

# **Regulatory Impact Statement**

## **Primary Sector Businesses: Horticultural removal costs and non-depreciable property under the Income Tax Act 2007**

### **Agency Disclosure Statement**

This Regulatory Impact Statement has been prepared by Inland Revenue.

The question in this Statement is whether the amortisation rules for primary sector businesses in the Income Tax Act 2007 should be aligned more closely with the general depreciation rules.

Officials have discussed these minor issues with the New Zealand Institute of Chartered Accountants and a selection of accountants (who are also kiwifruit growers) and they are accepting of the preferred options.

The Treasury agrees with our analysis.

No significant gaps, assumptions, dependencies, constraints, caveats or uncertainties have been identified in the analysis. The proposed change will not impose any significant compliance costs on taxpayers (minor compliance costs may be incurred). The proposed change does not impair private property rights, reduce market competition, provide disincentives to innovate and invest or override common law principles.

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## STATUS QUO AND PROBLEM DEFINITION

1. The kiwifruit Psa (*Pseudomonas syringae pv actinidiae*) virus has had a significant impact on New Zealand's gold kiwifruit industry, and as a consequence, a number of kiwifruit gold orchards have been or will be destroyed. The effect of the virus has highlighted three minor technical issues relating to the tax treatment of horticultural related removal costs, and subsidies giving rise to amortisable assets.

### *Issue 1: Removal costs of horticultural plants*

2. The Income Tax Act 2007 allows primary sector businesses (farming, horticulture, forestry and aquaculture) to amortise the costs of certain capital expenditure that are not expressly depreciable. This is similar to taxpayers' entitlement to claim depreciation on fixed assets. Specifically, and subject to certain criteria, when an orchardist removes a tree or vine, the orchardist generally receives a deduction for the net tax book carrying value of the tree or vine.

3. However, the extra cost of removing the vines (for example, the cost of hiring a contractor to tear out the vines) is capital in nature and the Income Tax Act 2007 does not explicitly provide a deduction for such costs. In contrast, when a taxpayer with a capital asset (for example, an item of physical plant or machinery) writes that item off, the taxpayer is entitled to a deduction for the tax book carrying value, and a deduction for the costs of physically removing the item.

4. In contradiction to the legislation, the general practice has been for taxpayers to claim a deduction for the costs of removing vines and plants. In the past, this has not been a significant integrity issue given the *ad hoc* and small amounts involved. However, the scale of the claims in respect of Psa virus has highlighted the lack of legislative provision for the deduction under subpart DO of the Income Tax Act 2007.

### *Issue 2: Removal costs of orchard infrastructure*

5. The Psa virus has also highlighted an anomaly in the tax treatment of infrastructure damaged by natural events. For example, if a natural event such as a flood, damaged an orchard's infrastructure, the orchardist would be allowed a deduction for the tax book carrying value of the infrastructure.

6. On the other hand, if an orchardist's infrastructure (for example trellising and wire) is rendered useless due to the Psa virus and they wish to change the crops that they grow, the cost of removing the infrastructure and the tax book carrying value of the infrastructure once it is removed, is considered to be a capital expenditure or loss, and therefore non-deductible.

7. Therefore similar to issue 1, there is no explicit permission under subpart DO of the Income Tax Act 2007 to allow for a deduction for these costs, despite the general practice for taxpayers to claim a deduction in these circumstances.

### *Issue 3: Capital contribution rules and amortisable assets*

8. If a person receives a subsidy (or similar payment) as compensation and the subsidy is used to acquire depreciable property, the receipt is dealt with under the "capital contribution rules" in the Income Tax Act 2007. The capital contribution rules prevent a person claiming deductions for expenditure for which they have not borne the cost.

9. Kiwifruit orchardists affected by the Psa virus may receive non-governmental financial assistance and some of these payments may be used to subsidise the cost of replanting. However, the capital contribution rules do not apply to these receipts. This is because the capital cost of replanting does not result in depreciable property, but rather “amortisable assets”. This is not consistent with the policy intent of the capital contribution rules, as the orchardist will be able to claim a full deduction for the expenditure, even though a portion of it was subsidised by another party.

#### *Question*

10. The question in this Statement is whether the amortisation rules for primary sector businesses in the Income Tax Act 2007 should be aligned more closely with the general depreciation rules in order to address the above issues.

### **OBJECTIVE**

11. The objective of the proposals in this Statement is to ensure that there is appropriate tax treatment for primary sector business deductions.

### **REGULATORY IMPACT ANALYSIS**

12. The status quo is not satisfactory because it does not align with the policy intent for the current deductions and capital contribution rules, and is prejudicial against the primary sector businesses due to the specific tax rules for this sector.

13. This means the provisions relating to each issue need to be changed and how these issues may be remedied is addressed separately below. Each of these changes are very minor technical remedies.

#### *Option to address issue 1: Removal costs of horticultural plants*

14. The lack of deduction (status quo) is clearly unintended. The solution officials have identified is to amend the Income Tax Act 2007 to explicitly provide a deduction for the cost of removing horticultural plants.

15. This option can be administered within the existing tax system, and would be similar to the tax treatment of costs to remove a capital asset that has been written off, therefore resulting in a more equitable tax treatment for the deduction rules for primary sector businesses.

16. The impact of this option on taxpayers will be negligible, as the legislation is being aligned with the current practice and would provide certainty to horticultural plant growers, and their agents.

17. The fiscal cost for this option is very minor. The costs do not factor in any additional tree or vine removal cost deductions that may be taken by other members of the (non-kiwifruit) horticultural industry. However, as noted above the current practice is for taxpayers to claim these deductions, therefore these fiscal costs are likely to be modest, if they exist at all.

18. Officials have not identified any further options to address this issue, as there are no other practical alternatives to deliver the appropriate outcome.

#### *Option to address issue 2: Removal costs of orchard infrastructure*

19. At present the Income Tax Act 2007 only provides a deduction if the infrastructure has been directly damaged by a physical event out of the taxpayer’s control. This is too restrictive.

Although the orchard infrastructure was not directly destroyed or damaged by the virus, it has in some cases nevertheless been rendered useless and effectively written off. Therefore the effect is the same as what is currently provided for under the Income Tax Act 2007, that is, the infrastructure cannot serve the purpose for which it was originally intended and has to be removed.

20. The Psa virus situation was not considered when the write off provisions in subpart DO of the Income Tax Act 2007 were initially proposed. However as the effect is the same as the current write off rules, officials have recommended that the Income Tax Act 2007 be amended to cover these circumstances. This solution would be more in line with the reality primary sector businesses face in an event outside of their control.

21. The fiscal cost and impact for this solution is negligible. The impact on compliance costs for taxpayers will also be minor, as the legislation is being aligned with the current practice. The proposed amendments will provide greater certainty of the tax treatment of these costs for kiwifruit growers, taxpayers and their agents in general.

22. Similar to issue 1, officials have not identified any further options to address this issue, as there are no other practical alternatives to deliver the appropriate outcome.

#### *Option to address issue 3: Capital contribution rules and non-depreciable amortisable assets*

23. When the capital contribution rules were implemented, officials had not considered capturing contributions towards assets that were amortisable under subpart DO. However, as the Psa virus has highlighted, if the Income Tax Act 2007 allows for a deduction for expenditure that gives rise to an amortisable asset, the result is the same i.e. effectively a tax subsidy.

24. The only option therefore is to amend the Income Tax Act 2007 to explicitly provide that the capital contribution rules apply where the relevant asset is amortisable, as well as where it is depreciable, so that taxpayers cannot claim a deduction for costs they have not in fact incurred.

25. Similar to when the capital contribution rules were proposed, the impact of the preferred option will most likely result in a marginal increase in taxpayer's compliance costs. However as the capital contribution rules have only been recently implemented (applies to capital contributions after May 2010) this new increase should be slightly lower than what was expected in 2010.

26. Officials did not identify any other options to address this issue.

## **CONSULTATION**

27. Officials have had two meetings with affected kiwifruit growers and their accountants, various accountants who are also kiwifruit growers, as well as the New Zealand Institute of Chartered Accountants. A tax technical article *Kiwifruit PSAv issues and effects on growers - information for agents* was published on 28 February 2012 and outlined the issues raised from these discussions and explained in this Statement.

28. All those who were consulted supported the proposed solution relating to the deductibility of removal costs and the retrospective application date. This solution was considered taxpayer friendly, and provided certainty for the tax treatment of this capital expenditure, by aligning the legislation with how these groups were currently treating these costs.

29. Regarding the application of the capital contribution rules, the groups were accepting of the changes, and understood the need to align the treatment of amortisable assets with depreciable property.

30. Officials have also consulted with the Treasury which agrees with our recommendations. The Ministry for Primary Industries has also been made aware of the proposals.

## **CONCLUSIONS AND RECOMMENDATIONS**

31. The recommended option is to amend the Income Tax Act 2007 to:

- provide a deduction for the removal cost of horticulture plants;
- provide a deduction for the removal cost of horticulture infrastructure, or tax book carrying value of the infrastructure, if the land is used for other purposes due to an event outside of the control of the taxpayer; and
- provide that the capital contribution rules apply to receipts which give rise to non-depreciable property that is amortisable under subpart DO of the Income Tax Act 2007.

## **IMPLEMENTATION**

32. The necessary legislative change would be included in the tax bill scheduled to be introduced in July 2012.

33. Any amendments to the Income Tax Act 2007 would have to be backdated to the start of the 2010-11 income year; the year in which the majority of the Psa virus-related deductions are being claimed. Officials will ensure that kiwifruit growers are aware of any changes when preparing their tax returns.

34. No implementation risks have been identified. Implementation can be managed within existing systems.

## **MONITORING, EVALUATION AND REVIEW**

35. There are no plans to monitor, evaluate and review the changes under the Income Tax Act 2007 following this amendment. This is because the reforms align the legislation with what is generally undertaken in the ordinary course of business by taxpayers. If any specific concerns are raised, officials will determine whether there are substantive grounds for review under the Generic Tax Policy Process. Also, the Income Tax Act 2007 is subject to regular review by officials.