Regulatory Impact Statement

Various tax issues arising in the context of the Canterbury earthquakes

Agency Disclosure Statement

This Regulatory Impact Statement has been prepared by Inland Revenue.

The questions addressed are:

1. Given the unusual situation in Canterbury, and following the damage caused to a significant number of capital assets in the Canterbury earthquakes, how should the tax depreciation rules operate in respect of particular scenarios that have been identified by tax practitioners?
2. Should the tax rules take account of business interruption insurance payouts received for the purchase on new assets?
3. Where an income-earning or business activity has been temporarily disrupted by the Canterbury earthquakes, how should the tax deduction rules apply to expenses or losses incurred?

The questions are limited to particular situations that have been raised with Inland Revenue by tax practitioners in respect of the Canterbury earthquakes. For this reason, the questions and the proposed amendments are focussed on the situation in Canterbury.

As noted, the issues addressed were originally identified by tax practitioners, and their suggested solutions have been incorporated into Inland Revenue's analysis. Inland Revenue consulted on the proposed policy responses with these tax practitioners, including all of the large accounting firms and the New Zealand Institute of Chartered Accountants. Further modifications were made to the final proposals in response to feedback received. Inland Revenue intends to consult on the draft legislation with this same group of practitioners.

The fiscal implications of the amendments proposed in relation to the first question could not be quantified. However they do not affect the fiscal baselines because they relate to what would otherwise be an unanticipated windfall tax revenue gain for Government.

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 business, 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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INTRODUCTION

1. This RIS summarises officials' analysis of proposed technical changes to the Income Tax Act 2007. It addresses issues arising with the current tax rules which, in light of the unprecedented situation facing businesses in Canterbury, are either not working as intended or result in difficult and undesirable outcomes. These issues have largely been identified by tax practitioners, who also suggested possible solutions which were incorporated into Inland Revenue's own analysis.

2. Each issue, and possible amendment, has been considered in light of the Government's desire to provide earthquake relief and assist in the recovery of the Canterbury region, while ensuring that the revenue base remains sufficiently protected. The focus of the amendments has been to provide temporary, time-limited earthquake relief and assistance in short-term recovery. They are not designed to address the issue of the overall and longer-term economic recovery of the Canterbury region, although they should not hinder it.

3. Analysis of each of the key issues and options for change is summarised in the table at paragraph 36.

STATUS QUO AND PROBLEM DEFINITION

Background

4. As a result of the Canterbury earthquake of 4 September 2010, and its aftershock, the 22 February 2011 earthquake, a number of urgent changes to tax law were made. These reflected the most immediate and apparent taxation issues arising, and included:

- *Donations of trading stock:* Income tax and gift duty relief for goods donated (or supplied for less than market value) to support Christchurch earthquake relief.
- *Employee welfare benefits*: Income tax relief for certain welfare payments and benefits provided by employers within the first two months of each earthquake.
- *WFF: family scheme income:* Ignore support given to people affected by the earthquake in the calculation of family scheme income.
- *Relief on subsidy payments*: Subsidy payment made on behalf of the Crown not treated as a taxable grant or subsidy for GST purposes.
- *Redundancy tax credit:* Retained and extended credits to redundancy payments received before 30 September 2011.
- *Rollover relief:* The deferral of recognition of income from insurance proceeds or depreciation recovered in respect of certain assets, by rolling-over the income tax liability to reduce the acquisition cost of replacement assets if acquired by 2015–16.
- *Relief from use-of-money interest for foreign workers:* Relief from back-dating of PAYE or provisional tax obligations of contractors if a worker's stay is prolonged.
- *Extensions of time*: Extending deadline for complying with certain tax filing and payment obligations.

5. These changes addressed the most apparent needs facing Christchurch taxpayers in the aftermath of the earthquakes. Since then, as taxpayers have begun to receive insurance or compensation payments, re-establish business or income-earning activities, and utilise some of the relief provisions described above, further issues have been identified by tax practitioners and Inland Revenue officials working in the field.

6. The main set of issues relates to the application of the tax depreciation rules. These have arisen because of the scale of earthquake damage caused to a significant number of capital assets. This has had a knock-on effect on the way insurance claims are being processed and paid. There are two additional issues concerning the purchase of a new asset under a business interruption insurance policy and the deductibility of certain expense items when an income-earning or business activity has been disrupted by the earthquakes.

Depreciation-related issues

7. Under tax legislation, 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. In addition to depreciation deductions, deductions are also allowed for expenditure incurred on the repair and maintenance of an asset.

8. When applied to assets damaged in the Canterbury earthquakes, the tax depreciation rules may lead to results that are unfair or harsh, e.g. a taxpayer having an unanticipated tax liability because earthquake damage triggers certain tax disposal rules.

9. As noted at paragraph 4, the 2011 Canterbury relief measures included depreciation roll-over relief, which effectively enables owners to defer the recognition of depreciation recovery income in respect of certain assets. This relief recognised the unanticipated windfall gain that would otherwise arise to the Government, and was developed in line with the general objective of not unnecessarily bringing forward future tax liabilities.[1]

10. Other issues have since been identified with the tax depreciation rules, including technicalities that may prevent taxpayers from accessing depreciation rollover relief as intended. The position under the current law and the issues arising in the Canterbury specific situation are discussed in more detail below (issues 1–6).

Issue 1: Insurance payouts for repairable depreciable assets

11. Under the normal insurance model, where an asset is damaged but can be repaired, the insurer either undertakes the repairs or reimburses the insured after they have undertaken repairs. The existing tax law is based on this approach; the repairs expenditure is incurred first, and the expense is taken as a deduction. The insurance proceeds follow and, to the

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[1] For a full discussion on the depreciation roll-over relief, see Regulatory Impact Statement "*Tax relief for depreciation claw back – Canterbury earthquake";* prepared by Inland Revenue, 30 March 2011.

extent that they recover the earlier repair expenses, the receipts are taxed as income (the "R&M recovery rule").

12. However, for depreciable assets damaged by the Canterbury earthquakes, it has been common in Canterbury for insurers to make insurance payouts *before* the insured taxpayer undertakes the relevant repairs. It is not clear whether the insurance proceeds are taxable under the R&M recovery rule in this instance ("Issue 1.1") or how the R&M recovery rule operates in terms of the timing of income recognition and expense deductibility ("Issue 1.2").

13. If the R&M recovery rule does operate, it may lead to income being taxable upfront but expenses being deducted over several years; this may create cash flow difficulties. If the R&M recovery rule does not operate, there will be a reduction in the asset's book value for tax purposes instead. If the insurance payout exceeds the asset's tax book value, then under the depreciation rules the excess is treated as income upfront, without taking into account repairs that may be undertaken subsequently. This too may create cash flow difficulties.

Issue 2: Insurance payouts for irreparably damaged depreciable assets

14. In a natural disaster, plant and machinery may be irreparably damaged and buildings[2] may be rendered useless for the purposes of deriving income, and demolished or abandoned for demolition. In these circumstances, the general rule is that the tax book value of the asset is a deductible loss. However, if the assets are insured, the tax consequences do not follow the general rule. Instead, the assets are deemed to be sold for the amount of the insurance proceeds.

15. Many of the buildings in Canterbury are insured, and often for more than their book value.[3] In these cases any depreciation previously deducted over the life of the asset will be fully or partially clawed back; this clawed back depreciation is then taxed as depreciation recovery income.[4] Although the depreciation rollover relief may provide some assistance in some of these cases, the rules do not provide sufficient clarity in situations where there is uncertainty and a potential time lag of several years between the insurance settlement, and the occurrence of expenses, such as future demolition costs.

Issue 3: Depreciable assets that are physically repairable, but are uneconomic to repair

16. Depreciation roll-over relief applies only to irreparable assets or buildings that are rendered useless for the purpose of deriving income and demolished or abandoned for demolition. In the atypical circumstances in Canterbury, the tax definition of "irreparable" or "rendered useless" can be quite narrow and may not align with insurers' decisions about writing off damaged assets or buildings which, although physically repairable, they consider to be uneconomic to repair.

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[2] Including grandparented structures as defined in section YA 1 of the Income Tax Act 2007.

[3] Although Budget 2010 made the depreciation rate on most buildings zero, many buildings in Canterbury will have benefited from prior depreciation deductions so that their tax book value will be lower than any insurance proceeds.

[4] Any insurance proceeds received in excess of the original cost (i.e. that exceed the depreciation deductions previously claimed) are not taxable; they are treated as a capital gain.

17. An example is a building damaged to the extent that the insurer considers it to be uneconomic to repair, but still able to be used by the person to carry on their business until a replacement building is ready, and the old building can be demolished.[5] Similar definitional issues also arise where an asset is effectively written off by the insurer but retained by the business and put to another, less productive, use. In these circumstances, the taxpayer is precluded from accessing the roll-over relief for the replacement asset. This is contrary to the general intent for this relief. This is because the taxpayer cannot defer the unanticipated tax liability that may result where insurance proceeds are received in excess of an asset's tax book value. Instead, the excess insurance proceeds are treated as depreciation recovery income rather than rolling over the proceeds to a replacement asset.

Issue 4: Amount of income where compensation received for a repairable asset

18. Insurance or compensation payments are treated differently depending on whether they are received in relation to (a) or (b) below:

a) plant and machinery that are treated under the Income Tax Act as "irreparably damaged" or buildings[6] that are rendered useless for the purposes of deriving income and demolished or abandoned for demolition; or

b) plant and machinery that are not treated by the Income Tax Act as "irreparably damaged" because they are physically repairable or still usable or buildings that can still be used for the purposes of deriving income.

19. For insurance payments relating to (a), the treatment is appropriate.

20. In respect of (b), any expenditure incurred in repairing the assets is usually deductible. However, the problem is that any insurance proceeds associated with the cost of these repairs will be taxable to the extent that payouts exceed the cost of any repairs and the asset's tax book value. This means that the rules may end up taxing more than the amount of earlier depreciation deductions allowed with respect to the asset.

Issue 5: Assets that are depreciated in a pool

21. The same issues outlined at paragraphs 11 to 17 arise for assets depreciated in a pool.

22. The pool depreciation method allows low-value assets (that each have a value of $2,000 or less where they meet certain criteria) to be grouped together and depreciated in order to reduce compliance costs. Pool assets are subject to their own special rules, rather than the general depreciation provisions that apply to other depreciable assets.

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[5] This can arise where, for example, a building is initially assessed by CERA as useable, but is later re-assessed for eventual demolition, and therefore written off by the insurer as uneconomic to repair.

[6] Including grandparented structures, as defined in section YA 1 of the Income Tax Act 2007.

Issue 6: Allowing depreciation for property that is temporarily unavailable for use

23. At present, a deduction for depreciation is allowed only if an asset is used or is available for use by a person during the income year. However, it is uncertain whether the meaning of "available for use" covers an asset that is temporarily unavailable (for example, because it is situated in the Christchurch red zone). If such assets are not covered, they will be deemed to be disposed under the depreciation rules and this may lead to a tax liability for the owner. This outcome is undesirable when the property will subsequently be available for use for income-earning or in a business activity.

Other issues

Issue 7: Capital contributions – business interruption insurance payouts for new assets

24. Under the depreciation rules, the amount of an insurance payout that relates to writing off an irreparably damaged asset or repairing a damaged asset is taken into account when calculating the amount of depreciation deduction allowed for the cost of a capital asset.

25. However, the Canterbury earthquakes highlighted a gap in these rules – if a person receives a payment under a business interruption insurance policy to purchase a new asset to restart or continue their business operations, the payment is not recognised in the depreciation rules. Further, the payment is not income of the person because it does not relate directly to income replacement. This means that the person can capitalise and claim full depreciation deductions for the total cost of the new asset even though they did not directly pay for it. This creates a risk to the tax base and is inconsistent with the policy of allowing a deduction for depreciation for the cost of the capital that is borne by the person.

Issue 8: Deductibility of expenses where there is no income-earning or business activity

26. Generally, a person is allowed a deduction for an amount of expenditure or loss to the extent that it is incurred by them in deriving their income (income-earning activity) or in the course of carrying on a business for the purpose of deriving their income (business activity).[7]

27. As a result of the Canterbury earthquakes, some taxpayers may not be able to deduct their expenses or losses (including depreciation losses) relating to their income-earning or business activity because their activities are so disrupted by the earthquakes that there is no longer a sufficient link between the expenses or losses and their activities. For example, a rental property or business premise, which is situated in the Christchurch CBD red zone, becomes untenanted or forcibly closed because the premise is not physically accessible. Given there is no income-earning or business activity, on-going expenses such as rates may not be deductible under the general permission, even if the activity subsequently resumes.

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[7] The general permission in section DA 1 of the Income Tax Act 2007.

Questions to be addressed

28. These eight issues raise the three questions to be addressed in this analysis:

1. Given the unusual situation in Canterbury, and following the damage caused to a significant number of capital assets in the Canterbury earthquakes, how should the tax depreciation rules operate in respect of particular scenarios that have been identified by tax practitioners?
2. Should the tax rules take account of business interruption insurance payouts received for the purchase on new assets?
3. Where an income-earning or business activity has been temporarily disrupted by the Canterbury earthquakes, how should the tax deduction rules apply to expenses or losses incurred?

OBJECTIVES

29. As noted in previous Regulatory Impact Statements[8] on Canterbury-earthquake related tax amendments, the Government's desired outcome from all tax measures aimed at providing earthquake relief or assisting the recovery on the Canterbury region has been broadly to:

- uphold the general direction of tax law and ensure that the revenue base remains sufficiently protected;
- make sure that the tax rules do not unnecessarily bring forward future tax liabilities;
- ensure that the tax rules do not produce results that may be seen as unfair in the context of Canterbury; and
- provide taxpayers with sufficient certainty as to their tax obligations and liabilities.

30. These broad objectives are relevant to the issues in this Statement. In addition, a key objective to be met in answering the questions at paragraph 28 is that the tax rules assist, or at least do not hinder, the recovery and rebuilding of the Canterbury region, particularly in respect of the timing of tax impacts.

31. These outcomes must be achieved within a relatively short timeframe, because the Government is responding to a devastating event that has already occurred. Ideally, people should have certainty as to what the tax treatment will be in respect of certain things that have occurred, or things they are contemplating doing as soon as practically possible.

32. Many of the issues covered in this paper are connected in some way to the tax treatment of insured assets and insurance receipts. Insurance payouts have started to be made during this current tax year, and taxpayers are beginning to make decisions on how they will use these payments. In doing this, they should be fully informed of the possible tax effects on the damaged assets, their insurance receipts, and any replacement assets that they may acquire.

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[8] For example see the Regulatory Impact Statement on "*Tax relief for welfare payments by employers – Christchurch earthquake"* (17 March 2011) and "*Tax relief for depreciation claw back* – Canterbury earthquake (30 March 2011)"

REGULATORY IMPACT ANALYSIS

33. All eight issues arise from the application of current tax legislation. In light of the unprecedented post-earthquake situation facing taxpayers in Canterbury, the legislation is either not working as intended or results in unanticipated, difficult and undesirable outcomes. Inland Revenue's operational discretion is limited and any response needs to be regulatory. Each regulatory option was considered against the 'status quo' (i.e. whether continuing to apply the existing legislation is a valid approach).

34. Officials' preferred options are generally concerned with ensuring that the correct overall outcome from a tax policy perspective is achieved in light of the situation in Canterbury, rather than providing "special relief" targeted at Canterbury. Most of the proposed amendments are Canterbury-specific, with the exception of the recommended solution for issue 1a and issue 7, which have a more generic application.

35. Officials' recommend that all of the issues be addressed in the same bill. In particular, the depreciation-related items are linked and so should be developed together to create a more coherent package.

36. The table below summarises each of the eight issues and the option for change (analysed against the status quo):

Issue	Options (against status quo)	RIA paragraph
Depreciation-related issues		
Issue 1: Insurance payouts for repairable or useable depreciable assets		38-44
1.1) Uncertain treatment of insurance payouts received upfront	1.1) Clarify that insurance payouts relating to deductible expenditure are taxable, irrespective of when insurance payout received.	
1.2) Timing mismatch between recognition of insurance or compensation received and expenditure incurred (on repairs etc).	1.2) Matching rule to smooth the timing of income and deductions on damaged assets until end of 2015–16 income year.	
Issue 2: Insurance payouts for irreparably damaged depreciable assets		45-47
Timing mismatch between recognition of insurance or compensation received and loss/costs from disposal of asset.	Matching rule to smooth the timing of income derivation and disposal losses until end of 2015–16 income year.	
Issue 3: Depreciable assets that are physically repairable, but are uneconomic to repair		48-54
Assets that are uneconomic to repair but still being used are not covered by depreciation roll-over relief rules. Timing mismatch for disposal costs of buildings that are later demolished.	Extend current roll-over relief rules, to defer any depreciation recovery income. Matching rule to smooth the timing of disposal costs until end of 2015–16 income year.	
Issue 4: Amount of income where compensation received for a repairable asset		55-58
Insurance or compensation received in excess of expenses/original cost are taxable as income, not a capital gain, if asset is repairable or still in use.	Cap the amount of income from insurance payouts received in respect of repairable assets to the amount of depreciation deductions previously claimed.	

Issue	Options (against status quo)	RIA paragraph
Issue 5: Assets that are depreciated in a pool		59-61
Timing mismatch between recognition of receipts and expenditure incurred (on repairs etc.) or loss on disposal and disposal costs.	Matching rules similar to those for non-pooled assets.	
Issue 6: Allowing depreciation for property that is temporarily unavailable for use		62-64
Depreciation can be claimed only if an asset is available for use; this application is uncertain if assets are capable of being used but because of the earthquakes cannot presently be used.	Clarification to ensure "available for use" covers properties that are only temporarily 'unavailable' because of the earthquakes.	
Other issues		
Issue 7: Capital contributions – insurance receipts for purchasing new assets		65-68
A payment under a business interruption insurance policy to purchase a new asset to restart or continue its business operations is not recognised as income and is not reflected in the cost of the new asset.	Include in the definition of "capital contribution", so the amount of insurance payment for purchasing a new asset is either included as income of the recipient or reduces the cost base of the new capital asset.	
Issue 8: Deductibility of expenses where no income-earning or business activity		69-73
Expenses may not be deductible because the income-earning or business activity has been disrupted by the earthquakes.	Either: Defer expense deduction until the income-earning or business activity resumes (*official's preferred option*).	
	Or: Allow a deduction when the expense is incurred, but claw back the deduction if the income-earning or business activity does not resume.	

Depreciation-related amendments

37. The regulatory options for each depreciated-related issue are discussed below.

Issue 1: Insurance payouts for repairable depreciable assets

Option 1A	Matching rule *(officials' preferred option)*
(Issue 1.1) Clarify that insurance payouts relating to deductible expenditure are taxable, regardless of when received. (generic) *(Issue 1.2)* Optional matching rule to smooth the timing of income and deductions on repairable damaged assets. Rule would match insurance payouts and repair expenditure incurred over several years; the net amount would be recognised either at the point of time the net outcome of the insurance proceeds and expenditure on repairs can be reasonably estimated, or the end of the 2015–16 income year, whichever is earlier. (Canterbury-specific)	
Option 1B	**Status quo**
No change to current legislation.	

38. Officials consider that option 1A (covering Issues 1.1 and 1.2) will both clarify the tax position for upfront insurance payouts, and address the timing mismatch that exists under

current tax law between deductions for depreciation, expenditure incurred on repairs and maintenance and the recognition of insurance proceeds as income. Consultation undertaken on this issue indicated that there was general support for this approach. The preferred option 1A addresses the fact that insurers in Canterbury have departed from their usual model of paying insurance proceeds after repairs are undertaken and have been paying insurance settlements upfront instead.

39. The proposed application date for the matching rule is the 2010-11 income year, although only a few taxpayers are likely to have received insurance payments in that year. For those taxpayers that do wish to use the matching rule for 2010-11, many have already arranged an extension of the date for filing these returns until 1 October 2012. Any taxpayer who has already filed their 2010–11 return under the current rules can apply to the Commissioner to amend their assessment to take advantage of the matching rule. There are no significant compliance costs anticipated for amending these few 2010-11 assessments.

40. The proposed matching rule will apply on a per asset basis as opposed to a portfolio basis; this is consistent with the existing approach under the depreciation rules, which apply to individual assets (with the exception of low-value assets). This may mean some taxpayers will face higher compliance costs as they will need to track individual assets for the purposes of applying the matching rule. However, the rule is optional for taxpayers to use, which gives them greater flexibility according to their unique circumstances; this flexibility is consistent with the feedback received during consultation.

41. One downside of having an optional rule is that it may be possible for taxpayers to "cherry-pick", i.e. elect in and/or out of the matching rule in relation to an individual asset based on whether it will achieve a more favourable tax outcome. Accordingly, to minimise cherry-picking, a taxpayer who elects to use the matching rule must use it for all of their repairable depreciable assets in relation to which they have received an insurance payment due to the Canterbury earthquakes, and apply the rule up to the time of settlement or the end of the fixed time period.

42. There are no implementation issues with option 1A, as taxpayers' decision to use the rule will simply be reflected by the tax positions they take in their income tax returns for each year and no earlier notification is required.

43. The matching rule is limited to assets damaged in the Canterbury earthquakes and is also limited in time, to income years before the 2016–17 income year. This is because officials consider that this option is suitable for responding to the unique circumstances arising because of the earthquakes but should not apply more generally, as the existing rules work well ordinarily.

44. Option 1B is to maintain the status quo. This does not address the issue currently arising under the tax rules where, as in Canterbury, insurance payments are received upfront before expenditure is incurred on repairing the relevant asset and the consequent potential unexpected tax liabilities that may fall on taxpayers. It does have the possible advantage of requiring taxpayers to comply with one rule. However, in the context of the Canterbury earthquakes, officials consider that a more flexible approach is required when working out taxable income or losses relating to damaged assets.

Issue 2: Insurance payouts for irreparably damaged depreciable assets

Option 2A	Matching rule *(officials' preferred option)*
Introduce a matching rule to smooth the timing of income derivation and disposal losses where income and expenses occur over several years. The rule will allow only the net amount of insurance payments and disposal proceeds, and the written-off tax book value and disposal costs, to be brought to account for tax purposes.	
Option 2B	Status quo
No change to current legislation.	

45. Option 2A will address uncertainty under the current tax rules about when income and expenditure are recognised under the depreciation rules when an insured depreciable asset is either sold or irreparably damaged. Therefore, it will have the advantage of increasing taxpayer certainty.

46. The rule is similar in design and intent to the matching rule proposed for reparably damaged assets at paragraphs 38 to 44 above. Accordingly, the advantages and disadvantages of this option are similar to the ones outlined above.

47. Option 2B is to maintain the status quo. This does not address the uncertainty that exists regarding when income and disposal costs need to be recognised when an insured asset is irreparably damaged.

Issue 3: Depreciable assets that are physically repairable, but are uneconomic to repair

Option 3A	Same treatment as "irreparably damaged" assets *(officials' preferred option)*
Extend current roll-over relief rules, to defer any depreciation recovery income. Matching rule to smooth the timing of disposal costs for assets that are uneconomic to repair until end of 2015–16 income year. The effect will be to treat assets deemed "uneconomic to repair" in the same way as assets considered under the tax rules to be "irreparably damaged".	
Option 3B	Status quo
No change to current legislation.	

48. Option 3A addresses the situation where assets have been damaged to the extent that the insurer considers them to be uneconomic to repair, but the plant is not regarded under tax legislation as "irreparably damaged", or the building is not "rendered useless for deriving income" in the immediate term. The insurance proceeds may include an amount for demolition costs, which will not be incurred by the taxpayer until a future date.

49. This option involves applying the same matching rule that is available for irreparably damaged assets (outlined at paragraphs 45–47). So these rules will apply, for example, to buildings that:

- are considered by an insurer to be uneconomic to repair;
- will require demolition before the beginning of the 2016–17 income year; and
- the taxpayer intends to acquire a replacement building before the beginning of the 2016–17 income year.

50. Using the matching rule for buildings will have the additional benefit of providing certainty to taxpayers regarding the treatment of demolition costs that they are committed to incur in the future, as the matching rule can be applied to these to bring them to account.

51. Option 3A also has the benefit of allowing depreciation roll-over relief to defer any income tax liability. As well as providing some immediate tax relief, an explicit part of the rollover relief policy was to incentivise rebuilding in Canterbury by refraining from imposing an "extra" tax on firms that merely want to be able to rebuild their business by replacing assets. The same rationale applies to assets that are not immediately destroyed but are uneconomic to repair (although they are still capable of being used in a different capacity) and to buildings that are uneconomic to repair and must be demolished within the next few years.

52. The disadvantage is that there may be some compliance costs as firms will need to separately track and account for assets where roll-over relief has been taken; this is a feature of roll-over relief in general and not just this particular option. However, this is tempered by the roll-over relief being optional. There may be some incentive to claim that buildings are not economic to repair simply in order to qualify for roll-over relief. Accordingly, along with the existing roll-over relief requirements (i.e. the building must be demolished by the end of the 2015–16 income year and there must be an intention to obtain a replacement building), there will be a requirement that the building has been assessed by an insurer as uneconomic to repair. In addition, this option is limited to buildings affected by the Canterbury earthquakes and will only apply for the period of the rollover relief, that is until the end of the 2015–16 income year.

53. Option 3B is to maintain the status quo. This has the advantage of retaining the current clear boundary between assets such as plant that are effectively totally destroyed, and buildings that are rendered useless for earning income and are demolished/ require demolition and other assets that may be damaged but are still able to be used for earning income.

54. Option 3B has the disadvantage of prolonging the current uncertainty regarding the tax treatment of future demolition costs. In addition, and contrary to the policy objectives for depreciation roll-over relief, taxpayers may face an unanticipated tax liability being imposed on insurance proceeds, which may affect rebuilding in Canterbury.

Issue 4: Amount of income where compensation received for a repairable asset

Option 4A	Cap on insurance payouts *(officials' preferred option)*
Cap the amount of income from insurance payouts received in respect of repairable assets to the amount of depreciation deductions previously claimed.	
Option 4B	Status quo
No change to current legislation.	

55. As explained at paragraph 20, the current legislation taxes the insurance proceeds received for a repairable asset to the extent that they exceed the cost of any repairs and the asset's tax book value. This means that the rules may end up taxing more than the amount of earlier depreciation deductions allowed with respect to the asset. This may cause problems for taxpayers who do not have a ready source of cash to fund the unanticipated tax liability.

56. Accordingly, capping the amount of depreciation recovery income at the amount of depreciation deductions previously claimed addresses the issue of the taxpayer facing an unexpectedly large tax liability. And as discussed above at paragraph 51, the extension of roll-over relief may mean that the income tax liability that they do incur on depreciation claw back can be deferred. Option 4A will provide indirect assistance in re-building Canterbury. It also has the benefit of ensuring consistency with the tax treatment of insurance received in relation to an irreparably damaged asset.

57. This option will be limited to assets damaged in a Canterbury earthquake and will expire at the end of the 2015–16 income year.

58. Option 4B is to maintain the status quo. This does not address the issue outlined above of taxpayers facing an unexpectedly large tax bill for insurance proceeds received in relation to assets that are damaged (but not irreparably so) in the Canterbury earthquakes.

Issue 5: Assets that are depreciated in a pool

Option 5A	Matching rule for pooled assets *(officials' preferred option)*
Introduce matching rules (similar to the ones discussed above) to smooth the timing of income derivation, repairs expenses and disposal losses.	
Option 5B	Status quo
No change to current legislation.	

59. Option 5A involves introducing matching rules for pooled assets that work in a similar manner to the ones outlined above at paragraphs 38 to 43 and 45 to 47 for non-pooled assets.

60. The advantages of introducing the matching rules are that it will provide more certainty and clarity regarding the timing of insurance and disposal proceeds and expenditure incurred for pooled assets. In other respects, the advantages and disadvantages of this option are the discussed above at paragraphs 38 to 43 and paragraphs 45 to 47.

61. Option 5B is to maintain the status quo. This option does not address the issue of taxpayer uncertainty regarding when insurance proceeds and repair and disposal costs should

be recognised for tax purposes for pooled assets affected by the earthquakes. It does have the advantage of applying the same rules to all pooled assets; however, this does not seem appropriate in the context of the Canterbury earthquakes.

Issue 6: Allowing depreciation for property that is temporarily unavailable for use

Option 6A	Clarify the meaning of "available for use" *(officials' preferred option)*
Clarify the meaning of "available for use" to cover properties that are only temporarily 'unavailable' because of the earthquakes.	
Option 6B	Status quo
No change to current legislation.	

62. Option 6A provides certainty for those affected by the Canterbury earthquakes. The impact of this option is minor as the legislation is being aligned with the current policy of treating properties as available for use even though they are temporarily unavailable (i.e. subject to repair or an inspection). Note that those who cannot deduct their depreciation because they no longer meet the general permission provision[9] may be required to defer their depreciation deduction until their income-earning or business activity resumes (see officials' preferred option for issue 8 at paragraphs 70–73 below).

63. The application of Option 6A is limited from 4 September 2010 (the day of the first Canterbury earthquake) to the 2015–16 income year. This solution aligns the relief time period with other specific Canterbury earthquakes tax reliefs such as depreciation rollover relief. It would be also inappropriate to treat properties as "available for use" if it does not become available for use by the 2015–16 income year.

64. Option 6B is to maintain the status quo, which may treat the properties that are temporarily available for use as being disposed of under the depreciation rules. This is undesirable where properties affected by the earthquakes will subsequently be available for use for income-earning or business activity.

[9] Section DA 1 of the Income Tax Act 2007.

Other amendments

Issue 7: Capital contributions – business interruption insurance payouts for purchasing new assets

Option 7A	Amend the capital contribution definition *(officials' preferred option)*
Include business interruption insurance payouts for purchasing new asset in the definition of "capital contribution", so the amount of insurance payment is either included as income of the recipient or reduces the cost of the new capital asset.	
Option 7B	Status quo
No change to current legislation.	

65. Option 7A is to amend the capital contribution rules so that insurance payouts under a business interruption insurance policy for purchasing new assets are either included as income of the recipient or reduce the cost of the new capital asset. Clawing back the amount of insurance payouts on the new asset, for depreciation purposes, is consistent with the policy to allow a deduction for depreciation for the cost of the capital which is actually borne by taxpayers. Moreover, this solution ensures that the tax base is protected.

66. This preferred option will result in a small unquantifiable increase in tax revenues. Similar to when the capital contribution rules were proposed, the impact of the preferred option would most likely result in a marginal increase in taxpayer's compliance cost. The impact is limited to those who received insurance proceeds under a business interruption insurance policy for purchasing new depreciable property after the 2011–12 income year (except for those people who filed tax returns before the proposed legislation is introduced, i.e. before the start of the Committee of the whole House stage of the debate on the *Taxation (Annual Rates, Returns Filing, and Remedial Matters) Bill)*. This limited application date allows taxpayers to rely on existing law at the time but prevent a risk to the tax base.

67. Affected taxpayers would be required to either include the insurance receipts as income and spread the amount over 10 years (the default rule) or choose to reduce the cost of the new capital asset, which would limit the amount of depreciation deduction on that capital asset in future. There are no significant administrative implications from this option.

68. Option 7B is to maintain the status quo. This is unsatisfactory as it does not align with the policy intent for only allowing a deduction for depreciation for the cost of the capital asset which is actually borne by taxpayers. When the capital contribution rules were implemented, officials excluded insurance receipts from the capital contribution rules to prevent double counting; insurance receipts relating to depreciable assets are already covered under the depreciation rules. The current gap in the depreciation rules (status quo) is unintended.

Issue 8: Deductibility of expenses where there is no income-earning or business activity

<table>
<tr><td>Option 8A</td><td>Deduction when income-earning or business activity resumes (officials’ preferred option)</td></tr>
<tr><td colspan="2">Defer any expense deduction until the income-earning or business activity resumes.</td></tr>
<tr><td>Option 8B</td><td>Deduction when expense incurred</td></tr>
<tr><td colspan="2">Allow a deduction when the expense is incurred, but claw back the deduction if the income-earning or business activity does not resume.</td></tr>
<tr><td>Option 8C</td><td>Status quo</td></tr>
<tr><td colspan="2">No change to current legislation.</td></tr>
</table>

69. Option 8C is the status quo, which denies deductions for expenses or losses that would otherwise be tax deductible but for the period of disruption caused by the earthquakes. This seems undesirable. Option 8A and 8B would both allow deductions; the main difference between these options is in the timing of the deduction.

70. The preferred Option 8A would defer the deduction by deeming the expenditure or loss to be incurred in the income year when the income-earning or business activity resumes. The benefit of this approach is that it provides certainty around deductibility of expenses or losses for affected taxpayers who intend to continue their income-earning or business activities. Also, this approach protects the tax base from taxpayers pre-deducting their expenditure or loss and not resuming (or unreasonably delaying) their activity.

71. Option 8A provides a number of benefits. The legislation will provide certainty around deductibility of expenses for those affected by the earthquakes and who intend to continue their income-earning or business activity. Option 8A also avoids complex notification and tracking processes inherent in Option 8B; for example, identifying the affected taxpayers intend to carry on their activities and determining whether they actually continue their activities at a future time. There are no significant administrative implications arising from this option as those affected by the earthquakes would simply rely on the law.

72. A drawback with Option 8A over Option 8B is that it leaves taxpayers to bear the expenses or losses temporarily until their activity resumes. However, the cost of delaying the deduction should be balanced with the revenue risk and complex administrative and compliance implications.

73. Option 8A would apply only to those affected by the Canterbury earthquakes, from 4 September 2010 to the 2015–16 income year. This solution aligns the relief time period with other specific Canterbury earthquakes tax reliefs such as depreciation rollover relief.

Fiscal impact

74. The fiscal implications of the options for the depreciation related issues discussed under Issues 1 to 5 (paragraphs 38 to 61) could not be quantified. The measures all relate to the relief of windfall tax revenue gains associated with the treatment of assets damaged in the Canterbury earthquakes, and their subsequent disposal or repair, and are ring-fenced to this event. The proposed matching rules prevent a timing mismatch which would otherwise arise

between recognising income from insurance payments and allowing deductions for repair or disposal. Since none of these windfall tax revenue gains or timing mismatches have been anticipated in the baseline tax revenue forecasts, the tax measures proposed in this Statement do not affect the fiscal baselines.

75. The options to extend the meaning of "available for use" (Issue 6) mostly clarify existing law and are therefore unlikely to have significant revenue implications.

76. There is a small unquantifiable revenue gain from the amendments to the definition of capital contributions (Issue 7). The amendment to address the deductibility of expenses where there is no income-earning or business activity (Issue 8) would have a small unquantifiable fiscal cost. This cost depends on two factors – the number of affected taxpayers' deciding to continue their income-earning or business activities and the length of their decision-making period.

Administrative, compliance and other impacts

77. Compliance costs are minimised with respect to the proposed matching rules (Issues 1, 2 and 5) by not requiring taxpayers to notify in advance of their election into the rule. Instead a taxpayer's decision to apply the matching rule would be reflected by the tax positions they take in their income tax returns for each year.[10]

78. The other measures outlined in this Statement do not have administrative implications for Inland Revenue, and would not impact on Inland Revenue's computer systems.

79. 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, and/or who have suffered disruption to their income-earning or business activity as a result of the earthquakes.

CONSULTATION

80. The issues addressed by these amendments were identified by 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 Inland Revenue's proposed amendments.

81. Consultation was undertaken with a small group of tax practitioners on each of these issues and the proposed solutions, by way of an informal policy paper being circulated to select 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 six firms, and officials also met or held telephone conferences with

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[10] For taxpayers who elect to use the roll-over relief, the existing law requires them to notify the Commissioner.

practitioners. Some modifications were made to the options outlined above in response to feedback received from consultation.

Summary of feedback

82. The key feedback received (and Officials' comments) was the need for simplicity, certainty and flexibility in the design of the rules.

Practitioner feedback	Officials' comment
Application date	***Issue 1.1***
Will taxpayers be able to re-open tax returns that have already been filed for the 2010–11 year or would be grandparented?	A flexible approach is proposed, because the amendment is generic and applies with no time limit. It should apply from the 2010–11 income year for taxpayers who have not taken a tax position for that year yet; and the 2011–12 income year for those who have.
	Issues 1.2-8
	Amendments should apply from 4 September 2010 until the last day of the 2015–16 income year (in line with the expiry of the CERA). No relief for tax positions already taken because taxpayers are able to arrange to extend the date for filing 2010–11 year returns until 1 October 2012.
The amendment should not apply retrospectively.	***Issue 7***
	The retrospective application date is consistent with other specific Canterbury earthquakes measures. Also, this application date does not require past assessments to be reopened.
Matching rule	***Issues 1 and 2***
Unanimous support for the matching approach. Differing views on whether the rule should apply in all cases or only when insurance proceeds are received before repairs are undertaken.	The matching rule has limited application to Canterbury, and is largely an issue of timing. Officials concluded that taxpayers should have the option to use the matching approach, but once selected it should apply to all of their assets.
Deduction rule – claw back	***Issue 8***
Broadly agree with the change; concern if expenses were allowed upfront but then clawed back unless the income-earning or business activity does not restart.	Officials concluded that the deferral approach (instead of the claw back approach) is preferred when balanced with revenue risk associated with the relief and complex administrative and compliance implications.

83. A number of minor technical issues were raised, which officials have worked through.

84. Inland Revenue intends to consult on the draft legislation with this same group of practitioners.

CONCLUSIONS AND RECOMMENDATIONS

85. Officials have considered the various issues and options outlined above. Although discussed separately, there is some overlap in the solutions recommended to address each issue. Officials consider that implementing the preferred options as a package would provide a holistic approach to best address the identified difficulties with the depreciation and deduction rules in the particular situation in Canterbury. The solutions limit the potential cost and risks associated with providing amendments to deal with specific circumstances, while providing appropriate tax relief for taxpayers and businesses affected by the earthquakes in a way that meets the Government's policy objectives.

IMPLEMENTATION

86. Given the need for certainty on the tax treatment of these items, many of which started to arise during the 2011–12 tax year, officials consider that the amendments should be legislated in the first available taxation bill. Officials have therefore recommended that any amendments are included in a Supplementary Order Paper to be introduced at the Committee of the whole House stage debate of the Taxation (Annual Rates, Returns Filing, and Remedial Matters) Bill.

87. The new rules would be administered by Inland Revenue through existing processes; there are no systems implications. The amendments will involve some initial costs for communication and education, which will be covered through Inland Revenue's baseline funding.

MONITORING, EVALUATION AND REVIEW

88. The preferred options are targeted to resolve particular technical issues which have arisen because of the specific circumstances in Canterbury resulting from the earthquakes. Several of the proposed approaches are optional and apply only in limited circumstances and/or for a limited time period. Therefore, the potential impacts should be confined to a relatively small group of taxpayers.

89. In general, Inland Revenue 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 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.