

QB 13/01: DEPRECIATION OF COMMERCIAL FIT-OUT

Question

Following changes in the depreciation rules for buildings, the Commissioner has been asked whether a taxpayer can re-characterise a part of a commercial building into components of commercial fit-out in order to claim depreciation on those items when those items had not been identified as separate depreciable property at the time the taxpayer acquired the property.

Answer

The Commissioner considers that in circumstances where taxpayers have depreciated items of commercial fit-out that were acquired with a building, as part of that building, section DB 65 of the **Income Tax Act 2007** ("the Act") sets out the way these items of commercial fit-out may continue to be depreciated. Because of this it is not possible to re-characterise part of a commercial building into components of commercial fit-out.

In circumstances where taxpayers have at all times depreciated items of commercial fit-out that was acquired with a building separately from the building, these items of commercial fit-out may continue to be depreciated using the most appropriate rate for the items. Where these separately identified items of commercial fit-out have historically not been depreciated using the depreciation rate most appropriate to that item, the Commissioner will consider amending the appropriate assessments, using the criteria set out in SPS 07/03 *Requests to amend assessments*.

Explanation

Background

With effect from the 2011/12 income year the depreciation rate for buildings with an estimated useful life of 50 years or more has been set at 0%. The 0% rate applies to all **buildings regardless of when they were acquired. The definition of "building" was amended and a definition of "commercial fit-out" was introduced to clarify that commercial fit-out would continue to be depreciable.**

In the past some commercial building owners had not been depreciating the building fit-out components separately from the building. That is, the building and the fit-out has been identified as a single asset at the time of acquisition and depreciation deductions have been claimed based on the total cost of the building, without any fit-out costs being separately identified. For these taxpayers, because the depreciation rate for buildings is reduced to 0%, this rate would also apply to any fit-out that has been treated as part of the building.

Inland Revenue has recently received enquiries from taxpayers seeking to retrospectively re-characterise a part of the building into various items of commercial fit-out in order to claim depreciation deductions on those items. Any retrospective re-characterisation and depreciation of fit-out would require the Commissioner to exercise her **discretion under section 113 of the Tax Administration Act 1994** ("section 113") to adjust the depreciation deductions in previous assessments.

Section DB 65 of the Income Tax Act 2007 to be applied in these circumstances

In order to claim a depreciation deduction on an item of depreciable property, a taxpayer is required to identify what the depreciable property is. In their issues paper *Post-budget depreciation issues of December 2010* ("the issues paper"), officials noted that, for a commercial building, a taxpayer may have chosen to identify and depreciate the building as one single item of depreciable property and that this was likely to have occurred where taxpayers had sought to minimise tax compliance costs. Alternatively, they may have identified items of fit-out and depreciated those items separately from the cost of the building.

To acknowledge that some taxpayers may not have separately identified items of commercial fit-out, **section DB 65 of the Income Tax Act 2007** ("section DB 65") was enacted as a transitional rule so that these taxpayers can depreciate commercial fit-out, despite not having done so separately in the past.

Section DB 65 sets specific limits for dealing with "commercial fit-out", which is a widely defined term extending to any non-structural item "attached to a building". The issues paper acknowledges that where an item of commercial fit-out has been acquired at the same time as the building and has always been depreciated as part of the commercial building, there may have been other ways in which taxpayers could separate out commercial fit-out from the cost of the building. However, the issues paper makes it clear that instead of allowing this to be done section DB 65 sets out the only way in which these items may now continue to be depreciated.

Section DB 65 allows a taxpayer to depreciate a portion of the **building's tax book value** as a pool of fit-out. This new deduction provision permits an annual deduction based on a one-off adjustment calculation that is available from the 2011/12 income year.

To qualify for the section DB 65 allowance, the taxpayer must:

- Own a commercial building that has a depreciation rate of 0% (i.e. the building has an EUL of 50 years or more);
- The building was acquired in the 2010/11 or earlier income year;
- The building had been depreciated in the 2010/11 income year and the building has not been disposed of since; and
- The commercial fit-out had not been separately depreciated if the fit-out was acquired at the same time as the building.

The "starting pool" is 15% of the building's adjusted tax value as at the end of the 2010/11 income year. This starting pool is reduced by the adjusted tax value of all items of commercial fit-out that had been separately depreciated (i.e. the items of commercial fit-out that were acquired after the building was acquired, or items of commercial fit-out acquired as part of the building where the taxpayer has chosen to **treat these as separate items of depreciable property**). The "starting pool" is depreciated at a rate of 2% in the 2011/12 and later income years.

No loss or recovery rules apply to the value of the pool when the building or fit-out is disposed of.

A practical example of how section DB 65 is applied was provided in a Tax Information Bulletin (TIB) item, *Clarifying that certain building fit-out is depreciable property*, published in TIB Vol 23, No 1 (Feb 2011). The example is reproduced here:

Company ABC acquired a warehouse on 1 April 1999 for \$1 million. Items of commercial fit-out within the building were not separately identified and depreciated at the time the

building was acquired. Twelve months later a refurbishment of the warehouse was completed. The refurbishment was itemised and depreciation was applied to the various items of commercial fit-out.

At the end of the 2010-11 income year the adjusted tax book value of the warehouse is \$640,000 and the adjusted tax book value of the associated commercial fit-out is \$64,000.

The starting pool value is:

- $(15\% \times 640,000) - 64,000 = \$32,000$

The annual deduction, assuming that the building is held for the 2011-12 income year is:

- $\$32,000 \times 2\% \times 12/12 = \640

Treatment of separately depreciated commercial fit-out

As stated previously, the owner of a commercial building can identify items of fit-out and depreciate those items separately from the cost of the building. In this circumstance commercial building owners have the option of depreciating various items of building fit-out under the asset category “**Building fit-out (When in books separately from building cost)**” in the Commissioner’s Table of Depreciation Rates. This asset category lists the rates and the items in a building that are commonly found in a commercial building.

Section DB 65 does not apply in circumstances where commercial fit-out has always been depreciated separately from the building and taxpayers are therefore able to continue to depreciate building fit-out separately using the most appropriate depreciation rate for that fit-out. Where a taxpayer has previously used an incorrect depreciation rate or asset class to depreciate commercial fit-out that taxpayer is able to request that the Commissioner’s discretion under section 113 be exercised to issue an amended assessment that corrects the error.

In exercising this discretion, the Commissioner will follow the criteria set out in SPS 07/03 *Requests to amend assessments*. This states that the Commissioner’s discretion will only be exercised to correct genuine errors. With respect to the depreciation of separately identified commercial fit-out, the Commissioner accepts that a genuine error will have occurred when a taxpayer has not used the most appropriate depreciation rate or asset class for that fit-out.

By contrast, if taxpayers choose to take particular tax positions under tax laws where legitimate alternatives had been available and later regret that choice, no error has occurred and the Commissioner’s discretion will not be exercised.

Voluntary disclosure

Taxpayers who have filed a tax return that incorrectly re-characterises a commercial building into components of commercial fit-out, after the building has been depreciated as one single asset previously, should make a voluntary disclosure to the Commissioner and new assessments will be issued.