusion in the definition of finance lease is not determinative, it is consistent with the view that lease terms do not determine EULs.

70. It appears the drafters of the definition of "finance lease" also held this view. The definition of finance lease has included this requirement (where the term of the lease is more than 75 percent of the EUL) since the Taxation (Accruals and Other Remedial Matters) Act 1999 introduced it into the Income Tax Act 1994. The definition of "specified lease", which "finance lease" replaced, did not contain this provision. In the 1999 officials' report to the Finance and Expenditure Committee on submissions on the Taxation (Accruals and Other Remedial Matters) Bill, the above EUL requirement provided in the definition of "finance lease" was briefly discussed (at page 34):

We also recommend that "estimated useful life" be linked to the estimated useful life as determined by the Commissioner when setting depreciation rates. Otherwise taxpayers could inappropriately determine their own "estimated useful life" for leased assets under the finance lease rules.

71. The above statement, which says it would be inappropriate for taxpayers to determine their own EUL for a leased asset under the finance lease rules, also tends to indicate that EULs are not determined by lease terms. This is also consistent with the above view that an individual taxpayer's decision to abandon or demolish the item is an irrelevant consideration when determining an EUL.

***Lease terms and factors relevant to determining an estimated useful life***

72. The EUL is defined in section EE 63(1) as the period over which the item might reasonably be expected to be useful in deriving assessable income or carrying on a business for the purpose of deriving assessable income, taking into account the passage of time, likely wear and tear, exhaustion, and obsolescence, and an assumption of normal and reasonable maintenance.
73. The consideration of "likely wear and tear" indicates that the period over which an item is likely to become fully deteriorated is relevant in determining an EUL. It is considered that the term of a lease does not, by itself, indicate that an item will be fully deteriorated by the end of the lease. The item may still be in reasonable condition for another business to be able to use the item after the particular business has ended the lease.
74. The consideration of "exhaustion" indicates that exhaustion will exist for an item after a period of time where an item can no longer be used due to the item being functionally used up or deterioration of resources used by the item, or some external influence such as resources being used up. It is considered that the term of a lease does not, by itself, indicate that an item will be exhausted by the end of the lease. Other businesses may be able to use the item after the particular business has ended the lease.
75. The consideration of "obsolescence" indicates that obsolescence will exist for an item after a period of time where external factors have caused the item to become useless to any business, disregarding any decision by a particular taxpayer to abandon or demolish the item. There may be

situations where the taxpayer will use an item only during the term of a lease. However, it is considered that the term of the lease does not, by itself, indicate that something is obsolete by the end of the lease. As indicated above, the mere abandonment or demolition of an item does not constitute obsolescence. Other businesses may be able to use the item (but for the demolition), or wish to use the item, after the particular business has ended the lease. It is acknowledged that some items may be specifically designed for a particular situation and have no use beyond that situation, to which a lease term may coincide. In such cases, it is the termination of the situation that causes the item to be obsolete, rather than the coincidental end of the lease term.

76. The consideration of "passage of time" does not mean the mere passage of time will determine an EUL. It is considered that an EUL should not be determined to be equal to a lease term based merely on the fact that time has elapsed. It is considered that something more than the passing of time to the end of the lease must occur for the EUL to be equal to the length of the lease. Something more would have to be the occurrence of deterioration, exhaustion, or some external factor that causes the item to no longer be of use to any business.
77. Therefore, the analysis of the terms "passage of time", "likely wear and tear", "exhaustion", and "obsolescence" indicates that lease terms are not consistent with any of the considerations that are to be taken into account in determining the EUL. This means that under section 91AAG(2), a lease term is not a relevant factor the Commissioner may have regard to when determining the EUL required for setting a special rate.

#### ***Financial reporting***

78. It is noted that section 91AAG(2) provides that the rate of depreciation that the person uses for the item for financial reporting purposes may be included as a relevant factor the Commissioner may have regard to when determining the EUL for the item. However, it is considered that the rate used for financial reporting purposes will not always be a relevant factor for determining an EUL.
79. New Zealand International Accounting Standard 16, Property, Plant and Equipment, states (at paragraph 50) that the "depreciable amount of an asset shall be allocated on a systematic basis over its useful life", and, of particular relevance, that legal or similar limits on the use of an asset, such as related leases, are factors in determining the useful life of an asset (at paragraph 56). Therefore, it appears that for financial reporting purposes lease terms are considered relevant to determining the "useful life" over which an item is to be depreciated, which conflicts with the above conclusion in relation to EUL.
80. New Zealand International Accounting Standard 16 states (at paragraph 57) that the "useful life of an asset is defined in terms of the asset's expected utility to the entity" and that the "useful life of the asset may be shorter than its economic life". In contrast, and discussed above, EUL is equated to an estimate of economic life and considered in terms of usefulness of the item to any entity, rather than usefulness to one particular entity. This is the case for any tax depreciation rate including special rates. Therefore, in the context of a lease situation, the "useful life" on which the rate of depreciation for financial reporting is based, will not necessarily be relevant to determining the EUL for the tax depreciation

rate. A “useful life” based on the term of a lease would not be consistent with the interpretation of the definition of EUL considered to be the correct interpretation.

81. Therefore, although section 91AAG(2) of the TAA provides that an estimate based on a depreciation method or on a valuer's report, or a rate of depreciation for financial reporting purposes may be relevant factors in considering an EUL for a special rate, such factors would be relevant only if they are consistent with the view of EUL being the estimated economic life or usefulness of the item to any business.

## **Conclusion**

82. It is concluded that the EUL is a necessary component in determining a special rate, and factors relevant to determining the EUL are the relevant factors the Commissioner may take into account when determining a special rate. The EUL is considered to be the estimated useful life of an item to any business, where an individual taxpayer's decision to abandon or demolish an item is irrelevant. It is concluded that the definition of EUL does not allow lease terms to be relevant factors for the Commissioner to take into account when determining a special rate, because they are not consistent with the criteria for considering EUL. Therefore, the Commissioner cannot issue a special rate that is based on an EUL that has been determined by the length of a lease to which the item is subject.
83. There may be cases where the EUL coincides with the lease term. However, in such cases the EUL will not have been determined by the length of a lease. In all cases the EUL will be determined by reference to the applicable criteria, being “passage of time”, “likely wear and tear”, “exhaustion”, and “obsolescence”. It is considered that these criteria are restricted to considerations of deterioration, exhaustion, and external factors that cause an item to no longer be of use to any business.

## **Examples**

84. The following examples illustrate situations in which the issue arises as to whether taxpayers may get a special depreciation rate based on an EUL that is equal to the length of the lease.

### ***Example 1***

85. The taxpayer is a lessee of an office and has purchased non-load-bearing partitions for the office. (This example assumes that the partitions are not part of the building. If they are part of the building then a special rate cannot be set for them as section EE 35(2) provides that a special rate cannot be set for buildings.) The taxpayer seeks an EUL for a special rate for the partitions equal to the length of the lease of the office, which is 10 years. The general economic depreciation rate for non-load-bearing partitions is based on an EUL of 20 years.
86. The Commissioner will not set a special rate for the partitions based on an EUL that is determined by the length of the lease. At the end of the lease, although the taxpayer may no longer use the partitions, the partitions would not necessarily be useless (but for any demolition at the end of the lease).

87. It is acknowledged that there may be factors that could cause the partitions to no longer be of use to any business after 10 years as a result of deterioration or external factors. However, a lease term is not such a factor, so is not considered a relevant factor in determining the EUL of the partitions.

***Example 2***

88. The taxpayer is a lessee of a mobile crane and seeks an EUL for a special rate for the mobile crane equal to the term of the lease, which is five years. (The lessee will be entitled to depreciation deductions on the crane if the lease is a "finance lease" as defined in the ITA 2007.) The general economic depreciation rate for mobile cranes is based on an EUL of 15.5 years.
89. The Commissioner will not set a special rate for the mobile crane based on an EUL that is determined by the length of the lease. At the end of the lease, although the taxpayer would no longer use the crane, the crane would not necessarily be useless.
90. It is acknowledged that there may be factors that could cause the crane to no longer be of use to any business after five years as a result of deterioration or external factors. However, a lease term is not such a factor, so is not considered a relevant factor in determining its EUL.