

Regulatory Impact Statement

Aircraft overhaul expenses: deductibility and timing

Agency Disclosure Statement

This Regulatory Impact Statement has been prepared by Inland Revenue.

It provides an analysis of options to address timing issues about deductions for aircraft overhaul expenses. As the issues relate to timing of deductions, the options are not intended to alter the total tax payable by commercial aircraft operators over the period of time an aircraft is owned by a taxpayer.

The options are considered in the light of the Civil Aviation Authority's rules for managing safety risks in the aviation sector. The rules require aircraft components to be regularly overhauled if the aircraft owner wishes to retain the aircraft's certificate of airworthiness. The length of the overhaul period is normally determined by time in service and is usually termed the overhaul cycle. It is illegal to operate an aircraft without a current certificate of airworthiness.

For the purpose of our analysis, we assumed that the review relates to significant aircraft operations such as commercial passenger and freight services, tourism operators, and commercial agricultural uses. Our analysis of the options is based on submissions on the consultation letter, and the economic and fiscal objectives of a coherent tax system.

The estimate of the potential fiscal effect for the timing options is uncertain as it is based on a sample of cost data drawn from larger aircraft operators and also an estimate of accrued provisions for future aircraft overhaul expenses drawn from a sample of small and medium sized aircraft operators. Because of data limitations it is not possible to identify the age profile of all aircraft held by aircraft operators.

None of the policy options had environmental or cultural impacts, and nor were there any other significant constraints, caveats and uncertainties concerning the regulatory impact analysis.

None of the policy options considered would restrict market competition, reduce the incentives for businesses to innovate and invest, unduly impair private property rights or override fundamental common law principles.



Peter Frawley
Policy Manager,
Policy and Strategy
Inland Revenue

21/08/2015

EXECUTIVE SUMMARY

This RIS provides an analysis of options to address timing issues relating to deductions for aircraft overhaul expenses. As the issues relate to timing of deductions, the options are not intended to alter the total tax payable by commercial aircraft operators over the period of time an aircraft is owned by a taxpayer.

The options are considered in the light of the Civil Aviation Authority's rules concerned with the management of safety risks for operating an aircraft. These rules require aircraft components to be regularly overhauled if the aircraft owner wishes to retain the aircraft's certificate of airworthiness. The length of the overhaul period is normally determined by time in service and is usually termed the overhaul cycle. It is illegal to operate an aircraft without a current certificate of airworthiness.

The policy proposals in this RIS are intended to:

- be straight-forward to administer and to implement; and
- maintain the integrity and coherence of the tax system, including minimising impacts on tax payments.

The options discussed in this RIS were released for consultation in a targeted letter. This consultation letter sought comment on a range of options. The options all related to timing of deductions for aircraft overhaul expenses and whether the timing was consistent with the policy objective of imposing tax on the best approximation of economic income of taxpayers.

Three submitters commented on the options set out in the consultation letter. All submitters agreed that the selected policy option should:

- give a reasonable approximation of economic income arising from aircraft operations;
- be consistent with accounting principles;
- provide suitable transitional rules that minimised potential adverse impacts on cashflows; and
- address the relationship between the policy proposals and other specific rules in the Income Tax Act.

Submitters considered that the cost of aircraft engine overhauls was a major expense for aircraft operators and that economically the cost of an engine overhaul relates to income earned over the years from one overhaul to the next overhaul. However, submitters considered that the cost of other types of aircraft overhaul was not material relative to the value of the aircraft.

Some submitters noted that in the longer term, compliance costs would not be impacted significantly. However, submitters considered it was also important to ensure that transitional measures did not adversely impact on compliance costs.

Following consideration of submissions received, our preferred option is to use the spreading method for aircraft engine overhauls, with full transitional adjustments (transitional alternative 1 – see paragraph 55 on page 17). For compliance cost reasons, an exception is proposed for taxpayers required to prepare general purpose financial reports using International Financial Reporting Standards (IFRS) and also for single-aircraft operators.

The main impacts on the timing of deductions for engine overhauls under the spreading method are:

- A faster rate of deduction for the original cost of the overhaul component of an aircraft engine. This cost is spread across the overhaul cycle following acquisition (instead of over the estimated useful life of the aircraft taxpayers – a taxpayer favourable result); and
- Aircraft overhaul expenses are spread across the next overhaul cycle instead of being deducted under the “as incurred basis” or under the provisioning practice, in advance of the deduction being incurred (a taxpayer adverse result).

We also recommend that:

- If a non-engine overhaul is a significant cost relative to the value of the aircraft the spreading method should also apply, otherwise non-engine overhauls would be deductible as repairs and maintenance.
- For simplicity and compliance cost reasons, IFRS taxpayers be permitted to use for income tax purposes, the IFRS accounting method for on-balance aircraft and to agree with the Commissioner a methodology for making appropriate tax adjustments to the IFRS accounting treatment for off-balance sheet aircraft.
- For simplicity and compliance cost reasons, single-aircraft operators be permitted to elect to time deductions for aircraft overhaul expenses under the “as incurred basis”.

STATUS QUO AND PROBLEM DEFINITION

Background: current regulatory environment

1. Under Civil Aviation Authority (CAA) rules for managing safety risks, an aircraft is not permitted to be in service unless it has a current airworthiness certificate. It is illegal to operate an aircraft without it having a current certificate of airworthiness.
2. To retain airworthiness status for an aircraft, a commercial aircraft operator must undertake a range of scheduled maintenance activities from time to time based on time in service. Scheduled maintenance activities are set out in either :
 - the manufacturer’s maintenance programme; or
 - CAA approved variations from the manufacturer’s maintenance programme for the aircraft, and its various sub-components, including aircraft engines, propellers, rotors, appliances, emergency equipment, and parts.
3. The scheduled maintenance programme consists of replacement of parts after stated periods of time in service (airworthiness limitations), hard-time maintenance when the aircraft or aircraft component is withdrawn from services (overhauls), and on-aircraft inspection. The overhaul of aircraft and aircraft sub-components are an essential part of the maintenance programme but an overhaul may also be required on an unscheduled basis, such as an aircraft engine overhaul that is required after a bird strike.

4. An overhaul of a sub-component is a major work carried out on specific instruments, mechanisms, equipment, part, or accessory (including airframe, aircraft engine, and propellers):
 - that are used in operating or controlling an aircraft ; and
 - which are identifiable by part number or serial number.
5. An overhaul is defined by the CAA as a major maintenance work in relation to an aircraft or aircraft component, which involves the “... *dismantling and complete testing to specification and renewal of operational life.*” This definition indicates that:
 - each major aircraft sub-component could be regarded as a separately identifiable asset rather than as a sub-component of a single wider asset, the aircraft; and
 - overhaul expenses relate to the period following the overhaul (overhaul cycle).
6. An overhaul involving the airframe and aircraft engines will normally result in either:
 - the aircraft being removed from service while the overhaul is performed in the engineering workshop (workshop visit); or
 - larger aircraft operators may replace a specific major sub-component of the aircraft (aircraft component) so the aircraft can be returned to service at an earlier stage. For example some larger operators carry spare engines for this purpose.
7. Out-of-cycle maintenance occurs when a part requires repair or replacement at earlier times than scheduled, and is generally treated as ordinary repairs and maintenance. Out-of-cycle maintenance may also involve an overhaul, such as an overhaul of an engine after a bird strike.

Status quo: timing rules

8. Under current tax law, aircraft overhaul expenses are normally treated as an allowable deduction, unless there is some major modification carried out that improves the performance of the aircraft component. A major modification of this nature would usually be a capital expense and depreciated.
9. An overhaul of some subcomponents, in particular the engine, is normally a material cost for any aircraft operator. Consequently, the timing of deductions for overhaul expenses impacts on the amount and timing of payments of income tax.
10. Currently, the main timing practices used in the aviation sector to allocate deductions for aircraft overhaul expenses either time deductions:
 - on the basis of future estimated overhaul expenses relating to each relevant sub-component. This practice is referred to as the “provisioning accounting practice” and is based on a now-withdrawn technical ruling of the Commissioner of Inland Revenue. Under this technical ruling, aircraft operators claimed overhaul deductions for future estimated expenses for each component rather than for historic cost of the last overhaul. The provisioning accounting practice had been followed by approximately 60% of aircraft operators; or

- to the year in which the overhaul expense is incurred. This is referred to as the “as incurred” basis. This practice is adopted by approximately 40% of aircraft operators and treats overhaul expenses as repairs and maintenance of a single operational asset.

The problem

11. In general the tax system seeks to impose tax on the best approximation of economic income. However, the two main timing practices used by aircraft operators are not consistent with this objective (provisioning accounting practice and the “as incurred” basis).
12. Because an overhaul of an aircraft component is essential for allowing an aircraft to continue in service after the overhaul, economically, the costs of the overhaul relate to the period following the overhaul (overhaul cycle). The spreading forward of those deductions to match the income generated from the use of the aircraft would then give the best approximation of economic income.
13. The key problems for these two main timing practices are as follows:
 - The provisioning accounting practice does not spread an incurred expense. Instead it values aircraft overhaul expenses on the basis of estimated future overhaul costs that have not been incurred. This results in deductions being timed in advance of the expense being incurred and so does not match the cost of an aircraft overhaul with the income generated from using the overhauled aircraft component.
 - The as incurred basis does not appropriately match the cost of an aircraft overhaul with the income generated from using the overhauled aircraft component.
14. In addition, the technical ruling allowing the provisioning accounting practice to be used for income tax purposes has been withdrawn because Inland Revenue now considers the technical ruling is inconsistent with:
 - the legal tests for deductibility of expenses.
 - the general policy setting that deductions should not be allowed for provisions for future expenses.
15. Following the withdrawal of the technical ruling, Inland Revenue’s current view of the law is that the as incurred basis would be the only timing method available for allocating deductions for aircraft overhaul expenses.
16. Each of these two timing practices gives rise to tax compliance costs for taxpayers and administration costs for Inland Revenue, and distortions as follows:
 - Under the as incurred basis for timing deductions, aircraft overhaul expenses gives rise to peaks and troughs in taxable income that are more closely aligned to net cash flows of the business than with the economic income of the business. This results in income tax being underpaid in some years (usually the year of overhaul), and overpaid in other years (the years between the overhauls).
 - Under the provisioning accounting practice income tax is underpaid in most years because overhaul expenses are based on estimates of future expenses. This underpayment of tax occurs because the estimate of future expenses is revised

annually by reference to current costs, which typically increase over the period between overhauls. This type of accounting results in a form of inflation-proofing in valuing overhaul expenses. The income tax system does not generally recognise the effect of inflation as a deductible expense.

- For small and medium sized enterprises (SMEs) using the as incurred basis, compliance costs include recording and tracking tax losses.
 - For IFRS taxpayers using the as incurred basis, compliance costs include making ongoing adjustments between the timing treatment under IFRS and the as incurred basis.
 - For companies using the provisioning accounting practice, the accruing provision must be recorded, updated each year, and ultimately adjusted against actual aircraft overhaul expenses incurred.
 - As there is no common approach to timing deductions for aircraft overhaul expenses, all other things being equal, this can lead to aircraft operators not being treated equally in the same circumstances. This is a horizontal equity concern.
 - The difference in timing rules also makes it more difficult for Inland Revenue to develop consistent and uniform risk assessment tools for the aviation sector. That may lead to a higher than necessary level of audit review in the sector.
 - When contrasted against other existing timing rules for deductions relating to the cost of assets, the provisioning accounting practice provides an advantage to the aviation sector that is not permitted in other sectors of the economy.
17. These inconsistencies can give rise to both economic distortions and fiscal impacts. An example of an economic distortion that could arise for small and medium size enterprises occurs when special purpose financial reports are prepared for income tax purposes rather than being general purpose financial reports. The inappropriate timing treatment of overhaul expenses contained in such a special purpose report that is also used to make financing and investment decisions may result in those decisions being based on inappropriate information.
18. A fiscal impact arising from both timing practices is that income tax is underpaid in some years and overpaid in other years within each overhaul cycle. In addition, taxpayers are more likely to be exposed to penalties in which overpayment of tax occurs because there is an increased risk of underestimating the amount of provisional tax payable.
19. The timing problem is significant for the aviation sector because aircraft overhaul expenses, particularly for engines, is a major cost for any aircraft operator irrespective of the size of the business.

OBJECTIVES OF THE REVIEW

20. The review is aimed at considering:
- the policy and legislative implications of Inland Revenue's view that the provisioning accounting practice does not give rise to an allowable deduction for the accruing provision;

- the administrative and compliance costs of potential alternative treatments of dealing with these overhauls for taxation purposes; and
 - a range of timing rules for deductions of aircraft overhaul expenses in relation to the overall efficiency and coherency of the tax system; and
 - views of significant stakeholders in the aviation sector.
21. Options for timing deductions of aircraft overhaul expenses will be evaluated against the following objectives:
- a. maintaining the efficiency and coherency of the tax system;
 - b. consistency with the economic effect of the transaction;
 - c. minimising tax and compliance costs for taxpayers;
 - d. minimising administration costs for Inland Revenue;
 - e. minimising the risk of non-compliance with CAA rules; and
 - f. maintaining fiscal neutrality over the time the aircraft is owned.
22. This review is not intended to alter the general tax treatment for:
- depreciable assets as a single operational unit but recognises some special characteristics of the aviation sector in relation to the overhaul of major sub-components of an aircraft; or
 - regular maintenance of aircraft; or
 - the capital revenue boundary in relation to an overhauled aircraft sub-component.
23. We also note that trade-offs will inevitably be made across the various objectives. For example, a solution that mandates one particular timing practice inevitably will result, during transition, in a minor increase in compliance cost for some taxpayers to ensure the overall objective of improving the efficiency of the tax system is achieved.
24. The question addressed in this RIS is whether the current timing rules for deductible aircraft overhaul expenses align with the policy objectives for imposing tax on the best approximation of economic income and, if not, how these timing rules can be improved.

REGULATORY IMPACT ANALYSIS

25. Five options (including the status quo) are considered in this RIS for addressing the problem. They are:

- Option 1: As incurred method. The general deductibility and timing rules of the Income Tax Act 2007 are applied to determine deductibility and timing of aircraft overhaul expenses.
- Option 2: Spreading method. The deductible costs for an overhaul of an aircraft (for example, an engine) are spread forward over the period from the time of the overhaul to the next overhaul, on a usage basis (time in service). Within this option, we considered three possible transitional approaches.
- Option 3: IFRS method. The accounting treatment of overhaul costs under generally accepted financial accounting practice (IFRS) would be acceptable for income tax purposes. For owned assets, this method is similar to the spreading method but for assets treated as operating leases for IFRS purposes, this method is similar to the provisioning accounting method.
- Option 4: Provisioning accounting method. Legislation would authorise the provisioning tax accounting practice to allow deductions for provisions for future expenses.
- Option 5: Equalisation method. This method is based on the provisioning accounting practice. An aircraft operator makes tax deductible cash deposits into an aircraft overhaul account administered by the Commissioner of Inland Revenue. Withdrawals from the account would be offset against the cost of the actual overhaul.

26. All options other than option 1 (the status quo) would require amendments to the Income Tax Act 2007. This is discussed later in this RIS under the section “Implementation”.

27. As an integrity measure, options 1, 2, and 3 also propose a claw-back of past provisions to ensure that a taxpayer would not have two deductions for the same expense. Under this accounting practice, the accumulated provision for future expenses is always reversed (netted off) against the actual expense when it is incurred. Options 1, 2, and 3 propose stopping provisioning, and therefore, it would be necessary to ensure that past deductible provisions were reversed against the actual overhaul expenses to give the same effect and ensure a second deduction is not allowed for that future overhaul expense.

28. Option 5 would require the Commissioner of Inland Revenue to establish a system to receive and pay out deposits.

29. If the Government decides not to pursue a legislative solution, taxpayers will be obliged to apply the current deductibility and timing rules (Option 1).

Analysis of options against the objectives of the review

Option 1: as incurred method

- a. *The efficiency and coherency of the tax system:* Option 1 is consistent with the general deductibility and timing rules of the Income Tax Act 2007 (the Act) and is well known and understood by taxpayers. However, the general deductibility and timing rules do not always result in an appropriate timing effect. In particular, for SMEs, option 1

gives rise to large variations in taxable income that are more closely aligned to the cash flows of the business rather than being aligned with the economic income of an aviation business.

- b. *The economic effect of the transaction:* Option 1 is inconsistent with the economic effect of an aircraft engine overhaul, as an overhaul enables an aircraft to return to service. Deductions should be matched to the income generated after the aircraft returns to service following the overhaul.
- c. *Minimising tax and compliance costs for taxpayers:* Option 1 is well understood by taxpayers and would not give rise to material impacts on compliance costs. However, as it gives rise to large variations in taxable income, tax is underpaid in some years and overpaid in other years. This also increases the exposure of aircraft operators to penalties and interest.
- d. *Minimising administration costs for Inland Revenue:* Option 1 is well understood by Inland Revenue and would not give rise to any material effects on administration costs.
- e. *Minimising the risk of non-compliance with CAA rules:* The economic returns in some aviation sectors are insufficient to provide for aircraft replacement, and the aircraft fleet in those sectors are aging. Compliance with CAA rules is a risk identified by a number of economic commentators and CAA itself. It is recognised that preparation of financial reports is a significant cost for smaller enterprises and that as many smaller-sized aircraft operators already use the current deductibility and timing rules little change in compliance cost would be expected if these taxpayers were permitted to elect to use option 1.
- f. *Fiscal neutrality over the time the aircraft is owned.* All deductions for aircraft overhaul expenses would be taken into account over the time the aircraft is owned.

Option 2: spreading method

- a. *The efficiency and coherency of the tax system;* Option 2 is consistent with the policy objective that tax is imposed on the best approximation of economic income.
- b. *The economic effect of the transaction:* Option 2 is consistent with the economics of an aircraft engine overhaul.
- c. *Minimising tax and compliance costs for taxpayers:* Some increase in compliance costs would be anticipated for taxpayers currently using option 1. In general, no material effect on compliance costs is expected because the information is either already required under CAA rules and the cost information is readily available and is already used by many taxpayers. The timing of payments of income tax will change due to an incurred cost being spread over the period between overhauls.
- d. *Minimising administration costs for Inland Revenue:* Option 2 is expected to result in better information for Inland Revenue, enabling better targeting of audit activity, and a resulting reduction in administration costs.
- e. *Minimising the risk of non-compliance with CAA rules:* The compliance costs for option 2 would be expected to be significant for small operators, particularly in the

agricultural sector. Consequently an election to use option 1 is proposed to overcome this problem and thereby minimise the risk of non-compliance with the CAA rules.

- f. *Fiscal neutrality over the time the aircraft is owned.* All deductions for aircraft overhaul expenses would be taken into account over the time the aircraft is owned.

Option 3: IFRS

- a. *The efficiency and coherency of the tax system:* Option 3 is consistent with the policy objective that tax is imposed on the best approximation of economic income.
- b. *The economic effect of the transaction:* Option 3 is consistent with the economics of an aircraft engine overhaul.
- c. *Minimising tax and compliance costs for taxpayers:* No material effect on compliance costs is expected for IFRS taxpayers, although their compliance costs would reduce. However, a significant increase in compliance costs would arise for non-IFRS taxpayers as recent reforms have removed the need for these taxpayers to prepare general purpose financial reports. The timing of payments of income tax will change due to an incurred cost being spread over the period between overhauls.
- d. *Minimising administration costs for Inland Revenue;* Option 3 is expected to result in better information for Inland Revenue, enabling better targeting of audit activity, and a resulting reduction in administration costs.
- e. *Minimising the risk of non-compliance with CAA rules;* the compliance costs for option 3 would be expected to be significant for small operators, particularly in the agricultural sector. Like option 2, an election to use option 1 is proposed to overcome this problem.
- f. *Fiscal neutrality over the time the aircraft is owned.* All deductions for aircraft overhaul expenses would be taken into account over the time the aircraft is owned.

Option 4: Provisioning accounting method

- a. *The efficiency and coherency of the tax system:* Option 4 is inconsistent with the coherency of the tax system. In particular, the estimates of future expenses under the provisioning accounting practice are revised annually and so include an inflationary element. Current tax policy settings do not allow deductions for inflation adjusted amounts, nor do they allow a deduction for provisions for future expenses that have not been incurred. Allowing option 4 would create an incentive for other sectors to seek similar treatment.
- b. *The economic effect of the transaction:* The valuation of the expense (estimated future expenses) is inconsistent with the economic effect of the transaction which would normally seek to match the value of the expense with the income generated from the aircraft after it is returned to service.
- c. *Minimising tax and compliance costs for taxpayers:* This method would increase compliance costs for taxpayers currently using option 1. In general, no material effect on compliance costs is expected because the information is either already required under CAA rules and the cost information is readily available and is already used by

many taxpayers. The timing of payments of income tax will change due to an incurred cost being spread over the period between overhauls.

- d. *minimising administration costs for Inland Revenue*: Option 4 is expected to result in better information for Inland Revenue, enabling better targeting of audit activity, and a resulting reduction in administration costs
- e. *Minimising the risk of non-compliance with CAA rules*; the compliance cost for option 3 would be expected to be significant for small operators, particularly in the agricultural sector. An election to use option 1 is proposed to overcome this problem.
- f. *Fiscal neutrality over the time the aircraft is owned*: All deductions for aircraft overhaul expenses would be taken into account over the time the aircraft is owned.

Option 5: Equalisation method

30. The same observations regarding option 4 apply equally to option 5. Other observations on the objectives of the review that are specific to option 5 are set out below.

- a. *The efficiency and coherency of the tax system*: This option increases the complexity in the tax system. Cash deposits made represent an increase in a sinking fund to provide financing for the next overhaul. .
- b. *The economic effect of the transaction*: Depositing cash up to the level of the provision made is inconsistent with the economics of the overhaul process.
- c. *Minimising tax and compliance costs for taxpayers*: option 5 would increase compliance costs for taxpayers currently using Option 1. Tax payments for taxpayers using the provisioning accounting practice would be unaffected if cash deposits were made. However, it was recognised that there had been little uptake within other equalisation schemes introduced to allow deductions for cash deposits backed by provisions recorded in general purpose financial reports.
- d. *Minimising administration costs for Inland Revenue*. This option would increase administration costs for Inland Revenue as a system would need to be established for option 5.
- e. *Minimising the risk of non-compliance with CAA rules*: The compliance cost for option 3 would be expected to be significant for small operators, particularly in the agricultural sector. An election to use option 1 is proposed to overcome this problem.
- f. *Fiscal neutrality over the time the aircraft is owned*: All deductions for aircraft overhaul expenses would be taken into account over the time the aircraft is owned.

Impacts of each feasible option:

The analysis of each option against the objectives of the review and the economic, fiscal, compliance and administrative impacts are summarised in table 1: *Summary of analysis: objectives and impacts*. Some further specific observations on economic and compliance impacts follow table 1.

Table 1 Summary of analysis: objectives and impacts

Description	Meets objectives	IMPACTS					Net impact
		Economic impact	Fiscal impact over five years	Compliance impacts	Administration impacts	Risks	
Option 1: As incurred method	(a) and (c) partly, (b) no (d),(e), and (f) yes	Understates income in year of overhaul. Overstates income in other years. Inconsistent with economics of overhauls for aircraft engines.	\$11 million positive.	Tax accounting practice is inconsistent with business management and investment decision needs.	Impact on provisional tax flows potentially affects risk assessment models	Potential exposure to penalties.	Does not address the problem. Not recommended.
Option 2: Spreading method	(a), (b), (d), (e) and (f) yes (c) mostly	Consistent with economics of overhauls. Removes potential for distortions in business and financing decisions inherent in existing practices.	\$30 million positive.	Negligible impact for most taxpayers as it is consistent with general accounting principles. Minor cost in transition in calculating transitional adjustments.	Post-implementation review of compliance by Inland Revenue	Potential for non-compliance by smaller sized SMEs	Addresses the problem. Consistent with policy objectives and with information needs for business management. Specific concerns about compliance costs for single aircraft operators. Recommended method.
Option 3: IFRS method	(a), (b) and (d) yes (c) partly (e) yes (f) yes	Consistent with economics of overhauls. Removes potential distortions in business and financing decisions inherent in existing practices.	\$30 million positive.	Compliance costs increase significantly for taxpayers not required to prepare general purpose finance reports (most taxpayers in the aviation sector).	Post-implementation review of compliance by Inland Revenue Minor compliance costs in calculating transitional adjustments	Potential for non-compliance by smaller sized SMEs	Addresses the problem. Consistent with policy objectives and with information needs for business management. Specific concerns about compliance costs for non-IFRS taxpayers. Not recommended.
Option 4: Provisioning accounting method	(a), (b) and (c) no (d), (e) and (f) yes	Consistent with economics of overhauls. Consistently overstates value of overhaul expenses in years between overhauls.	\$60 million negative.	High compliance costs for aircraft operators not required to prepare general purpose financial reports.	Post-implementation review of compliance by Inland Revenue Minor compliance costs in calculating transitional adjustments	Potential for non-compliance by smaller sized SMEs	Partly addresses the problem but overstates the value of overhaul expenses. Not recommended.
Option 5: Equalisation method	(a), (b), (c) and (d) no (e) and (f) yes	Consistent with economics of overhauls. Consistently overstates value of overhaul expenses in years between overhauls. Cash deposited earns lower rate of return that when invested in the business.	\$60 million negative.	High compliance costs for aircraft operators not required to prepare general purpose financial reports.	Post-implementation review of compliance by Inland Revenue Minor compliance costs in calculating transitional adjustments	Equalisation measures may not be adopted. Potential for non-compliance by smaller sized SMEs.	Partly addresses the problem but overstates the value of overhaul expenses. Not recommended.

Economic impacts

31. Options 2 and 3 were the only options were consistent with policy objective that timing of deductions should appropriately reflect the economics of transactions and with the objectives of a coherent tax system of using common valuation bases (i.e. the historic cost basis) across timing rules. It was also clear that option 1 was not preferred by most submitters.
32. Other potential economic impacts considered were:
- The potential impact on cash flows in transition for taxpayers using the provisioning method. Potential impacts on cash flows in transition are addressed by matching the reversal of the provision to the future expenses for which the provision was made.
 - Whether complying with the spreading method might impose a disproportionate compliance burden on single-aircraft operators. This potential impact is addressed by permitting single-aircraft operators to elect to apply option 1 instead of using option 2.

Fiscal impacts

33. The estimated fiscal impact for each option is based on the same data set and relate to aircraft engine overhauls only. The estimated fiscal impacts are for a period of five years following the proposed year of implementation (2017-18 income year). All of the fiscal impacts relate to timing of deductions and would reverse out over the period of ownership of the aircraft.

Compliance impacts

Small and medium size enterprises

34. Permitting smaller sized taxpayers to elect out of the recommended option (option 2) and instead use the current deductibility and timing rules for aircraft overhaul expenses (option 1) is supported on compliance cost grounds. Many smaller-sized taxpayers already use the current deductibility and timing rules and little change in compliance costs would be expected if this concession were adopted. Submitters suggested this threshold could be set at single-aircraft taxpayers.

IFRS taxpayers

35. IFRS taxpayers are those required to comply with international financial reporting standards. IFRS taxpayers required to treat aircraft overhaul expense in two different ways depending on whether the aircraft is on-balance sheet or off-balance sheet:
- For on-balance sheet aircraft, aircraft overhaul expenses are spread evenly across the overhaul cycle. The original cost of the overhaul component is spread across the first overhaul cycle.
 - For off-balance sheet aircraft, aircraft overhaul expenses are spread using the provisioning accounting method. Off-balance sheet aircraft are leased aircraft that are treated as operating leases under IFRS.

36. For on-balance sheet aircraft, it is considered that compliance costs would be reduced if their treatment of aircraft overhaul expenses under IFRS could be used for income tax purposes.
37. However, leases of off-balance sheet aircraft are generally finance leases for income tax purposes. Aircraft leased under a finance lease are treated as owned for income tax purposes, irrespective of the treatment under IFRS. There are significant differences in the treatment of lease expenses for off-balance sheet aircraft between IFRS and the tax finance lease rules. This is illustrated Table 2.

Table 2: compare IFRS to finance lease rules

	IFRS	Tax finance lease rules
<i>Lease payment</i>	<i>Expensed</i>	<i>Interest component – a deduction</i>
<i>Asset</i>	<i>Off-balance sheet</i>	<i>Cost of entire asset capitalised and depreciated, capital portion of lease payment treated as loan repayment.</i>
<i>Aircraft overhaul expenses</i>	<i>Provisioning accounting practice</i>	<i>As incurred (as stated in annual reports)</i>

38. Given the differences in accounting treatment for off-balance sheet aircraft between IFRS and tax law, it is considered that Inland Revenue should continue to consult on developing an agreed method for making appropriate tax adjustments relating to off-balance sheet aircraft of IFRS taxpayers.

Non-engine overhauls

39. Consultation indicated that most taxpayers consider overhaul costs of a non-material nature should be treated as repairs and maintenance. For compliance cost reasons, it is considered that non-engine overhauls that are non-material relative to the value of the aircraft should be treated as repairs and maintenance in line with the principles set out in the Commissioner’s Interpretation Statement 12/03: *Income tax – deductibility of repairs and maintenance Expenditure – general principles*.

Social, cultural or environmental impacts

40. None of the options have social, cultural or environmental impacts.

CONSULTATION

41. Policy proposals were provided in a consultation letter to the Aviation Industry Association of NZ (Inc.), Air New Zealand, Jetstar (New Zealand), the Ministries of Business Innovation and Employment, Primary Industries, Tourism and Transport, Tourism New Zealand, and the New Zealand Institute of Chartered Accountants (now Chartered Accountants Australia and New Zealand). The consultation was limited to interested parties on the basis that the proposals related to complex technical aspects relating to tax accounting for aircraft operators.

42. Written submissions were received and considered, and a series of follow-up meetings held with those submitters who sought to continue the dialogue on a range of complex technical issues.
43. Submitters indicated that a single approach to the deductibility and timing of aircraft overhaul expenses was preferred. An approach that resulted in financial reports reflecting the economic income of an aircraft operation was considered to be a high priority as this information was relevant to management and financing decisions, as well as for calculating income tax payable.
44. The Aviation Industry Association and Chartered Accountants Australia and New Zealand both indicated their first preference was to codify the provisioning accounting practice. However, both bodies also recognised that adopting this alternative would give rise to a distortion in the tax system by allowing deductions for estimated future expenses that had no relationship with current periods of time. This distortion could give rise to pressures from other sectors seeking deductibility of provisions for future expenses.
45. Submitters considered that the accounting methodology for the spreading method:
- is not a new accounting practice; and
 - would be consistent with the objective of providing the best approximation of economic income for the assessment of income tax.
46. The IFRS method was preferred by IFRS users but not by other submitters. IFRS taxpayers consider that allowing IFRS to be acceptable for income tax purposes would reduce compliance costs. The cost of complying with IFRS is significant as it applies to all balance sheet and income statement items, and not just assets. Non-IFRS submitters considered that its cost would outweigh the benefits of improved financial reporting.
47. The equalisation method was considered possible but would create an administration overload for taxpayers and for Inland Revenue.
48. Submitters also suggested that whether all aircraft overhaul costs should be subject to a timing rule should be considered in the light of Inland Revenue's interpretation statement concerning the deductibility of repairs and maintenance (*IS12/03: Income tax – deductibility of repairs and maintenance expenditure – general principles*). In that interpretation statement, the materiality of an overhaul expense relative to the aircraft as a whole is an important aspect in determining whether an expense is treated as repairs and maintenance; or treated as a capital expense (and a deduction for that expense spread under a timing rule).

CONCLUSIONS AND RECOMMENDATIONS

49. We recommend option 2 under which:
- Non-IFRS taxpayers would spread aircraft engine overhaul deductions over the period following the overhaul up to the next overhaul by reference to the use of the aircraft.
 - IFRS taxpayers may use the IFRS treatment for owned aircraft for income tax purposes.
 - IFRS taxpayers may make appropriate tax adjustments to their reported IFRS income for aircraft treated as operating leases for financial reporting purposes.

- For administration cost reasons, the IFRS treatment would apply only in relation to IFRS taxpayers resident in New Zealand or for non-resident IFRS taxpayers, for aircraft registered with the Civil Aviation Authority.
- Single-aircraft operators could elect to apply Option 1.
- Transitional adjustments would be made to align the tax values of existing aircraft engines with the recommended method.
- A transitional adjustment would be made to apply the recovery of past provisions for aircraft overhaul expenses against the next aircraft engine overhauls.

50. The proposals would be consistent with:

- the objectives of both general purpose financial reporting (IFRS) and special purpose financial reporting to provide useful management and financing information.; and
- The usual matching of deductions for assets used over a period of time with the income generated from the use of the asset.
- Aircraft operators be defined to exclude non-commercial, non-powered aircraft, drones, and microlights.

While there may be some increased compliance costs (compared to the status quo) in the transitional period in calculating the one-off deduction for aircraft engines, this is adequately compensated by the deduction in the short term. There are not expected to be significant additional compliance costs otherwise.

IMPLEMENTATION

51. The proposal is intended to work in harmony with the Civil Aviation requirements for aircraft operators. Aircraft operators must retain logbooks keeping up to date information on the time in service and service of the aircraft, propellers, engines and other airworthiness directives.

52. We considered three approaches for transitioning to the recommended spreading method, including whether to allow a deduction for a catch-up adjustment (see Table 3 following).

53. Transitional adjustments include:

- A catch-up adjustment relating to the undepreciated value of the aircraft overhaul component at transition.
- Reversing past provisions for future aircraft overhaul expenses that have previously been allowed as deductions under the administrative ruling given in a now-withdrawn technical ruling.
- Depreciation on the component would stop, resulting in reduced depreciation deductions in the future. However, this is because the undepreciated value of the component would have been adjusted in transition.

54. The catch up adjustment relates to depreciation of the original cost of acquiring an aircraft engine overhaul component. For example, if that cost was \$1 million, under current law the cost would be spread over 15 years under the depreciation rules. Under the proposed spreading method, that cost would be spread over the first overhaul cycle. The catch-up adjustment ensures that any remaining undepreciated value of an existing aircraft overhaul

component is aligned to the spreading method treatment and is taxpayer friendly. Assuming this undepreciated value was \$600,000 at transition, this value would be:

- an allowable deduction in transition, if the component has completed its first overhaul prior to transition; or
- if the component had not been overhauled since acquisition, spread across the period from transition up to the first overhaul.

Table 3: Transitional approaches

	Fiscal impact over 5 years	Transitional impact	Effect on taxpayer
<i>Approach 1:</i>	<i>\$30 million positive</i>	<p><i>Catch-up deduction allowed for all aircraft.</i></p> <p>Depreciation stops on overhaul component for all aircraft because depreciation values taken into account in catch-up deduction.</p> <p>Past provisions for future aircraft overhaul expenses are reversed.</p> <p>Future deductions for overhaul expenses spread across overhaul cycle (for all aircraft).</p>	<p><i>Taxpayer friendly result</i></p> <p><i>Taxpayer neutral result</i></p> <p><i>Taxpayer adverse result</i></p>
<i>Approach 2:</i>	<i>\$116 million positive</i>	<p><i>No catch-up deduction allowed for all aircraft.</i></p> <p>Depreciation stops on overhaul component for all aircraft, and undepreciated value taken into account on disposal of the aircraft.</p> <p>Past provisions for future aircraft overhaul expenses are reversed (for all aircraft).</p>	<p><i>Taxpayer adverse result</i></p> <p><i>Taxpayer adverse result</i></p>
<i>Approach 3:</i>	<i>\$9 million positive</i>	<p><i>Spreading rules apply only to aircraft acquired after implementation.</i></p> <p>No catch-up deduction allowed for all aircraft.</p> <p>The cost of the aircraft engine component would be spread across the first overhaul cycle</p> <p>Existing aircraft apply the “as incurred basis” and existing depreciation rules.</p>	<p><i>Taxpayer adverse result</i></p> <p><i>Taxpayer friendly result</i></p> <p><i>Taxpayer adverse result</i></p>

Analysis of transitional approaches

Approach 1

55. This approach is consistent with the economics of the overhaul process, and would be consistent with the objective that the tax system should not distort investment decisions (objective (a): efficiency and coherency of the tax system).

56. There would be one-off compliance costs in transition for calculating the one-off transitional adjustments. It is considered that these costs are more than outweighed by the benefit of the catch-up adjustment as the fiscal estimate includes a fiscal cost in transition of approximately \$33 million which is recovered within 2 years. Submitters consider this approach is appropriate if the recommended spreading method is adopted.

Approaches 2 and 3

57. Both of these approaches are inconsistent with the economics of the overhaul process for existing aircraft. The deferral of the depreciation deductions until disposal of the aircraft may incentivise taxpayers to either replace existing aircraft earlier than anticipated or to enter into sale and leaseback arrangements to obtain the benefit of the accelerated deductions for the overhaul components.
58. There would be negligible impact on compliance costs in transition as there are no significant transitional adjustments.

Preferred transitional approach - conclusion

59. We prefer approach 1 because it is consistent with the economics of the overhaul process, is consistent with the objectives that the tax system does not distort investment decisions (objective (a): efficiency and coherence of the tax system), and takes into account the concern in submissions that transitional options should not adversely impact on cash flows.
60. All three approaches give timing related fiscal related impacts which all reverse out over the period of ownership of the asset.

Further implementation details

61. The recommended option and transitional approach would be included in the first available tax bill scheduled for introduction in 2016.
62. Owing to the complex technical nature of the issues, draft legislation would be provided to key stakeholders for comment. This consultation would be completed later in 2015.
63. The recommended option and transitional approach is proposed to apply from the beginning of the 2017-18 income year. This date is selected to allow taxpayers sufficient time to understand the technical requirements of the recommended option and transitional approach.
64. When introduced into Parliament, commentary will be released explaining the amendments, and further explanation of their effect will be contained in a Technical Information Bulletin item to be released shortly after the bill receives Royal assent. Normal submission processes occur when the bill is referred to the Finance and Expenditure Committee.
65. The recommended option and transitional approach would have no systems implications for Inland Revenue but may result in some additional administration costs, such as costs associated with publications to communicate the changes and to monitor and evaluate compliance with the changes. However, these costs are expected to be minor and would be met within existing baselines.

MONITORING, EVALUATION AND REVIEW

66. In general, Inland Revenue's monitoring, evaluation, and review of new legislation takes place under the Generic Tax Policy Process (GTPP). The GTPP is a multi-stage tax policy process that has been used to design and implement tax policy since 1995.

67. The final stage in the GTPP contemplates the implementation and review stage, which can involve 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.
68. Inland Revenue's normal assurance activity will evaluate and review that the preferred option achieves its intended policy objectives, as set out in paragraph 21 of this RIS.

