Deferred tax update

Removal of tax depreciation on commercial and industrial buildings

As a "revenue raiser" for the new coalition government, the removal of tax depreciation on commercial buildings has been widely publicised since the election. This publication addresses the accounting impacts of the removal of tax depreciation deductions for certain buildings.

Introduction

In March 2020, legislation was introduced to reinstate tax depreciation for buildings with an estimated useful life of 50 years or more, as part of the government's COVID-19: Economic Response Package. This in turn reversed the previous 2010 removal of tax depreciation deductions for certain industrial and commercial buildings, including hotels and motels.

From 2020, industrial and commercial buildings were able to claim tax depreciation on a 2% diminishing value or 1.5% straight-line basis for the relevant tax book value of qualifying buildings held from the 2020/21 tax year.

From 1 April 2024, tax depreciation on buildings will again be at 0% and will apply from the first day of the 2024/25 income tax year (e.g., 1 January 2024 for a December early-balancer).

The points discussed below refer only to assets identified as "buildings" [1] as defined in tax law and not (for example) costs allocated to most fit-out, which continued to be tax depreciable after 2010.

Accounting implications of the removal of depreciation deductions

The change in tax legislation to remove depreciation deductions will likely have a significant impact on many entities preparing financial statements in accordance with New Zealand equivalents to International Financial Reporting Standards (NZ IFRS) and Public Benefit Entity Standards for Tier 1 and 2 entities (PBE Standards). The impact of the removal of tax depreciation will depend on several things including:

- The timing of acquisition of the building
- The method of acquisition (direct purchase or acquired via a business combination)
- The expected manner of recovery of the asset
- The current accounting for deferred tax applied since acquisition of the building

Refer below to our examples for further information.

[1] The Bill as introduced includes the definition of "building" and will be amended to exclude commercial fit-out. The Commissioner's view on the "meaning of building" is set out in Interpretation Statement IS 22/04 Claiming depreciation on buildings.

Key impacts

The loss of tax deductions for depreciation will adjust the tax base of assets to nil.

1. The removal of the tax base will likely create significant taxable temporary differences for all buildings, irrespective of their date of acquisition. Recognition of that temporary difference as a deferred tax liability will depend on the timing of acquisition, whether deferred tax was previously not recognised due to the application of the initial recognition exception (IRE) in NZ IAS 12 and any accounting policy choices made.
2. In limited situations, a new tax base may arise due to the reinstated transitional provision for depreciable fit-out for pre 2010/11 buildings and reintroduced tax depreciation of specific grandparented structures (acquired on or before 30 July 2009).
3. The net impact of any newly recognised deferred tax is recognised in tax expense in the year of change, rather than opening retained earnings.

Current accounting requirements

NZ IAS 12 *Income Taxes* (NZ IAS 12) requires entities to account for deferred tax based on legislation that is substantively enacted by the end of the reporting period. The Taxation (Annual Rates for 2023-24, Multinational Tax, and Remedial Matters) Bill received Royal Assent on 28 March 2024. For entities with a 31 March 2024 reporting date, the impact of these changes is required to be reflected in their 31 March 2024 financial statements.

Existing buildings

The key impact relates to buildings that a taxpayer currently owns and holds with the intention of use in the future (rather than when the expected manner of recovery is through sale), and that have an estimated useful life of 50 years or more (as determined by the Commissioner of Inland Revenue). The changes are applicable for buildings held for own use under NZ IAS 16 *Property, Plant and Equipment*. Investment properties recognised in accordance with NZ IAS 40 *Investment Property* that have applied the rebuttable presumption in NZ IAS 12.51C [2] will also be in scope.

Under NZ IAS 12, the tax base of an asset is defined as the amount that will be deductible for tax purposes against any taxable economic benefits that will flow to the entity when it recovers the carrying amount of the asset. For buildings that are intended to be held for use, the carrying amount of the asset will be recovered over the remaining estimated accounting useful life of the asset.

The removal of tax deductions for depreciation means that there will (again) be no tax deductions to claim against the taxable benefits generated through use of the asset. Therefore, the tax base of the asset will decrease to nil. In limited situations, depreciable fit-out for pre 2010/11 buildings and depreciation on specific grandparented structures can be reinstated and will therefore be added to the tax base for the relevant assets.

For impacted entities, the net decrease in the tax base may create a new taxable temporary difference (deferred tax liability (DTL)) or reduce the deductible temporary difference (deferred tax asset (DTA)) previously recognised. The actual determination of the outcome of the change in tax legislation will depend on when the asset was acquired, whether the IRE was applied on initial recognition of the building and any accounting policy choices made.

We note that NZ IAS 12 has limited guidance on the deferred tax impacts of subsequent changes in tax base where the IRE originally applied. Therefore, in some circumstances, management may need to make an accounting policy choice with respect to how subsequent tax law changes impact their tax accounting. We suggest speaking to your local EY advisor to consider the implications.

For existing buildings, if an adjustment is required to increase a recognised DTL or decrease a recognised DTA, the amount must be recognised in profit or loss in the year which the adjustment is made. This could create a potentially large increase in that year's tax expense.

Future building purchases

The removal of depreciation deductions is not expected to impact an entity that buys a building after 28 March 2024 (other than in a business combination). The IRE in NZ IAS 12 is an exemption that, in most cases, allows an entity to ignore any deferred tax relating to a non-deductible asset when first acquired. Therefore, typically, no deferred tax would be recognised in this situation. (However, there will be an impact for buildings acquired in a business combination, as the IRE does not apply in this situation.)

We have provided examples below to explain.

[2] In accordance with NZ IAS 12.51C, there is a rebuttable presumption that investment property will be recovered through sale. However, if this assumption is rebutted and the investment property is determined to be held for use, these changes will be applicable.

Substantively enacted

NZ IAS 12 requires an entity to measure current and deferred tax at the tax rates that have been enacted or substantively enacted. The Taxation (annual Rates for 2023-24, Multinational Tax, and Remedial Matters) Bill received Royal Assent on 28 March 2024. The changes will need to be reflected in financial statements with reporting date on or after 31 March 2024.

Entities that are yet to issue financial statements with reporting date before 28 March 2024 (e.g., financial statements as at 31 December 2023) may consider disclosure of the change depending on how material it is to the entity. Such disclosures should include the nature of the changes and an estimate of the financial effect (or a statement indicating such an estimate cannot be made).

Key impacts

The changes will need to be reflected in financial statements with reporting dates on or after 31 March 2024.

Definition of a qualifying building

The removal of tax depreciation is for qualifying non-residential buildings. Non-residential buildings are defined in section YA 1 of the Income Tax Act 2007 (the Act) as any building which is not a residential building (i.e., dwellings and certain other short-term accommodation types). This document refers to these assets generally as "buildings".

Tax base

The 2024/25 tax opening book value is nil for all qualifying buildings. There is no requirement to consider the tax base of a building owned prior to the 2010/11 income year differently to those acquired since.

Accounting revaluations

For those entities that have chosen to revalue their building assets, it would be common for a DTL to be recognised at the time of the revaluation (regardless of how the asset was acquired) on the presumption the assets carrying value would be recovered through use and assuming the tax depreciated amount is less than the book revalued amount. As such, the deferred tax on revaluations is not expected to be impacted by the removal of building depreciation.

Assets realised through sale

Where a building is held with the intention of sale, any resultant deferred tax is measured based on the tax consequences of sale. Similarly, for investment properties, it is assumed their recovery will be through sale unless otherwise rebutted.

For tax accounting purposes, deferred tax recognised in relation to a building held for sale and on capital account for tax purposes will continue to be calculated with reference to the amount of tax depreciation to be recovered on sale.

Tax losses

Some taxpayers may have unused tax losses (or deductible temporary differences) that have not been previously recorded as a DTA in the balance sheet due to insufficient future probable taxable income.

Taxpayers in such situations should reconsider whether some or all those tax losses or deductions should now be recognised to offset the increased taxable temporary difference on existing buildings because of the removal of tax depreciation deductions.

Illustrative examples

The examples below highlight the accounting implications in different scenarios.

Example 1 – A building acquired before 2010/11

Example - A building is acquired on 1 July 2006 for $10m and is depreciated for tax and accounting at 2%. The IRE is not applied because on initial recognition there is no temporary difference.

The carrying value of the asset immediately prior to the 2024 change in tax legislation was $6.4m (18 years depreciation and no impairment or revaluation). The tax base is now $5.64m (illustrative purposes only). A DTL is recognised of $213k ($760k multiplied by the tax rate of 28%).

On the 2024 change in tax legislation, the tax base of $5.64m is reduced to nil. The taxable temporary difference is now $6.4m and, multiplied by the tax rate of 28%, results in a recognised DTL of $1.79m (being an increase to the previous DTL of $1.58m). The increase in DTL is recognised in tax expense.

Example 2 – A building acquired between 2010/11 and 2019/20

The accounting for a building that has been acquired between 2010 and 2020 will depend specifically on the treatment of deferred tax on initial recognition as well as the subsequent accounting for the change in tax legislation that arose in 2020.

We recommend you speak to your local EY representative to discuss further if this situation arises. We also refer you to our publication from 2020 which walks through the accounting policy choice entities had when considering the reinstatement of depreciation that occurred in 2020. Click here for further details.

Example 3 – A building acquired between 2020 and 2024

Example – A building is acquired on 1 July 2021 for $30m and its tax base is $18m (illustrative purposes only) giving rise to a taxable temporary difference of $12m. No DTL is recognised as the IRE applies to the day 1 temporary difference.

The asset is depreciated over 40 years and the tax deduction is 1.5% each year.

At 30 June 2024, immediately prior to the change in the tax legislation, the carrying amount of the asset is $ 27.75m (three years of depreciation at 2.5%). The tax base of the asset is $ 17.19m (three years of tax depreciation at 1.5%). This gives rise to a temporary difference of $10.56m. This is made up of two parts:

- The first part relates to the original IRE which has reduced from $12m (initial difference) to $11.1m (being the original difference amortised over the 40-year life of the asset) and remains unrecognised.
- The second part relates to a new deductible temporary difference of $0.54m, which gives rise to a recognised DTA of $0.15m.

In 2024 the tax base is reduced to nil. A new temporary difference arises and must be recognised because it didn't exist on initial recognition. The taxable temporary difference is the carrying value *less* the new tax base (nil), *less* the amount of temporary difference that relates to the IRE. The accounting carrying value of $27.75m *less* the new tax base of $0 *less* the IRE that remains of $11.1m gives rise to a new temporary difference of $16.65m.

The DTA must be removed ($0.15m) and a new DTL of $4.66m ($16.65m x 28%) is recognised.

The derecognition of the DTA and recognition of the new DTL totalling $4.81m is recognised in tax expense.

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