

QUESTION WE'VE BEEN ASKED QB 14/04

INCOME TAX – DEPRECIATION ROLL-OVER RELIEF FOR CANTERBURY

All legislative references are to the Income Tax Act 2007 unless otherwise stated.

This Question We've Been Asked is about s EZ 23B.

Question

1. How does the formula in s EZ 23B(4) allocate the excess recovery amount when an item of affected property is replaced with one or more items of replacement property?

Answer

2. The formula determines how much of the excess recovery amount is to be allocated against the cost of a particular replacement item. It does this with reference to the accumulated cost of **other** items of replacement property acquired before the particular replacement item (s EZ 23B(4) and (5)). This means that where only one replacement item is acquired, the cost of other items of replacement property acquired before the particular replacement item is zero.
3. Since the focus of this Question We've Been Asked is on the application and effect of the formula, it supplements the comprehensive analysis of s EZ 23B in "Canterbury earthquake relief measures" *Tax Information Bulletin* Vol 23, No 8 (October 2011) at 66–68.
4. The formula in s EZ 23B(4) applies to affected property not depreciated in a pool. Therefore, the scope of this Question We've Been Asked is limited to those classes of affected property not depreciated in a pool.

Explanation

5. Section EZ 23B provides roll-over relief in respect of depreciation recovery income for taxpayers affected by the Canterbury earthquakes. It applies when a person receives insurance or compensation that gives rise to depreciation recovery income for items of depreciable property (called the affected property) lost or irreparably damaged in the Canterbury earthquakes (s EZ 23B(1)). Provided certain conditions are met, the amount that would be depreciation recovery income is available to be allocated against the cost of replacement items (s EZ 23B(2) and (3)). Any amount of depreciation recovery income not allocated to replacement items by the end of the 2018–19 income year at the latest is taxable as depreciation recovery income (ss EZ 23B(2B) and EZ 23B(8)).
6. This Question We've Been Asked clarifies the effect of the formula in s EZ 23B(4). The formula calculates the amount of the depreciation recovery income that can be allocated against the cost of the replacement property. There has been some confusion about how the formula works. The confusion appears to arise because one of the items in the formula uses the expenditure incurred in acquiring **other** items of replacement property instead of using the expenditure in acquiring the particular item of replacement property. This is necessary to ensure that the depreciation recovery income is not over-allocated to the particular replacement item.
7. The purpose of the depreciation roll-over relief provisions (s EZ 23B) is to provide affected taxpayers with options in relation to the potential tax liability on the

depreciation recovery income arising from the insurance or compensation received. In addition to the option of simply returning the depreciation recovery income, taxpayers can elect to use the depreciation roll-over relief provisions. This election gives taxpayers the further option to defer or “suspend” the recognition of the depreciation recovery income to a later income year (with the latest income year being the 2018–19 income year) or to suspend and “roll-over” the depreciation recovery income into the cost of the replacement item.

8. The formula progressively allocates the depreciation recovery amount to each item of replacement property as it is acquired (ie, on a “first-in-first-served” basis) until the total cost of the replacement item or items equals or is more than the cost of the affected class (s EZ 23B(4)). It works in the same way where multiple replacement items are acquired at the same time, because the items are treated as having been acquired in the order chosen by the person (s EZ 23B(11C)).
9. The effect of the formula is to roll-over into the cost of the replacement item or items all of the depreciation recovery arising from insurance or compensation received if the total cost of the replacement item or items equals or is more than the cost of the affected class (s EZ 23B(4)).
10. If, on the other hand, the total cost of all replacement items is less than the cost of the affected class, only a proportion of the depreciation recovery amount can be rolled-over into the cost of the replacement items. The balance of the depreciation recovered is recognised as income at or before the end of the 2018–19 income year (s EZ 23B(2B) and EZ 23B(8)).
11. Any amount rolled-over to a replacement item reduces the adjusted tax value of the replacement item (s EZ 23B(3)(a) and EZ 23B(11)). This means that when the replacement item is eventually sold, the amount that was rolled-over to the replacement item will be fully taxable as depreciation recovery income provided the replacement item is sold for more than its adjusted tax value. The tax liability associated with disposal of the affected property has effectively been rolled forward until disposal of the replacement property.
12. If the affected property is not actually replaced, then any depreciation recovery income arising from the insurance or compensation received is brought into account as income in the earlier of:
 - the 2018–19 income year (s EZ 23B(8)(a));
 - the income year in which the person decides not to purchase more replacement property (s EZ 23B(8)(b)); or
 - the income year in which the person goes into liquidation or bankruptcy (s EZ 23B(8)(c)).

How the formula works

13. The formula applies to the following groups or classes of affected property:
 - a building or grandparented structure (not depreciated in a pool) (s EZ 23B(10)(b)(i));
 - commercial fit-out (not depreciated in a pool) (s EZ 23B(10)(b)(ii));
 - other depreciable property (not depreciated in a pool) (s EZ 23B(10)(b)(iv)).
14. The following steps must be taken for each of these affected classes of depreciable property:

Step 1: Calculate the depreciation recovery income (called the excess recovery).

Step 2: Calculate, using the formula, the amount (called the reduction amount for the purposes of this Question We've Been Asked) to be used for both:

- allocating against the cost of the replacement item; and
- reducing the amount of suspended recovery income.

Step 3: Reduce the adjusted tax value of the replacement item by the reduction amount.

Step 4: Reduce the suspended recovery income by the reduction amount.

Repeat steps 2–4, if more than one replacement item is purchased.

Step 5: Return any unallocated suspended recovery income as depreciation recovery income.

Examples demonstrating how the formula works

15. The following three examples demonstrate how the formula works using the steps set out above. Examples 1 and 2 apply the formula to different scenarios where only one replacement item is acquired. Example 3 applies the formula to the situation where multiple replacement items are acquired.

Example 1: Acquisition of a replacement building costing more than the destroyed building

16. Tom receives insurance proceeds of \$10 million for a building destroyed in a Canterbury earthquake. The original cost of the building was \$10 million and its adjusted tax value was \$9 million. Tom plans to acquire a replacement building costing \$12 million.
17. Because the cost of the replacement building is equal to or greater than the cost of the affected property, the whole excess recovery amount should be available to be rolled-over against the cost of the replacement building.

Step 1: Calculate the excess recovery

18. The insurance proceeds exceed the building's adjusted tax value by \$1 million. Therefore, Tom has an excess recovery of \$1 million.

Step 2: Calculate the reduction amount

19. Tom now has to calculate the reduction amount by applying the following formula:

$$\frac{\text{limited replacement cost} \times \text{excess}}{\text{affected cost}}$$

20. The limited replacement cost is the lesser of:
- (i) the amount by which the cost of the affected class (in this example, the destroyed building) exceeds the total expenditure in acquiring other replacement property before the replacement item; or
 - (ii) the amount spent on the replacement item.
21. The affected cost is the total cost of the destroyed building.

22. No other replacement property has been acquired before the \$12 million replacement building. Therefore, the amount under (i) above is:
- $$\$10 \text{ million} - \$0 = \$10 \text{ million}$$
23. The amount spent on the replacement building under (ii) above is \$12 million.
24. As the limited replacement cost is the lesser of these two amounts, the "limited replacement cost" is \$10 million. The reduction amount can now be calculated using the following amounts in the above formula:

$$\frac{\$10 \text{ million} \times \$1 \text{ million}}{\$10 \text{ million}} = \$1 \text{ million}$$

Step 3: Reduce the adjusted tax value of the replacement item by the reduction amount

25. The reduction amount of \$1 million is now available to roll-over into the adjusted tax value of the replacement building as follows:

$$\$12 \text{ million (cost of replacement property)} - \$1 \text{ million (the reduction amount)} = \$11 \text{ million (adjusted tax value)}$$

Step 4: Reduce the excess recovery by the reduction amount

26. The reduction amount of \$1 million is now also available to reduce the excess recovery:

$$\$1 \text{ million (excess recovery)} - \$1 \text{ million (the reduction amount)} = \$0$$

27. Any amount remaining after reducing the excess recovery now becomes the suspended recovery income.

Step 5: Return any unallocated suspended recovery income as depreciation recovery income

28. Since the excess recovery has been reduced to zero, Tom has no liability to return any unallocated suspended recovery income.

Summary of example 1

29. In this example, the depreciation roll-over relief provisions act to:
- (a) fully allocate the depreciation recovery income of \$1 million against the cost of the first and, in this example, the only replacement building, because its cost is greater than the cost of the destroyed building;
 - (b) reduce the adjusted tax value of the replacement building to \$11 million;
 - (c) defer the recognition of depreciation recovery income of \$1 million until the subsequent sale of the replacement building (assuming the building is sold for more than its adjusted tax value).

Example 2: Acquisition of a replacement building costing less than the destroyed building

30. Kiwico Ltd receives insurance proceeds of \$20 million for a building destroyed in a Canterbury earthquake. The original cost of the building was \$20 million and its adjusted tax value was \$18 million. Kiwico Ltd plans to acquire a replacement building costing \$15 million.

31. Because the cost of the replacement building is less than the cost of the affected property, only some of the excess recovery amount can be allocated against the cost of the replacement building.

Step 1: Calculate the excess recovery

32. The insurance proceeds exceed the building's adjusted tax value by \$2 million. Therefore, Kiwico Ltd has an excess recovery of \$2 million.

Step 2: Calculate the reduction amount

33. Kiwico Ltd now has to calculate the reduction amount by applying the following formula:

$$\frac{\text{limited replacement cost} \times \text{excess}}{\text{affected cost}}$$

34. The limited replacement cost is the lesser of:
- (i) the amount by which the cost of the affected class (in this example, the destroyed building) exceeds the total expenditure in acquiring other replacement property before the replacement item; or
 - (ii) the amount spent on the replacement item.

35. The affected cost is the total cost of the destroyed building.

36. No other replacement property has been acquired before the \$15 million replacement building. Therefore, the amount under (i) above is:

$$\$20 \text{ million} - \$0 = \$20 \text{ million}$$

37. The amount spent on the replacement building under (ii) above is \$15 million.

38. As the limited replacement cost is the lesser of these two amounts, the "limited replacement cost" is \$15 million. The reduction amount can now be calculated using the following amounts in the above formula:

$$\frac{\$15 \text{ million} \times \$2 \text{ million}}{\$20 \text{ million}} = \$1.5 \text{ million}$$

Step 3: Reduce the adjusted tax value of the replacement item by the reduction amount

39. The reduction amount of \$1.5 million is now available to roll-over into the cost of the replacement building:

$$\$15 \text{ million (cost of replacement property)} - \$1.5 \text{ million (the reduction amount)} = \$13.5 \text{ million (adjusted tax value)}$$

Step 4: Reduce the excess recovery by the reduction amount

40. The reduction amount of \$1.5 million is now also available to reduce the excess recovery:

$$\$2 \text{ million (excess recovery)} - \$1.5 \text{ million (the reduction amount)} = \$500,000$$

41. The suspended recovery income is now the reduced amount of \$500,000.

Step 5: Return any unallocated suspended recovery income as depreciation recovery income

42. The unallocated suspended recovery income of \$500,000 must be returned as depreciation recovery income in the income year in which Kiwico Ltd decides not to acquire any more replacement property in this class, goes into liquidation, or at the end of the 2018–19 income year (whichever comes first).

Summary of example 2

43. In this example, the depreciation roll-over relief provisions act to:
- (a) roll-over \$1.5 million of the depreciation recovery income of \$2 million into the cost of the replacement building;
 - (b) reduce the adjusted tax value of the replacement building to \$13.5 million;
 - (c) defer the recognition of the suspended recovery income of \$500,000 to the income year in which Kiwico Ltd decides not to acquire any more replacement property in this class, goes into liquidation, or the end of the 2018–19 income year (whichever comes first);
 - (d) defer the recognition of the depreciation recovery income of \$1.5 million until the subsequent sale of the replacement building (assuming the building is sold for more than its adjusted tax value).

Example 3: Multiple replacement items

44. The following example demonstrates how the formula works where more than one item of replacement property is acquired.
45. Linda receives insurance proceeds of \$1 million for plant and equipment (not previously depreciated under the pool method) destroyed in a Canterbury earthquake. The original cost of the plant and equipment was \$1 million and its adjusted tax value was \$700,000. Linda is not required to replace items of affected property “like for like” as long as the affected property is not a building or grandparented structure, or commercial-fit-out. She acquires the following replacement items:
- Year 1: plant and equipment costing \$400,000;
 - Year 2: an overhead crane costing \$400,000;
 - Year 3: a digger costing \$400,000;
 - Year 4: plant and equipment costing \$10,000.

Step 1: Calculate the excess recovery

46. The insurance proceeds exceed the adjusted tax value of the plant and equipment by \$300,000. Therefore, Linda has an excess recovery of \$300,000.

Year 1 – Step 2: Calculate the reduction amount

47. Linda now has to calculate the reduction amount for year 1 by applying the following formula:

$$\frac{\text{limited replacement cost} \times \text{excess}}{\text{affected cost}}$$

48. The limited replacement cost is the lesser of:

- (i) the amount by which the cost of the affected class (in this example, the destroyed plant and equipment) exceeds the total expenditure in acquiring other replacement property before the replacement item; or
 - (ii) the amount spent on the replacement item.
49. The affected cost is the total cost of the destroyed plant and equipment.
50. No other replacement property has been acquired before the first replacement item of plant and equipment of \$400,000. Therefore, the amount under (i) above is:

$$\$1 \text{ million} - \$0 = \$1 \text{ million}$$

51. The amount spent on the replacement plant and equipment under (ii) above is \$400,000.
52. This means the "limited replacement cost" is \$400,000. The reduction amount for year 1 can now be calculated using the following amounts in the above formula:

$$\frac{\$400,000 \times \$300,000}{\$1 \text{ million}} = \$120,000$$

Year 1 – Step 3: Reduce the adjusted tax value of the replacement item by the reduction amount

53. The reduction amount of \$120,000 is now available to roll-over into the adjusted tax value of the replacement plant and equipment:

$$\begin{aligned} & \$400,000 \text{ (cost of replacement property)} - \$120,000 \text{ (the reduction amount)} \\ & = \$280,000 \text{ (adjusted tax value)} \end{aligned}$$

Year 1 – Step 4: Reduce the excess recovery by the reduction amount

54. The reduction amount of \$120,000 is now also available to reduce the excess recovery:

$$\$300,000 \text{ (excess recovery)} - \$120,000 \text{ (the reduction amount)} = \$180,000$$

55. The suspended recovery income is now the reduced amount of \$180,000.

Year 2 – Step 2: Calculate the reduction amount

56. For year 2, Linda applies the formula as follows.
57. Total expenditure in acquiring other replacement property before the second replacement item is \$400,000 (being the cost of the first replacement item of plant and equipment). Therefore, the amount under (i) above is:

$$\$1 \text{ million} - \$400,000 = \$600,000$$

58. The amount spent on the replacement overhead crane in year 2 under (ii) above is \$400,000.

59. This means the "limited replacement cost" is \$400,000 (the lesser of \$600,000 calculated under (i) and \$400,000 calculated under (ii)). The reduction amount for year 2 can now be calculated using the formula:

$$\frac{\$400,000 \times \$300,000}{\$1 \text{ million}} = \$120,000$$

Year 2 – Step 3: Reduce the adjusted tax value of the replacement item by the reduction amount

60. The reduction amount of \$120,000 is now available to roll-over into the adjusted tax value of the replacement overhead crane:

$$\begin{aligned} & \$400,000 \text{ (cost of replacement property)} - \$120,000 \text{ (the reduction amount)} \\ & = \$280,000 \text{ (adjusted tax value)} \end{aligned}$$

Year 2 – Step 4: Reduce the suspended recovery income by the reduction amount

61. The reduction amount of \$120,000 is now also available to reduce the suspended recovery income:

$$\begin{aligned} & \$180,000 \text{ (suspended recovery income as reduced in year 1)} - \$120,000 \text{ (the} \\ & \text{reduction amount)} = \$60,000 \end{aligned}$$

62. The suspended recovery income is now reduced further to \$60,000.

Year 3 – Step 2: Calculate the reduction amount

63. For year 3, Linda applies the formula as follows.

64. Total expenditure in acquiring other replacement property before the third replacement item is \$800,000 (\$400,000 for each of the plant and equipment and the overhead crane). Therefore, the amount under (i) above is:

$$\begin{aligned} & \$1 \text{ million} - \$800,000 = \$200,000 \end{aligned}$$

65. The amount spent on the replacement digger in year 3 under (ii) above is \$400,000.

66. This means the “limited replacement cost” is \$200,000 (the lesser of \$200,000 calculated under (i) and \$400,000 calculated under (ii)). The reduction amount for year 3 can now be calculated using the formula:

$$\begin{aligned} & \frac{\$200,000 \times \$300,000}{\$1 \text{ million}} = \$60,000 \end{aligned}$$

Year 3 – Step 3: Reduce the adjusted tax value of the replacement item by the reduction amount

67. The reduction amount of \$60,000 is now available to roll-over into the adjusted tax value of the replacement digger:

$$\begin{aligned} & \$400,000 \text{ (cost of replacement property)} - \$60,000 = \$340,000 \text{ adjusted tax} \\ & \text{value} \end{aligned}$$

Year 3 – Step 4: Reduce the suspended recovery income by the reduction amount

68. The reduction amount of \$60,000 is now also available to reduce the suspended recovery income:

$$\begin{aligned} & \$60,000 \text{ (suspended recovery income as reduced in year 2)} - \$60,000 = \$0 \end{aligned}$$

69. At the end of year 3, the combined cost of the replacement items is reduced by a total of \$300,000 from \$1.2 million to \$900,000. Therefore, the depreciation recovery income of \$300,000 is fully rolled into the cost of the replacement property, which reduces the adjusted tax value for depreciation purposes. This is

what would be expected, because the total cost of the replacement items exceeds the cost of the affected property.

Year 4

70. Because the cost of other replacement items (\$1.2 million, being \$400,000 in each of years 1–3) exceeds the cost of the affected property (\$1 million) no further reductions are available (s EZ 23B(4)(a)). This makes sense because the full amount of the excess recovery has already been allocated against replacement items.

Step 5: Return any unallocated suspended recovery income as depreciation recovery income

71. Since the suspended recovery income has been reduced to zero, Linda has no liability to return any unallocated suspended recovery income.

Summary of example 3

72. In this example, the depreciation roll-over relief provisions act to:
- (a) fully allocate the depreciation recovery income of \$300,000 against the cost of the replacement items purchased in years 1–3, on a first-in-first-served basis;
 - (b) reduce the adjusted tax values of the replacement items from \$1.2 million to \$900,000.
73. The same result would be achieved had Linda purchased all the replacement items at the same time but chose to treat them in her income tax return as being acquired in the same order as in this example.

Other requirements for depreciation roll-over relief

74. To qualify for the depreciation roll-over relief, the replacement asset must be:
- acquired before the end of the 2018–19 income year (s EZ 23B(1)); and
 - depreciable property (that is not depreciable intangible property) (s EZ 23B(1)(a)(i)); and
 - in the same category as the affected property if the affected property is a building or grandparented structure, or commercial fit-out (s EZ 23B(7)).
75. In addition, any replacement building or grandparented structure, or commercial fit-out must be located in greater Christchurch (s EZ 23B(7)).
76. Taxpayers who wish to make use of the depreciation roll-over relief provisions must elect to do so by giving written notice to the Commissioner specifying the affected property and linking each item of replacement property with an affected class. This notice must be given by the later of 31 January 2012 or when the income tax return is filed for the income year in which the insurance pay-out can be reasonably estimated. Written notice must also be given in each subsequent year in which the depreciation recovery income is suspended (s EZ 23B(1)(f) and EZ 23B(9)).

The Commissioner's operational approach

77. The Commissioner recognises that taxpayers may have incorrectly applied the formula under s EZ 23B(4) in their calculation of the reduction amount as a result of the interpretive uncertainty discussed in this Question We've Been Asked. In some cases, the application of the formula has produced incorrect results because

of the uncertainty clarified in the Taxation (Annual Rates, Foreign Superannuation, and Remedial Matters) Act 2014 enacted on 27 February 2014 regarding when multiple items of replacement property are acquired at the same time.

78. Where, for one of the reasons set out above, the application of the formula has resulted or will result in an overpayment of income tax, taxpayers can request Inland Revenue amend their assessment under s 113 of the Tax Administration Act 1994. The Commissioner will apply the principles set out in the Standard Practice Statement "SPS 07/03 Requests to amend assessments" *Tax Information Bulletin* Vol 19, No 5 (June 2007) at 8 (or any replacement) on a case by case basis to determine whether to amend assessments.
79. If, for one of the reasons set out above, the application of the formula has resulted or will result in an underpayment of income tax, the Commissioner will not actively apply her resources to seek to amend assessments. This approach applies only to the application of the formula in relation to returns filed prior to the publication of this Question We've Been Asked.
80. In other cases of underpayment, the Commissioner's normal approach will apply.
81. Taxpayers should ensure that they apply the formula correctly from the date of publication of this Question We've Been Asked (including in respect of previous periods for which a return is yet to be filed).

References

Related rulings/statements

"Canterbury earthquake relief measures" *Tax Information Bulletin* Vol 23, No 8 (October 2011)

SPS 07/03 Requests to amend assessments" *Tax Information Bulletin* Vol 19, No 5 (June 2007)

Subject references

Income tax

Depreciation

Depreciation roll-over relief

Canterbury earthquakes

Legislative references

Income Tax Act 2007, s EZ 23B