The main features of depreciation AND how to deal with insurance proceeds

I have been fairly active in recent months with talking to investors and I have been getting several questions repeated so I thought perhaps it was time to clear up a few points.

To do this I have used the IRD publications on depreciation (IR260 & IR264) and have used extracts from these publication as IRD do explain it clearly.

Most importantly I have covered IRD's position in relation to Insurance proceeds. This is obviously relevant to those investors with property in Christchurch.

IRD publication extracts as follows;

Main features of depreciation law

From the 1994 income year, depreciation law relates to all depreciable assets regardless of the date you acquired them. You must make depreciation deductions each year, unless you make an election not to treat a particular asset as depreciable.

- You can only claim a depreciation deduction once you own the asset and it's used or available for use in deriving your gross income or in carrying on a business that aims to generate your gross income.
- Depreciation is calculated according to the number of months in an income year you own and use the asset.
- From the 2011–12 income year, depreciation on buildings has reduced to 0% where buildings have an estimated useful life of 50 years or more. This applies to both commercial and residential properties including leasehold property.
- You may not claim depreciation in the year you dispose of any asset, unless it's a building.
- Although the general depreciation rates are set by a formula, you can apply for a higher or lower special depreciation rate if you can establish the general rate is unsuitable for your particular circumstances.
- Expenditure for repairs and maintenance can be claimed as a deduction through business accounts. Anything more than repairs or maintenance is capital expenditure and isn't deductible, but will be subject to normal depreciation rules.
- Both straight line and diminishing value methods are available for calculating depreciation on most assets and you can switch freely between the two.

- Assets that cost or have an adjusted tax value of $2,000 or less can be depreciated collectively, rather than individually, using the “pool” depreciation method.
- Subject to certain rules, assets costing $500 or less can be written off in the year of purchase or creation.
- Gains on sale or disposal must be recognised in the year of sale. Losses on sales of depreciable assets, other than buildings, are deductible in the year of sale.
- There are restrictions on the depreciation deductions that can be made to depreciable assets transferred between associated parties.
- You may be able to write off the residual tax value of any depreciable asset that you no longer use to derive gross income.

Compulsory depreciation claims

You must claim the amount of depreciation you are entitled to unless you elect an asset not to be depreciable property. It’s usually not possible to defer or only partially claim allowable depreciation. If no depreciation deduction is claimed and no election is made, you’re considered to have claimed depreciation for the purposes of calculating the adjusted tax value of the asset and when calculating the depreciation recovered .

If you don’t claim depreciation in your tax return, the adjusted tax value of the asset will still be reduced by the amount calculated using the appropriate method. The default method for calculating depreciation is diminishing value.

For depreciation recovery purposes, where the depreciable asset is disposed of for more than the adjusted tax value, then the taxable income will be the lesser of:

1. the previously allowed depreciation (including deemed to be allowed), or
2. the amount by which the amount received exceeds the adjusted tax value.

Electing not to depreciate

Although it’s compulsory for you to claim a depreciation deduction, we recognise there can be instances where you may not want to. If you don’t want to claim depreciation on an asset, and you want to avoid paying tax on depreciation recovered when it was not claimed, you should elect not to treat the asset as depreciable.

You can’t pick and choose the years in which you depreciate an asset. However, if an asset periodically will be and then won’t be used in your business (such as a residential building that is temporarily let), you may choose whether or not to depreciate the asset in each period. Our Rental income (IR 264) guide discusses this option in more detail. If you elect not to depreciate your asset, it will no longer be a depreciable asset and the depreciation recovery or loss on sale provisions won’t apply to it.

How to make an election not to depreciate

You’ll need to let us know if you’re making an election by attaching your notification to your tax return for the income year that you:

- purchase the asset, or
- changed the asset use from non-business to business, or
- elect not to depreciate an asset that you’ve not claimed depreciation on in any previous year.

This election will then apply to every year from when the asset was purchased.
Your notification needs to provide the following details:

- a description of the asset
- the purchase date
- the income year the election is being made for
- whether the asset has been newly acquired or its use has changed if the election is for retrospective depreciation.

Cost of assets for depreciation purposes

Generally, the cost of an asset is the amount paid by the purchaser—normally the market value—and this principle applies to associated persons.

If you inherit depreciable assets, there can be no depreciation because there has been no cost to you.

For income tax purposes a deduction is not usually available for expenses incurred in acquiring a capital asset. This includes legal fees charged by a solicitor for preparing and registering the various documents relating to the purchase. From the 2010 income year business-related legal expenses for buying or selling a property can be deducted. This is provided your total legal expenses for the income year, including the fees associated with buying and selling a property, are equal to or less than $10,000.

In all other cases, this type of expenditure may be added to the cost of the purchased asset when calculating depreciation on that asset. The depreciation you calculate each year is deducted from the value of your asset. The remaining value is called the asset's adjusted tax value.

Insurance proceeds

Assets lost or destroyed

If you receive an insurance payout for an asset which is lost or destroyed, it's treated as though you had sold the asset for the amount of the insurance payout:

- If the insurance payout is more than the asset's adjusted tax value but less than its original cost, you must include the difference between the insurance payment and the adjusted tax value as taxable income.

- If the insurance payout is more than the asset's adjusted tax value and also more than the asset's original cost, you must include the difference between the cost and the adjusted tax value as taxable income. The difference between the insurance payout and the asset's cost is a capital gain and not taxable.

- If the insurance payout is less than the asset's adjusted tax value, you can claim the difference as if it was a loss on sale. Remember, if the asset was a building, any loss on sale isn't deductible.

Damaged assets

If you receive an insurance payout to repair a damaged asset, you don't include it as income and you can't claim the cost of the repairs which are covered by the insurance. However, please note the following:

- If the insurance payment is more than the cost of the repairs, you're required to deduct the excess from the asset's adjusted tax value. If this makes the adjusted tax value a negative amount, you're required to include this amount in your gross rental income.

- If the insurance payout is less than the cost of the repairs, you can deduct the extra cost of the repairs from your taxable income. Remember to keep all invoices relating to the repairs.

Loss on disposal of buildings

When an unexpected event causes damage to the building or to the neighbourhood of the building, rendering the building useless and unable to be used to derive income then a deduction for a loss on the disposal of a building is allowed. This is providing the damage has not been caused by the owner. The unexpected event could be a natural disaster such as an earthquake, flood or fire.

Damage of the neighbourhood of the building can be where:

- two buildings next door are badly damaged by fire, and your building has to be demolished to demolish the fire damaged buildings
- the building is undamaged but an earthquake has made the ground unstable so that it must be demolished.

Any disposal costs (for example demolition costs) can reduce any disposal proceeds before calculating the loss or gain on disposal.

Example

A building is damaged in an earthquake and must be demolished.

Original purchase price of building	$ 140,000
Less total depreciation claimed	$ 40,000
Adjusted tax value	$ 100,000
Insurance proceeds	$ 120,000
Less demolition costs	-$ 25,000
Net disposal proceeds	$ 95,000
Loss on disposal	-$ 5,000

The building is disposed of for less than its adjusted tax value resulting in a loss of $5,000 which can be claimed as a deduction.