

PROPERTY PREVIOUSLY USED OTHERWISE THAN FOR DERIVING INCOME OR CARRYING ON A BUSINESS IN NEW ZEALAND— APPLICATION FOR A SPECIAL DEPRECIATION RATE AND MEANING OF “ESTIMATED USEFUL LIFE”

Summary

Section EG 10 allows the Commissioner to issue special depreciation rates. When determining whether or not to allow a special depreciation rate and the rate (if any) at which such a rate is to be set, section EG 10(2) requires the Commissioner to have regard to the formula set out in section EG 4(3) and the rate of depreciation (if any) adopted by the taxpayer in respect of the property for financial reporting purposes. The formula contained in section EG 4(3) refers to the “estimated useful life” (EUL) of the depreciable property.

When an asset has been used in New Zealand for deriving income or carrying on business ever since it was new, it does not matter that it may have been owned by more than one taxpayer. The EUL of depreciable property is the total period that the property could be useful for deriving income or carrying on a business in New Zealand.

This Interpretation Statement deals with the question of how the definition of “estimated useful life” is applied in setting a special depreciation rate where a taxpayer has depreciable property which was previously used for a purpose other than deriving gross income or carrying on a business in New Zealand. Examples of situations where this will occur are:

- The property was previously used outside New Zealand otherwise than for deriving gross income or carrying on a business in New Zealand (e.g. secondhand imported assets).
- The property was previously used for private purposes in New Zealand and so has not been used in deriving gross income or carrying on a business in New Zealand.

For the purposes of determining the EUL of property, the words “in New Zealand” in the definition of “estimated useful life” mean the property’s EUL in New Zealand conditions (i.e. physical conditions and legal and regulatory conditions). The test applied is the total period for which the asset could be used in New Zealand and not the period for which it is actually used in this country for business or income earning purposes. The EUL of such an asset is not reduced by the period in which it is not used for deriving gross income or carrying on business in New Zealand.

Background

The purpose of section EG 10 is to enable a taxpayer to apply for a rate of depreciation in respect of a particular asset owned by the taxpayer which is different to the general rate which has been established by the Commissioner under section

EG 4 for assets of that type, or to apply for a provisional rate if no general rate applies. A taxpayer may choose to apply for a different rate of depreciation to the general rate if special circumstances apply to the particular asset which mean that the asset depreciates at a different rate to the rate at which assets of that type normally depreciate. In these circumstances the general rate may be inappropriate, and so a special rate can be applied.

Legislation

Section EG 1(1) states:

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 sets out the alternative formulae for calculating the depreciation deduction under section EG 1. One of the components of these formulae is the applicable annual depreciation rate. The applicable annual depreciation rate is determined under sections EG 5 - EG 9, depending on the type of depreciable property in question. In determining the applicable annual depreciation rate under sections EG 5 - EG 9, the property's basic economic depreciation rate is relevant.

Under section EG 4(1), the Commissioner must specify the basic economic depreciation rate for any depreciable property, other than fixed life intangible property or excluded depreciable property, by determination made under section EG 4. Under section EG 4(3), in setting a diminishing value economic rate under section EG 4, the Commissioner shall have regard to the following formula:

$$1 - \left(\frac{\text{residual value}}{\text{cost}} \right)^{\frac{1}{\text{estimated useful life}}}$$

Section EG 4(3) defines "residual value" as the greater of:

- (a) Estimated residual market value; and
- (b) 13.5% of cost.

Section OB 1 defines "estimated residual market value" as meaning, in respect of any depreciable property:

... its market value at the end of its estimated useful life, estimated reasonably as at the date of acquisition and based upon an assumption of normal and reasonable maintenance of that property over its estimated useful life:

Section OB 1 defines "estimated useful life" as meaning, in respect of any depreciable property:

... the period over which such property might reasonably be expected to be useful in deriving gross income or 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:

Section EG 10(1) provides for the setting of special depreciation rates. It states:

The Commissioner may, upon application in writing from a taxpayer in respect of any depreciable property other than fixed life intangible property or excluded depreciable property, allow that taxpayer to apply in respect of that property, for such income year or years as the Commissioner may specify -

- (a) A special base economic depreciation rate higher or lower than that specified in a determination under section EG 4; or
- (b) A provisional basic economic depreciation rate, where no applicable economic rate is specified in a determination under section EG 4.

Section EG 10(2) states:

When determining whether or not to allow a special economic rate or a provisional economic rate under subsection (1), and the rate (if any) at which such a rate is to be set, the Commissioner shall have regard to -

- (a) The formula set out in section EG 4(3); and
- (b) The rate of depreciation (if any) adopted by the taxpayer in respect of the depreciable property for financial reporting purposes.

Application of the Legislation

Section EG 10(2) requires the Commissioner to have regard to both the formula set out in section EG 4(3) and the rate of depreciation adopted by the taxpayer in respect of the depreciable property for financial reporting purposes, when determining whether or not to allow a special depreciation rate and what that rate (if any) should be. In the Commissioner's view the primary focus of this provision is to reconsider the formula and set a depreciation rate having regard to the use of the particular asset. The rate used for financial reporting purposes is included in the legislation so that the Commissioner may compare the impact of relevant factors upon the asset's EUL proposed in the application with the effect assigned to these factors for financial reporting purposes.

The formula in section EG 4(3) is the diminishing value formula that is also used for calculating the general depreciation rates. The variables in this formula are: cost, residual value, and EUL.

A key variable is the "estimated useful life", as defined in section OB 1. Essentially, the definition refers to "the period that property might reasonably be expected to be useful in deriving gross income or carrying on a business in New Zealand". In the context of setting a general depreciation rate under section EG 4, "that property" in the definition of "estimated useful life" is the class of property for which the general rate is being set. In setting a special depreciation rate the focus is on a particular item of property, and "that property" (when the definition of "estimated useful life" is considered in that context) is the particular asset or group of assets for which the special rate is being set.

The question to be answered is how long the property might reasonably be expected to be useful in deriving gross income or carrying on business in New Zealand. This test focuses on the use of the asset, not the use of the asset by a particular taxpayer. If an asset has been used in New Zealand since new in deriving income or carrying on a

business it does not matter that it has been owned by more than one taxpayer. The EUL test is a test of how long the asset could have been expected to be useful in New Zealand.

However, the question arises as to the situation where an asset that has not previously been used for deriving gross income or carrying on business in New Zealand is subsequently used by a taxpayer for those purposes. This Interpretation Statement deals with how the definition of “estimated useful life” is applied in setting a special depreciation rate for property in that context.

There are two possible approaches as to how the definition of “estimated useful life” applies when a taxpayer applies for a special depreciation rate in respect of property which was previously not used for deriving gross income or carrying on a business in New Zealand.

A. The Total Life approach

The first is that the definition of "estimated useful life" focuses on the potential usefulness of the asset to any business in New Zealand and only takes into account the effect of factors that cause the asset to depreciate as set out in the definition of that term (i.e. wear and tear, the passage of time, exhaustion, and obsolescence). When determining the EUL of a particular asset using this approach it is irrelevant that the asset has previously been used for purposes other than deriving gross income or carrying on a business in New Zealand. This means that the EUL of a particular asset is *not reduced* by the time the asset was not used in producing gross income or carrying on a business in New Zealand. The EUL of the asset applied in setting a special depreciation rate for the asset is **the total life** of that asset, **not the remaining life** to that taxpayer.

B. The Remaining Life approach

The second approach determines the EUL by assessing the period a particular asset will actually be used to produce income or carry on a business in New Zealand. When determining the EUL, this approach takes into account the factors that may cause the asset to depreciate as set out in the definition of that term, and also takes into account the period that the asset is used for purposes other than deriving gross income or carrying on a business for the purposes of deriving gross income in New Zealand. This means that the EUL of the particular asset *is reduced* by the time that the asset is not used in producing gross income or carrying on a business in New Zealand.

The wording of the definition of “estimated useful life” is capable of supporting both the first and second approaches. The first approach interprets the words “the period over which such property *might reasonably be expected to be useful* in deriving gross income or carrying on a business *in New Zealand*” broadly, as meaning the period over which there is a possibility that the asset theoretically *could* be useful for producing income or for a business in New Zealand. Under this interpretation the EUL of an asset will generally begin at the start of the asset’s actual life, and it does not matter whether the asset actually is used for deriving income or carrying on a

business in New Zealand for all of the asset's actual life. This is because the asset could potentially be useful for these purposes in New Zealand for all of its actual life.

The second approach interprets the words "might reasonably be expected to be useful" narrowly, as meaning the period an asset *is used or is physically available for use* for deriving income or carrying on a business in New Zealand. Under this interpretation the EUL is taken from the time that the asset is first used for these purposes in New Zealand, and does not include any time that it is used for other purposes (e.g. private use in New Zealand, or for producing income or carrying on a business overseas).

While it is acknowledged that the legislative wording could be more certain, the Commissioner's view is that the first approach – the Total Life approach - is correct. When a taxpayer applies for a special depreciation rate, the EUL for the particular asset will only be reduced by "such factors as likely wear and tear, the passage of time, exhaustion, and obsolescence and based on the assumption of normal and reasonable maintenance". The fact that the asset was previously used for a purpose other than deriving income or carrying on a business in New Zealand will not reduce its EUL.

Reasons for adopting this interpretation

There are a number of reasons for adopting this interpretation of "estimated useful life".

- As previously noted, in relation to secondhand assets generally, the definition of "estimated useful life" is specific to assets or classes of assets, rather than being taxpayer specific. It focuses on the EUL of an asset, or asset class, and does not relate to a particular taxpayer. It is the total potential life of the particular asset to the New Zealand economy that is important, and not the life to a particular taxpayer. The Total Life approach is consistent with the EUL being specific to the life of an asset or class of assets. The Remaining Life approach is not, and focuses on the life of an asset to a particular taxpayer.
- The definition of "estimated useful life" does not require the EUL to be measured at the time the asset is acquired by the owner. This can be compared to the definition of "estimated residual market value", which requires the estimated residual market value of property to be measured as at the date of acquisition. The absence of such wording in the definition of "estimated useful life" confirms that that definition refers to the total life of the particular asset, and not to the asset's remaining useful life.
- The Remaining Life approach adopts what is, in effect, a "remaining estimated useful life" test. However, the definition of "estimated useful life" makes no reference to "remaining" life. This can be compared to the definition of "fixed life intangible property" in the depreciation regime which contains the phrase "the property's remaining estimated useful life". This strongly suggest that the definition of "estimated useful life" refers to property's *total* estimated useful life.

If this were not the case, the word “remaining” would not have been necessary before the reference to EUL in the definition of “fixed life intangible property”.

- The purpose behind allowing taxpayers to apply for and be issued with special depreciation rates was to enable taxpayers to apply more accurate rates in respect of certain property. The special rates were to be allowed where specific or unusual conditions affected the property in question. There is no indication in the legislation that the term “estimated useful life” should have one meaning for setting general rates (i.e. total life) and another for setting special rates (i.e. remaining life). If Parliament intended this, it would have expressly provided for it.
- Under the Remaining Life approach to the application of the term “estimated useful life”, the term only applies to the period that an asset will actually be used in deriving gross income or carrying on a business in New Zealand. If the overseas or private use part of a particular asset’s life can be disregarded in determining the asset’s EUL, there will be different estimated useful lives within a class of assets for those assets which have been overseas or in private use and those which have not. Further, assets which have been overseas or in private use for different lengths of time will also have different estimated lives.

This can be demonstrated by the following example. An asset with a total expected useful life of 20 years is held overseas for 10 years by a non-New Zealand resident taxpayer, and is then sold to a New Zealand resident taxpayer. Under the second approach, the EUL of the asset is reduced by the time that the asset spends in non-New Zealand income producing or business use. The New Zealand taxpayer could apply to the Commissioner for a special depreciation rate based on the asset’s remaining useful life of 10 years. Varying the example, if the asset is instead held by the overseas taxpayer for 15 years, the Commissioner could grant the New Zealand taxpayer a special depreciation rate based on the asset’s remaining 5 years of EUL to the New Zealand taxpayer. This would result in assets of the same class ending up with widely varying depreciation rates, depending on the remaining number of useful years to the owner (in the example, the EUL of the asset would be either 20 years, 10 years, or 5 years, depending on when it was purchased by a New Zealand taxpayer). The Commissioner does not consider that the depreciation regime was intended to operate in this way.

- The basic economic depreciation rate for any class of depreciable assets is based on a formula in which one of the components is the EUL of assets in that class. If assets which belong to a particular class have different estimated useful lives depending on whether and how long they have spent overseas or in private use, it will be impossible to set a general basic economic depreciation rate for that class of assets. This is plainly not what was intended. Instead, assets of a particular type should generally all have the same EUL (regardless of time spent outside New Zealand or in private use) and have the same applicable economic depreciation rate, unless special circumstances apply to a particular asset.
- Another implication of the Remaining Life approach is that it would result in more favourable depreciation rates applying to imported secondhand assets than

would apply to New Zealand secondhand assets (other than those which had been in private use). This would occur because an imported asset's total useful life would be reduced by the time that it was not used in deriving income or carrying on a business in New Zealand, while a New Zealand asset's EUL would be the total useful life of that asset. This would appear to provide an unintended incentive for taxpayers to import secondhand assets, rather than purchase the equivalent secondhand New Zealand asset. Such an incentive is contrary to the proposition that the tax system should have a neutral effect on business investment decisions unless the legislation is clearly intended to be concessionary or provide an incentive.

- The Total Life approach is also consistent with the final recommendation of the Consultative Committee on the Taxation of Income from Capital (“the Valabh Committee”). The final recommendations of the Valabh Committee on depreciation were contained in their letter to Government of 14 November 1991. This letter refers to the definition of “estimated useful life” and states:

The definition reflects our view that the useful life on 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 the taxpayer.

The Valabh Committee stated that the “estimated useful life” of an asset for depreciation purposes is the life for which it *is or will be useful*. The definition of “estimated useful life” reflects this by saying “might be expected to be useful”. The Valabh Committee did not contemplate that the definition would only apply to the period during which the asset was actually being used in New Zealand.

Conclusion

The EUL of property is the total period that the property theoretically could be used for deriving gross income or carrying on a business in New Zealand. Generally, this period begins when the asset is new (there may be exceptional cases where the estimated useful life of an asset does not begin when the asset is new, e.g. where it would not make commercial sense for any New Zealand business to purchase a particular type of asset new, but the purchase of the same asset secondhand at a later stage when the cost is lower is a sensible investment decision). What is relevant in determining the end of the EUL is whether any New Zealand business would choose to retain the asset for use in deriving gross income or carrying on that business.

Examples

Example 1

Company A imports a secondhand machine into New Zealand. The machine is 15 years' old, and is expected to be useful in New Zealand for a further 4 years. It will then cease to comply with New Zealand safety standards, and so will be scrapped or sold offshore. No unusual factors will cause it to deteriorate faster than normal.

Taking the Total Life approach, the EUL of the machine is 19 years - being the total number of years that the machine could potentially be expected to be useful for deriving income or carrying on a business in New Zealand. The machine could potentially have been used for deriving income or carrying on a business in New Zealand during its entire life, even though it was actually outside New Zealand for its first 15 years.

Taking the Remaining Life approach, the EUL of the machine is 4 years - being the number of years the machine will actually be used for deriving income or carrying on a business in New Zealand.

The first approach is correct. The machine has an EUL of 19 years.

Example 2

Company B purchases a secondhand asset in New Zealand. The asset was previously used privately for 5 years, and will be used by Company B for another 3 years before it is scrapped. The asset would normally last for another 5 years, but the way that the company uses it will cause it to deteriorate within 3 years of acquisition.

The EUL of the asset is 8 years. This includes the 5 years that the asset was used privately as it might reasonably have been expected to be useful in a business in New Zealand during this period. The 8-year EUL also takes into account the abnormal use by Company B of the asset which causes it to lose value faster than normal (normally that type of asset would have an EUL of 10 years).

Example 3

Taxpayer A acquires a new depreciable asset for \$500,000. The asset has a 20-year EUL, and is expected to have a nil estimated residual market value. The asset's basic economic depreciation rate, using the diminishing value method, is 9.5%, calculated as follows:

$$1 - \frac{(13.5\% \text{ of cost})}{\text{cost}} \times \frac{1}{\text{estimated useful life}} = 1 - \left(\frac{67,500}{500,000} \right) \frac{1}{20} = 9.5\%$$

If Taxpayer A retains the asset for 10 years, the asset's adjusted tax value at that time will be \$203,163. The depreciation deduction available in that year will be \$19,300. The depreciation deductions for the 11th, 12th, and 13th years of ownership are as follows:

	Adjusted tax value	Depreciation deduction
Year 11	\$ 183,863	\$ 17,467
Year 12	\$ 166,396	\$ 15,808

Year 13	\$ 150,588	\$ 14,305
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Taxpayer B acquires an asset which belongs to the same class as the asset owned by Taxpayer A. The asset is 10 years old and has not been used for the purposes of deriving income or carrying on a business in New Zealand during that time. Taxpayer B purchases the asset for \$200,000.

There is no difference between the asset purchased by Taxpayer B and other assets of the same class in terms of the industry or the physical environment in which the asset has operated or will operate, or in terms of the way or amount the asset has been or will be used.

The formula for calculating the depreciation deduction in respect of Taxpayer B's asset is set out in section EG 2 of the Act and is:

$$a \times b \times \frac{c}{12}$$

where -

- a is the annual depreciation rate applicable to the property and the depreciation method;
- b is the adjusted tax value of the property at the end of the income year before the depreciation deduction is taken; and
- c is the number of whole or part calendar months in the income year that the property is owned by the taxpayer.

The formula will give rise to different results depending on which of the two approaches discussed in this statement is applied. Under the Total Life approach, the annual depreciation rate is the basic economic depreciation rate for that type of asset (in this case 9.5%). Under the Remaining Life approach, Taxpayer B can be issued with a special depreciation rate based on the remaining EUL of the property. A special depreciation rate based on the remaining EUL (10 years) of the property would be:

$$1 - \left(\frac{13.5\% \text{ of cost}}{\text{cost}} \right) \frac{1}{\text{remaining estimated useful life}} = 1 - \left(\left(\frac{27,000}{200,000} \right) \frac{1}{10} \right) = 18 \%$$

Using the special depreciation rate of 18% (and assuming the asset is owned for the entire income year), the depreciation deduction for the 10-year old asset in its first year of ownership by Taxpayer B will be:

$$\begin{aligned} & \text{special depreciation rate} \times \text{adjusted tax value of asset (in this case the cost price)} \\ & = 18\% \times 200,000 = \$ 36,000. \end{aligned}$$

Using this special depreciation rate, the depreciation deductions in the asset's 11th, 12th, and 13th years (Taxpayer B's 2nd, 3rd, and 4th years of ownership) will be:

	Adjusted tax value	Depreciation deduction
Year 10	\$ 200,000	\$ 36,000
Year 11	\$ 164,000	\$ 29,520
Year 12	\$ 134,480	\$ 24,206
Year 13	\$ 110,274	\$ 19,849

Comparing the depreciation of Taxpayer A and Taxpayer B's identical assets, it can be seen that if the depreciation rate is based on the *remaining* EUL of the asset (i.e. where approach 2 is used), the asset depreciates at a much faster rate than it normally would.

If, instead, the EUL of the secondhand asset is the *total* EUL of that asset, so the depreciation rate of the asset is not adjusted, the depreciation deduction for the 10-year old asset in its first year of ownership by Taxpayer B will be:

annual depreciation rate \times adjusted tax value of asset (in this case the cost price)

$$= 9.5\% \times 200,000 = \$ 19,000.$$

Using the standard 9.5% depreciation rate, the depreciation deductions in the asset's 11th, 12th, and 13th years (Taxpayer B's 2nd, 3rd, and 4th years of ownership) will be:

	Adjusted tax value	Depreciation deduction
Year 10	\$ 200,000	\$ 19,000
Year 11	\$ 181,000	\$ 17,195
Year 12	\$ 163,805	\$ 15,561
Year 13	\$ 148,244	\$ 14,083

It is clear that the depreciation deductions which result from using the basic economic depreciation rate are very similar to those which would apply had Taxpayer B owned the asset for its entire life. Given that there are no special circumstances affecting the asset to make it depreciate at a faster rate than other assets of the same class, there does not appear to be any reason for Taxpayer B to apply a higher depreciation rate, calculated using the *remaining* EUL of the asset, than the basic economic depreciation rate pertaining to the asset.