23 September 2013

Public Consultation
Inland Revenue Department
PO Box 2198
Wellington 6140

QWB00129: Income tax – Depreciation roll-over relief for Canterbury

The New Zealand Law Society (Law Society) appreciates the opportunity to comment on the draft question
QWB00129: Income tax – Depreciation roll-over relief for Canterbury (QWBA).

Answer – paragraphs 2 to 4

The Law Society's understanding of the formula in section EZ 23B(4) is that it applies differently when multiple
replacement items are acquired sequentially, to how it applies when those replacement items are acquired
together. The "Answer" in paragraphs 2 to 4 of the draft question should explain how the depreciation
recovery amount is allocated between the replacement properties (for example, on a "first in, first served"
basis based on the ratio of the replacement asset's cost to the damaged asset's cost).

Example 3: Multiple replacement items

The existing Example 3 addresses the situation where multiple replacement items are acquired in separate
income years. However, the QWBA does not address the issue of what happens where multiple replacement
items are acquired together. This is contemplated in the legislation by the use of the words "with … the
replacement item" in both sections EZ 23B(4)(a) and EX 23B(5)(a)(i). An ancillary issue is the temporal scope
of the word "with". Do sections EZ 23B(4)(a) and EX 23B(5)(a)(i) include only items purchased on the same
day, or do they extend to all replacement items purchased in the same income year?

The Law Society also has a concern that the formula in section EZ 23B(4) does not produce the correct
outcome where two replacement assets are purchased together, where their total cost exceeds the cost of
the damaged asset. The formula under-allocates the excess recovery amount, leaving an amount outstanding
that cannot be used even if further replacement assets are bought. This amount must be recognised as
income. This seems contrary to the intended policy of the legislation. We include a worked example of this
below.

Example: Two replacement assets acquired together

Sally received insurance proceeds of $10 million for the destruction of her building (which cost $10 million) in
the Canterbury earthquakes.

In the first income year, after the excess recovery amount would have been derived, Sally enters into a contract with LandCo, and purchases two smaller buildings to replace the destroyed building. Each of these buildings costs $6 million.

Building one

Applying the formula in section EZ 23B(4)(b), the amount of the excess recovery amount allocated to the first of those buildings is given by:

$$\frac{\text{limited replacement cost}}{\text{affected cost}} \times \text{excess}$$

The limited replacement cost is defined in section EZ 23(B)(5)(a) as being the lesser of:

i. the cost of the replacement item ($6 million);

ii. the amount by which the cost of the affected property ($10 million) exceeds the total expenditure in acquiring other replacement property "with or before" the replacement cost. Since the second building is acquired with the first building, the total expenditure in acquiring other replacement property will be $6 million. The amount by which $10 million exceeds $6 million is $4 million.

The affected cost is defined in EZ 23(B)(5)(c) as being the cost of the destroyed building, that is, $10 million.

So the formula gives:

$$\frac{\$4 \text{ million}}{\$10 \text{ million}} \times \text{excess}$$

So 40% of the excess is allocated to the first building.

Building two

Similarly, the limited replacement cost for the second building is the lesser of:

i. the cost of the replacement item ($6 million);

ii. the amount by which the cost of the affected property ($10 million) exceeds the total expenditure in acquiring other replacement property "with or before" the replacement cost. Since the first building is acquired with the second building, the total expenditure in acquiring other replacement property will be $6 million. The amount by which $10 million exceeds $6 million is $4 million.

Since the affected cost is still $10 million, the formula allocates 40% of the excess to the second building too. Therefore, there is 20% left unallocated which will become income in the 2015–2016 income year if left unallocated.

Inability to use 20% still unallocated

If a further replacement amount is used, section EZ 23B(4) will apply. This provides that the amount of the reduction (to both the cost base of the replacement property and the suspended excess) is zero if the cost of the affected property ($10 million) is less than the person's total previous expenditure in acquiring replacement property. Here, that has already been $12 million. So no amount of the suspended 20% can be used even if further replacement assets are purchased.

Conclusion

This submission was prepared with assistance from the Law Society's Tax Law Committee. If you wish to discuss this further please do not hesitate to contact the committee convenor Casey Plunket, through the committee secretary Rhyn Visser (04 463 2962, rhyn.visser@lawsociety.org.nz).

Yours sincerely

Chris Moore
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