

Tax treatment of expenditure on distribution networks

A tax policy consultation document



Inland Revenue
Te Tari Taake

April 2022

First published in April 2022 by Policy and Regulatory Stewardship, Inland Revenue, PO Box 2198, Wellington 6140.

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ISBN 978-1-98-857342-7 (Online)



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CHAPTER 1

Introduction

Issue

- 1.1 The current income tax depreciation rules have been in place since 1 April 1993. They provide that the Commissioner sets the economic depreciation rate that applies to an item of depreciable property by issuing a determination under the Tax Administration Act 1994.
- 1.2 The Commissioner in April 1993 issued Depreciation Determination 1 (DEP 1) and determined the depreciation rates for all depreciable property¹ in the schedule to DEP 1 (Depreciation Schedule). In relation to distribution networks (for example, electricity reticulation (distribution) networks) the Depreciation Schedule provides depreciation rates for specified component items (such as poles, switches and cables) and a default rate that applies to network items not separately identified. It has never included a depreciation rate for an electricity (or any other) distribution network. DEP 1 is based on an assumption that an electricity network itself is not depreciable property, but the components of it are.
- 1.3 Owners of electricity (and other) distribution networks have been depreciating component items of networks in accordance with the Depreciation Schedule and for the most part treating the component items as the relevant item of property for repairs and maintenance purposes since the current rules were introduced on 1 April 1993. This has meant that the cost of installing replacement components has been capitalised and depreciated, rather than deducted as repairs and maintenance.
- 1.4 Inland Revenue was required to review the correctness of the component approach to electricity distribution networks reflected in the Depreciation Schedule. Following a review of relevant case law, Inland Revenue has concluded that the ‘component items’ approach followed by distribution network owners is not legally correct.² For the purposes of the depreciation rules and for determining whether expenditure on repairs and maintenance is deductible or depreciable, the legally correct position is that a network (and not its component items) is the relevant depreciable property (network interpretation). The network interpretation by extension impacts the approach to the depreciation and repairs and maintenance treatment of all other distribution networks (other examples include telecommunications and gas).

Summary of proposals

- 1.5 Officials intend to recommend legislative amendments to change the law to confirm that the component items approach applies to distribution networks from 1 April 1993. The legislative amendments will:
 - define a “distribution network”, and
 - provide that for a distribution network:

¹ Other than for fixed life intangible property and excluded depreciable property.

² See *Poverty Bay Electric Power Board v Commissioner of Inland Revenue* [1999] 2 NZLR 438 and *Hawkes Bay Power Distribution Ltd v Commissioner of Inland Revenue* (1998) 18 NZTC 13,685 and the cases referred to in these decisions.

- the items of depreciable property are its component items, as identified in a depreciation determination and not the network itself, and
 - that component items are the relevant items of property for determining whether repairs and maintenance expenditure is deductible.
- 1.6 The proposed legislative amendments are likely to have no material impacts on owners of distribution networks. The proposed amendments simply confirm that the component approach is the correct approach and thus retains that long-standing practice, which has been, for the most part, consistently applied by owners of distribution networks since 1 April 1993.
- 1.7 Officials seek your views on whether the proposed amendments are appropriately targeted and whether they could materially impact owners of distribution networks.

Inland Revenue's operational approach

- 1.8 While the policy proposals described above are considered, it is Inland Revenue's operational intention to continue to accept returns from distribution network owners using component items depreciation rates and treating component items as the relevant item of property for repairs and maintenance purposes.

Making a submission

- 1.9 Officials invite submissions on the proposals in this document, including the specific questions asked and any other issues raised in the document.
- 1.10 Include in your submission a brief summary of the major points and recommendations you have made. Please indicate if officials from Inland Revenue can contact you to discuss the points raised, if required.
- 1.11 The closing date for submissions is **25 May 2022**.
- 1.12 Submissions can be made:
- by email to policy.webmaster@ird.govt.nz with "Distribution Networks" in the subject line, or
 - by post to:
- Distribution Networks
C/- Deputy Commissioner, Policy and Regulatory Stewardship
Inland Revenue Department
PO Box 2198
Wellington 6140
- 1.13 Submissions may be the subject of a request under the Official Information Act 1982. Please clearly indicate in your submission if any information should be withheld on the grounds of privacy, or for any other reason (contact information such as an address, email, and phone number for submissions from individuals will be withheld). Any information withheld will be determined using the Official Information Act 1982.

CHAPTER 2

Historical context and current policy and law

Historical context

1894 – 1976: depreciation at Commissioner’s discretion

- 2.1 A deduction for depreciation was first introduced into the income tax legislation in 1894 (applicable from 1 April 1893). The provision granted the Commissioner a discretion to allow a deduction for the depreciation of implements, utensils, or machinery in respect of diminished value by reason of fair wear and tear that could not be made good by repairs, or such assets being rendered obsolete or useless.
- 2.2 Numerous amendments followed, primarily to allow deductions for obsolescence of plant and equipment and to recapture excess deductions on disposal. The basic structure of the depreciation provision however remained unchanged through to and including the Income Tax Act 1976.
- 2.3 To facilitate administration, the Commissioner published a schedule of depreciation rates. The Commissioner periodically added assets and accompanying rates to the schedule to ensure the schedule provided rates for the capital assets being used in the economy.

1987: ESAs enter tax system and Commissioner issues Depreciation Guidelines

- 2.4 In line with Government policy of bringing public agencies providing goods and services on a commercial basis into the income tax base, electricity supply authorities (ESAs), the owners of electricity distribution networks, became subject to income tax from 1 April 1987.³
- 2.5 On entering the income tax base, ESAs faced the problem of not being able to establish, for depreciation purposes, the cost and adjusted tax-values of the component assets of their networks. This arose, in large part, because ESAs had not previously needed to maintain taxation based fixed assets registers. In response to the problem, the Commissioner in 1987, provided comprehensive depreciation guidelines to ESAs. The guidelines provided that the component assets of an electricity distribution network fell into two groups – assets owned on 31 March 1987 and assets acquired after that date.
- 2.6 For assets owned on 31 March 1987, the Commissioner permitted the use of a globo (pool) accounting method under which separate assets were pooled and treated as one. This method allowed ESAs to treat the entirety of an existing network as a single asset (at a value agreed by the Commissioner) and to depreciate the single asset over a 20-year period on a straight-line basis.
- 2.7 For assets acquired after 31 March 1987, ESAs were required to calculate depreciation for each component item at the depreciation rates set out in the guidelines. This treatment for assets acquired after 31 March 1987 was in line with the policy position that component items of networks have different economic lives and that a component items approach provides a more accurate

³ The 29 electricity distribution businesses currently operating in New Zealand are (in broad terms) descended from electricity supply authorities, which were corporatised (under electricity sector reforms in the early 1990s) with effect from 1 April 1993.

measure of economic depreciation than a globo/pool approach, due to the difficulty of estimating the useful life of an electricity network.

1987 – 1993: review of depreciation

- 2.8 The Government in December 1987 announced the Commissioner was going to undertake a review of depreciation rates, which had not been comprehensively reviewed since 1957. The Commissioner commenced the review. However, it was placed on hold pending the outcome of the Valabh Committee's review of depreciation (which did not include the review of rates) as part of the Committee's wider review of the income tax system.
- 2.9 The Valabh Committee in its February 1991 discussion paper⁴ recommended depreciation be a statutory entitlement and that a comprehensive statutory depreciation regime should be enacted. It recommended that the statutory regime provide a definition of depreciable property, specify the permitted depreciation methods, provide that depreciation rates align with economic rates of depreciation, and that depreciation rates be set by the Commissioner. The Committee also recommended that repairs and maintenance be subject to the ordinary deductibility provisions of the Act and not a specific provision.
- 2.10 In its paper, the Committee noted that the Commissioner employed a wide range of depreciation methods in determining annual depreciation allowances, including the “pool asset” or “globo accounting method” aimed predominantly at low value assets of less than \$1,000 per asset. It also noted that most of the pool accounts covered assets with similar economic lives, but ESAs were being allowed to maintain globo accounts containing assets with differing economic lives and with per asset values exceeding \$1,000.
- 2.11 The Government in the 1991 Budget accepted the Valabh Committee's recommendations. It announced it would legislate to introduce a depreciation regime and that it did not wish to hold up the Commissioner's comprehensive review of rates.
- 2.12 The Commissioner resumed the review of depreciation rates, and a new depreciation schedule was developed. In December 1992, Inland Revenue released a draft of the new schedule for consultation. As a result of consultation, minor amendments were made to the schedule, and it was finalised as the schedule to DEP 1 (that is, the Depreciation Schedule).

1993 to the present

- 2.13 The current depreciation rules came into force on 1 April 1993. They are in subpart EE of the Income Tax Act 2007 and in sections 91AAF – 91AAM of the Tax Administration Act 1994.
- 2.14 *Key features of the depreciation rules:*
 - Definitions of what is, and what is not, depreciable property.
 - Depreciable property is defined as property that, in normal circumstances, might reasonably be expected to decline in value while it is being used, or is available for use, in deriving income.

⁴ Consultative Committee on the Taxation of Income from Capital Tax Accounting Issues (31 January 1991).

- Taxpayers have an amount of depreciation loss (a statutory entitlement) for an item of depreciable property for an income year unless they elect the property is not depreciable.
 - The amount of depreciation loss is calculated by reference to the value or cost of an item of depreciable property and the economic depreciation rate that applies to a kind of item of depreciable property.
 - The economic depreciation rate for a kind of item of depreciable property is calculated by reference to the item's estimated useful (economic) life.
 - The permitted depreciation methods are the diminishing value method, the straight-line method, and the pool method.
 - Rules for calculating amounts of depreciation loss under the three depreciation methods.
 - An item of depreciable property must have a value of \$5000 or less to be included in a pool (unless a higher value is set in a determination).
 - The globo method is not permitted as a depreciation method for an item of depreciable property unless the item was accounted for at the end of 1992-93 income year using this method - with the Commissioner's permission.
 - The Commissioner sets economic depreciation rates from time to time by following specified procedures and issuing a determination under section 91AAF of the Tax Administration Act 1994.
 - The depreciation determinations are secondary legislation under section 91AAF(7) of the Tax Administration Act 1994.
 - Taxpayers may apply to the Commissioner for the issue of a determination allowing them to use for an item of depreciable property:
 - a special rate higher or lower than the economic rate set by the Commissioner under section 91AAF for the item, or
 - a provisional rate when no applicable rate, other than a default rate, has been set in a determination under section 91AAF.
 - Taxpayers may apply to the Commissioner for the issue of a determination allowing them a maximum pooling value for an item of depreciable property greater than the value currently available to them.
 - Taxpayers may dispute and challenge a determination of a special rate or a provisional rate.
- 2.15 The Commissioner on 5 April 1993 issued DEP 1 and determined the basic depreciation rates for items of depreciable property to be the rates specified in the Depreciation Schedule. The Commissioner has issued more than 100 further general depreciation determinations, which amend the Depreciation Schedule. It specifies depreciation rates for specified component items of electricity (and other) distribution networks. The Depreciation Schedule has never included a depreciation rate for an electricity (or any other type of) distribution network.

Network interpretation

- 2.16 As discussed in paragraph 1.4, Inland Revenue has recently concluded that for distribution networks, the ‘component items’ approach reflected in the Depreciation Schedule is not legally correct.⁵ Accordingly, for the purposes of the depreciation rules and for determining whether expenditure on repairs and maintenance is deductible, a distribution network (and not its components) is the relevant asset.
- 2.17 Under the network interpretation the existence of a rate for an item in the Depreciation Schedule does not identify the item as depreciable property. Instead, the identification of depreciable property is determined by applying the “combined asset versus component item” approach from case law. This approach concentrates on identifying “what is the asset” by determining whether an item is connected to or separate from a larger asset. If the item is connected to a larger asset, the larger asset (and not its component items) is the relevant asset for depreciation purposes and for determining whether expenditure on repairs and maintenance is deductible.
- 2.18 The network interpretation by extension impacts the approach to the depreciation and repairs and maintenance treatment of other networks – such as telecommunications and gas.

Issues with network interpretation

- 2.19 The network interpretation can operate successfully and coherently as an approach to the tax treatment of network expenditure. Officials understand that it is the approach taken in Australia, for instance. However, it has a number of drawbacks, particularly in the current New Zealand context.
- 2.20 Identifying an appropriate rate for a distribution network is difficult. With regular repairs and maintenance, the physical life of a network could be indefinite, and thus the economic life is more likely to be constrained by factors of obsolescence or technical advance. These factors are long term and difficult to predict, making identification of the useful life problematic. Components of a network are likely to have a much more predictable economic life, which allows the depreciation rate for them to be more accurate. The component items approach therefore provides a more accurate measure of economic depreciation than a network approach.
- 2.21 Turning to the particular New Zealand context, there are two factors in favour of a component approach. First it is simpler to continue with the component items approach, since components have shorter lives and rates have already been identified for components.
- 2.22 Second, transitioning to a network interpretation would also raise some significant and difficult tax issues for electricity distribution network owners and the Government. In relation to networks already owned, the historical use of the component interpretation is likely to mean that the tax book value of networks is understated as compared to the tax book value that would have resulted had the network interpretation always been applied. Even though the network interpretation gives rise to greater deductions for on-going expenditure in relation to a network already owned, this effect is likely to be smaller than the effect of the higher depreciation rates under a component approach. Allowing owners to simply shift to the network interpretation without

⁵ See *Poverty Bay Electric Power Board v Commissioner of Inland Revenue* [1999] 2 NZLR 438 and *Hawkes Bay Power Distribution Ltd v Commissioner of Inland Revenue* (1998) 18 NZTC 13,685 and the cases referred to in these decisions.

recognising this understatement would mean an inappropriate pattern of deductions for network expenditure (including both acquisition and on-going costs). These difficulties are avoided by retaining the component items approach.

- 2.23 There may also be other practical difficulties which officials are not aware of arising from changing the current tax treatment by network owners of their network expenditure.

CHAPTER 3

Proposals

- 3.1 Officials intend to recommend legislative amendments to confirm the component items approach to distribution networks that has applied in practice since 1 April 1993. The legislative amendments, which are intended to apply retrospectively from 1 April 1993, will:
- define a “distribution network”, and
 - provide that for a distribution network:
 - the items of depreciable property are its component items and not the network itself, and
 - component items are the relevant items of property for determining whether repairs and maintenance expenditure is deductible.

Definition of distribution network

- 3.2 Officials propose that a definition of “distribution network” be inserted into section YA 1 of the Income Tax Act 2007.
- 3.3 It is proposed that the definition would cover electricity networks as well as gas, telecommunications and water networks. Definitions of each of these networks could be based on those in existing legislation including:
- Electricity Act 1992
 - Electricity Industry Act 2010
 - Gas Act 1992
 - Telecommunications Act 2001
 - Water Services Act 2021

Identification of network components

- 3.4 Amending the legislation to confirm that the assets of distribution network owners are components rather than the network would not in itself provide statutory guidance as to the identification of components and the appropriate level of itemisation.
- 3.5 The Depreciation Schedule currently contains depreciation rates for various specified component items of distribution networks (and a default rate for items not separately identified). The long-standing in-practice acceptance of the specified component items suggests the current identification and itemisation of components are appropriate. The Depreciation Schedule, however, can be changed, through determinations, to ensure that depreciation rates are provided for the relevant and appropriate component items. If taxpayers and the Commissioner disagree on what are the relevant and appropriate component items (and depreciation rates), this can be resolved through the challenge procedure.
- 3.6 We welcome submissions as to how much guidance should be provided by the legislation as to what component assets must be identified.

Application date and savings provisions

- 3.7 Officials understand that the vast majority of owners of distribution networks have always applied a component items approach for purposes of both depreciation and repairs and maintenance. The proposals in this document should have no impact on them other than confirming their longstanding treatment. A commencement date of 1 April 1993 would require related changes to the Income Tax Act 1976, 1994, 2004 and 2007.

Networks already applying the network approach

- 3.8 Officials are aware of the possibility that a small number of distribution network owners may be applying a network approach for the purpose of identifying repairs and maintenance expenditure. This could only be achieved by identifying different assets for, on one hand, repairs and maintenance purposes and, on the other hand, for depreciation purposes or by applying the default rate to depreciate a network. Neither of these approaches is consistent with the intended operation of the relevant provisions.
- 3.9 If the law is changed with effect from 1 April 1993 this would leave previous returns from these network owners as non-compliant. However, the majority of income tax returns since 1993 are now time-barred and any remaining non-time barred returns would need to be considered by the Commissioner as to whether resources should be allocated to amending these positions.
- 3.10 For the reasons set out in the two paragraphs above, officials do not propose a savings provision for network owners in this situation. However, we welcome submissions on any specific circumstances where further consideration may be worthwhile. We also welcome submissions on any transitional provisions that may be necessary to support these taxpayers.

Consultation

- 3.11 Officials seek your views on whether the proposed amendments are appropriately targeted and whether they could materially impact owners of distribution networks.