

## Special Tax Alert Post-budget depreciation issues

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An issues paper with draft legislation has been released seeking feedback on proposals to deal with two depreciation issues that have arisen out of the Budget 2010 package. Specifically, the treatment of commercial fit-out in light of the removal of depreciation on buildings and “grandparenting” issues to do with the timing of the removal of depreciation loading. Overall the proposals are positive, albeit the technical detail needs to be refined a little. We set out the broad proposals below. We thought you may be interested in these proposals given submissions close on 1 September 2010.

### Commercial fit-out

The law is to be clarified to confirm that expenditure on “commercial fit-out” can be separately depreciated from the building structure. A distinction is to be made between non-residential and residential fit-out.

Depreciation on fit-out in respect of commercial and industrial buildings as well as buildings used for short-term accommodation such as motels, hotels, rest homes, hospices, boarding houses and hospitals will be still claimable at the applicable rate applying to the item of fit-out. However second homes (like holiday homes) and timeshare apartments will not qualify for the commercial fit-out rules.

The items of fit-out which will be depreciable are those described in the “Building fit-out” category within the Commissioner’s table of depreciation rates. The building

structure will not be depreciable. According to the issues paper, building structure includes: the foundations; the building frame; floors; external walls, cladding, windows and doors; stairs; the roof; and load-bearing structures such as pillars and load-bearing internal walls.

A dominant purpose test is proposed for mixed purpose buildings where the fit-out is shared between the residential and non-residential spaces. For example, a lift that serves a 4-storey building which has 3 floors of commercial space and a penthouse at the top will have a dominant purpose of providing commercial space. Therefore the lift can be depreciated under the new commercial fit-out rules (rather than the residential rental property rules stipulated in *IS 10/01 (Residential rental properties – depreciation of items of depreciable property)*).

A transitional rule will provide a one-off election opportunity for taxpayers who are currently depreciating commercial fit-out as part of the building (i.e. have not split out the commercial fit-out from the building). Essentially a building fit-out “depreciation pool” can be created by taking 15% of the building’s adjusted tax book value as at the end of the 2011 income year. An annual deduction will be available using the following formula:

**0.15 x starting adjusted tax value (as at end of 2011 income year) x 0.02 x (whole months used or available for use / 12)**

No deduction will be permitted for any loss on the value of the pool which is sold or scrapped and neither will there be any depreciation recovered, albeit the depreciation recovery rules will still apply to the building component.

It should be noted that to be eligible for this transitional adjustment, no amount of depreciation can have previously been claimed on an item of commercial fit-out. Practically this means that this transitional rule will not apply if a taxpayer made a conscious decision to split out one aspect of the fit-out, but didn't split out the rest.

It is not proposed to alter the capital /revenue boundary rules concerning repairs and maintenance as part of this review.

### Depreciation loading

As part of Budget 2010, the 20% depreciation loading applying to purchases of certain new assets was removed, subject to a grandparenting rule which was intended to apply if a taxpayer had committed to the purchase of an asset prior to the Budget day announcement. The original grandparenting rule did not work as well as intended and therefore a new grandparenting rule is proposed to clarify how depreciation loading should apply to cover the following situations:

- When a person begins to build an asset themselves, but had not finished it prior to 20 May 2010; or
- When a person enters into multiple contracts for a single item of depreciable property, with at least some of the contracts being binding on or before 20 May 2010.

The proposed rule is that for an item to be eligible for loading, its owner -

- (a) Acquires the item on or before 20 May 2010; or
- (b) Intends to purchase or construct the item, and
  - (i) enters into a binding contract for the purchase or construction of the item on or before 20 May 2010; or
  - (ii) starts construction of the item on or before 20 May 2010.

To rely on paragraph (b) above the person must be able to provide documentation (which is dated prior to 20 May 2010) that evidences an intention to purchase or construct an item (such as board approval or an approved purchase order).

A statutory declaration must be sent to the Commissioner that evidences the person had such an intention. This is because Inland Revenue need to ensure that there was a commitment to the acquisition or construction of the entire "item" and not just a component of it.

In the above context, construction is to mean that the physical process of assembly had started or that the physical process necessary to begin assembly has started. It would not include activities such as applying for resource consents and drawing up plans.

Therefore if a taxpayer had an intention to construct an internally built piece of plant and had started the physical process of constructing the plant (e.g. undertaking earthworks) on or before 20 May 2010, then the plant will qualify for the loading when completed, assuming the evidentiary requirements are met.

However take the example where a taxpayer can demonstrate an intention to construct a printing production line prior to 20 May 2010 but hadn't yet commenced construction. There may be many separate elements of depreciable property which make up the overall production line asset (for example, cutting machines, folding machines etc which each have a separate depreciation rate). Whether the depreciation loading ultimately applies may vary depending on what is considered to be the "item" of depreciable property. Is it the overall printing production line asset, or is it each component which is capable of separate operation? If it is the former, only one binding contract will be required; if it is the latter, then a binding contract will be required for each separately depreciable component. It is always a question of fact and degree when assessing these questions. Given it is a timing difference, the total time spent pondering the question ultimately comes back to the value of the asset.

We recommend taxpayers review the proposals carefully and determine whether a submission is required to ensure particular scenarios are catered for.

### Conclusion

The submission deadline is 1st September 2010. The full paper and draft legislation can be obtained from the Inland Revenue's Policy Advice Division Website. If you are affected by these proposals, please contact us to discuss the implications for your situation. Particularly if you have commercial fit-out that has not previously been split out. Advice should be sought as the tax treatment adopted in tax returns for the 2010 and 2011 income years could impact on options available in the 2012 income year.

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