[Interpretation statement IS3175 issued by Adjudication & Rulings in September 2000]

ASSETS UNDER CONSTRUCTION—DEPRECIATION

INTRODUCTION

This interpretation statement sets out the Commissioner's view on whether assets still under construction constitute "depreciable property', as defined in section OB 1 of the Income Tax Act 1994, and if so how the allowable deduction for depreciation is to be determined under subpart EG.

In determining whether or not an asset still under construction can be depreciated for tax purposes, several criteria must be satisfied. Firstly, section EG 1(1) requires that the property in question must be owned by the taxpayer and must constitute "depreciable property", as that term is defined in section OB 1. Secondly, the property must be used or available for use for some purpose by the taxpayer (section EG 2(1)). These criteria will be considered in this statement. As well, the method for calculating the deduction allowed for depreciation under section EG 2(1) will be addressed.

LEGISLATION

All legislative references are to the Income Tax Act 1994 unless otherwise stated.

Section OB 1 defines the term "depreciable property as:

In this Act, unless the context otherwise requires,–
"Depreciable property", in relation to any taxpayer,–
(a) Means any property of that taxpayer which might reasonably be expected in normal circumstances to decline in value while used or available for use by persons–
  (i) In deriving gross income; or
  (ii) In carrying on a business for the purpose of deriving gross income; but
(b) Does not include–
  (i) Trading stock of the taxpayer:
  (ii) Land (excluding buildings and other fixtures and such improvements as are listed in Schedule 16):
  (iii) Financial arrangements:
  (iv) Intangible property other than depreciable intangible property:
  (v) Property which the taxpayer has elected to treat as low value property under section EG 16:
  (vi) Property the cost of which is allowed as a deduction under any of sections BD 2(1)(b)(i) and (ii), DJ 6, DJ 11, DL 6, DM 1, DO 3, DO 6, DO 7, DZ 1, DZ 3, EO 5, EZ 5, and EZ 6, or by virtue of an amortisation or other similar deduction allowed under any section of this Act such as sections DJ 9, DL 2, DO 4, DO 5, and EO 2, other than sections EG 1 to EG 15 and section EG 18:
  (vii) Property which will not, in respect of the taxpayer, decline in value as a result of any right of the taxpayer to receive compensation for any decline in value on disposition of that property:
  (viii) Property the cost of which was or is allowed as a deduction in any income year to any other taxpayer under any of sections DO 3, DZ 2, DZ 3 and DZ 4 of this Act (or any of sections 127, 127A and 128 of the Income Tax Act 1976 or sections 119, 119D and 119G of the Land and Income Tax Act 1954):
  (ix) Property that the taxpayer elects under section EG 16A to treat as not depreciable:

Section EG 1(1) allows a deduction for depreciation:

Subject to this Act, a taxpayer is allowed a deduction in an income year for an amount on account of depreciation for any depreciable property owned by that taxpayer at any time during that income year.

Section EG 2 prescribes the formula for calculating the allowable deduction for depreciation:

(1) Subject to this Act and to subsection (2), the deduction allowed to a taxpayer for any income year on account of depreciation under section EG 1 for any depreciable property shall be the smallest of the following amounts:

(a) In the case of property that is not schedule depreciable property, an amount calculated in accordance with the following formula:

$$a \times b \times {}^{c}/_{12}$$

where–

a is the annual depreciation rate (expressed as a decimal) applicable in that income year to such property and to the depreciation method used by the taxpayer in respect of the property; and

b is–
(i) In any case where the diminishing value method is being used, the adjusted tax value of the property at the end of the income year before any deduction for depreciation in that income year has been made; and
(ii) In any case where the straight-line method is being used, the cost of the property to the taxpayer (excluding any expenditure of the taxpayer allowed as a deduction under any provision of this Act other than sections EG 1 to EG 15 and EG 18); and

c is the number of whole or part calendar months in the income year in which the property is owned by the taxpayer and used or available for use for any purpose by the taxpayer:

(b) In the case of schedule depreciable property, an amount calculated in accordance with the following formula:

$$a \times b \times {}^{c}/_{365}$$

where–

a is the annual depreciation rate (expressed as a decimal) applicable in that income year to the property and to the depreciation method used by the taxpayer in respect of the property; and

b is–
(i) In any case where the diminishing value method is being used, the adjusted tax value of the property at the end of the income year before any deduction for depreciation in that income year has been made; and
(ii) In any case where the straight-line method is being used, the cost of the property to the taxpayer; and

c is the number of whole or part days in the income year in which the property is owned by the taxpayer and is used or available for use for the purposes of deriving gross income or in carrying on a business for the purposes of deriving gross income:

(c) The adjusted tax value of the property at the end of the income year immediately before the deduction of any amount on account of depreciation for that income year:

(d) Where the property is a motor vehicle to which section DH 1(3) applies, an amount calculated in accordance with the following formula:

$$d \times e$$

where–

d is the amount of the deduction calculated in accordance with paragraph (a) of this subsection in respect of the motor vehicle; and

e is the proportion of business use to total use of the vehicle for the income year (expressed as a decimal) calculated in accordance with sections DH 2 to DH 4:

(e) where–
(i) The property is, at any time during the income year, not wholly used or available for use by the taxpayer in deriving gross income or in carrying on a business for the purpose of deriving gross income; and
(ii) Any use other than in deriving gross income or in carrying on a business for the purpose of deriving gross income is not subject to fringe benefit tax under this Act; and
(iii) The property is not a motor vehicle to which section DH 1(3) applies,–

an amount calculated in accordance with the following formula:

$$d \times {}^{f}/_{g}$$

where–

d is the amount of the deduction calculated under paragraph (a) of this subsection in respect of the property; and

f is the number of days or other appropriate units of measurement (whether relating to time, distance, or otherwise) in the income year (or in such lesser period as that property was owned by the taxpayer in that income year), being days or other appropriate units of measurement for which–
(i) The property was physically used or operated to produce gross income or in carrying on a business for the purpose of producing gross income; or
(ii) Fringe benefit tax was payable in respect of the use of the property; or
(iii) The property was not physically used or operated for any purpose whatever but was available for the purpose set out in subparagraph (i); and

g is the total number of days or other units of measurement (being the same units of time or other measurement as are used in item f) for which the depreciable property was used or available for use for any purpose in the income year (or in such lesser period as the property was owned by the taxpayer in that income year).

…

2(2A) In this section and in section EG 16, if at any time an asset owned by a taxpayer is temporarily under repair or under inspection, and if immediately before that time the asset was used or available for use by the taxpayer in deriving gross income, or in carrying on a business for the purpose of deriving gross income, the asset is to be regarded as available for use for either purpose during the period of repair or inspection.

APPLICATION OF THE LEGISLATION

Depreciable property

Before any asset can be depreciated, section EG 1(1) requires it to constitute "depreciable property" owned by the taxpayer. The term "depreciable property" is defined in section OB 1. According to this definition, an asset under construction by a taxpayer becomes depreciable property of that taxpayer when it is in such a state that it may reasonably be expected in normal circumstances to decline in value while used or available for use in deriving gross income or in carrying on a business for the purpose of deriving gross income.

Thus, before calculating the depreciation deduction allowable under section EG 2(1), three criteria must be met. Firstly, the asset under construction must constitute "property". Secondly, it must be owned by the taxpayer. Thirdly, it must reasonably be expected under normal circumstances to decline in value while used or available for use in deriving gross income or in carrying on a business for the purpose of deriving gross income. These three criteria will be considered in turn.

Property

Firstly, the assets under construction must constitute "property". The term "property" is not defined in the Act for the purposes of subpart EG (except that it includes consents granted in or after the 1996-97 income year under the Resource Management Act 1991) (definition of "property" in section OB 1). The ordinary meaning of the term, as defined in the *Concise Oxford Dictionary of Current English,* 8th ed., is as follows:

> **1 a** something owned; a possession, esp. a house, land, etc. **b** *Law* the right to possession, use, etc. **c** possessions collectively, esp. real estate …

This gives a wide meaning to the term, with the two aspects of ownership or right to possession being similarly recognised in law, depending upon the context in which the term is used. For example, *Stroud's Judicial Dictionary of Words and Phrases*, 5th ed., (London: Sweet & Maxwell Limited, 1986), at page 2,057, states:

> "Property" is the generic term for all that a person has dominion over. Its two leading divisions are (1) real, and (2) personal; …

Butterworths New Zealand Law Dictionary, 4th ed., (Wellington: Butterworths of New Zealand Ltd, 1995) similarly states:

> **property** **1.** A thing owned, that over which title is exercised, whether tangible or intangible, real or personal. **2.** A title to or right of ownership in goods or other property.

In order to determine the meaning of "property", as that term is used in the definition of "depreciable property", it is necessary to consider the context in which the term is used. As Nicholls LJ stated at page 953 of *Kirby (Inspector of Taxes) v Thorn EMI plc* [1988] 2 All ER 947:

> "Property" is not a term of art, but takes its meaning from its context and from its collocation in the document or Act of Parliament in which it is found and from the mischief with which that Act or

document is intended to deal: see Lord Porter in *Nokes v Doncaster Amalgamated Collieries Ltd* [1940] 3 All ER 549 at 574 …

Applying the ordinary meaning of "property" to the definition of "depreciable property" in section OB 1, the term is used in the phrase "property of that taxpayer". In its ordinary meaning, then, this connotes an item that is owned by the taxpayer or which the taxpayer has the right to possess and use. In the light of the wording of section EG 1(1), however, depreciable property not owned by the taxpayer will not qualify for a depreciation deduction.

Hence, in the context in which it is used in the definition of "depreciable property" and in section EG 1(1), an asset under construction will constitute "property" according to its ordinary meaning provided it is a possession of the taxpayer; something which the taxpayer owns and has the right to use as desired. The concept of "property" being a thing that the taxpayer owns also fits with the legal sense of the term.

Owned by the taxpayer

Secondly, as noted above when considering the term "property", the property consisting of assets under construction must be owned by the taxpayer in order to qualify for a depreciation deduction under section EG 1(1). An interpretation statement on the issue of the Commissioner's view of what constitutes being "owned or acquired" is being prepared for future publication.

Declining in value

Thirdly, the assets under construction must reasonably be expected to decline in value while used or available for use in deriving gross income or in carrying on a business for the purpose of deriving gross income. Since a decline in value must reasonably be expected, the asset will generally have a limited useful life and an asset expected to retain its value or to appreciate in value over time will not meet this criterion. For example, an original work of art will not generally constitute depreciable property since it would not be expected, in normal circumstances, to decline in value while used or available for use in deriving gross income or in carrying on a business for the purpose of deriving gross income (see the item on this issue in *Tax Information Bulletin*, Vol 10, No 9 (September 1998) at page 12).

Additionally, it is considered that in order to meet this criterion the whole or some part of the asset under construction must be **able** to be used in deriving gross income or in carrying on a business for the purpose of deriving gross income. That is, the whole or part of the asset, as the case may be, must be in such a state that a person, at the point in time that a depreciation deduction is sought, **could** use it in deriving gross income or in carrying on a business for the purpose of deriving gross income. Actual use in deriving gross income or in carrying on a business for this purpose is not necessary to meet this criterion, given that the wording of the definition specifically includes property merely available for use. Nevertheless, whether the property is used, or merely available for use, in deriving gross income or in carrying on a business for the purpose of deriving gross income, it is necessary for the property to be able to be used for this purpose.

Example 1 – raw materials
Z Limited wishes to build a piece of machinery to use in its manufacturing business. It purchased all the component material in December 1998, but did not complete the machine until June 1999. At no time before its completion was the machine able to be used in deriving gross income or in carrying on a business for the purpose of deriving gross income.

No depreciable property exists until June 1999 when the machine is completed since, before completion, it could not be used in deriving gross income or in carrying on a business for the purpose of deriving gross income. Thus, since no depreciable property existed until June 1999, depreciation deductions will not be allowed before this time.

Depreciation calculation

Having determined that an asset under construction constitutes depreciable property, the deduction allowed for depreciation is calculated under section EG 2(1). This section details various formulæ in limbs (a) to (e) with the deduction allowed being the smaller of the values calculated under these limbs.

Unlike the definition of "depreciable property", the formulæ in section EG 2(1) focus on the use or availability for use **by the taxpayer**. This is an important distinction. Whereas it is conceivable that any piece of equipment, say, could meet the definition of "depreciable property", no depreciation will be allowed unless **the taxpayer** will use it or has it available for use. Thus, it is considered that the better view of the wording of the formulæ in section EG 2(1) is that it favours the interpretation that a deduction for depreciation is only allowed when the "depreciable property" is in a state which **the taxpayer** uses it, or intends to use it for some purpose (i.e. it is available for such use). This is considered further when looking at incomplete assets.

For non-schedule depreciable property, limb (a) of section EG 2(1) gives the maximum amount allowed to the taxpayer as a deduction. Limb (a) states that the depreciation deduction allowed to the taxpayer is equal to the annual depreciation rate for the asset being depreciated, multiplied by the cost or adjusted tax value of the depreciable property (depending upon whether the straight-line or diminishing value method is used). The value so obtained is then multiplied by the proportion of the income year (in months) that the depreciable property was owned by the taxpayer and used or available for use for **any** purpose by the taxpayer.

This limb (or limb (b) in the case of schedule depreciable property) will apply in the case of assets whose construction is complete **and** which are wholly used or available for use in deriving gross income or in carrying on a business for the purpose of deriving gross income.

In this regard, under section EG 2(2A), temporary unavailability of depreciable property, while being repaired or inspected, is treated as a time when the property is being used or available for use in deriving gross income or in carrying on a business

for the purpose of deriving gross income, provided that immediately before this time the depreciable property was so used or available for use.

It follows that, given that the repair of assets will often be delayed until appropriate personnel are available to repair it, the legislative intent of section EG 2(2A) is that the provision would also apply when a damaged asset is awaiting repair, provided that immediately before the time the asset was damaged it was used or available for use in deriving gross income or in carrying on a business for the purpose of deriving gross income. This is because the asset would have been inspected after the damage occurred in order to ascertain the extent of the damage and the repair needed.

However, in the context of section EG 2(2A), the word “repair” does not apply to reconstruction or the like. “Repair”, as a revenue concept versus a capital one, has been considered in the courts in the context of allowable deductions for income tax purposes. The better view of the use of the term “repair” in section EG 2(2A) is one that fits with the type of work, the cost of which would be an allowable deduction under section BD 2.

Example 2 – temporary unavailability

Y Limited has built itself a new $2 million factory, completing the construction in April 1999. The depreciation rate for the building is 1% per annum. The company did not shift its business into the new factory until July 1999, and in the meantime the factory stood empty. In June 1999, massive flooding caused damage to the empty factory, making it unusable until repairs were carried out at the end of that month. The company wishes to calculate the deduction allowed for depreciation for the income year ended 31 March 2000.

Since the factory was available for use in deriving gross income, or in carrying on a business for the purpose of deriving gross income, immediately before the flood damage occurred, section EG 2(2A) deems the time that it was unavailable while awaiting repair and being repaired as a time when the property was being used or available for use in deriving gross income or in carrying on a business for the purpose of deriving gross income.

Hence, after its completion, the factory was at all times during the income year either used or available for use in deriving gross income or in carrying on a business for the purpose of deriving gross income. Therefore, limb (a) of section EG 2(1) provides for a deduction for depreciation for the year ended 31 March 2000 of:

$$0.01 \times 2{,}000{,}000 \times {}^{12}/_{12} = \$20{,}000$$

If the depreciable property is not wholly used or available for use by the taxpayer in deriving gross income or in carrying on a business for the purpose of deriving gross income, and any other use is not subject to fringe benefit tax, limb (e) will generally apply. The two exceptions are motor vehicles subject to section DH 1(3), which will be subject to limb (d), and schedule depreciable property where limb (b) provides the formula for apportionment.

Limb (e) limits the deduction allowed for depreciation by apportioning the amount calculated under limb (a). The apportionment is calculated by determining the time, or other appropriate unit of measurement, in which:

- the property is physically used in deriving gross income or in carrying on a business for the purpose of deriving gross income; or
- fringe benefit tax is payable on its use; or
- the property is not physically used for any purpose, but is available for use in deriving gross income or in carrying on a business for the purpose of deriving gross income,

expressed as a fraction of the total time (or other appropriate unit of measurement) that the property is used or available for use for **any** purpose **by the taxpayer**.

Regarding assets under construction, in two situations the asset will not be wholly used for deriving gross income or in carrying on a business for the purpose of deriving gross income:

- the asset is complete, but not wholly used or available for use in deriving gross income or in carrying on a business for the purpose of deriving gross income; or
- the asset is not yet complete, but nevertheless constitutes depreciable property, i.e. a part of the asset is capable of being used in deriving gross income or in carrying on a business for the purpose of deriving gross income.

Asset complete but not wholly used or available for use

If an asset is complete, but is not being wholly used or available for use by the taxpayer in deriving gross income or in carrying on a business for the purpose of deriving gross income, a straightforward application of the formula in limb (e) is required, with the unit of measurement used being dependent upon the type of asset in consideration.

Example 3 – completed asset not wholly used for deriving gross income

X, a sole trader, has built a $120,000 house for renting out, completing it on 21 June 1999. The depreciation rate for the house is 2% SL per annum. However, although the owner advertised the availability of the house from the time of its completion until the end of September 1999, he was unable to find a tenant. From 1 October 1999, the owner allowed a refugee family to live in it at no cost for a fixed period of seven months (i.e. until 30 April 2000). On 30 April 2000, the refugee family shifted out and a rent-paying tenant shifted in.

The owner wishes to calculate the depreciation deduction allowed for the income year ended 31 March 2000.

As the house was used or available for use from its completion on 21 June 1999, the amount calculated under limb (a) of section EG 2(1), is:

$$0.02 \times 120{,}000 \times {}^{10}/_{12} = \$2{,}000$$

While the house was occupied by the refugee family at no cost, it was not used nor available for use by X in deriving gross income or in carrying on a business for the purpose of deriving gross income. Therefore, an apportionment is required under limb (e) of section EG 2(1). The apportionment will be calculated according to the number of days that the house was available for use in deriving gross income (i.e. 22 June 1999 to 30 September 1999, inclusive) expressed as a ratio of the number of days in the income year that it was used or available for use for any purpose (i.e. 22 June 1999 to 31 March 2000, inclusive), giving a deduction of:

$$2{,}000 \times {}^{101}/_{284} = \$711.27$$

Asset incomplete but a part is capable of use

An issue arises where an asset's construction is not yet complete, but a part is capable of being used by the taxpayer in deriving gross income or in carrying on a business for the purpose of deriving gross income.

In this situation, as emphasised at the beginning of this discussion on the calculation of depreciation, the use or availability for use of the completed part, which will determine the depreciation deduction allowed, must be that of the taxpayer in question. Because a part of a yet to be completed asset is capable of some use, or could be used by some other person in deriving gross income, does not mean that any deduction is allowed under section EG 2.

Bearing this in mind, in this situation the application of limb (e) is also appropriate, since the incomplete asset cannot be wholly used or available for use in deriving gross income or in carrying on a business for the purpose of deriving gross income (sublimb (i)). However, it is acknowledged that the specific wording of the formula in the limb creates some difficulties in applying it to such a situation.

This can be seen from item "f" of the formula which envisages that the depreciable property will be **wholly** used by the taxpayer but for only **some** of the time, or for only **some** of the distance travelled, etc. In the case of an incomplete asset, but where a part is capable of being used by the taxpayer, it is only that **part** which will be used – the whole cannot be used because it has yet to be completed. However, since the incomplete asset constitutes property owned by the taxpayer that had a cost, and is being used or available for use by the taxpayer in deriving gross income or in carrying on a business for the purpose of deriving gross income, it is considered that in such a situation a court would interpret the wording of the formula broadly in order to allow a depreciation deduction.

Therefore, in order to apply the formula to the case of an asset under construction, where a part is used or available for use by the taxpayer in deriving gross income or in carrying on a business for the purpose of deriving gross income, it is necessary to apportion the depreciation deduction allowed under limb (a) by comparing the completed part to the whole asset to be constructed. While the wording of the formula is not ideal to effect this comparison, it is considered that a court would adopt an apportionment reflecting the cost of that part of the asset that is capable of being used by the taxpayer in deriving gross income or in carrying on a business for this

purpose (and is not used for another purpose), expressed as a ratio of the cost to date of the asset being constructed.

Such an approach is consistent with the statutory interpretation principles outlined by Lord Donovan in *Mangin v CIR* [1971] NZLR 591 at page 594:

> Thirdly, the object of the construction of a statute being to ascertain the will of the Legislature it may be presumed that neither injustice nor absurdity was intended. If therefore a literal interpretation would produce such a result, and the language admits of an interpretation which would avoid it, then such an interpretation may be adopted.

In this regard, the legislative intent of section EG 2(1) was to apportion the deduction for depreciation allowed under limb (a) when depreciable property was not wholly used or available for use by the taxpayer in deriving gross income or in carrying on a business for the purpose of deriving gross income. Except for specific types of property (e.g. schedule depreciable property and motor vehicles), no other limb of section EG 2(1) allows for such an apportionment except for limb (e). Therefore, it is considered that limb (e) was intended by legislature to deal with all other situations where the depreciable property was not wholly used or available for use by the taxpayer in deriving gross income or in carrying on a business for the purpose of deriving gross income. An apportionment by way of a cost comparison gives a fair result that a court would be likely to adopt.

It is acknowledged that this approach requires the costs between the completed part and incomplete parts to be apportioned. In some instances it will be possible to directly attribute certain expenditure to the complete or incomplete parts, as the case may be. For example, wallpapering and carpeting the completed ground floor of a building is directly attributable to that part, whereas a lift servicing the upper floors is directly attributable to those floors and not attributable to a completed ground floor.

In other situations, it is necessary to apportion costs between the complete and incomplete portions. For example, since the foundations of a five-storey building equally support all floors, the cost of the foundations could be apportioned equally across the five floors. Whether certain expenditure should be apportioned equally or not, however, will depend upon the particular facts. For example, where the painting costs of the exterior of a four-storey building need to be apportioned, and the ground floor is twice the height of each of the other floors, an equal apportionment would not be appropriate since twice as much paint and painting time would be needed for the ground floor. In these circumstances, an appropriate apportionment of the expenditure on paint and painting would be $^{2}/_{5}$ for the ground floor and $^{3}/_{5}$ for the remainder.

Example 4 – incomplete asset partly available for use

W Limited is building a 10-storey office block to be depreciated at 1% per annum. In July 1999, the bottom floor was completed and available for leasing out as retail space. The space was duly leased in September 1999. The remaining floors were not completed until May 2000, with no part able to be used before that time in deriving gross income or in carrying on a business for the purpose of deriving gross income.

The company wishes to calculate the depreciation deduction allowed for the income year ended 31 March 2000.

At 31 March 2000, a total of $5 million has been spent on the building. Of this total, $650,000 has been spent fitting out the bottom floor. A further $500,000 has been incurred on installing the lift. All other expenditure is considered to be attributable to each floor equally.

Following completion of the bottom floor, (i.e. July 1999), the Commissioner considers that the better interpretation of the law is that the entire office block constitutes depreciable property since it was property owned by the company, which was able to be used by the taxpayer in deriving gross income or in carrying on a business for the purpose of deriving gross income, and which would reasonably be expected in normal circumstances to decline in value while so used or available for use. Hence, subject to section EG 2(1), a deduction for depreciation will be allowed.

The amount calculated under limb (a) of section EG 2(1) for the income year ended 31 March 2000 is:

$$0.01 \times 5{,}000{,}000 \times {}^{9}/_{12} = \$37{,}500$$

Under limb (e) of section EG 2(1), this amount is apportioned according to the cost of the bottom floor as a proportion of the total cost to date for the building. The cost of the bottom floor is as follows:

Fitting out the floor	650,000
Lift (considered to be attributable to the upper floors only)	-
All other costs ($^{1}/_{10} \times (5{,}000{,}000 – 650{,}000 – 500{,}000)$)	385,000
	$1,035,000

Applying the formula in limb (e) of section EG 2(1) gives a deduction of:

$$37{,}500 \times {}^{1{,}035{,}000}/_{5{,}000{,}000} = \$7{,}762.50$$