# Deferred tax update

## Reinstatement of tax depreciation on commercial and industrial buildings (updated)

July 2020

## Introduction

The COVID-19 outbreak has brought increased disruption and uncertainty to businesses and economies globally. With the recent and rapid development of the coronavirus outbreak, many countries have imposed measures that affect business operations. These disruptions are more immediate and pronounced in many industries affected by protective measures introduced in New Zealand and across the globe.

The New Zealand government has announced measures to protect the economy and population hit by COVID-19 ranging from wage subsidies and unemployment benefits to loan reliefs and corporate income tax reductions. This publication addresses the accounting impact of one such measure being the reinstatement of tax depreciation deductions for certain buildings.

In 2010, legislation was introduced to remove tax depreciation for buildings with an estimated useful life of 50 years or more, which came into force from 1 April 2011 (for a standard 31 March income tax year). As part of the Government's COVID-19: *Economic Response Package*, depreciation deductions will be reintroduced for new and existing industrial and commercial buildings, including hotels and motels. There is no specific application process as the increased deduction will be available as part of the normal tax filing processes.

For tax purposes, industrial and commercial buildings will be able to claim tax depreciation on a 2% diminishing value or 1.5% straight line basis for the relevant tax book value of qualifying buildings held from the 2020/21 tax year.

It is important to note that the first step in assessing the accounting impact of the proposed changes is to understand the impact from a tax perspective. The points discussed below refer only to assets identified as "buildings" and not (for example) costs allocated to most fit-out, which continued to be tax depreciable after 2010.

### Accounting implications of the reinstatement of depreciation deductions

The change in tax legislation on depreciation deductions may have a significant impact on many entities preparing financial statements in accordance with generally accepted accounting practice in New Zealand (NZ GAAP). The impact of the reinstatement of tax depreciation will depend on several things including the timing of acquisition of the asset and the current accounting for deferred tax applied since acquisition. Refer below to our examples for further information.

**Key impact**

- The reinstatement of tax deductions for depreciation increase the tax base of the assets. The increase in the tax base may create deductible temporary differences (deferred tax assets) or at least reduce the taxable temporary differences (deferred tax liabilities) previously recognised.
- The impact of these changes is recognised in tax expense in the year of change, rather than opening retained earnings.

## Current accounting requirements

NZ IAS 12 *Income Taxes* ("NZ IAS 12") requires entities to account for deferred tax based on legislation that is substantively enacted by the end of the reporting period. COVID-19 Response (Taxation and Social Assistance Urgent Measures) Bill received Royal Assent on 26 March 2020 and is enacted at that date. For entities with a 31 March 2020 reporting date the impact of these changes is required to be reflected in their 31 March 2020 financial statements.

The key impact relates to buildings that a taxpayer currently owns and holds with the intention of use in the future (rather than when the expected manner of recovery is through sale), and that have an estimated useful life of 50 years or more (as determined by the Commissioner of Inland Revenue). The changes are applicable for buildings held for own use under NZ IAS 16 *Property, Plant and Equipment*. Investment properties recognised in accordance with NZ IAS 40 *Investment Properties*, that have applied the rebuttable presumption in NZ IAS 12.51C[1] , will also be within scope.

Under NZ IAS 12, the tax base of an asset is defined as the amount that will be deductible for tax purposes against any taxable economic benefits that will flow to the entity when it recovers the carrying amount of the asset. For buildings that are intended to be held for use, the carrying amount of the asset will be recovered over the estimated useful life of the asset.

The reinstatement of tax deductions for depreciation means that there will (again) be tax deductions to claim against the taxable benefits generated through use of the asset. Therefore, the tax base of the asset will increase. The treatment of the increase will depend on how on the building was accounted for on initial recognition of the asset. The increase in the tax base may create deductible temporary differences (deferred tax assets) or at least reduce the taxable temporary differences (deferred tax liabilities) previously recognised. However, where the initial recognition exemption[2] has been applied to a building acquired after May 2010 different outcomes may arise. We have provided examples below to explain this further.

## Substantively enacted

NZ IAS 12 requires an entity to measure current and deferred tax at the tax rates that have been enacted or substantively enacted. COVID-19 Response (Taxation and Social Assistance Urgent Measures) Bill received Royal Assent on 26 March 2020. The changes will need to be reflected in financial statements with reporting date on or after 26 March 2020 (e.g. 31 March 2020).

Entities that are yet to issue financial statements with reporting date before 26 March 2020 (e.g. financial statements as at 31 December 2019) may consider disclosure of the change depending on how material it is to the entity. Such disclosures should include the nature of the changes and an estimate of the financial effect (or a statement indicating such an estimate cannot be made).

Key impact

- The changes will need to be reflected in financial statements with reporting date on or after 31 March 2020.

## Definition of a qualifying building

The reinstatement of tax depreciation is for qualifying non-residential buildings. Non-residential buildings are defined in section YA 1 of the Income Tax Act 2007 ("the Act") as any building which is not a residential building (i.e. dwellings and certain other short-term accommodation types). This document refers to these assets generally as 'buildings'.

## Tax base

In summary[3], the 2020-21 tax base post the changes:

- For buildings owned by the taxpayer in the 2010-11 income year: expected deductions over the useful life of the building up to the 2010-11 un-depreciated tax book value, less fit out deductions taken since 2010-11 under section DB 65 (if applicable) plus building related capital additions incurred since 2010-11.
- For buildings acquired after 2010–11 income year: expected deductions over the useful life of the building up to the cost of the building *plus* non-deductible building related capital additions incurred since acquisition until the beginning of the 2020–21 income year.

## Accounting revaluations

For those entities that have chosen to revalue their building assets in accordance with NZ IAS 16 a deferred tax liability will have likely been recognised at the time of the revaluation (regardless of whether the asset was acquired before or after 2010). It is our expectation that there will be no impact on deferred tax accounting for revaluations arising from the reinstatement of deductions for tax depreciation.

[1] In accordance with NZ IAS 12.51C, there is a rebuttable presumption that investment property will be recovered through sale. However, if this assumption is rebutted and the investment property is determined to be held for use, these changes will be applicable.

[2] Refer to NZ IAS 12 *Income Taxes* paragraphs 15 and 24.

[3] Refer to the Inland Revenue commentary on the IR's Tax Policy website https://taxpolicy.ird.govt.nz/publications/2020-commentary-covid-19-bill/income-tax

## Assets realised through sale

Where a building is held with the intention of sale, any resultant deferred tax is measured based on the tax consequences of sale. Similarly, for investment properties, it is assumed their recovery will be through sale unless otherwise rebutted.

For tax accounting purposes, deferred tax recognised in relation to a building held for sale, and on capital account for tax purposes, will likely mean that any deferred tax liability is calculated with reference to the amount of tax depreciation to be recovered on sale.

## Recognition of deferred tax assets

NZ IAS 12 requires that deferred tax assets are only recognised to the extent it is probable that taxable profit will be available against which the deductible temporary difference can be utilised. Therefore, an entity will need to take this into consideration in recognising any deferred tax asset that may arise from the legislative changes described above.

## Accounting requirements for future purchases

For future building purchases, it is possible that the accounting carrying value and the tax base are the same on initial recognition.  This is on the assumption that the useful life for accounting is consistent with the tax base. On this basis there will be no deferred tax to recognise.

In situations where a difference does arise between the tax base and accounting carrying value on initial recognition, the resulting deferred tax effect is unlikely to be recognised due to the initial recognition exemption.

## Tax losses

Some taxpayers may have unused tax losses (or deductible temporary differences) that have been previously recorded as a deferred tax asset in the balance sheet.  The previous recognition of deferred tax assets may have been because the entity had sufficient taxable temporary differences, or the entity could demonstrate that future taxable profits would be available to offset the tax losses/deductions. Taxpayers in such situations should reconsider whether some or all those tax losses/deductible temporary differences should now be de-recognised to offset the reduced taxable temporary difference on buildings because of the reinstatement of tax depreciation deductions.

## Illustrative Examples

The examples below highlight the accounting implications in different scenarios.

### Illustrative example 1 – building purchased before 2010 (no accounting revaluation)

An entity purchased a building on 1 July 2006 for $10,000,000. For accounting and tax purposes it has been depreciated at 2% (straight line method) per annum, being a useful life of 50 years. As at 30 June 2011, the carrying amount of the asset for accounting purposes was $9,000,000. Prior to the changes in tax legislation, the tax base of the asset would have also been $9,000,000, as the deductions an entity would receive for tax purposes would be equal to the depreciation it will deduct over time. This means that there was no difference between the accounting carrying amount and the tax base of the building. Hence, no deferred tax was recognised at 30 June 2011.

However, with the 2010 change in tax legislation, effective from 1 July 2011, the entity could no longer claim tax depreciation deductions. Therefore, the tax base of the building was decreased to nil, but its accounting carrying amount remained $9,000,000. The difference between these two amounts was a taxable temporary difference of $9,000,000 which gave rise to a deferred tax liability at the 28% company tax rate of to $2,520,000. An entity would have recognised a deferred tax liability of $2,520,000 and tax expense of the same amount via the following journal:

| | |
|---|---|
| DR Tax Expense | $2,520,000 |
| CR Deferred Tax Liability | $2,520,000 |

As at 30 June 2020 the building's carrying amount will be $7,200,000. Before re-introduction of tax deductions relating to depreciation, tax base of the building would have been nil giving rise to taxable temporary difference of $7,200,000. The entity would have had a deferred tax liability at the 28% tax rate amounting to $2,016,000.

Following re-introduction of tax depreciation, the entity will be able to claim depreciation over the remaining period the building is in use up to the undepreciated cost (being $9,000,000) via depreciation over the coming years. As such, the tax base of the building could be as high as $9,000,000 resulting in a deductible temporary difference of $1,800,000 (being $9,000,000 less $7,200,000) and the corresponding deferred tax asset of $504,000.

In the above example, the expected period of use of the building is its accounting useful life of 50 years, therefore in 2020 it has 36 years remaining useful life. Deductions of 1.5% (straight line) will be available over the next 36 years giving rise to a tax base of $4,860,000 ($9,000,000 *1.5% * 36 years). The temporary difference is therefore reduced from

$7,200,000 to $2,340,000. At 28% the deferred tax liability would reduce to $655,200. The entry will be recognised in profit and loss via the following journal.

| | |
|---|---|
| DR Deferred Tax Liability | $1,360,800 |
| CR Tax Expense | $1,360,800 |

**Illustrative example 2 – building purchased after 2010 (no accounting revaluation)**

An entity purchased a building on 1 July 2016 for $20,000,000. For accounting purposes, it has been depreciated at 2% (straight line method) per annum. At the time of purchase, the tax base of the building was nil as depreciation could not be claimed for tax purposes resulting in a prima facie taxable temporary difference of $20,000,000.

However, no deferred tax liability was recognised by the entity at the time of purchase in accordance with the "initial recognition exemption" under NZ IAS 12 for temporary differences resulting from the initial recognition of an asset or liability in a transaction which is not a business combination at the time of the transaction, affects neither accounting profit nor taxable profit (tax loss).

At 30 June 2020 the building will have an accounting carrying amount of $18,400,000. Prior to re-introduction of depreciation no deferred tax assets or liabilities would have been recognised in relation to that asset due to application of the initial recognition exemption noted above.

Following re-introduction of depreciation, the entity will be able to claim up to $20,000,000 of tax depreciation over the remaining years the building is expected to be in use. Assuming expected period of use of the building is equal to accounting useful life, the new tax base of the building is $13,800,000 (being $20,000,000 *1.5% * 46 years). NZ IAS 12 is not clear on how the adjustment to the tax base should be treated when the initial recognition exemption had been applied. There are two possible scenarios:

*A* A "net" deductible temporary difference of $nil, because the difference between $18,400,000 and $13,800,000 is still 'covered' by the initial recognition exemption. OR

*B* The temporary difference is analysed into a taxable temporary difference of $18,400,000 (which is not recognised due to the initial recognition exemption) and a deductible temporary difference of $13,800,000 (which arose after initial recognition). The new deductible temporary difference gives rise to a deferred tax asset of $3,864,000 which is recognised in the profit and loss via the journal:

| | |
|---|---|
| DR Deferred Tax Asset | $3,864,000 |
| CR Tax Expense | $3,864,000 |

Given NZ IAS 12 is unclear on the treatment of a change in tax base with the initial recognition exemption has been applied, it is likely the entity will be required to make an accounting policy choice. The difference between the two approaches is one of timing. Under approach A, the reduction in income tax expense, and the effective tax rate, is recognised prospectively over the life of the asset. Under approach B the change in legislation reduces income tax expense and the effective tax rate, in the year of the change. The choice will impact an entities effective tax rate.

**Is accounting policy choice a free choice?**

- When required management uses judgement in developing and applying an accounting policy that results in information that is relevant to the users and reliable.
- An entity applies its accounting policies consistently for similar transactions, other events and conditions.

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