In Brief
Accounting implications of tax depreciation of buildings

At a glance

In March 2020 the Government enacted several urgent measures to respond to the economic impacts of the COVID-19 outbreak. One of these measures reverses the removal of tax depreciation on buildings from the start of the 2011/12 tax year. In this In Brief we highlight the accounting implications of the reinstatement of tax depreciation of buildings.

What's the issue?

On 25 March 2020 the Government enacted the COVID-19 Response (Taxation and Social Assistance Urgent Measures) Act (Act). The Act among other measures, reintroduces tax depreciation deductions on industrial and commercial buildings with effect from the start of the 2020/21 tax year.

Tax depreciation on buildings with an estimated useful life of 50 years or more was previously removed from the start of the 2011/12 tax year.

The Act determined the 2020/2021 tax book value as follows:

- For buildings owned at the end of the 2010/11 tax year: (unamortised tax book value at the end of the 2010/11 tax year) + (any non-deductible capital expenditure on the building incurred from the start of 2011/12 to the end of 2019/20 tax year) - (any deductions for fit out already claimed).
- For buildings acquired after the 2010/2011 tax year: (the cost of the building) + (any non-deductible capital expenditure on the building from the time it was acquired until the beginning of the 2020/21 tax year).

Management will need to assess the deferred tax impact of the reinstatement of tax depreciation of buildings in their financial statements.

Buildings that are intended to be held for use in the business will be the most impacted. The change will have to be reflected in financial statements with balance dates on or after 25 March 2020.

Accounting implications

Considerations for different reporting dates

The Act was enacted under urgency in a single day on 25 March 2020. This has different implications for balance dates that precede / fall on or follow that date.

- **Balance dates prior to 25 March 2020:** For accounting periods (including interims) that ended before 25 March 2020, but where financial statements are yet to be authorised for issue, the enactment of the Act is a non-adjusting post balance date event described in NZ IAS 10 *Events after the Reporting Period*. Management should consider disclosing the nature of the legislative change and an estimate of its financial effect if this is material.
- **Balance dates on or after 25 March 2020:** NZ IAS 12 *Income Taxes* requires entities to measure deferred tax based on legislation that is substantively enacted by the end of the reporting period. This means that entities with a 25 March reporting date and onwards should reflect the impact of the tax law change in the current reporting period.

Buildings where deferred tax is recognised on a *use* basis

The change will impact buildings where deferred tax is recognised on a *recovery through use basis* under NZ IAS 12, that is, when buildings are held with the intention of use in the business. The deferred tax implication of the reintroduction of tax depreciation will depend on whether the building was acquired prior to, or subsequent to the May 2010 tax law change.

Buildings acquired prior to 21 May 2010

Tax depreciation on buildings with an estimated useful life of 50 years or more was removed from the 2010/2011 tax year. The law change was substantively enacted on 21 May 2010 with the change accounted for from that date. The May 2010 law change reduced the tax base of those buildings where deferred tax was measured on a use basis. This resulted in the recognition of deferred tax liabilities for those buildings.

The reinstatement of tax depreciation on these buildings from the 2020/2021 tax year will increase the tax base and will at least reduce, or in some cases reverse the existing deferred tax liability. To the extent the revised tax base exceeds the carrying amount of the building, a deferred tax asset may arise subject to recoverability. The change in deferred tax should be recognised in profit or loss.

Example 1 - Building A acquired prior to 21 May 2010

Consider an entity that purchased building A prior to 21 May 2010. Building A’s carrying amount and its tax base immediately prior to the May 2010 law change was $10 million. Building A is depreciated at a rate of 2% straight-line for accounting and tax purposes. The entity measures deferred tax on a use basis. Therefore no deferred tax was recognised prior to 21 May 2010.

The removal of the tax depreciation on building A resulted in an increase in the deferred tax liability of $2.8 million on 21 May 2010.

The reinstatement of tax depreciation from the 2020/21 tax year increases the tax base of building A to $10 million and effectively reverses the original deferred tax liability. As the revised tax base of $10 million exceeds the building’s carrying amount of $8.4 million at the time of the 2020 law change, a deferred tax asset arises (subject to recoverability and the considerations on measurement of the deferred tax arising on page 4). The change in deferred tax is recognised in profit or loss.

$m	Carrying amount	Tax base	(Taxable) / Deductible temporary difference	(Deferred tax liability) / Deferred tax asset	Impact on profit or loss (Cr) / Dr
Before 2010 law change	10.00	10.00	0.00	0.00	0.00
After 2010 law change	10.00	0.00	(10.00)	(2.80)	2.80
March 2020 (before 2020 law change)	8.40	0.00	(8.40)	(2.35)	(0.45)
March 2020 (after 2020 law change)	8.40	10.00	1.60	0.45	(2.80)

Buildings acquired on or after 21 May 2010

Prior to the 2020 law change, the initial recognition exception (IRE) would have been applied where buildings were acquired on or after 21 May 2010 and no deferred tax would have been recognised (other than in relation to any subsequent revaluations).

Tax depreciation of these buildings is reinstated from the 2020/21 tax year. NZ IAS 12 does not contain clear guidance where the IRE has been applied previously, so different interpretations of the standard may be possible in relation to the accounting for the tax change:

- One view is to continue to not recognise deferred tax when the change occurs to the extent that the tax base does not exceed the carrying amount as the law change reverses some or all of the temporary difference previously covered by the IRE. To the extent the revised tax base exceeds the carrying amount of the building, the entity recognises a deferred tax asset (subject to recoverability) on the *excess*.
- An alternative approach is that a new tax base arises from the tax legislation change, which is *separate* to the purchase of the asset or capital expenditure incurred where the IRE was previously applied. Therefore, it gives rise to a deferred tax asset in respect of the *entire* new tax base (subject to recoverability) while no deferred tax liability is recognised in respect of the taxable temporary difference related to the original purchase transaction that is covered by IRE.

Management will have to consider which approach better reflects the economic substance of the transaction when determining the accounting approach. Management should apply the selected approach consistently.

Buildings acquired on or after 21 May 2010 as part of a business combination

For buildings purchased on or after 21 May 2010 as part of a business combination the IRE did not apply and therefore a deferred tax liability would have been recognised on acquisition, with a consequential impact on goodwill. The accounting treatment of the reinstatement of tax depreciation will be consistent with that described for buildings acquired prior to 21 May 2010. That is, the reversal of the previous deferred tax liability is recognised in profit or loss (instead of adjusting goodwill).

Example 2 - Building B acquired after 21 May 2010

Consider an entity that purchased building B for $10 million 5 years ago (not in a business combination). The building is depreciated at a rate of 2% straight-line for accounting purposes. The entity measures deferred tax on a use basis. Tax depreciation was not available in respect of the building. The IRE was applied to the taxable temporary difference and no deferred tax was recognised.

The reinstatement of tax depreciation from the 2020/21 tax year increases the tax base of the building and effectively reverses the unrecognised temporary difference. The revised tax base exceeds the carrying amount in FY20. This results in a new deductible temporary difference on which a deferred tax asset arises (subject to recoverability and the considerations on measurement of the deferred tax arising on page 4). Applying the first view described above, the change in deferred tax is recognised in profit or loss.

$m	Carrying amount	Tax base	IRE	Deductible temporary difference	Deferred tax asset	Impact on profit or loss (Cr) / Dr
March 2020 (before 2020 law change)	9.00	0.00	9.00	0.00	0.00	0.00
March 2020 (after 2020 law change)	9.00	10.00	0.00	1.00	0.28	(0.28)

Applying the alternative approach described above, the entity would recognise a deferred tax asset of $2.8 million.

Measurement of tax asset arising

The period during which an entity can claim tax depreciation on its buildings may be longer than the remaining accounting useful lives of those buildings. In these cases, management should consider whether reflecting tax depreciation deductions in the tax base beyond the building's accounting useful life is appropriate.

Revalued buildings

Where entities elected to revalue their buildings in accordance with NZ IAS 16 *Property, plant and equipment,* a deferred tax liability would have been recognised in relation to revaluation gains (regardless of whether the asset was acquired before or after 2010). As the revaluation gain is recognised in other comprehensive income, the related deferred tax would have also been recognised in other comprehensive income.

However, any reversal of a deferred tax liability as a result of the tax change as discussed above should be reversed through profit or loss, even if that deferred tax was originally recognised in other comprehensive income. This is because the reversal of the deferred tax liability is a result of a change in tax base rather than a result of a reversal of the accounting revaluation.

Buildings where deferred tax is recognised on a *sale* basis

There is no change where deferred tax on buildings is recognised on a *recovery through sale basis* under NZ IAS 12, that is, the building is held with the intention of sale. For example, in respect of investment property measured at fair value where the sale presumption is not rebutted, deferred tax continues to be measured based on the expected tax consequences of sale (e.g. tax depreciation recovery on sale).

Other considerations

Deductible temporary differences, tax losses and tax credits

Entities may have recognised a deferred tax asset in relation to deductible temporary differences, tax losses and tax credits on the basis that the entity had sufficient taxable temporary differences, or the entity could demonstrate that future taxable profits would be available, to offset the tax losses/deductions. Management should reconsider if this is still the case following the 2020 tax law change.

Need more information?

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