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A special report from the
Policy Advice Division of Inland Revenue

Canterbury earthquake-related measures in the Taxation (Annual Rates, Returns Filing, and Remedial Matters) Act 2012

This special report provides early information on several Canterbury earthquake-related amendments to the Income Tax Act 2007, contained in the Taxation (Annual Rates, Returns Filing, and Remedial Matters) Act enacted on 2 November 2012.

This special report precedes full coverage of the new legislation that will be published in a *Tax Information Bulletin* later this year.

Depreciation

Sections EE 22, EE 45(8) and EZ 23B to EZ 23G, of the Income Tax Act 2007

Following the February 2011 earthquake in Canterbury, taxpayers have begun to receive insurance or compensation payments, and to re-establish business or income-earning activities. This has highlighted some particular problems, largely relating to the income tax rules for asset depreciation, the taxation of insurance proceeds that are not received or cannot be used in the conventional way, and the repair or abandonment of damaged buildings and other assets.

Many of these problems have arisen because of the scale of earthquake damage to a significant number of capital assets, which has affected the way insurance claims are being processed and paid.

With some exceptions, the focus of the changes contained in the Taxation (Annual Rates, Returns Filing, and Remedial Matters Act) 2012 is to provide temporary, time-limited earthquake relief and assistance, as reflected in the application dates of some of the provisions.

Key features

Changes to the depreciation rules:

- provide optional matching rules to smooth the timing of income and deductions/disposal losses when insurance proceeds have been received for earthquake-damaged depreciable assets;
- align the tax treatment of depreciable assets that are uneconomic to repair with the treatment of depreciable assets that have been "irreparably damaged" or are "useless for earning income" for tax purposes;

- limit the depreciation recovery income that arises under the tax rules when insurance proceeds have been received for a damaged asset that is repairable to the amount of depreciation deductions previously claimed for the asset;
- address minor technical issues with the pool depreciation rules; and
- allow a depreciation deduction in relation to depreciable property when access to the property is temporarily restricted as a result of a Canterbury earthquake**.**

Detailed analysis

Consideration when depreciable property is irreparably damaged or rendered useless

Section EE 45(8) has been amended to ensure that the amount derived from a depreciable asset that is irreparably damaged or rendered useless for earning income includes any proceeds from its disposal – for example, any scrap value.

Previously, the provision stated that the amount derived from disposal of the asset was the amount of insurance, indemnity or compensation received and did not take into account any disposal proceeds.

Application date

The amendment applies for the 2011–12 and later income years. This includes taxpayers who have been granted an extension of time for filing an income tax return for the 2010–11 income year under the Canterbury Earthquake (Inland Revenue Acts) Order 2011.

Damaged depreciable property that is uneconomic to repair

New section EZ 23C provides for the deemed disposal and reacquisition of assets which are damaged in a Canterbury earthquake and uneconomic to repair.

The tax depreciation rules do not provide an appropriate outcome when an asset has been damaged in a Canterbury earthquake and the insurer considers it to be uneconomic to repair (and requiring replacement), even though the asset may be physically repairable. This is because the current rules make a distinction between assets that are repairable and those that are irreparably damaged or rendered useless for earning income. Assets that are uneconomic to repair are generally included in the former category.

The consequence is that a taxpayer may face a significant unexpected tax liability when an insurance amount is received, as a result of the application of section EE 52. Section EE 52 treats as taxable any insurance proceeds in excess of an asset's adjusted tax value and expenditure on repairing the asset. This means that an amount greater than the depreciation deductions previously claimed for the asset may be treated as taxable. By contrast, for an asset that is irreparably damaged or rendered useless for earning income, the depreciation rules cap depreciation recovery income at the amount of previous depreciation deductions.

In addition, the depreciation "roll-over relief" rule in section EZ 23B, which was developed last year as a response to the Canterbury earthquakes to give taxpayers the ability to defer any depreciation recovery income, applies only to irreparably damaged assets or buildings that are rendered useless for the purpose of deriving income.

Accordingly, amendments have been made to align the treatment of assets that are uneconomic to repair with the existing treatment under the depreciation rules of assets that are irreparably damaged or rendered useless for earning income. This recognises that assets that are uneconomic to repair in the context of the Canterbury earthquakes are, in substance, very similar to assets that are physically irreparable and therefore should receive similar treatment under the depreciation rules.

This objective is achieved through new section EZ 23C which treats assets that are uneconomic to repair as being disposed of for the amount of insurance received for the asset, on the date of the Canterbury earthquake that caused the asset to be uneconomic to repair. This deemed disposal ensures that section EE 48 in the depreciation rules (which applies to irreparably damaged assets) also applies to assets that are uneconomic to repair.

The criteria for an asset to be subject to deemed disposal and reacquisition under section EZ 23C are:

- The depreciable asset is damaged by a Canterbury earthquake, as that term is defined in section 4 of the Canterbury Earthquake Recovery Act 2011.
- The owner of the asset is entitled to an amount of insurance or compensation for the damage to the item.
- The asset has been assessed by the insurer as uneconomic to repair.
- The damage has not caused the asset to be irreparably damaged or rendered useless for earning income in accordance with section EE 47(4).

The term "Canterbury earthquakes" is defined broadly in section 4 of the Canterbury Earthquake Recovery Act 2011 as "any earthquake in Canterbury on or after 4 September 2010, and includes any aftershock". Accordingly, when assets have sustained cumulative damage through multiple earthquakes and aftershocks, taxpayers can use the date of the earthquake which caused the asset to be damaged to the extent that it is uneconomic to repair as the relevant date of the deemed disposal and reacquisition under section EZ 23C.

The asset is treated as being reacquired on the same date as the deemed disposal for nil consideration. This is to ensure that post-earthquake repairs are correctly capitalised (and not treated as deductible expenditure).

Roll-over relief for income tax liabilities arising from the receipt of insurance for earthquake-damaged assets has been extended to assets that are subject to a deemed disposal and reacquisition under section EZ 23C by an amendment to section EZ 23B.

Section EZ 23C overrides section EE 52, which means that for an asset meeting the criteria for section EZ 23C to apply, section EE 52 will not apply.

The deemed disposal and reacquisition under section EZ 23C is not treated as a disposal or reacquisition for the purposes of the land provisions (sections CB 6 to 23).

Example

A building has a cost of $5 million, accumulated depreciation deductions of $4 million and an adjusted tax value (ATV) of $1 million. It is damaged in a Canterbury earthquake and the insurance company decides it has an obligation under the insurance policy to replace it at a cost of $10 million because it is no longer fit for purpose and is uneconomic to repair. The damaged building is retained by the insured party and put to another, less productive, use.

The building meets the criteria for section EZ 23C to apply. Therefore, the building is treated as being disposed of and reacquired for nil consideration on the date of the earthquake which caused the asset to be uneconomic to repair. As the building is treated as having been disposed of, the owner of the asset can apply the matching rule in section EZ 23F to smooth the timing of income calculated under section EE 48.

Under section EE 48, the result will be:

Original cost:	$5,000,000
Depreciation deductions:	$4,000,000
ATV:	$1,000,000
Amount item disposed for (consideration):	$10,000,000
Depreciation recovery income:	$4,000,000
Capital gain:	$5,000,000

Roll-over relief (under section EZ 23B) is available to the building owner for the $4 million of depreciation recovery income.

Application date

This Canterbury earthquakes-specific amendment applies for the 2010–11 to 2015–16 income years. The Commissioner may exercise the discretion under section 113 of the Tax Administration Act 1994 to amend an assessment.

Cap on depreciation recovery income

New section EZ 23D limits depreciation recovery income calculated under section EE 52 to the amount of depreciation deductions previously taken, when insurance proceeds are received for a repairable damaged asset.

Section EE 52 provides that when insurance proceeds are received for damage to a repairable depreciable asset, the proceeds are taxable to the extent they exceed the cost of any repairs and the asset's adjusted tax value. As noted above, this means that the tax rules may end up taxing more than the amount of earlier depreciation deductions allowed for the asset. In the context of the Canterbury earthquakes, this means that taxpayers may face significant unanticipated income tax liabilities in relation to damaged (but repairable) assets.

The cap on depreciation recovery income determined under section EE 52 is confined to depreciable assets damaged by a Canterbury earthquake (as defined in section 4 of the Canterbury Earthquake Recovery Act 2011), the damage does not cause the asset to be irreparably damaged or rendered useless for earning income, and section EZ 23C does not apply to the asset.

Example

A building costing $5 million was damaged in a Canterbury earthquake but is repairable. The building has an adjusted tax value of $1 million, with depreciation deductions of $4 million taken. Insurance proceeds of $7 million are received, with $1 million of the proceeds being spent on repairing the asset. Section EZ 23C does not apply because the asset is not uneconomic to repair.

Under section EE 52, the depreciation recovery income would be $5 million. However, section EZ 23D caps the amount of depreciation recovery income at $4 million. The remaining $1 million is treated as a capital gain.

Application date

This Canterbury earthquakes-specific amendment applies for the 2010–11 to 2015–16 income years. The Commissioner may exercise the discretion under section 113 of the Tax Administration Act 1994 to amend an assessment.

Optional timing rule for income and deductions when insurance proceeds are received for earthquake-damaged, irreparable depreciable assets

New section EZ 23F provides an optional rule to smooth the timing of income and deductions when insurance proceeds have been received for depreciable property that has been irreparably damaged or rendered useless for earning income as a result of the Canterbury earthquakes. The timing rule also applies to depreciable assets that are uneconomic to repair and to which section EZ 23C applies. The rule applies to individual items of depreciable property, in line with the general approach under the depreciation rules.

The policy intent is that the matching rule allows the net amount of:

- insurance payments
- disposal proceeds

less

- the write-off of the tax book value; and
- expenditure on disposing of the asset

as determined under section EE 48 to be brought to account for tax purposes by a taxpayer.

The timing rule may be used for a depreciable asset when:

- The asset is damaged by a Canterbury earthquake as that term is defined in section 4 of the Canterbury Earthquake Recovery Act 2011.
- The damage causes the asset to be irreparably damaged or rendered useless for earning income and thus meets the requirements of section EE 47(4) or causes the asset to be subject to a deemed disposal and reacquisition under section EZ 23C.
- The owner is entitled to insurance or compensation for the damage.
- The owner chooses to apply the timing rule to all their depreciable assets meeting the above requirements.

The timing rule provides that any income or deductions are recognised at the earlier of:

- when insurance proceeds, the cost of and proceeds from disposing of the asset have been derived or incurred or are able to be reasonably estimated; or
- the 2015–16 income year.

Whether insurance proceeds and other amounts can be reasonably estimated is essentially a question of fact, which will depend on the individual circumstances of each case. However, it is envisaged that some form of documentation would be required – for example, a written quote from an insurer.

Section EZ 23F overrides the timing rules in sections EE 1, EE 22 and EE 48. The section can also be applied to assets depreciated in a pool.

A person who opts to use the matching rule must use it for all their items of depreciable property that meet the criteria for applying the rule. This is to prevent taxpayers "cherry-picking" the assets to which they apply the rule.

A taxpayer's decision to elect into the matching rule will be reflected in the tax position they take in their return of income for each tax year – no prior notice of election is required.

Example

Equipment originally costing $10,000 is irreparably damaged in a Canterbury earthquake. The asset's tax book value is $7,000, with $3,000 of accumulated depreciation deductions. The disposal costs are reasonably estimated to be $1,000 in 2012–13. The insurance proceeds received for the asset are reasonably estimated in 2013–14 as being $9,000. The equipment has a scrap value of $100, which is reasonably estimated in 2012–13.

Applying the matching rule, any income or deductions are recognised in the 2013–14 income year, as this is when the insurance proceeds, disposal costs and disposal proceeds can be reasonably estimated. Accordingly, in the 2013–14 income year, section EE 48 applies to determine the amount of depreciation recovery income or depreciation loss.

Application date

This Canterbury earthquakes-specific amendment applies for the 2010–11 to 2015–16 income years. The Commissioner may exercise the discretion under section 113 of the Tax Administration Act 1994 to amend an assessment.

Optional timing rule for income and deductions when insurance proceeds are received for depreciable property that is damaged but repairable

New section EZ 23G introduces an optional rule to smooth the timing of income and deductions when insurance proceeds have been received for a depreciable asset that has been damaged in a Canterbury earthquake but is repairable. The rule is broadly similar to section EZ 23F in design.

The timing rule may be used for a depreciable asset when:

- The asset is damaged by a Canterbury earthquake as that term is defined in section 4 of the Canterbury Earthquake Recovery Act 2011.
- The asset is not irreparably damaged or rendered useless for earning income and therefore does not meet the requirements of section EE 47(4) and the asset is not subject to a deemed disposal and reacquisition under section EZ 23C.
- The owner is entitled to insurance or compensation for the damage.
- The owner chooses to apply the timing rule to all their depreciable assets meeting the above requirements.

The timing rule provides that any income or deductions are recognised at the earlier of:

- when insurance proceeds and the cost of repairing the asset have been derived or incurred or are able to be reasonably estimated; or
- the 2015–16 income year.

Section EZ 23G overrides the timing rules in sections CG 4, EE 22 and EE 52. The section is also applicable to assets depreciated in a pool.

Example

Machinery originally costing $100,000 is damaged in a Canterbury earthquake. The asset's adjusted tax value (ATV) is $60,000, with $40,000 of accumulated depreciation deductions. The insurance proceeds are estimated in 2011–12 as being $110,000. Repair costs are estimated in 2012–13 to be $20,000 and $10,000 is actually incurred in each of 2012–13 and 2013–14.

Applying the matching rule, any income or deductions are recognised in the 2012–13 income year, as this is when the insurance proceeds and total repair costs can reasonably be estimated. Accordingly, in the 2012–13 income year, sections CG 4 and EE 52 apply.

The repair costs are deductible under the general deductibility rules.

Section CG 4 treats $20,000 of the insurance proceeds as taxable, as this is the amount of insurance proceeds which recovers deductible expenditure.

Section EE 52 applies to the insurance proceeds as follows:

ATV of $60,000 less ($110,000 – $20,000) = ($30,000)

Accordingly, the ATV is reduced to nil and depreciation recovery income under section EE 52 is $30,000.

Amendments to the pool depreciation rules

Section EE 22 has been amended to address some minor technical issues with the depreciation rules for pool assets, arising from the Canterbury earthquakes.

A new subsection (2B) has been included to ensure that when a person receives insurance proceeds for damage caused to an asset included in a pool, any insurance proceeds that are more than the expenditure the person has incurred in repairing the asset is subtracted from the pool's adjusted tax value. The rationale is to align the treatment of damaged pool assets more closely with the treatment of non-pool assets under the depreciation rules. Under the general depreciation rules, insurance proceeds received that are more than the repair costs incurred for a damaged asset reduce the asset's adjusted tax value. Section EE 22(3) has been amended to clarify that insurance proceeds are included as an amount derived from the disposal of an asset included in a pool, and to ensure that any excess of the insurance proceeds over disposal costs or loss is subtracted from the pool's adjusted tax value on the date of disposal. Again, this aligns the pool depreciation rules more closely with the general depreciation rules.

Application date

These generic amendments apply for the 2011–12 and later income years. However, for a person who is granted an extension of time for filing an income tax return for the 2010–11 income year under the Canterbury Earthquake (Inland Revenue Acts) Order 2011, the amendments apply for the 2010–11 and later income years.

Property that is available for use

For an item of property to be depreciated, the item must be used in a business or available for use. It was unclear how this rule should be applied when access to depreciable property was temporarily restricted following a Canterbury earthquake.

To clarify the tax treatment in this case, new section EZ 23E treats an item of property as being available for use while access to the property is temporarily restricted due to the effects of a Canterbury earthquake (as defined in section 4 of the Canterbury Earthquake Recovery Act 2011), if the following conditions are met:

- The item was used or available for use immediately before the restriction was imposed.
- The item would be used or available for use in the absence of the restriction.
- The income year is the 2015–16 or an earlier income year.

This amendment allows businesses to continue to have depreciation deductions for their depreciable property even though it is temporarily unavailable for use as a result of a Canterbury earthquake.

Application date

This amendment applies for the 2010–11 to the 2015–16 income years.

Correction of minor drafting error in roll-over relief provision

An incorrect cross-reference in section EZ 23B(2)(b) has been amended. The reference to "subsection (7)" has been changed to "subsection (8)".

Application date

This generic amendment applies from 4 September 2010, the date section EZ 23B came into force.

Timing of insurance receipts for expenditure or loss

Section CG 4 of the Income Tax Act 2007

Previous legislation was developed on the assumption that expenditure incurred on, for example, repairing a damaged asset, would be incurred (and the expense taken as a deduction) before insurance proceeds were received. It was therefore not clear how the legislation would operate if an insurance payout was made before expenditure had been incurred on repairing a damaged asset.

Key feature

An insurance receipt which recovers deductible expenditure will be taxable irrespective of whether the insurance is received before or after the expenditure has been incurred.

Detailed analysis

Previous legislation was based on the assumption that expenditure incurred on, for example, repairing a damaged asset, would be incurred (and the expense taken as a deduction) before insurance proceeds were received. This was consistent with the normal insurance model, where the insurer either undertakes the repairs or reimburses the policyholder after they have undertaken repairs on the affected property. However, in the context of the Canterbury earthquakes, it has been common for insurers to make insurance payouts *before* the policyholder undertakes the relevant repairs.

The problem with the previous wording of section CG 4 was that it was not clear if it operated when insurance payouts were made before expenditure is incurred on repairing a damaged asset. If the section did not operate in these situations, it could mean there would be a reduction in the damaged asset's adjusted tax value instead, under section EE 52 of the tax depreciation rules. Furthermore, if an amount of insurance was received that was greater than the adjusted tax value, section EE 52 would treat the excess as taxable income upfront, without taking into account repairs undertaken at a later time. In other words, the compensation payment would be treated as depreciation recovered rather than a recovery of the future expenditure on repairs.

Accordingly, the wording of section CG 4 has been amended to resolve this problem. Section CG now provides that an insurance receipt which relates to deductible expenditure is taxable irrespective of whether the insurance is received before or after the repair expenditure is incurred.

In cases when insurance proceeds are received before repair costs are incurred, and those costs are incurred in more than one income year, any income from insurance proceeds must be recognised in each income year that the repair costs are incurred.

Application date

This generic amendment applies for the 2011–12 and later income years. However, for a person who is granted an extension of time for filing an income tax return for the 2010–11 income year under the Canterbury Earthquake (Inland Revenue Acts) Order 2011, the amendment applies for the 2010–11 and later income years.

Business interruption insurance: timing of derivation

Section CG 5B of the Income Tax Act 2007

Under the previous legislation, if a person received an amount of insurance, indemnity, or compensation for an interruption or impairment of business activities following an event, any income arising was allocated to the earlier of the income year in which the amount was reasonably estimated or, in case of interim payments, when they were received.

On this basis, if an insurer estimated in an earlier income year a loss of income for a number of future income years, the entire estimated amount would be allocated to that earlier income year. This result is inconsistent with the general tax and accounting practice of allocating income on an accrual basis.

Key feature

Income derived under a business interruption insurance policy is now allocated to the later of the income year to which the replaced income relates or the income year the amount is reasonably estimated (or, in case of interim payments, when they are received).

Detailed analysis

Section CG 5B(3) of the Income Tax Act 2007 has been amended so that income derived under a business interruption insurance policy is allocated to the later of:

- the income year to which the replaced income relates; or
- the earlier of –
  - the income year in which the amount is received; or
  - the income year in which the amount is reasonably able to be estimated.

The amendment ensures an entire estimated income amount for a number of future years is not allocated to an earlier income year.

The income derived under a business interruption insurance policy is allocated to the period the income relates to if the income relates to future income years only. If the income relates to past income years, it will continue to be allocated to the income year in which the amount is either received or reasonably estimated. This is to avoid complex compliance and administrative costs involved in amending past years' income tax returns.

Application date

This generic amendment applies for the 2011–12 and later income years. However, for a person who is granted an extension of time for filing a return of income for the 2010–11 income year under the Canterbury Earthquake (Inland Revenue Acts) Order 2011, the amendment applies for the 2010–11 and later income years.

Business interruption insurance for a replacement property and capital contribution

Section YA 1 of the Income Tax Act 2007

Previously, if a person received a business interruption insurance payment for a replacement property to restart or continue their business operations, the payment was not recognised in the person's taxable income as it is of a capital nature. Also the person could claim full depreciation deductions for the cost of the replacement property even though they had not paid for the replacement property. Allowing the person to capitalise and claim full depreciation deductions for the total cost of the new replacement property was not consistent with the policy to only allow depreciation deductions for the cost of the property which is actually borne by the person.

Key feature

A business interruption insurance payment that relates to a purchase of a replacement property is now a capital contribution for the purposes of sections CG 8, DB 64 and EE 48.

Detailed analysis

The definition of "capital contribution" in section YA 1 of the Income Tax Act 2007, for the purposes of sections CG 8, DB 64 and EE 48, has been amended to include a business interruption insurance payment that relates to a purchase of a replacement property.

An amount will now be treated as a capital contribution if the amount:

- is paid by a person (other than in their capacity of settlor, partner or shareholder of the recipient) to a recipient under an agreement between them;
- is not income of the recipient, ignoring section CG 8;
- is paid, under the express terms and conditions of the agreement, as a contribution for depreciable property owned or to be acquired by the recipient; and
- if the agreement is a contract of insurance, indemnity or compensation, is paid in relation to an interruption or impairment of business activities.

A capital contribution, including the business interruption insurance payment that relates to a replacement property, is treated as income of the recipient under section CG 8 unless the recipient chooses to reduce the cost base of the replacement property under section DB 64.

Application date

This generic amendment applies for the 2011–12 and later income years.

There is a savings provision for people who filed returns before 28 August 2012, which is the date on which the Taxation (Annual Rates, Returns Filing, and Remedial Matters) Bill was first considered by a Committee of the whole House.

Deductibility of expenses when there is no income-earning activity

Section DZ 20 of the Income Tax Act 2007

After the Canterbury earthquakes, some taxpayers were no longer able to deduct their expenses or losses relating to their income-earning activity. Their activity was so disrupted by the earthquakes that there is no longer a sufficient nexus between the expenses or losses and their activity.

For example, some rental properties or business premises situated in the Christchurch CBD red zone have become untenanted or forcibly closed because the premises are not physically accessible. Given there is no income-earning activity, on-going expenses such as rates may not be deductible under the general permission in section DA 1 even if the activity subsequently resumes.

Key feature

A person whose income-earning activity in greater Christchurch was interrupted by a Canterbury earthquake, may receive a deduction for expenditure relating to the income-earning activity in the year in which that activity resumes. This applies only when the income-earning activity is resumed before the 2016–17 income year.

Detailed analysis

New section DZ 20 provides certainty on the deductibility of expenses or losses for affected taxpayers who intend to continue their income-earning activities. To qualify for this relief, a person must meet all of the following conditions:

- the person has an income-earning activity in "greater Christchurch" (as defined in section 4 of the Canterbury Earthquake Recovery Act 2011) immediately before a Canterbury earthquake (as defined in that section);
- the income-earning activity is interrupted for a period (the period of interruption) as a result of the Canterbury earthquake;
- in the current year, during the period of interruption, the person incurs expenditure or loss (the interruption expenditure) in meeting an obligation relating to the income-earning activity;
- the interruption expenditure does not meet the requirements of the general permission in section DA 1 but would do so but for the interruption; and
- the person resumes the income-earning activity in an income year (the resumption year) before the 2016–17 income year.

If all of these conditions are met, the person is allowed to deduct the interrupted expenditure in the year their income-earning activity is resumed. This new section supplements the general permission in section DA 1. The general limitations in section DA 2 still apply.

Application date

The amendment applies for the 2010–11 to 2015–16 income years.

Example

Victoria carries on a dry cleaning business as a sole trader in the Christchurch CBD. She has a loan for the business that requires a $2,000 monthly interest payment. After the earthquake of 22 February 2011 she was no longer able to access her business premise. She temporarily stopped her business activity while considering whether to continue the business elsewhere.

Without new section DZ 20, Victoria would not be able to deduct the interest payments on the business loan since February 2011 because there is no dry cleaning business so there is no longer a sufficient nexus between the interest expenditure and an income-earning activity.

In September 2012, Victoria resumes the same dry cleaning business in Hoon Hay. She can deduct $40,000 ($2,000 x 20 months) interest incurred on the business during the interruption period in the 2012–13 income year.

Roll-over relief for buildings and land held on revenue account

Section CZ 25 of the Income Tax Act 2007

Section CZ 25[1] was introduced in 2011 to provide special roll-over relief for profits arising from compensation payments received in relation to buildings held on revenue account that were destroyed due to a Canterbury earthquake. The relief did not apply to land, or to buildings that were not demolished, or abandoned for later demolition.

If the roll-over relief provision applies, the cost of any replacement building for tax purposes is reduced by [up to] the amount of profit made on the destroyed building. The effect is that, in most cases, a tax liability arising from the profit from compensation or insurance received in relation to the destroyed building is deferred until the replacement building is eventually sold.

Key features

The roll-over relief now also applies to:

- land held on revenue account that is damaged as a result of the Canterbury earthquake; and
- Crown purchases of buildings held on revenue account. This is intended to address purchases being made under the Government's "red zone compensation package", and applies even in situations when the building is not demolished.

Detailed analysis

New section CZ 25(1)(a)(i) applies the roll-over relief provisions to land held on revenue account that is damaged as a result of a Canterbury earthquake.

[1] This roll-over relief provision was originally inserted as section CZ 23 by the Taxation (Tax Administration and Remedial Matters) Act 2011. Section CZ 23 was already in the Income Tax Act 2007, the newly inserted section CZ 23 was renumbered as section CZ 25 by the Taxation (Annual Rates, Returns Filing, and Remedial Matters) Act.

New section CZ 25(1)(a)(ii) applies the roll-over relief provisions to both land and buildings, if the owner accepts the compensation provided by the Crown's offer of purchase made in accordance with section 53(1) of the Canterbury Earthquake Recovery Act 2011. In this situation only, the roll-over relief can be claimed regardless of whether the building is destroyed or abandoned for later destruction.

The remaining conditions of the roll-over relief, which relate to the replacement building or (now) replacement land, remain unchanged. In summary these are:

- The owner must incur, or intend to incur expenditure on replacement building(s) or land in or before their 2015–16 income year.
- The owner must hold the replacement building(s) or land on revenue account.
- The replacement building(s) or land must be located in the greater Christchurch area (as defined by section 4 of the Canterbury Earthquake Recovery Act 2011).

Amounts received under a Crown offer of purchase for a building may be used to acquire replacement land and vice versa, as long as the remaining conditions are met.

Application date

The amendments apply from 4 September 2010, being the same date as the roll-over relief became effective.

Disposal of buildings and land within 10 years of acquisition

Section CZ 26 of the Income Tax Act 2007

Under sections CB 6 to CB 12 of the Income Tax Act 2007, the proceeds from land purchased with the intention or purpose of sale are taxable. Broadly speaking, a seller may also derive income from the disposal of land if it is disposed of within 10 years of purchase or within 10 years of improvements being made to the land, and the seller is, or is associated with, a person in the business of dealing in, developing or building on land, or if there has been non-minor development of the land within 10 years of its acquisition.

These provisions could apply to Government purchases of land under its "red zone compensation package", if the person acquired the land within 10 years of accepting the Government's offer of purchase.

Key features

The tax rules relating to disposal of land within 10 years of acquisition, or improvement, or following non-minor development do not apply to Crown purchases of land made under the Government's "red-zone compensation package".

Detailed analysis

The context of the Crown's purchases of buildings and land under section 53(1) of the Canterbury Earthquake Recovery Act 2011, as part of the "red-zone compensation package", is to recognise that a disastrous event has rendered the buildings and land substantially damaged and unusable.

Section CZ 26 ensures that the rules in sections CB 9 to CB 12, which relate to disposals of land with 10 years of the land being acquired, or certain disposals following the development or division of the land, do not apply to Crown purchases of land made under section 53(1) of the Canterbury Earthquake Recovery Act 2011. A person who accepts the Crown's offer of purchase will not be considered to derive income from the disposal of land under those sections.

The exception does not apply to land that was initially acquired with the intention of resale and development. The general rules in sections CB 6 and CB 7 will continue to operate. However the roll-over relief provisions in section CZ 25 may apply in these circumstances.

There is no requirement that a person to whom the rules in sections CB 9 to CB 12 would have applied, if they were not excepted by the new section CZ 26, must purchase new land with the monies received under the compensation package. However if they do subsequently acquire new land, the 10-year period provisions in sections CB 9 to CB 12 may start afresh for the newly acquired land.

Application date

The amendments apply from 4 September 2010.

Note: This amendment, and the previous amendment, was developed in part to deal with concerns raised by potential sellers in relation to the Crown's offer of purchase under the "red zone compensation package" as it applied to residential properties. The amendment may also be relevant to similar issues with the acquisition of non-residential properties and land, as announced as part of the Central Christchurch Recovery Plan. These broader issues are being considered at the moment, as the detail of the plan is developed.

Optional adjustment to assets under thin-cap rules

Section FZ 7

New section FZ 7 provides an optional adjustment to how group assets are measured for the purposes of the thin-capitalisation rules. The adjustment mitigates a timing problem that arises because insurance proceeds are recognised at a later date than damage caused by the Canterbury earthquakes.

Background

The thin-capitalisation rules are based on accounting measures of assets. For accounting purposes, damaged assets are immediately impaired or derecognised. In contrast, insurance proceeds cannot be recognised until they are reasonably expected (for example, can be given a confirmed value).

Section FZ 7 is designed to mitigate this timing difference by allowing certain taxpayers to carry back known insurance proceeds to the date on which an asset was impaired or derecognised as a result of damage caused by the Canterbury earthquakes. The amount that can be carried back is limited to the lesser of the amount of damage or the related insurance proceeds.

Key features

Before a person can choose to use the optional adjustment, they must first satisfy the conditions in section FZ 7(1).

These conditions are that:

- an asset of the person's New Zealand group has been has been damaged as a result of the Canterbury Earthquakes;
- the asset has been impaired or derecognised under generally accepted accounting practice as a result of that damage; and
- insurance for the damage has been recognised at a later date under generally accepted accounting practice.

In such cases, the New Zealand group is able to choose to carry-back the insurance amount and regard this as an asset. The amount that can be carried back is limited to the lesser of the amount of damage or the related insurance proceeds. For impaired assets the damage is measured as the amount the asset has been impaired (as long as the impairment was a result of the earthquake damage rather than other reasons). For derecognised assets the damage is the amount of the derecognised asset (again, as long as the asset has been derecognised as a result of earthquake damage).

Section FZ 7(2) provides for this additional asset to exist for a temporary period beginning on the day that the relevant asset is impaired or derecognised and ending on the day that the corresponding amount of insurance is recognised for accounting purposes.

Section FZ 7(3) requires that if a person chooses to use section FZ 7(2) to increase the assets of their New Zealand group they must also increase the assets of their worldwide group by the same amount for a corresponding period. This ensures the worldwide group test continues to operate on a consistent basis.

A person could receive insurance pay-outs for several different events. In such cases, each insurance pay-out is treated separately and can only be carried back to the date of the related damage.

Example

A company has $1 million of impairment as a result of an earthquake that occurred during its 2010–11 income year. In its 2011–12 income year there is a further $500k of impairment relating to a different earthquake. It receives $1.5 million of insurance pay-outs for both events in the 2011–12 income year. The company would only be able to claim an asset of $1 million in the 2010–11 income year.

Under generally accepted accounting practice the insurance may be recognised all at once if it is for a certain amount. Alternatively, if the person is entitled to reimbursement of costs actually incurred in repairing an asset, then the insurance revenue could be recognised gradually as the repair costs are incurred.

In cases when the insurance is recognised gradually, the amount that is available under the provision should also be reduced gradually, at the same time that the insurance is recognised.

Example

A company has $2 million of impairment, $500k of which is repaired and reimbursed by insurance in 2011–12 and the remaining $1.5 million is repaired and reimbursed in 2012–13. In 2011–12 the company can claim $1.5 million of additional assets under section FZ 7 ($2m - $500k = $1.5m) and in 2012–13 all the impairment has been met by insurance so section FZ 7 no longer applies ($2m - $2m = 0).

Notification requirement

Section FZ 7(4) requires a person who chooses to use section FZ 7(2) to inform the Commissioner that they are applying this rule and to provide some information on its effect, including:

- notice to the Commissioner that section FZ 7 of the Income Tax Act 2007 has been applied;
- the amount of income that would arise under section CH 9 of the Income Tax Act 2007 in the absence of section FZ 7; and
- the amount of income that arises under section CH 9 by applying section FZ 7.

This information should be e-mailed to competent.authority@ird.govt.nz by the later of 30 November 2012 or the day that the person is required to make a return of income for the corresponding tax year.

Application date

Section FZ 7 applies for income years ending after 4 September 2010 and before the 2016–17 income year.