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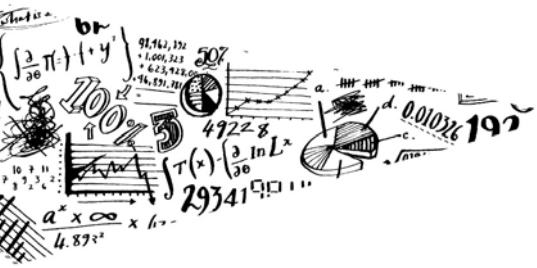

Depreciation on buildings

Financial reporting and tax considerations

The change to the tax depreciation rates in the May 2010 Budget for long-lived buildings has a major impact on future depreciation deductions that can be claimed for tax purposes. It also has a significant effect on the financial statements of entities that are required to account for deferred tax under financial reporting standards. In this publication, we update our June 2010 publication 'Depreciation on long-lived buildings' for proposed changes to both tax legislation and accounting standards. We discuss below:

- The buildings to which the Budget 2010 depreciation rate changes relate
- A recent issues paper on the treatment of commercial fit-out going forward
- A recap of the accounting implications of the change to tax depreciation deductions
- Proposed changes to the accounting standard on deferred tax

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The depreciation rate change to 0% relates to buildings and not structures.

Removal of tax depreciation for buildings – tax implications

The 2010 Budget tax legislation[1] introduced new tax depreciation rules for buildings with an estimated useful life of 50 years or more. From the 2011-12 income tax year (i.e. 1 April 2011 for a standard 31 March income tax year), the depreciation rate for buildings will be 0%. This 0% rate will apply to existing buildings owned and new buildings acquired after the start of the 2011-12 income tax year.

Depreciation claimed prior to the 2011-12 income tax year will still give rise to tax depreciation recovered if buildings are sold in the future for greater than tax book value. There will continue to be no loss on disposal for tax purposes when the building is sold.

The presumption of the new legislation is that all buildings have an estimated useful life of 50 years, as the default estimated useful life of a building is 50 years, unless a depreciation determination provides for an estimated useful life of less than 50 years.

If taxpayers consider particular buildings have an estimated useful life of less than 50 years, those buildings are not automatically depreciable. It is necessary to apply to the Inland Revenue for a provisional depreciation rate for classes of buildings considered to have an estimated useful life of less than 50 years. It should be noted new provisions in the Budget tax legislation remove the right to apply for a special rate for a particular building.[2] Current indications are that the onus of proof on applicants to establish estimate useful lives for classes of buildings of less than 50 years will be high.

It is important to also note the depreciation rate change to 0% relates to buildings and not structures. The Inland Revenue issued an Interpretation Statement[3] on the meaning of "building" earlier this year to help distinguish between a building and a structure. Depreciation on structures will continue to be available at the applicable rate as per the depreciation determinations.

Post-budget depreciation issues paper

The Policy Advice Division of Inland Revenue and the Treasury released an issues paper[4] on 11 August 2010 covering certain issues relating to the Budget 2010 tax depreciation changes. Submissions closed on 1 September 2010.

Based on the issues paper, taxpayers should be able to continue to separate out commercial fit-out from the building on a broad basis and depreciate the fit-out separately. For taxpayers who have not previously separated commercial fit-out from the building, the issues paper offers a mechanism to provide relief. Given the changes to building depreciation discussed above, the distinction between buildings and commercial fit-out is now much more important. By allocating an appropriate amount to fit-out, some of the impacts of the change to building depreciation can be mitigated, including the tax impacts, accounting impacts and the wider commercial impacts discussed later in this publication.

The main points in the issues paper are as follows:

- Commercial fit-out will continue to be allowed to be treated separate to the building and can be depreciated using appropriate building fit-out depreciation rates for items listed or the default building fit-out depreciation rate for non-listed items.
- The definition of commercial buildings will be restricted to the foundations, the building frame, floors, external walls, cladding, windows, doors, stairs, the roof, and load bearing structures such as pillars and load-bearing internal walls, effectively allowing everything else within the building to be depreciated separately. Further clarification is being sought in respect of certain doors and stairs within a building. Plant integrated into buildings will be separately depreciable as plant; however, further clarification is required to determine the cut-off between plant and buildings in certain situations.
- In certain situations, if a person has not separately depreciated commercial fit-out in a building, they may be allowed a one-off transitional adjustment to carve out 15% of the adjusted tax value of the building and depreciate it on a straight line basis at 2% going forward (being the current building depreciation rate). No loss on disposal will be allowed, nor will there be any depreciation recovery on this depreciation claimed. The issues paper is silent on whether taxpayers, at their own cost, can separately identify commercial fit-out that has not previously been split out and depreciate it at the appropriate rate instead of applying the general 15% fit-out pool provision. Further clarification is being sought on a number of issues associated with the pool.
- Definitions are provided for distinguishing between commercial buildings and residential buildings. We note that issues with distinguishing the difference will arise when buildings with mixed purposes have shared facilities, such as lifts and lobbies, which may be treated differently for commercial building purposes as opposed to residential purposes. Note that the Inland Revenue previously released a residential rental property depreciation paper.[5]
- There is no comment on what is considered deductible repairs and maintenance, which means case law should continue to be used when determining whether an item is capital or revenue account expenditure.

As this is an issues paper, we expect that there will be a number of submissions that will seek to clarify or change any of the issues/solutions discussed in the issues paper.
The final position in respect of the issues discussed above may be quite different to the solutions presented in the issues paper. Given the greater importance of separating commercial fit-out from buildings, as discussed above, we recommend taxpayers continue to monitor progress and seek advice on what it means to them in respect of commercial fit-out.

Accounting implications of loss of depreciation deductions

The change in tax legislation on depreciation deductions has a major impact on entities that prepare financial statements under New Zealand equivalents to International Financial Reporting Standards (NZ IFRS) and that do not qualify for differential reporting concessions.

The accounting impact (explained below) has caused serious concerns in the business community – for many, the resulting deferred tax liabilities do not represent 'real' liabilities in an economic sense, particularly when any potential future tax liability is unlikely to crystallise for decades or even centuries. Those entities with investment properties and revalued property, plant and equipment have already had to record deferred tax liabilities arising from asset revaluations. The removal of depreciation deductions for long-lived buildings has therefore increased some existing deferred tax liabilities, while creating some new deferred tax liabilities for entities that may have not previously been faced with this troublesome issue in the past.

We discuss below the accounting impact of the loss of depreciation deductions, based on the current requirements of NZ IAS 12 *Income Taxes* (NZ IAS 12). We also discuss some proposed changes to the standard, which could bring relief to some affected entities in the future.

It is important to note that the first step in assessing the accounting impact of the Budget changes is to understand the impact from a tax perspective. The points discussed earlier, such as whether a particular asset is a 'building' for tax purposes or some other type of structure, the length of its estimated useful life for tax purposes, and whether some portion of the cost should be allocated to fit-out, all need to be taken into account. The accounting impacts below only relate to those assets for which tax depreciation deductions have been effectively removed.

Current accounting requirements

The accounting impact of the loss of depreciation deductions will need to be reported in financial statements prepared for a reporting period that ends after 21 May 2010, such as June, September and December 2010 balance dates. The key impact relates to buildings that an entity currently owns and holds with the intention of use in the future (rather than sale), and that have an estimated useful life of 50 years or more (as determined by the Commissioner of Inland Revenue). This is applicable for both investment properties within the scope of NZ IAS 40 *Investment Property* and for buildings held for own use under NZ IAS 16 *Property, Plant and Equipment*.

Under NZ IAS 12, a "taxable temporary difference" arises when the carrying amount of an asset for accounting purposes exceeds its tax base. 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 key impact relates to buildings that an entity currently owns and holds with the intention of use in the future, rather than sale.

(either for own use or for use as an investment property), the carrying amount of the asset will be recovered over the estimated useful life of the asset. The removal of tax deductions for depreciation means that there will no longer be tax deductions to claim against the taxable benefits generated through use of the asset. Therefore, the standard requires a deferred tax liability to be recognised, based on the difference between the carrying amount of the asset and its tax base.

Broadly speaking, the removal of the depreciation deductions has the following implications for entities reporting under NZ IFRS.

Existing buildings

The impact of the removal of depreciation deductions will depend on an entity's intended use of the building in the future:

- Intention to hold for use (either for own use or as an investment property): The liability is measured based on the tax consequences of use. In this case, the use of the asset is expected to generate future taxable income and, in the absence of depreciation deductions to claim against that taxable income after the end of the 2011 tax year, a taxable temporary difference will arise based on the carrying value of the building less the remaining year's depreciation deduction. The resulting deferred tax liability will be measured based on the company tax rate.
- Intention to sell: The liability is measured based on the tax consequences of sale. For example, for a building held on capital account for tax purposes, this typically means the deferred tax liability is based on the amount of depreciation to be recovered on sale.

For existing buildings, any adjustment to increase a deferred tax liability must be recognised in profit or loss in the year in which the adjustment is made, creating a potentially large increase in that year's tax expense.

However, some entities might have unused tax losses (or deductible temporary differences) that have not been recorded as an asset in the balance sheet because previously the entity could not demonstrate that future taxable profits would be available against which those tax losses/deductions could be used. Entities in this situation should consider whether some or all of those tax losses/deductions could now be recognised to offset the taxable temporary difference that has now arisen on existing buildings because of the removal of depreciation deductions.

Future building purchases

The removal of depreciation deductions is not expected to impact an entity that buys a building after 21 May 2010 (other than in a business combination). NZ IAS 12 contains an exemption that, in most cases, allows an entity to ignore any deferred tax relating to a non-deductible asset when first acquired. Therefore, typically, no deferred tax would be recognised in this situation. (However, there will be an impact for buildings acquired in a business combination, as the exemption in NZ IAS 12 does not apply in this situation.)

The following numerical examples highlight the significant impact the removal of depreciation deductions can have on an entity's financial statements.

Example 1: Building carried at cost

An entity purchased a building 2 years ago on 1 July 2008 for $10,000,000. For accounting and tax purposes it has been depreciated at 2% per annum. As at the company's year ended 30 June 2010, the carrying amount of the asset for accounting purposes was $9,600,000. Prior to the changes in tax legislation, the tax base of the asset would have also been $9,600,000, 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 is no difference between the accounting carrying amount and the tax base of the building. Hence, no deferred tax is recognised.

However, with the change in tax legislation, the entity can now only claim a depreciation deduction for one further year, before the tax legislation change takes effect. Therefore, the new tax base of the building is only $200,000, but its carrying amount for accounting purposes is $9,600,000. The difference between these two amounts is $9,400,000. This difference is referred to as a "taxable temporary difference" in NZ IAS 12. The deferred tax liability on this taxable temporary difference at the 28% company tax rate equals $2,632,000. An entity would thus be required to recognise a deferred tax liability of $2,632,000 and tax expense of the same amount.

The above analysis assumes that the building is intended to be held for use. However, if the entity intends to sell the building, then deferred tax is calculated based on the tax consequences of sale. For example, if the building is held on capital account, then there would be tax on the depreciation recovered of $400,000 x 28% = $112,000.

Example 2: Revalued building

An entity purchased a building 2 years ago on 1 July 2008 for $10,000,000. For accounting purposes, it has been revalued to its current fair value of $15,000,000. For tax purposes, depreciation has been claimed at $200,000 per year, totalling $400,000. Prior to the changes in tax legislation, the entity would have expected to claim depreciation deductions totalling $9,600,000 over the life of the building ($10,000,000 cost less $400,000 claimed to date). Following the change in tax legislation, only one further year's depreciation of $200,000 can be claimed.

If the building is held for use, then taxable economic benefits of $15,000,000 (the current carrying amount of the building) will be generated over its life, but only $200,000 depreciation deductions can be claimed against this taxable income. Hence, the tax consequences of use are: ($15,000,000 - $200,000) x 28% = $4,144,000. This liability comprises the deferred tax on:

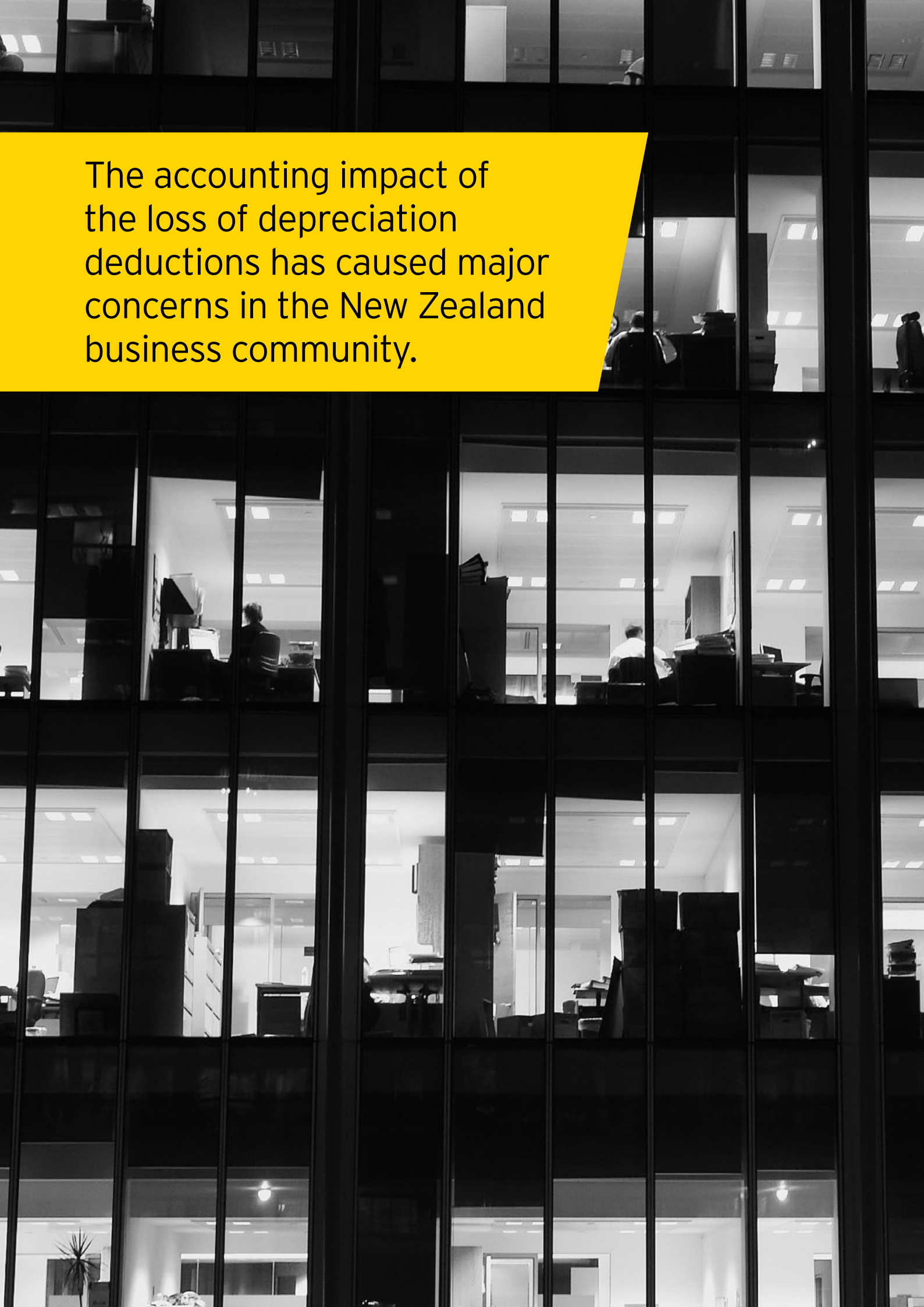
(a) the revaluation of the building: ($15,000,000 less $9,600,000) x 28% = $1,512,000; and

(b) the reduction in the tax base following the change in tax legislation from $9,600,000 to $200,000, i.e. a reduction of $9,400,000, which at 28% results in deferred tax of $2,632,000.

However, if the entity intends to sell the building and the building is held on capital account for tax purposes, the tax consequences on sale would be tax on the depreciation recovered = $400,000 at 28% = $112,000.

These examples demonstrate that the loss of depreciation deductions can have a huge impact on the financial statements. The examples also demonstrate that the impacts can vary widely, depending on whether deferred tax is calculated based on the tax consequences of sale or the tax consequences of use. For instance, in Example 2 above, the deferred tax recorded on the balance sheet would be either $112,000 (if the building is to be sold) or $4,144,000 (if the building is held for use).

The accounting impact of the loss of depreciation deductions has caused major concerns in the New Zealand business community.



Other impacts of the loss of depreciation deductions

Over and above the financial statement and tax impacts, there are other implications arising from the loss of depreciation deductions. In particular, debt covenants could be affected – the accounting impact significantly increases an entity's liabilities, so debt covenants (such as debt to equity ratios) that do not exclude deferred tax liabilities could be compromised.

Affected entities also need to consider the impact on profit announcements and other communications with stakeholders. Due to the significant impact this might have on an entity's after-tax profit or loss for the year, affected entities should consider whether profit announcements and other communications will need to be made or amended.

New Zealand reactions

The accounting impact of the loss of depreciation deductions has caused major concerns in the New Zealand business community. As noted earlier, many consider that the resulting deferred tax liabilities do not represent 'real' liabilities in an economic sense, particularly when any potential future tax liability is unlikely to crystallise for decades. In addition, for buildings that are measured at current market values, any economic impact of the loss of tax deductions would be reflected in the building valuation – thereby raising concerns that recording a deferred tax liability is 'double-counting' the impact of the loss of tax deductions.

In response to these concerns, the Accounting Standards Review Board (ASRB) and Financial Reporting Standards Board (FRSB) considered whether amendments should be made to NZ IAS 12 or whether exemptions from the standard should be given.[6] However, the Boards concluded that this would not be a viable solution, because of time constraints (i.e. the time required to consider, consult on and finalise any such amendments or exemptions) and because of the wider implications for the New Zealand financial reporting framework, if New Zealand accounting standards were to depart from IFRS.

New Zealand constituents, including the FRSB and members of the Audit Committee Leadership Network[7], contacted the International Accounting Standards Board (IASB) to raise their concerns about the standard and to request changes be made – either as part of the IASB's short-term project on income taxes (discussed below) or as part of a subsequent project to comprehensively review the standard.

Proposed changes to IAS 12 Income Taxes

The IASB currently has a limited-scope project to address problems arising in practice with IAS 12, but without fundamentally changing the standard. This is because any fundamental change would require a comprehensive review of the standard, which would take a long time to complete.

One of the issues currently being considered is the calculation of deferred tax on investment property, especially in jurisdictions like New Zealand where no capital gains tax exists. In these situations, the differences between calculating deferred tax on a 'sale' basis or a 'use' basis can be very large – as shown in the examples set out above. Yet, in practice, it can be difficult to determine whether a property will be sold or held throughout its economic life or a combination (e.g. held for several years and then sold).

On 10 September 2010, the IASB issued an Exposure Draft to propose adding a new exception to IAS 12. The exception would apply to investment property, property, plant and equipment, and intangible assets, but only where the entity revalues these assets for accounting purposes under the relevant accounting standards. The exception would also apply to investment properties, property plant and equipment and intangible assets acquired in a business combination, provided that the acquirer intends to subsequently revalue these assets under the relevant accounting standards. The exception would not apply to buildings or other assets that are carried at cost. The limited scope of the exception reflects the limited scope of the IASB project.

Where the exception applies, deferred tax would be calculated using the rebuttable presumption that the asset will be sold. In the examples discussed earlier, this would mean that deferred tax would be calculated on the depreciation recovered on sale, so would only be $112,000.

However, the proposals in the Exposure Draft also state that if there is clear evidence that the entity will continue to use the asset throughout its economic life, then the 'sale' presumption is rebutted. In this situation, deferred tax will be calculated on a 'use' basis. In Example 1 and 2 above, this would result in deferred tax of $2,632,000 and $4,144,000 (respectively).

Therefore, if the proposed changes to IAS 12 go ahead, an important issue will be identifying the circumstances in which 'clear evidence' exists that the entity will use the asset throughout its economic life. This would likely include considering such things as documented business plans, minutes of board meetings and examples based on previous practice. For example, typically, an investment property is not held throughout its entire economic life and, therefore, it is likely that clear evidence to rebut the 'sale' presumption will not exist. In this situation, deferred tax would be measured based on the tax consequences of sale. On the other hand, for major infrastructural assets or specialised plant and equipment that are essential to the entity's operations, there could be clear evidence that the entity will continue to use the asset throughout its economic life. In this situation, the 'sale' presumption might be rebutted, in which case deferred tax would be measured based on the tax consequences of use.

Next steps

The IASB Exposure Draft is out for comment until 9 November 2010. Depending on the responses from constituents, the IASB intends to finalise the amendments to IAS 12 relatively soon – possibly within the next six months. However, it is not known what the reactions from constituents will be and, therefore, whether the amendments will be finalised as proposed in the Exposure Draft. The amendments cannot be applied until they have been finalised and incorporated into NZ IAS 12.

If and when NZ IAS 12 is amended, affected entities will need to consider the impact on the measurement of deferred tax liabilities under the amended standard. It is likely that the amendments will apply retrospectively. Therefore, when preparing 2011 annual financial statements, comparative figures for 2010 would be restated to be consistent with the revised measurement approach.

Concluding comments

The change to depreciation deductions on buildings in the 2010 Budget has had a major impact on many organisations, both from a tax perspective and also from an accounting perspective. In turn, these impacts have flow-on effects, such as impacts on banking covenants, profit announcements and other stakeholder communications.

Also, further proposed changes to both tax legislation and accounting standards mean that further impacts are in the pipeline. For affected entities, it will be essential to be aware of these on-going developments and understand how they could impact on your business.

[1] Taxation (Budget Measures) Act 2010

[2] Section EE 35(2) of the Income Tax Act 2007 from 2011-12 income year

[3] IS10/02 - Meaning of "building" in the depreciation provisions

[4] Post-budget depreciation issues – An officials' issues paper August 2010

[5] IS10/01 - Residential rental properties - Depreciation of items of depreciable property

[6] ASRB-FRSB communiqué, 18 August 2010 (www.asrb.co.nz)

[7] The Audit Committee Leadership Network is a group of audit committee chairs and members from some of New Zealand's leading companies interested in improving the performance of audit committees. Its primary focus is to access emerging best practices and share insights into issues that dominate the changing corporate governance environment.

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