

# Regulatory Impact Statement

## Further Canterbury earthquake tax measures

### Agency Disclosure Statement

This Regulatory Impact Statement (RIS) has been prepared by Inland Revenue.

As a result of the Canterbury earthquakes, a number of changes to tax legislation were made in 2011 and 2012. This RIS provides an analysis of options to ensure the existing tax measures work as intended, as taxpayers have begun to receive insurance or compensation payments and commenced rebuilding.

The key policy objective behind the existing measures is to ensure the tax rules do not over-tax insurance proceeds or unnecessarily bring forward future tax liabilities for taxpayers affected by the earthquakes. A further objective has been to ensure that the tax rules do not produce unfair results and that they assist recovery and rebuilding in the Canterbury region.

The particular questions addressed, in the context of these policy objectives, are:

1. Should the current 2015-16 time limit for a number of Canterbury earthquake-specific tax measures be extended, bearing in mind the pace of the rebuild?
2. How should the existing policy of providing relief to taxpayers with unanticipated tax liabilities from destroyed buildings and other assets be maintained when taxpayers reinvest in Canterbury jointly with other investors, i.e. through multiple owners pooling together to invest in large building complexes?

Inland Revenue consulted on most of the proposed policy responses with tax practitioners familiar with the issues faced by taxpayers within the Canterbury region, including all of the large accounting firms and the New Zealand Institute of Chartered Accountants. Consultation has also been undertaken with the Treasury and CERA. Further modifications were made to the final proposals in response to feedback received.

The amendments proposed do not affect the fiscal baselines because they relate to what would otherwise be an unanticipated windfall tax revenue gain for the Government (such as depreciation recovery income arising from insurance proceeds).

There are no other significant constraints, caveats and uncertainties concerning the regulatory analysis undertaken. The recommended approaches to the various issues raised do not impose additional costs on businesses, impair private property rights, restrict market competition, reduce the incentives on businesses to innovate and invest, or override fundamental common law principles.



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## **STATUS QUO AND PROBLEM DEFINITION**

1. As a result of the Canterbury earthquakes, a number of changes to tax law were made in 2011 and 2012. These measures included deferring recognition of depreciation recovered in respect of certain assets (“roll-over relief”), and rules to smooth the timing of income recognition for insurance proceeds received for damaged assets.

2. The key policy objective behind the existing measures is to ensure the tax rules do not over-tax insurance proceeds or unnecessarily bring forward future tax liabilities for taxpayers affected by the earthquakes. A further objective has been to ensure that the tax rules do not produce unfair results and that they assist recovery and rebuilding in the Canterbury region.

3. Further tax issues have been identified as the Canterbury recovery plans have developed and the rebuild has commenced. These issues largely relate to ensuring that the existing tax measures work as intended in the context of the rebuilding activity taking place in Canterbury, rather than with providing additional “special relief” measures.

4. Two key issues have been identified:

### **I. Extending the 2015-16 time limit for Canterbury earthquake tax measures**

5. Tax measures introduced to address Canterbury earthquake-specific issues are due to expire at the end of the 2015–16 income year. This time limit was chosen to align with the date that CERA’s special powers expire and with little knowledge of the pace of the rebuild and for how long the measures would be required. The relevant tax measures are:

- provision allowing unanticipated depreciation recovery income to be deferred by being rolled over into cost base of replacement asset (“depreciation roll-over relief”) (s EZ 23B);
- roll-over relief for buildings and land on revenue account (s CZ 25);
- timing rules for smoothing income and deductions/disposal losses when insurance proceeds are received for depreciable assets (ss EZ 23G-F);
- provision regarding assets that are uneconomic to repair (s EZ 23C);
- provision capping depreciation recovery income arising under s EE 52 (s EZ 23D);
- amendment to the “available for use” depreciation rule (s EZ 23E);
- provision allowing deduction of expenses where income-earning activity was temporarily interrupted (s DZ 20); and
- provision allowing adjustment to assets under thin-capitalisation rules (s FZ 7).

6. As it is taking taxpayers longer to settle insurance claims and replace damaged property than first anticipated, the issue of extending the 2015-16 time limit has been raised.

### **II. Extension of depreciation roll-over relief to joint investment situations**

7. A Canterbury-specific rule was introduced in 2011 to allow the deferral of the claw-back of depreciation that ordinarily arises when insurance proceeds are received for items of depreciable property that have been irreparably damaged in an earthquake. It works by rolling over the depreciation recovery income to reduce the acquisition cost of replacement depreciable property.

8. The purpose of the rollover relief is to defer any unanticipated tax liability resulting from the destruction of insured depreciable assets in the earthquakes, and to assist the rebuilding in Canterbury.

9. When capital assets (buildings, plant and machinery) are purchased, there is no income tax deduction for that expenditure. However, depreciation is deductible while the asset is available for business use. Depreciation is an estimate of the decline in value of an asset as it is used to earn income. When an asset is sold or destroyed, the actual decline in value of the asset becomes clear. If the asset is sold for less than its depreciated tax value (tax book value), that loss is generally deductible since it demonstrates that depreciation was underestimated. If an asset is sold for more than its tax book value, then the depreciation deducted over the life of the asset was overestimated and the excess depreciation (the difference between the tax book value and the sales proceeds) is included as income. This is a clawing back of excess depreciation previously allowed and is known as “depreciation claw-back” or “depreciation recovery”.

10. Many income-producing assets are insured. In these cases, assets are deemed to be sold for the value of any insurance proceeds received. If the insurance proceeds exceed an item’s tax book value, any excess depreciation is clawed back as income.

11. The Canterbury earthquakes triggered an unanticipated tax liability for a significant number of taxpayers who owned depreciable assets. The purpose of the existing depreciation roll-over relief rule is to relieve this unanticipated tax liability.

12. The current depreciation roll-over relief is designed on the basis that the person who owned the damaged asset is the same person who will purchase the replacement asset. However, we understand that reinvestment in Canterbury is occurring through multiple owners pooling together to invest in large building complexes – this is partly because of CERA’s requirements for the minimum size of new developments in the central city area, and also because of practical design issues, for example, with building foundations.

13. The current roll-over relief rule does not allow taxpayers who reinvest jointly to access roll-over relief, which means that such taxpayers continue to face an unexpected tax liability for their damaged depreciable assets.

## **OBJECTIVES**

### **I. Extending the 2015-16 time limit for Canterbury earthquake tax measures**

14. The objectives are to:

- a) Ensure that the time limit for various Canterbury earthquake tax measures introduced in 2011 and 2012 is extended, to take into account that some taxpayers may not have replaced their damaged assets or settled with their insurance companies by the end of the 2015/16 income year.
- b) Ensure that tax relief is provided only to those taxpayers who are genuinely committed to reinvesting in Canterbury, to assist in the recovery and rebuilding of Canterbury in accordance with the wider objectives outlined in paragraphs 1 and 2.

## **II. Extension of depreciation roll-over relief to joint investment situations**

15. The objectives are to:

- c) Extend the existing depreciation roll-over relief provision to ensure it is accessible to taxpayers seeking to rebuild in Canterbury but who are required to pool with other investors to invest in large building complexes. This necessity to pool with others is partly because of CERA's requirements for the minimum size of new developments in the central city area, and also because of practical design issues, for example, with building foundations.
- d) Ensure the original policy intent behind depreciation roll-over relief is maintained, namely, ensuring taxpayers do not have an unexpected tax liability in relation to assets destroyed by the earthquakes and assisting in the rebuilding of Canterbury.

16. The outcomes are subject to a time constraint; any amendments must be enacted reasonably promptly and before the current 2015-16 deadline.

## **REGULATORY IMPACT ANALYSIS**

### **I. Extension of the 2015-16 time limit for Canterbury earthquake tax measures**

17. There are four options that may deal with the problem and achieve the objectives:

1. Extending the time limit by 3 years to 2018-19 combined with requiring taxpayers who wish to access depreciation roll-over relief for buildings to show a firm commitment to rebuilding by the end of the existing 2015-16 time limit (preferred option).

This option involves requiring taxpayers to show a substantive commitment by the end of 2015/16 to reinvesting in Canterbury in order to access the extension of depreciation roll-over relief for the 2016-17 to 2018-19 income years. Such commitment could be demonstrated by, for example, applying for the relevant regulatory or planning consents by the end of 2015-16.

2. Extending the time limit by 3 years to 2018-19;
3. Extending the time limit by a longer period, such as 5 years;
4. Extending the time limit combined with loosening the requirement in the existing depreciation roll-over relief rule that a taxpayer must complete the acquisition of any replacement property by the end of the 2018-19 income year, e.g. by replacing the requirement to "acquire" replacement property by a lesser form of commitment, such as partial construction by the end of the time limit.

| <i>Option</i>  | <i>Impacts</i>  |
|--|---|
| 1. Extending the time limit by 3 years combined with requiring taxpayers to show a firm commitment to rebuilding by the end of the existing 2015-16 time limit (preferred option). | This option meets the objectives of providing more time for taxpayers to replace their damaged assets without facing unexpected and/or unfair tax consequences and ensuring tax relief is provided only to those who are committed to reinvesting, in order to facilitate the recovery and rebuilding of Canterbury. Improves status quo by providing tax relief for a longer period.       |
| 2. Extending time limit by 3 years.  | This option meets the objective of providing more time for taxpayers to settle with their insurance companies and replace their damaged assets without facing unexpected and/or unfair tax consequences but does not meet the objective of ensuring tax relief is provided only to those who are committed to reinvesting. Improves status quo by providing tax relief for a longer period. |
| 3. Extending time limit for a longer period.   | As above but for a longer period. Officials consider it is preferable to have a slightly shorter time period to incentivise investors to rebuild sooner rather than later. Improves status quo by providing tax relief for a longer period.   |
| 4. Extending time limit combined with loosening current rule that requires a taxpayer to construct or purchase any replacement property by the end of the 2018-19 income year.     | As above but may introduce some uncertainty into the current rules.   |

*Social, environment or cultural impacts of all options*

18. There are no social, environment or cultural impacts to the options considered to address any of these issues. The groups affected by the amendments proposed are taxpayers that have assets damaged by the Canterbury earthquakes.

*Net impact of all options*

19. The net impact of all options is to extend the period for which various tax measures apply to taxpayers affected by the Canterbury earthquakes, taking into account the pace of the rebuild.

## II. Extension of depreciation roll-over relief to joint investment situations

20. There are a number of options that may deal with the problem and achieve the objectives:

|                     |   |
|---------------------|---|
| <b>Option one</b>   | <p>Depreciation recovery income remains with the original owner of the damaged building. Depreciation recovery income crystallises when:</p> <ol style="list-style-type: none"> <li>i. the original owner exits the joint investment entity or goes into liquidation or bankruptcy; or</li> <li>ii. the replacement asset is disposed of.</li> </ol> <p>The amount of depreciation recovery income that an investor can defer should be proportionate to the ratio of their share of the cost of the replacement asset compared with the original cost of their destroyed asset (<i>Preferred option</i>).</p>  |
| <b>Option two</b>   | <p>Depreciation recovery income remains with the original owner. Any depreciation recovery income is spread over a specified period, e.g. five years, instead of being taxed upfront. A minimum level of investment applies. (<i>Amortisation</i>)</p>  |
| <b>Option three</b> | <p>Depreciation recovery income is transferred to the new joint investment entity and rolled into the cost base of the replacement asset. Any depreciation recovery income crystallises when:</p> <ol style="list-style-type: none"> <li>i. the associated person decides not to acquire more replacement property;</li> <li>ii. the association between the original owner and the person acquiring the replacement is broken;</li> <li>iii. the original owner or associated person goes into liquidation or becomes bankrupt; or</li> <li>iv. a person who is not associated with the original owner acquires an interest in the replacement. (<i>Associated investors</i>)</li> </ol> |
| <b>Option four</b>  | <p>Combination of options 2 and 3:</p> <ol style="list-style-type: none"> <li>i. When the original owner re-invests with associated persons, option 3 applies.</li> <li>ii. Where an original owner reinvests with non-associated persons, the treatment under option 2 applies. (<i>Combination</i>)</li> </ol>  |

21. The impacts of these options are summarised in the table below.

*Summary of impacts of options one and two*

| <b>Option</b>                                 | <b>Meets Objective?</b> | <b>Impacts</b>    |  |   | <b>Net Impact</b>  |  |
|---|-------------------------|-------------------|--|---|--|--|
|   |                         |                   | <b>Fiscal/economic impact</b>  | <b>Administrative/compliance costs</b>                  |  | <b>Risks</b>   |
| <b>One</b><br><i>(Preferred option)</i>       | Yes                     | <i>Tax system</i> | No fiscal implications. May assist in reinvestment in Canterbury by deferring tax liability.   | No administrative costs.                                | None   | Improves status quo by extending depreciation roll-over relief. Simpler to design and comply with than other options.  |
|   |                         | <i>Taxpayers</i>  | May act as a barrier to the winding-up of companies (i.e. they may be kept in existence solely to preserve relief). However, probably only an issue where company has non-taxable capital gains. | Less than status quo and other options considered.      | None   |  |
| <b>Two</b><br><i>(Amortisation)</i>           | Yes                     | <i>Tax system</i> | No fiscal implications. May assist in reinvestment in Canterbury by deferring tax liability.   | Unlikely to have administrative costs.                  | None   | Improves status quo by providing some depreciation roll-over relief but imposes higher compliance costs than preferred option.   |
|   |                         | <i>Taxpayers</i>  | Provides some depreciation roll-over relief but may be much less than under existing roll-over relief.   | Higher compliance costs than option one and status quo. | Taxpayers would need to spread their depreciation recovery income over the correct period.   |  |
| <b>Three</b><br><i>(Associated investors)</i> | Yes                     | <i>Tax system</i> | No fiscal implications. May assist in reinvestment in Canterbury by deferring tax liability.   | Unlikely to have administrative costs.                  | May be hard to monitor compliance.   | Improves status quo by extending depreciation roll-over relief to joint investment situations but imposes higher compliance costs than preferred option.   |
|   |                         | <i>Taxpayers</i>  | May be complex to apply in practice when there are a number of investors, as would reduce cost base of new asset.  | Higher compliance costs than option one and status quo. | May be complex to apply.   |  |
| <b>Four</b><br><i>(Combination)</i>           | Yes                     | <i>Tax system</i> | No fiscal implications. May assist in reinvestment in Canterbury by deferring tax liability.   | Unlikely to have administrative costs.                  | May need to monitor whether correct rule is being used by a taxpayer - two different taxpayers in similar situations may be subject to different rules because of investment structure used. | Improves status quo by extending depreciation roll-over relief to associated investor situations and providing limited relief in other joint investment situations. Imposes higher compliance costs than preferred option. |
|   |                         | <i>Taxpayers</i>  | May impact on investment structures used as extent of roll-over relief depends on how investment structured.   | Higher compliance costs than option one and status quo. | Taxpayers' relief would depend on investment structure used.   |  |

### *Social, environment or cultural impacts of all options*

22. There are no social, environment or cultural impacts to the options considered to address any of these issues. The groups affected by the amendments proposed are taxpayers that have assets damaged by the Canterbury earthquakes.

### *Net impact of all options*

23. The net impact of all options is to extend roll-over relief for depreciation recovery income to investors who reinvest in Canterbury through pooling with other investors.

## **CONSULTATION**

24. The issues addressed by these amendments have been discussed with tax practitioners dealing with Christchurch-based clients. These practitioners also suggested solutions to the specific issues they were seeing in Canterbury, which have been incorporated into the proposed amendments.

25. Consultation was undertaken through a letter containing proposals circulated to interested parties. This group included representatives from all of the large accounting firms, and the New Zealand Institute of Chartered Accountants' tax advisory group. Written feedback was received from five firms, and officials also met or held telephone conferences with practitioners. Modifications were made to the options outlined above in response to feedback received from consultation.

26. CERA and the Treasury were consulted in the development of the proposals.

### **Summary of feedback**

27. The key feedback received was the need for simplicity, certainty and flexibility in the design of the rules.

#### ***I. Extension of the 2015-16 time limit for Canterbury earthquake tax measures***

28. Submitters unanimously supported the proposal to extend the time limit by three years, until the end of the 2018-19 income year. A few submitters suggested that this time limit could be reviewed closer to the end of 2018-19 to determine if a further extension is required. At this stage, there is no intention of reviewing the 2018-19 time limit unless a compelling reason to do so presents itself.

29. One submitter suggested that there should be some flexibility in the time limit, for example, by allowing taxpayers to apply to the Commissioner of Inland Revenue for an extension of time where they can show they will not complete rebuilding by the end of the 2018/19 income year. However, officials consider a problem with this approach is that it would place Inland Revenue in the position of assessing taxpayers' development plans, for which it does not have the relevant expertise or resource.

30. The proposal to combine an extension of the 2015-16 time limit with tightening the level of commitment that a taxpayer is required to demonstrate before being eligible to access



depreciation roll-over relief for buildings was not consulted on due to time constraints. However, tax practitioners and taxpayers will have the opportunity to comment on this proposal through the select committee process.

31. A related issue was replacing the requirement in the existing depreciation roll-over relief rule that replacement property be “acquired” by the end of the time limit. Submitters generally favoured a lower threshold such as taxpayers having to show a “definitive commitment”, such as entering into a binding contract and incurring some expenditure by the time limit. However, officials consider this might introduce more uncertainty into the current depreciation roll-over relief rule, e.g. taxpayers could be rolling depreciation recovery income into the cost base of a replacement asset without knowing its cost base with any certainty.

## ***II. Extension of depreciation roll-over relief to joint investment situations***

32. A number of comments were received on proposals to extend roll-over relief to joint investment situations.

### *a. Extending roll-over relief to all qualifying joint investment situations (preferred option)*

33. There was general support for this approach as being fairer, simpler and more comprehensive than other options. One issue noted was the requirement that the original tax liability remain with the investor (rather than being transferred to the new entity undertaking the reinvestment) may act as a barrier to the winding up of companies (i.e. they may be kept in existence solely to preserve roll-over relief). However, this is likely to be an issue only where shareholders in a company want to wind up the company to access non-taxable capital gains held in the company.

### *b. Two separate rules – extending roll-over relief to associated investor situations and amortisation over five year period for non-associated investor situations*

34. While some submitters supported having two separate rules, others favoured a single rule. They noted (and officials agree) that it is better to have one rule that accommodates different investment structures. In particular, having two rules may create discrepancies in the treatment of different investment structures when, from a policy perspective, the two should be treated equally – for example, two cases where two investors combine to re-invest but in one case, the two investors are associated (e.g. are relatives) and so qualify for more generous treatment. In addition, this option poses a number of complex technical issues that would need to be carefully worked through.

35. In relation to the proposal to have a five year period for spreading depreciation recovery income, submitters generally favoured a ten year period instead. In addition, there was general feedback that a minimum level of investment may not be feasible in practice.

## **CONCLUSIONS AND RECOMMENDATIONS**

### **I. Extension of the 2015-16 time limit for Canterbury earthquake tax measures**

Option one (three-year extension combined with requiring taxpayers to show a commitment by the end of the 2015-16 income year to rebuilding in order to access depreciation roll-over relief for buildings for the 2016-17 to 2018-19 income years) is the preferred option because it meets the objectives of providing more time for taxpayers to replace their damaged assets without facing unexpected and/or unfair tax consequences and of ensuring tax relief is only provided to those who are substantively committed to reinvesting in Canterbury.

36. This option involves requiring taxpayers to show a substantive commitment by the end of 2015-16 to acquiring a replacement building in Canterbury in order to access depreciation roll-over relief. Commitment could take the form of acquiring the relevant regulatory or planning consents by the end of 2015-16. Another option is that a taxpayer could demonstrate a substantive commitment commercially, such as by entering into binding contracts for the acquisition of a building.

37. This option improves the status quo by reducing compliance costs for taxpayers and providing tax relief for a longer period. The requirement for taxpayers to show a commitment to rebuilding by the end of the 2015-16 year should not impose higher compliance costs, as commitment would be demonstrated through steps that taxpayers need to undertake in the ordinary course of the rebuilding process.

38. Option two (extension by three years) is not favoured, as it would not meet the objective of ensuring tax relief is provided only to those taxpayers who evidence a real commitment to rebuilding in Canterbury.

39. Option three (extension by longer period) is not favoured because, while it also achieves the objective, officials consider it is preferable to have a slightly shorter time period, as it provides an incentive for investors to commence rebuilding sooner rather than later.

40. Option four (extension combined with loosening requirements) is not favoured because it may introduce uncertainty to the rules.

### **II. Extension of depreciation roll-over relief to joint investment situations**

41. Option one is the preferred option because it meets the objective of extending depreciation roll-over relief to ensure it is accessible to taxpayers seeking to rebuild in Canterbury but who are required to pool with other investors to invest in large building complexes. In addition, it meets the objective of ensuring that the original policy intent behind depreciation roll-over relief is maintained, namely, ensuring taxpayers do not have an unexpected tax liability in relation to assets destroyed by the earthquakes and assisting in the rebuilding of Canterbury.

42. This option means that depreciation roll-over relief will remain with the original owner of the damaged building. Depreciation recovery income will crystallise when:

- i. the original owner exits the joint investment entity or goes into liquidation or bankruptcy; or
- ii. the replacement asset is disposed of.

43. The amount of depreciation recovery income that an investor can defer should be proportionate to the ratio of their share of the cost of the replacement asset compared with the original cost of their destroyed asset. For example, a person has depreciation recovery income of \$4 million for a destroyed building, which originally cost \$5 million. The person reinvests with three other investors into a company which acquires a replacement building at a cost of \$30 million. The person's share of the cost is 10 per cent, i.e. \$3 million. The amount of depreciation recovery income they could defer would be:  $\$3m/\$5m \times \$4m = \$2.4$  million. The remaining \$1.6 million would be taxable.

44. The other options are not favoured as, while they would achieve the policy objective of extending depreciation roll-over relief provision to ensure it is accessible to taxpayers seeking to rebuild in Canterbury through joint investments, they are likely to be complex to apply and impose relatively higher compliance costs on taxpayers.

## **IMPLEMENTATION**

45. The amendment will be implemented through a Supplementary Order Paper to the Taxation (Annual Rates, Foreign Superannuation, and Remedial Matters) Bill this year. The amendment would apply for the 2010-11 income year and subsequent income years.

46. There should be no significant implementation issues with the amendment. Inland Revenue will communicate the change in rules through existing channels to taxpayers (such as the Tax Information Bulletin) and tax agents, including updating its guides.

47. Extending the time limit and extending depreciation roll-over relief will assist in reducing compliance costs to Canterbury taxpayers. The preferred options are targeted to resolve particular technical issues which have arisen because of the specific circumstances of the Canterbury earthquakes. Applying for depreciation roll-over relief is optional and applies only in limited circumstances and/or for a limited time period. Therefore, the potential impact should be confined to a relatively small group of taxpayers.

## **MONITORING, EVALUATION AND REVIEW**

48. Monitoring, evaluation and review of the extension of the time limit for Canterbury earthquake tax measures will be undertaken closer to the end of the proposed 2018-19 deadline.

49. There are no specific plans to monitor, evaluate and review the extension of depreciation roll-over relief to joint investment situations – however, we anticipate receiving informal feedback from tax practitioners familiar with the tax issues in Canterbury on the effectiveness of the measure. If any detailed concerns are raised, officials will determine whether there are substantive grounds for review under the Generic Tax Policy Process (GTPP).

50. In general, Inland Revenue monitoring, evaluation and review of new legislation takes place under the Generic Tax Policy Process. The GTPP is a multi-stage tax policy process that has been used to design tax policy in New Zealand since 1995. The final stage in the GTPP is the implementation and review stage, which involves post-implementation review of the legislation, and the identification of any remedial issues. Opportunities for external consultation are also built into this stage. In practice, any changes identified as necessary for

the new legislation to have its intended effect would generally be added to the Tax Policy Work Programme, and proposals would go through the GTPP.