Inland Revenue
Te Tari Taake

2 April 2019

QUESTION WE'VE BEEN ASKED

QB 19/02
Depreciation – change of use event

We have been asked to clarify whether a change of use event occurs for depreciation purposes when a business becomes a charity but continues to apply its assets in the same way it did before becoming a charity. The question has been raised because the change of use event could give rise to depreciation recovery income.

Key provisions
Sections EE 47(2) and EE 47(2B) of the Income Tax Act 2007

Key term
Depreciable property - property expected to decline in value while used or available for use in deriving assessable income.

Question

Could depreciation recovery income arise when a business becomes a charity?

Answer

Yes. Depreciation recovery income may arise where a change of use of depreciable property results in depreciation deductions no longer being available. For these purposes, a change of use refers to the use of property in deriving assessable income. Because a charity's income is exempt, the property will no longer be available for use in deriving assessable income, so will no longer qualify as being "depreciable property". This change of use results in depreciation deductions being denied. The recent introduction of s EE 47(2B) means that the change of use (and any depreciation recovery income) will occur immediately before the income exemption applies.

Explanation

1. We have been asked to clarify whether a change of use of depreciable property occurs where a business becomes a charity and derives exempt income. This issue is relevant as a change of use could give rise to depreciation recovery income.

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

Depreciation recovery income

3. Under s EE 1 a person has depreciation recovery income for an income year if:

- they own an item of depreciable property;
- the property is disposed of or a relevant event occurs; and
- an amount of depreciation recovery income is calculated under a relevant provision, including s EE 48 (effectively where the consideration exceeds the adjusted tax value of the property).

4. The provisions relating to the calculation of depreciation recovery income in ss EE 44 to EE 48 apply where either a disposal or another relevant event occurs. One such event is a change of use of the property, as a result of which a person is denied a depreciation deduction for the next income year. Sections EE 47(1) and (2) provide:

> **EE 47 Events for purposes of section EE 44**
>
> *Events to which sections EE 48 to EE 52 apply*
>
> (1) For the purposes of section EE 44, this section describes the events to which sections EE 48 to EE 52 apply.
>
> *Change of use or location of use*
>
> (2) The first event is the change of use, or change of location of use, of an item of property, as a result of which a person is denied a deduction for an amount of depreciation loss for the item for the next income year. The event is treated as occurring on the first day of the next income year, and includes a change in use of an item for the purposes of the definition of commercial fit-out and a change in the status of a building related to an item for the purposes of that definition.

5. Where s EE 47(2) applies, the consideration for the property is treated as being the market value of the property at the time the change of use occurs (s EE 45). If the market value of the property exceeds the property's adjusted tax value on the date that the change of use event occurs (or is treated as occurring), the difference in these amounts is the depreciation recovery income that arises (although this income is capped at the total amount of depreciation loss claimed). Similarly, if the market value of property is less than its adjusted tax value on that date, the difference in those amounts may give rise to an amount of depreciation loss under s EE 48(2) (excluding buildings under s EE 48(3)) which may be deductible in accordance with ss DA 1(1) and DA 1(4).

6. A new provision, s EE 47(2B), provides for the timing of the change of use event in certain circumstances as follows:

> *Event timing for person's becoming tax exempt*
>
> (2B) Despite subsection (2), if the event is connected to a person's income becoming exempt income, the event is treated as occurring immediately before the person's income becomes exempt.

What is a "change of use"?

7. Where a business becomes a charity but continues to be carried on in the same way, it has been suggested that there is no change of use as the property is still being applied in the same way as before the exemption.

8. The word "use" has various meanings. The *Concise Oxford English Dictionary* (11th ed, 2012) defines the term "use" as:

> Take, hold or deploy as a means of achieving something…. Treat in a particular way. …

9. In *Thornton Estates Ltd v CIR* (1998) 18 NZTC 13,577 Richardson P commented:

> As any dictionary will show, "use" and "used" have a wide range of meanings. Thus in relation to property, the Oxford English Dictionary (2ed) defines "use" as: "8. a. To employ or make use of (an article, etc), esp. for a profitable end or purpose; to utilize, turn to account"; and also "12. To expend or consume (a commodity, etc) by use; 13. to use up: a. To consume (a commodity or stock) by use." In turn, "used" means "1. b. That is or has been made use of; utilized" and also "II. Used up ..." and "7. Reduced, exhausted, or consumed by using". Similarly, the Tasman Dictionary defines "use" as "1. To employ for some purpose" and "3. To expend or consume in use". Which meaning is intended must be taken from the context.

10. Accordingly, the relevant event could relate to a change of the holding, deployment or treatment of an asset in a particular way. Relevantly, it could mean to employ or make

use of for a particular purpose or aim, or it could mean to consume. The first of these potential meanings supports a view that a "change of use" refers to the purpose for which property is employed. The second potential meaning of "use", being to "consume", supports a narrower meaning relating to the application of the property in a particular way (for example, its physical use).

11. Assistance in determining which is the correct interpretation can be taken from the wider context of the depreciation regime.

12. "Depreciable property" is defined in s EE 6 as property that might be expected to decline in value while used or available for use in either deriving assessable income or carrying on a business for the purpose of deriving assessable income.

13. If an item is used or available for use in deriving exempt income, or for a private use, the property is not depreciable. Specific rules apply to property that is partly used for deriving assessable income and partly used for other (non-taxable) purposes at the same time (see ss EE 49 and EE 50).

14. Accordingly, it can be seen from these provisions that the use (or availability) of the property in deriving assessable income or for carrying on a business for the purpose of deriving assessable income (and not for deriving exempt income nor private use) is the important background context for depreciation purposes.

15. In summary, depreciation recovery income may arise where a change of use of depreciable property results in depreciation deductions no longer being available. For these purposes, a change of use refers to the use of property in deriving assessable income.

When will depreciation deductions be denied?

16. Relevantly, s EE 47(2) requires that the change of use has a result that the person is denied a depreciation deduction for the next income year. A person will be denied a depreciation deduction where property is not used or available for use in deriving assessable income. This indicates that the relevant change of use must be one that relates to a change in the depreciable status of the property. This supports the wider meaning of "use" referred to above, as being one for a relevant purpose (that is, a purpose of deriving assessable income), rather than just its application in the business.

17. A person is allowed a deduction for depreciation loss where property is "depreciable property" and the general permission in s DA 1 is satisfied. That is, a depreciation deduction is available to the extent it is incurred in deriving assessable income or excluded income or is otherwise incurred in the course of carrying on a business for the purposes of deriving such income. Under s DA 2, a deduction is not available to the extent that expenditure or loss is incurred in deriving exempt income or for private use (amongst other things).

18. Section BD 1(2) provides that an amount of income is "exempt income" if it is a person's exempt income under subpart CW. In the context of charities, ss CW 41 and CW 42 exempt all income derived by a charity or a charitable business. Accordingly, where s CW 42 applies to a previously taxable business (for example, because its shares were acquired by a charity, or it becomes a charity itself), the business is no longer deriving "assessable income" but is deriving exempt income.

19. Accordingly, as a charity's income is exempt, its property will not be available for use in deriving assessable income, and so will not qualify as being "depreciable property". This change of use results in depreciation deductions being denied.

Will ss EE 47(2) and EE 47(2B) apply?

20. A change of use under s EE 47(2) is not limited to referring to a change in the application of an asset but refers to a change in its use for a particular purpose, being the derivation of assessable income. This could still involve a change in the application of the item (such as property being taken out of a business and used for private use) but also extends to an item being applied in the same way in a business, but for a purpose of deriving exempt income. This conclusion is consistent with the purpose of depreciation recovery income, which is to recover excess deductions for depreciation that was not actually experienced on the property, at the time the property is no longer available for use in deriving assessable income.

21. Accordingly, the context and purpose of the depreciation regime supports the view that when a business becomes a charity (or any other entity deriving exempt income) there will be a change of use event under ss EE 47(2) and EE 47(2B). This is because the property is no longer used in a business for the purpose of deriving assessable income, but instead is used for the purpose of deriving exempt income. A result of this change is that depreciation deductions are no longer available.

22. The recent enactment of s EE 47(2B) changes the timing of the change of use (and therefore the derivation of any depreciation recovery income or loss on disposal). The change of use will occur, and any depreciation recovery income will be derived (or loss incurred) immediately before the entity's income becomes exempt. For completeness, depreciation deductions will be denied from the beginning of the income year in which the change of use is treated as occurring under s EE 47(2B).

Conclusion

23. Section EE 47(2) will apply where a business becomes a charity and begins to derive exempt income, even though assets are still being applied in the business in the same way. This change of use of depreciable property is treated as if there were a disposal of the depreciable property for market value. A consequence of this conclusion is that the business may have a depreciation gain (or loss) on disposal. The recent enactment of s EE 47(2B) provides that the change of use occurs immediately before the entity's income becomes exempt (and therefore any depreciation gain or loss also arises immediately before the entity's income becomes exempt).

24. As an aside, the same conclusion would also be reached for any business which begins to derive exempt income under subpart CW. Also, the same conclusion about a change of use occurring would also apply to any other change in the use of an item that was used or available for use in deriving assessable income (for example, where an item is no longer used for deriving assessable income and instead is used for private use).

25. Examples 1 and 2 illustrate the application of this approach.

Examples

Example 1 - Business acquired by a charity

Warm Feelings Ltd is in the business of manufacturing and selling sustainably sourced woollen blankets. The shares in Warm Feelings Ltd are acquired by a registered charity, with the intention that Warm Feelings Ltd would continue to operate in the same way, although all profits would be used for charitable purposes (and its constitution amended accordingly). Once Warm Feelings Ltd satisfies the requirements in s CW 42, it will begin to derive exempt income.

Warm Feelings Ltd had been depreciating various items of equipment used in manufacturing the blankets. After satisfying the requirements in s CW 42, those items are no longer available for use in deriving assessable income. Accordingly, there will be a change of use of the items under ss EE 47(2) and EE 47(2B) that results in deductions for depreciation loss being disallowed.

Warm Feelings Ltd may be liable for depreciation recovery income if the market value of its depreciable property exceeds the adjusted tax value of that property on the relevant date under s EE 47(2B). Similarly, it may have a depreciation loss on disposal if the market value of depreciable property is less than the adjusted tax value of that property. The change of use (and any depreciation recovery income or loss) is treated as occurring immediately before its income became exempt. Any other depreciation loss is denied in that income year.

Example 2 – Calculation and timing

The shareholders of Warm Feelings Ltd register as a charity (and satisfy s CW 42) with effect from 1 April 2019. Warm Feelings Ltd has a standard balance date. As with example 1, at the time Warm Feelings Ltd ceases to derive assessable income, there is a change of use event and ss EE 47(2) and EE 47(2B) apply.

Section EE 47(2B) treats the change of use as occurring immediately before the income becomes exempt, on 31 March 2019. As with example 1, Warm Feelings Ltd may be liable for depreciation recovery income if the market value of its depreciable property exceeds the adjusted tax value of that property on that date.

On 31 March 2019, an amount of depreciation recovery income or loss will need to be calculated and will be taxable or potentially deductible in that income year. No other amount of depreciation loss will be deductible for that year.

Warm Feelings Ltd had acquired its manufacturing equipment on 1 April 2013 for $10,000. Using the DV depreciation rate of 13%, it had claimed depreciation loss deductions for the last five years. The adjusted tax value of the equipment as at 31 March 2019 was $6,098. However, at that date the market value of the equipment was valued at $6,500. Accordingly, Warm Feelings Ltd will derive an amount of depreciation recovery income of $402 in the income year ended 31 March 2019.

References

Subject references

Income Tax
Depreciation
Change of use

Legislative references

Income Tax Act 2007 ss BD 1(2), DA 1, DA 2, EE 1, EE 6, EE 44, EE 45, EE 47, EE 48

Case reference

Thornton Estates Ltd v CIR (1998) 18 NZTC 13,577