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Accounting for deferred tax – removal of tax depreciation deduction for commercial buildings

KPMG Accounting Advisory Services

May 2024

Introduction/purpose

This update sets out the possible accounting impacts of the Government policy decision to remove the tax depreciation deduction for commercial and industrial buildings.

Background

In 2010 the Government removed the tax depreciation deduction on buildings with a life of 50 years or more. As part of its response to Covid-19 the Government reintroduced a tax deduction for depreciation on commercial and industrial buildings (including hotels and motels) from the 2020/21 income year.

In March 2024 the Government issued the Taxation (annual rates for 2023–24, Multinational Tax, and Remedial Matters) Bill. This Bill encompassed a range of changes to tax legislation including the removal of the tax deduction for depreciation on non-residential buildings.

Specifically, this Bill removes tax deductions for depreciation on commercial and industrial buildings with application from the 2024/25 income year.

The Bill went through its Third Reading in Parliament on 26 March 2024 and received Royal Assent on 28 March 2024.

Are all buildings impacted by the change?

No, not all buildings qualified for a deduction. The removal of the tax deduction will only affect entities that own commercial and industrial buildings.

No tax deduction is permitted for residential buildings, dwellings and certain short-term accommodation. The current accounting position is unchanged for entities that hold such assets.

What is the tax base of a building upon change of tax law?

The tax base of an asset is the amount that will be deductible for tax purposes against any taxable economic benefits that will flow to an entity when it recovers the carrying amount of the asset.

When the tax base is less than the carrying amount of the asset for accounting purposes, a temporary difference will arise and result in a deferred tax liability.

On the removal of the tax deduction in March 2024, the tax base will be nil from the point in time tax deductions are no longer permitted. A temporary difference will therefore arise.

What is the tax base when the carrying amount when the carrying amount of a building (held on capital account) is expected to be recovered entirely through sale?

In this case, the tax base of a building is limited to tax depreciation to be recovered on sale.

How will deferred tax be impacted?

The impact on deferred tax will depend on when the building was acquired and whether tax deductions for depreciation were permitted at that time, whether the initial recognition exemption (IRE) applied at that time, and to what extent the IRE remains available.

Does the initial recognition exemption apply when the tax law changes in March 2024?

The IRE applies to commercial and industrial buildings acquired:

- After the removal of the tax depreciation deduction i.e. 26 March 2024, and
- To buildings acquired between May 2010 and 17 March 2020.

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Does the initial recognition exemption apply when the tax law changes in March 2024 (cont.)?

The IRE does not apply to assets that were recognised for the first time before the tax law changed unless there was a difference on initial recognition between the accounting base and tax base, i.e. buildings acquired before May 2010 and buildings acquired in the period 18 March 2020 to 25 March 2024.

Any adjustment to the tax book value, in our view, represents either:

- The increase or decrease of a previous temporary difference and not a new temporary difference (net approach). In this case, the IRE continues to apply to these buildings to the extent it remains available and no deferred tax, or reduced deferred tax, is recognised to the extent a temporary difference arose on initial recognition, or
- A separate event that results in a separately recognised deferred tax balance (gross approach – not illustrated). In this case, the IRE continues to apply to the buildings and the impact of a tax base arising as a result of changes in tax law is accounted for separately. In our experience few entities applied the gross approach in 2020 and as such we don't expect to see this commonly applied in practice.

Where in the financial statements will the deferred tax impact be recognised?

The change in deferred tax will be reflected in the statement of financial performance as a tax expense with a corresponding change recognised in the statement of financial position. The principle in NZ IAS 12 is that tax follows the underlying transaction.

Where the buildings are measured at cost and depreciation is recognised in profit or loss, any change in deferred tax as a result of the removal of a tax deduction for depreciation should also be reflected in profit or loss. This is because the change in tax base is not related to an accounting revaluation of an earlier or future period.

If the building is subsequently accounted for at fair value under the revaluation model, the portion of deferred tax arising as a result of the revaluation, is recognised in OCI and therefore a portion of the change in deferred tax should also be recognised in equity..

When will the deferred tax impact be recognised?

The impact on deferred tax will be recognised for all reporting periods ended after 26 March 2024, the date the change is regarded as substantively enacted.

The measurement of current tax liabilities and assets is based on tax law that is enacted or substantively enacted by the reporting date. In most cases, the calculation of deferred tax will be based on tax rates that have been enacted. In general, the effects of future changes in tax laws or rates are not anticipated. [NZ IAS 12.46]

In some cases it may be clear that a change in tax rate is going to be enacted - even though the legal process necessary to effect the change has not yet been completed. In these circumstances, the determination of whether a tax rate is 'substantively enacted' requires judgement. [NZ IAS 12.47-48]

Our view is that in New Zealand a law is generally considered substantively enacted when it has passed the Third Reading in Parliament, which in this case happened on 26 March 2024. Therefore, entities that own commercial and industrial buildings will need to assess the impact and recalculate and recognise the impact on deferred tax for all reporting periods ended after the 26th March 2024.

What if my reporting date is before 26 March 2024?

If the change in tax laws is enacted, substantively enacted, or announced after the reporting period, entities will need to disclose any significant effect of those changes on its current and deferred tax assets and liabilities in accordance with NZ IAS 10 *Events after the reporting period*. [NZ IAS12.88]

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What is the impact on buildings held for use?

Depreciation deduction and deferred tax

MAY 2010 | **MARCH 2020** | **26 March 2024** Tax law enacted/ substantively enacted

Tax deduction permitted for depreciation	Tax deduction for depreciation removed May 2010	Tax deduction for depreciation reintroduced March 2020	Tax deduction for depreciation removed 26 March 2024
Building 1 acquired pre May 2010 Measured at cost ▪ If accounting base = tax base then no temporary difference (TD) arises ▪ If accounting base > tax base then a TD arises & IRE applies to TD ➢ No Deferred tax or is unrecognised	▪ Tax base = nil ▪ Accounting base > tax base Temporary difference created IRE continues to apply but only to the extent it is available ➢ Deferred tax liability recognised to the extent temporary difference > IRE	▪ Tax base = deemed tax book value ▪ Accounting base may differ from tax base Temporary difference reduced ▪ IRE continues to apply to the extent it is available ➢ Deferred tax liability is recognised but is reduced	▪ Tax base = nil ▪ Accounting base > tax base ▪ Temporary difference increases ▪ IRE continues to apply to the extent it is available ➢ Deferred tax liability increased and recognised to the extent temporary difference > available IRE
	Building 2 acquired after May 2010 Measured at cost ▪ Tax base = nil ▪ Accounting base > tax base ▪ Temporary difference created ▪ IRE applied ➢ No deferred tax recognised	▪ Tax base increases to amount of deductions available ▪ Accounting base may differ from tax base ▪ Temporary difference reduced ▪ *Net Approach:* ➢ IRE removed to the extent of the new tax base. ➢ IRE continues to apply to the extent available and no deferred tax recognised. ▪ *Gross approach:* ➢ IRE remains for building - deferred tax not recognised. ➢ Change in tax base results in new deferred tax asset (DTA)	▪ Tax base = nil ▪ Accounting base > tax base ▪ Temporary difference increased ▪ *Net Approach:* ➢ IRE continues to apply to the extent available and deferred tax recognised to the extent the temporary difference exceeds the IRE available. ▪ *Gross approach:* ➢ Derecognise DTA arising on tax base. ➢ No deferred tax on recognised building as IRE continues to apply in full.

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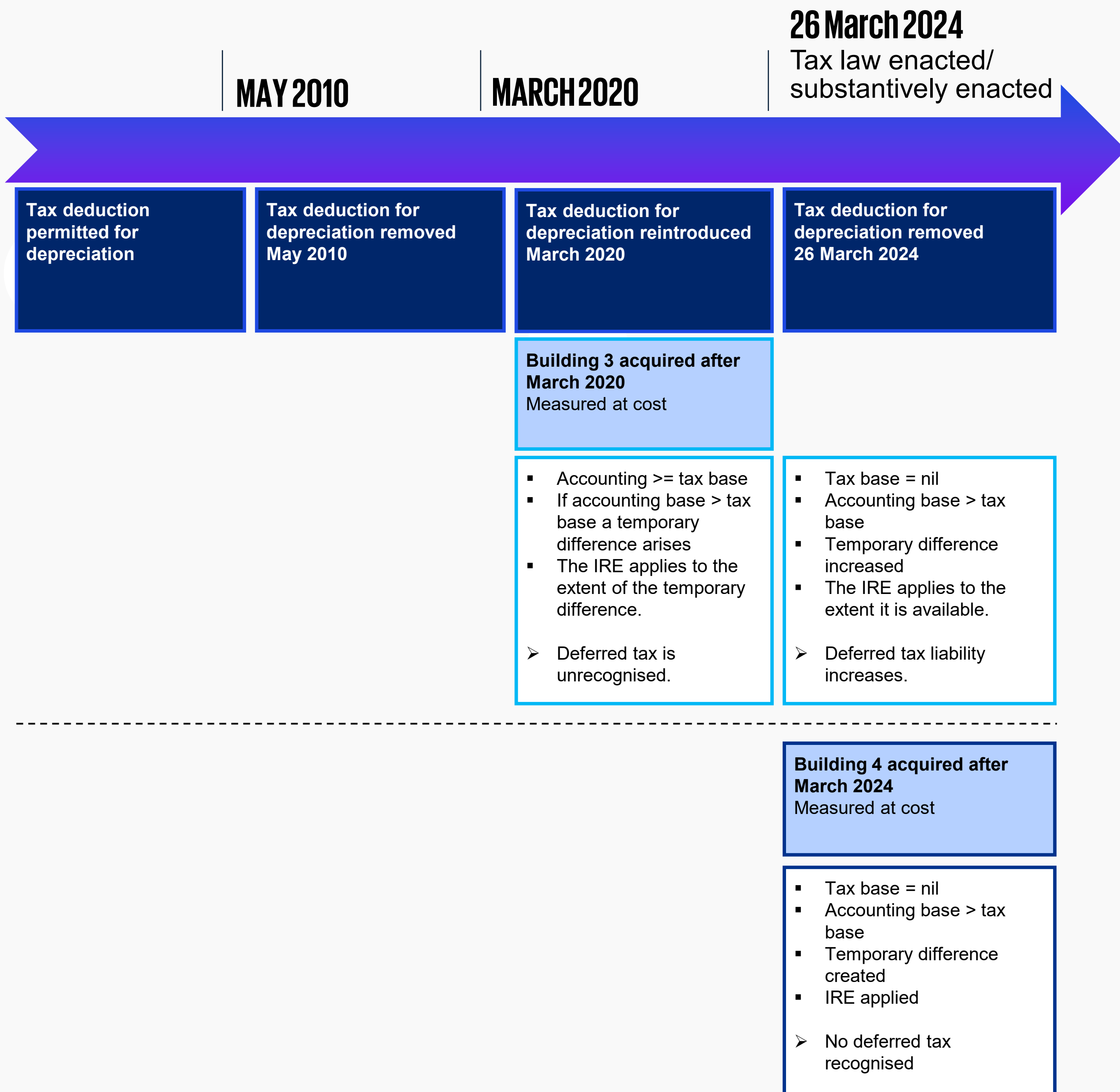
What is the impact on buildings held for use?

Depreciation deduction and deferred tax



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Examples
Deferred tax on buildings

The following examples aim to illustrate the impact of the change in tax law on buildings acquired at different times:

Building	Acquisition date	Accounting cost	Tax law
Building 1	30 June 2009	$50m	Tax deductions for depreciation are permitted at 2.0% per annum of the building cost on a straight-line basis
Building 2	1 January 2011	$50m	Tax deductions for depreciation not permitted
Building 3	1 April 2020	$50m	Tax deductions for depreciation are permitted at 1.5% per annum of the building cost on a straight-line basis
Building 4	1 May 2024	$50m	Tax deductions for deprecation are not permitted

Basic fact pattern

Entity A has a balance date of 30 June and owns a number of commercial buildings.

Tax situation

- Prior to March 2010 depreciation on building was deductible for tax purposes.
- In May 2010 the tax law changes and the tax deduction for depreciation is removed.
- On 1 March 2020, as part of Government's response to the Covid-19 pandemic, the tax law is amended and reintroduces tax deductions on buildings based on the deductions that would have been available had the deduction not been removed in 2010.
- On 31 March 2024, the tax law is again amended to remove the tax deduction for depreciation.

Accounting treatment

- All buildings are depreciated for accounting purposes at 2% (50-year accounting life).
- When tax deductions are available, buildings are depreciated for tax purposes:
  - At 2% on a straight-line basis for periods up to May 2010, and
  - At 1.5% on a straight-line basis for periods from 1 March 2020 – 26 March 2024.
- Tax law removing tax deductions is substantively enacted on 26 March 2024.
- None of the buildings were acquired as part of a business combination.
- The buildings are accounted for using the cost model under NZ IAS 16. Their carrying value is expected to be recovered entirely through use.

The following examples illustrate an approach (net approach) to this issue we believe is acceptable and likely to be generally applied by entities in New Zealand.

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Examples
Deferred tax on buildings

Building 1

Building 1 was acquired on 30 June 2009 for $50m. In addition to the above basic fact pattern:

- At this time the cost of the building is deductible for tax purposes at 2.0% pa on a straight-line basis.
- Therefore, the tax base is $50.0m and the taxable temporary difference is nil. The initial recognition exemption is not applied. No deferred tax liability is recognised.
- On 1 May 2010, the Government removes tax deductions for depreciation on buildings. As a result the tax base is reduced to nil and a taxable temporary difference arises of $49.1667m. As a result a deferred tax liability of $13.767m is recognised.
- On 1 March 2020 as part of its Covid response the Government reintroduces tax deduction on the buildings. At the time of the law change the tax base of Building 2 is restated (rebased) to reflect the future tax deductions available over the remainder of the accounting useful life – being $29.750m.
- On 31 March 2024 the tax deduction is removed.

Deferred tax: Net approach

When the building is acquired, it does not have a tax base and the temporary difference is nil and the IRE does not applied. No deferred tax is recognised.

At 1 May 2010 the tax deduction is removed, a temporary difference arises ($49.1667m), and a deferred tax liability of $13.767m is recognised.

At 1 March 2020, the change in tax law reintroduces a deduction for depreciation. The tax base increases – based on remaining deductions available over the useful life of the building ($29.500m). As a result the temporary difference is reduced to $9.833m and the deferred tax liability reduces to $2.753m.

On 31 March 2024, the tax deduction is removed. The carrying amount of the building at that date is $35.250m and in this example there is no IRE. Entity A recognises a deferred tax liability of $9.870m (28% of the TD of $35.250m)

Building 1	Accounting base	Tax base	Temporary difference	IRE	Tax rate	Deferred tax dtl/(dta)
Net approach						
30 June 2009	50.000m	50.00m	0m	0m	28%	Nil
Building acquired for $50m. At this time a tax deduction is permitted based on a tax rate of 2% of the cost of the building ((50m x 2%) * 50 years)). Hence no temporary difference arises.. No deferred tax is recognised. The initial recognition exemption is not applied.						
1 May 2010	49.167m	0m	49.167m	0m	28%	13.767m
Tax deduction was removed on 1 May 2010. The tax base is nil, temporary difference arises and a deferred tax liability of $13.766m ($49.167m*28%) is recognised.						
1 March 2020	39.333m	29.5m	9.833m	0m	28%	2.753m
Tax deduction is reintroduced on 1 March 2020. The tax base is the amount of tax deductions permitted on the building over its remaining useful life $29.5m ($50m*1.5%*39 years 4 months). A temporary difference arises.						
31 March 2024	35.250m	0m	35.250m	0m	28%	9.870m
Tax deduction removed on 31 March 2024. The tax base of the building reduces to nil and a temporary difference arises. The initial recognition exemption does not apply. In this case a deferred tax liability is recognised $9.87m (32.5*28%)						
30 June 2024	35.000m	0m	35.000m	0m	28%	9.800m

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Examples
Deferred tax on buildings

Building 2

Building 2 was acquired on 1 January 2011 for $50m. In addition to the above basic fact pattern:

- Building 2 was acquired after the tax law change in May 2010.
- At this time the cost of the building is not deductible for tax purposes, even on its eventual disposal.
- Therefore, the tax base is nil and a taxable temporary difference of $50m arises. The initial recognition exemption is applied as required by NZ IAS 12, and no deferred tax liability is recognised [NZ IAS 12.15(b), 22].
- As Entity A applies the exemption, no deferred tax is initially recognised; and no deferred tax is recognised subsequently as the carrying amount of Building 2 is depreciated or impaired.
- On 1 March 2020 as part of its Covid response the Government reintroduces tax deduction on the buildings. At the time of the law change the tax base of Building 2 is restated (rebased) to reflect the future tax deductions available over the remainder of the accounting useful life.
- On 31 March 2024 the tax deduction is removed.

Deferred tax: Net approach

When the building is acquired, it does not have a tax base and a temporary difference of $50m arises. However, the initial recognition exemption is applied and no deferred tax is recognised.

At 1 March 2020 the carrying amount of the building is $40.833m, the tax base at this time is $30.625m (being tax deduction available at 1.5% over the buildings remaining useful life), and a temporary difference of $10.208m arises. The remaining IRE applies ($10.208m) is applied and deferred tax is nil.

On 31 March 2024, the tax deduction is removed. The carrying amount of the building at that time is $36.750m. The remaining IRE is $9.188m (being the difference between the carrying value and tax base immediately before the removal of the tax deduction) and a deferred tax liability of $7.716m is recognised (($36.750-$9.188) @28%).

Building 2	Accounting base	Tax base	Temporary difference	IRE	Tax rate	Deferred tax dtl/(dta)
Net approach						
1 January 2011	50.000m	0	50.000m	50.000m	28%	Nil
Building acquired for $50m. At this time no tax deduction is permitted and a temporary difference arises. However the initial recognition exemption is applied and no deferred tax is recognised.						
1 March 2020	40.833m	30.625m	10.208m	10.208m	28%	Nil
Tax deduction reintroduced on 1 March 2020. The tax base is the amount of tax deductions permitted on the building over its remaining useful life (for illustrative purposes 30.625 = 50*1.5%*(40 years and 10 months)). A temporary difference arises. However, the initial recognition exemption applies (reduced) and no deferred tax is recognised.						
31 March 2024	36.750m	0	36.750m	9.188m	28%	7.718m
Tax deduction removed 31 March 2024. The tax base of the building reduces to nil and a temporary difference arises. The initial recognition exemption applies, but only to the extent it remains available. In this case a deferred tax liability is recognised to the extent the temporary difference exceeds the available IRE ((36.750-9.188)*28%).						
30 June 2024	36.500m	0	36.500m	9.014m	28%	7.696m
IRE reduces over time – In this example it is reduced over the remaining useful life of the building at the time the tax deduction is removed. (9.188/36 years 9 months). Other methods are possible.						

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Examples
Deferred tax on buildings

Building 3

Building 3 acquired on 1 April 2020. In addition to the above basic fact pattern:

- At the time of acquisition the carrying value of the building was $50m. However, because tax deductions are only permitted at a rate of 1.5%pa on the cost of the asset, and the asset has a useful life of 50 year the tax base is only $37.5m ($50m*1.5%*50 years).
- Entity A applies the IRE, (as required by NZ IAS 12) because Building 3 was acquired after the tax law change in March 2020 which reintroduced tax deductions. However, The IRE was only applied to the extent of the temporary difference that arose on initial recognition being $12.5m ($50m-$37.5m).
- On 26 March 2024 the tax deduction for the building is removed. At this time the carrying amount of the building is $46.0m, the tax base of the building is nil and a temporary difference arises. However, the initial recognition exemption had been applied to the temporary difference (arising as a result of the difference between accounting and tax depreciation rates). To the extent the IRE is still available it reduces the temporary difference (in this case $11.5m, being the difference between the carrying value and tax base immediately before the removal of the tax deduction)
- At the end of year 30 June 2024, the carrying amount of the building is $45.750m after recognising depreciation. A net temporary difference of $34.312m remains resulting in a deferred tax liability of $9.660m. ($45.750m-$11.438m) @ 28%.

Building 3	Accounting base	Tax base	Temporary difference	IRE?	Tax rate	Deferred tax
1 April 2020	50.000m	37.500m	12.500m	12.500m	28%	nil
Building acquired for $50m. At this time a tax deduction is permitted and a temporary difference arises relating to the difference between accounting depreciation and tax deductions over the expected life of the building. However, the initial recognition exemption is applied and no deferred tax is recognised.						
31 March 2024	46.000m	0	46.000m	11.500m	28%	9.660m
On 31 March 2024 the tax deductions are removed and the tax base is reduced to zero. The IRE continues to apply to the extent is it available and a deferred tax liability of 9.660m is recognised.						
30 June 2024	45.750m	0	45.750m	11.438m	28%	9.608m
IRE reduces over time – In this example it is reduced over the remaining useful life of the building at the time the tax deduction is removed. (11.500/46 years). Other methods are possible.						

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Examples
Deferred tax on buildings

Building 4

Building 4 is acquired on 1 May 2024, after the Government removes the tax deduction for depreciation effective from the 2024 income year.

- The tax base is nil and a temporary difference of $50m arises on Building 4.
- However, the IRE applies because Building 4 is acquired after the tax law change in March 2024. As a result no deferred tax is recognised on initial recognition.
- At 30 June 2024, the carrying amount of the building for accounting purposes is $47.833m and no deferred tax is recognised.

Building 4	Accounting base	Tax base	Temporary difference	IRE?	Tax rate	Deferred tax
1 May 2024	50.000m	0	50.000m	50.000m	28%	nil
Building 4 acquired for $50.000m						
30 June 2024	49.833m	0	49.833m	49.833m	28%	nil

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Appendix

Calculating deferred tax
NZ IAS 12 - Deferred tax

Temporary differences

Under NZ IAS 12, *Income Taxes* (NZ IAS 12), deferred tax is calculated on the amount of temporary differences, being differences between the carrying amount of an asset or liability in the statement of financial position and its tax base. Temporary differences may be either:

a) taxable temporary differences, which are temporary differences that will result in taxable amounts in determining taxable profit (tax loss) of future periods when the carrying amount of the asset or liability is recovered or settled; or

b) deductible temporary differences, which are temporary differences that will result in amounts that are deductible in determining taxable profit (tax loss) of future periods when the carrying amount of the asset or liability is recovered or settled.

Initial recognition exemption

Under the initial recognition exemption deferred tax is not recognised for certain temporary differences that arise on the initial recognition of assets and liabilities. The exemption applies to:

- a deferred tax liability (but not a deferred tax asset) that arises from the initial recognition of goodwill; and
- a deferred tax asset or liability that arises from the initial recognition of an asset or liability in a transaction that:
    - is not a business combination; and
    - at the time of the transaction:
        - affects neither accounting profit nor taxable profit; and
        - does not give rise to equal taxable and deductible temporary differences

When the initial recognition exception is applied, an entity does not recognise subsequent changes in the unrecognised deferred tax liability or asset as the asset is depreciated.

How is deferred tax measured?

Deferred tax assets and liabilities are measured at the tax rates that are expected to apply to the period when the asset is realised or the liability is settled, based on tax rates (and tax laws) that have been enacted or substantively enacted by the end of the reporting period and which reflect the manner in which the value of the building is expected to be recovered – through use or sale.

For buildings that are held for use the tax rate is the entity’s marginal income tax rate. For investment properties that are measured using the fair value model, there is a rebuttable presumption that the carrying amount of the investment property will be recovered through sale. Accordingly, unless the presumption is rebutted, the measurement of the deferred tax liability or deferred tax asset reflects the tax consequences of recovering the carrying amount of the investment property entirely through sale.

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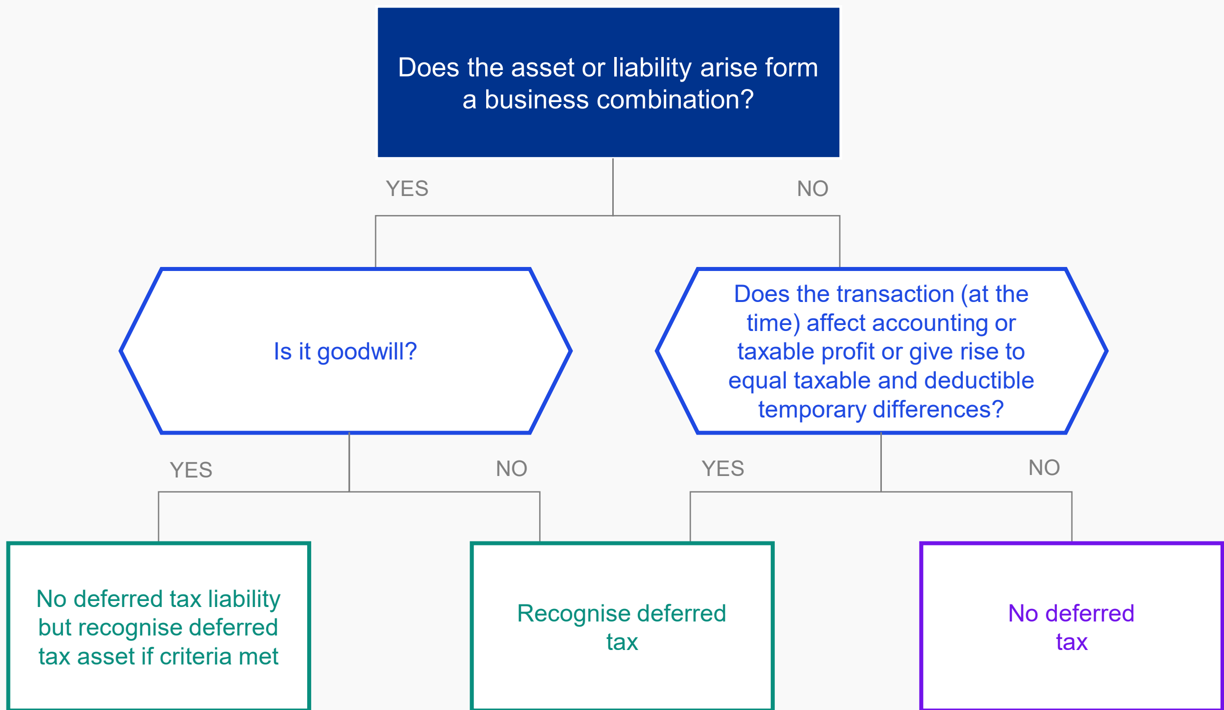
Calculating deferred tax
NZ IAS 12 - Deferred tax

The following diagram illustrates how to apply the initial recognition exemption.



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