NEW RULES FOR BUSINESS ENVIRONMENTAL EXPENDITURE

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Introduction

The rules covering tax deductions for business environmental expenditure to avoid, remedy or mitigate the discharge of contaminants have been clarified and expanded by:

- specifying categories of qualifying environmental expenditure and default deduction rates;
- giving the Commissioner the power to issue rates for other categories of environmental expenditure;
- removing the current distinction between industrial and non-industrial waste; and
- introducing a mechanism so that site restoration and monitoring costs can be matched against prior business income.

Background

These changes have been made to ensure that all business operating costs, including those for dealing with environmental concerns, are taken into consideration in calculating taxable income, and that the timing of such deductions is appropriate. The changes counter uncertainty regarding the scope of tax deductions available for environmental expenditure.

Previously, business taxpayers could claim a tax deduction for environmental expenditure in three ways[1]:

- a deduction for normal operating (revenue) expenditure;
- a deduction under the tax depreciation rules for certain types of capital expenditure, such as tanks, reservoirs, pipes, pumping machinery and screens; and
- a deduction under section DB 37 (Income Tax Act 2004) or DJ 10 (Income Tax Act 1994) for other capital environmental expenditure.

Under the previous rules, section DJ 10 permitted business taxpayers a deduction for expenditure incurred for the purpose of treating industrial waste when no other allowance was available. It allowed business taxpayers to claim a deduction for the cost of constructing on land in New Zealand any earthworks, ponds, settling tanks, or other similar improvements primarily for the purpose of treating industrial waste to prevent or combat pollution of the environment. When a deduction was available, it was spread evenly over five years, beginning with the year in which the expenditure was incurred.

Despite the existence of a specific section to provide for environmental costs, there were certain expenses which were arguably not deductible. Section DJ 10 pre-dated the Resource Management Act 1991, so did not clearly provide a deduction for costs incurred in complying with new health and environmental standards. It was also unclear what was covered by the term "industrial waste".

[1] Excluding industry-specific provisions.

The uncertainty around the meaning of "industrial waste" and ability to claim tax deductions for site restoration resulted in the incorrect calculation and taxation of income from business activities.

There were also problems in matching business income and tax deductions for environmental costs incurred on or after the cessation of business. Even if a tax deduction was permitted it was likely to give rise to a tax loss of limited value. In determining the tax liability of a business, future restoration liabilities were not taken into account.

Key features

A number of changes have been made to the tax rules to counter the problems identified with the tax treatment of business environmental expenditure.

Default expenditure categories and deduction rates

Section DB 37 along with Schedule 6B now set out categories of deductible environmental expenditure and the rate at which a deduction is available to business taxpayers. The schedule of deductible environmental expenditure is set out in full in Appendix 1 and is based around the following four categories of costs:

General description of expenditure	Rate
Testing and feasibility expenditure	100%
Construction/improvement expenditure	Default rate based on the lesser of 35 years (1/35) or the length of the applicable resource consent granted (1/life of resource consent).
Restoration expenditure	100%
Monitoring expenditure	100%

Taxpayers are now able to claim a tax deduction for environmental expenditure under section DB 37 if:

- they carry on business in New Zealand[2];
- they incur, as part of that business, or in ending the operations of the business, expenditure listed in Schedule 6B;
- the expenditure is not listed in Part C of Schedule 6B (land reclamation expenditure, non-environmental dredging expenditure or expenditure related to the acquisition of land);
- the expenditure is not incurred in relation to revenue account property (other than land that is subject to a section CB 6B election); and
- no other provision allows a tax deduction for the expenditure.

To avoid the uncertainty surrounding the definition of industrial waste, section OB 1 now contains a definition of "contaminant". The definition is linked to section 2(1) of the Resource Management Act 1991 and an item can still be a contaminant even if it is never discharged into the environment.

[2] Farming businesses are now included in these provisions so that when the specific agricultural provisions do not provide for an environmental tax deduction, farmers can now rely on section DB 37.

Amount and timing of deduction

Section DB 37 sets out the amount of the tax deduction and when this can be claimed. The amount of the deduction for an income year is calculated by multiplying the value of the expenditure by the applicable rate.

The default rates are 100% for testing and feasibility, restoration and monitoring expenditure (listed in Schedule 6B, Part A, item 1 and Part B) and based on the lesser of 35 years or the length of the applicable resource consent for construction and improvement expenditure.

The formula for calculating the rate for construction and improvement expenditure is set out in section DB 37(7). The rate is 100% divided by the assumed life[3] of the environmental expenditure and rounded to the nearest rate listed in Schedule 11. Businesses can opt for either a straight-line or diminishing value deduction by adjusting the rate accordingly.

Section DB 37 also provides for the destruction of an environmental improvement or closure of a business. In these situations, a business can claim the remaining unamortised balance of the expenditure.

Claw-back

While the default deduction rate for environmental construction and improvement expenditure is based on the life of the applicable resource consent, there is a clawback mechanism in section CB 24B. This is intended to prevent businesses from manipulating the period of their resource consent for the purpose of obtaining a faster tax deduction.

Where a business has claimed a tax deduction based on the period of a resource consent and then substantially altered the period of that consent (consent period is extended or renewed by more than 50%) the taxpayer will be required to calculate tax deductions based on the default rate of 35 years. Any difference between the deductions claimed to date will be clawed back as taxable income in the year that the consent is altered.

Section CB 6B election

A tax deduction for restoration expenditure will not always equate to the loss in land value from contamination but in the majority of circumstances it provides a practical solution. However, landfill operators are likely to suffer a complete loss in land value no matter how much is spent on site restoration. The new environmental tax rules therefore allow taxpayers who acquire and use land for the purpose of constructing and operating a landfill to file a revenue account property election under section CB 6B. This ensures a tax deduction is available for the cost of land used for a landfill.

The section CB 6B election must be made before 24 June 2006 or 12 months after the date of acquisition (whichever is the latest). To ensure a consistent treatment, all of a business's landfill sites and those of any associated parties also need to be subject to the same election.

[3] For expenditure that does not require a resource consent the assumed life is 35 years. For expenditure that requires a resource consent, the assumed life is the lesser of 35 years and the number of years remaining in the resource consent period at the time the expenditure is incurred.

Any consideration received on the disposal of the landfill property will also be taxable income of the business under section CB 6B.

Category-specific deduction rates

Where the default deduction rates will not result in the correct calculation and taxation of income, a business is able to apply to Inland Revenue under section 91AAN of the Tax Administration Act 1994 for a category-specific deduction rate.

The Commissioner may determine that a person, group or class of persons is to use a particular diminishing value or straight-line rate listed in Schedule 11 for certain types of environmental expenditure.

In making the determination, the Commissioner may consider a number of factors including:

- the length of time that the expenditure is expected to be effective for its intended purpose;
- the length of time that the expenditure is expected to earn income;
- the accounting treatment (including depreciation method);
- the period of any associated resource consent; and
- a valuer's estimate.

The Commissioner may decline to issue a determination if the information supplied in support of the determination request is insufficient or if the proposed rate does not differ sufficiently from the existing rate.

Within 30 days of issuing a determination the Commissioner must give notice of the determination to the applicants and publish a notice in the *New Zealand Gazette* stating where copies of the determination can be obtained. A business affected by a determination may dispute or challenge the determination under Parts 4A and 8A.

Environmental restoration account

The new environmental tax rules introduce a matching mechanism so that site restoration and monitoring costs can be matched against prior business income. Section EK 1 establishes a Crown Bank Account called the Environmental Restoration Funds Account (referred to as an ERA in subpart EK) into which businesses can make payments towards their restoration and environmental monitoring liabilities.

Operators of a business can make cash deposits into an ERA equivalent to the tax effect of their accounting restoration provision. This deposit will give rise to a tax deduction so that the business's cash position is unchanged. Interest will be paid on deposits at 3% per annum.

Business taxpayers can obtain a refund from the account if they incur restoration and monitoring expenditure or if the anticipated liability for restoration (as shown by their audited financial statements) decreases. This refund will give rise to taxable income which will be offset by tax deductions for restoration and monitoring expenditure. This is consistent with the objective of matching restoration and monitoring costs against prior business income.

If a business transfers their liability for site restoration or environmental monitoring (for example, on the sale of a site, death, liquidation or bankruptcy) the balance of the restoration account will be transferred to the new taxpayer, if they can be identified, or otherwise to the Ministry for the Environment.

Payments to an ERA

Section EK 4 requires the Commissioner to keep an ERA in the name of every business who makes a qualifying payment. Every payment made under section EK 2 must be entered in that person's ERA.

Under section EK 2, to be eligible to make payments to an ERA, a taxpayer must carry on business in New Zealand and expect to incur future expenditure included in a provision in its audited financial statements, that:

- is listed in Part B of Schedule 6B (monitoring and restoration expenditure);
- is not listed in Part C of Schedule 6B (land reclamation, non-environmental dredging and land acquisition costs); and
- is not on revenue account property (other than where section CB 6B applies).

The minimum payment to an ERA is $1,000 (section EK 3). A business's maximum payment is defined in section EK 22 as the lesser of:

- the amount by which the maximum account balance[4] exceeds the ERA balance at the end of the income year; and
- the amount permitted as a deposit under the initial five-year spreading mechanism[5].

A business is allowed a tax deduction under section DQ 4 for a payment to an ERA. The amount of the deduction is calculated by dividing the amount of the payment by the applicable tax rate (section EK 7). The applicable tax rate is the highest rate of income tax that is stated in Schedule 1 which could apply to the business.

The deduction is allowed for the income year for which the payment is made. Section EK 3 deals with the amount and time for making payments to an ERA. Any payment made up to six

[4] A business's maximum account balance (defined in section EK 23) is:

- zero, if the person does not satisfy section EK 2; or
- an amount calculated by multiplying the level of their accounting restoration provision by the applicable tax rate.

[5] The spreading mechanism is a transitional measure intended to reduce the cost of allowing payments for historic restoration liabilities. After the initial five-year period taxpayers will be able to make payments up to the (tax effected) level of their accounting restoration provision. Under the spreading mechanism, the maximum payment for the 2005-06 to the 2010-11 income years is calculated as follows:

Level increase + (year x 0.2 x initial level) – contents

- "Level increase" is the greater of zero or the amount by which the maximum account balance exceeds that for the 2005-06 income year.
- "Year" is 1 for the 2005-06 income year and increases by 1 for each successive income year. This allows a "catch-up" if no deposit is made for the 2005-06 income year.
- "Initial level" is the maximum account balance for the 2005-06 income year.
- "Contents" is the amount of the ERA at the end of the income year.

months after the end of an income year will be treated as a payment for that income year. Discretion has also been given for the Commissioner to accept payments made after this period.

To ensure that the Commissioner has sufficient information to deal with an ERA payment, section EK 5 requires a business making a payment to provide (within two working days) some basic information. This includes:

- the name of the person;
- the income year for which the payment is made;
- a calculation of the business's maximum payment; and
- any additional information required by the Commissioner.

When this information is not supplied, section EK 9 requires the Commissioner to refund the payment to the payee as soon as it is practical. The amount will not qualify for a deduction under DQ 4, for interest under section EK 6, or be taxable under section CX 43B (section EK 10). Any payment which is in excess of a business's maximum payment receives the same treatment.

Section EK 21 gives the Commissioner the power to require ERA information in an electronic format and section 36BC of the Tax Administration Act 1994 allows the Commissioner to prescribe the electronic format in which details may be provided. This provides flexibility should the system be administered via the internet in the future.

Refunds from an ERA

Amounts entered into a business's ERA may not be removed except by way of refund under sections EK 9 or EK 12 or by way of transfer.

Under section EK 11, a business is able to apply for an ERA refund when they have incurred Schedule 6B Part B (monitoring and restoration) expenditure that is not listed in Part C of the schedule. The expenditure must be incurred after the date that the business first establishes their ERA and must be equal to or greater than the amount calculated by dividing the refund requested by the applicable tax rate (section EK 12). The Commissioner must also make a refund where a business's ERA balance exceeds their maximum account balance.

The application for the refund must be in writing, state the amount of the refund required, grounds on which the refund is made and provide evidence to support those grounds. The amount of the refund is limited to the lesser of the refund requested, the balance of the ERA, and the amount of qualifying expenditure.

A refund is income under section CB 24B. The amount of income is calculated by dividing the value of the refund by the applicable tax rate. ERA refunds are sourced from payments on a first-in-first-out basis (section EK 18).

ERA transfers

A business may also apply for a transfer from an ERA. An amount may be transferred from an ERA:

- to the ERA of another business in accordance with sections EK 15 or EK 16(3)(b);
- to Ministry for the Environment under section EK 16(3)(a); or
- to an ERA of an amalgamated company under section EK 19.

The transfer application must be in writing, state the grounds on which the application is made and the amount of the transfer required (section EK 14). A business who makes a transfer from their ERA under sections EK 15, EK 16 or EK 19 derives income equivalent to the grossed-up amount of the transfer (section CB 24B).

The transfer is treated by the recipient as a payment (meaning a tax deduction is available under section DQ 4) as long as the associated environmental obligations have also been transferred, and the business would be entitled to make an equivalent ERA payment. If any part of the transfer does not satisfy these requirements the Commissioner may return the non-qualifying amount back to the transferor. This will be effective as at the date of the original transfer.

As well as a voluntary transfer by a business, the ERA rules also provide for a transfer on the death, bankruptcy or liquidation of a taxpayer. Under section EK 16, if an administrator, the Official Assignee or a liquidator notifies the Commissioner that the obligation associated with an ERA deposit has been transferred, the Commissioner must also transfer the ERA balance. Where the obligation has "in effect" been transferred to the New Zealand Government (for example, where it is an orphan site) then the Commissioner is required to transfer the associated ERA balance to the Ministry for the Environment.

The amount of the transfer will be the amount in the business's ERA on the day they die, become bankrupt or are put into liquidation. The transfer will result in income for the transferor derived on the day before the taxpayer's death, bankruptcy or liquidation.

Sections EK 19 and EK 20 set out what happens upon an amalgamation or tax consolidation. If an amalgamating company ceases to exist on an amalgamation then there is a transfer to the ERA of the amalgamated company. The amalgamated company is treated as having made all the payments, transfers and refunds made by the amalgamating company. Under section EK 20, on consolidation, the nominated company makes payments and receives refunds on behalf of the consolidated group.

Interest on ERA balances

To encourage businesses to participate in the ERA scheme, the rules provide for a small amount of interest (3% p.a.) to be paid on deposits. This is equivalent to the interest rate paid on the income equalisation scheme.

Interest is calculated from the day after a payment is made until the date it is included in a refund under section EK 12 or transfer under sections EK 15, EK 16 or EK 19. It is paid out on the earlier of 31 March each year or the date that the payment is included in a refund or transfer under sections EK 15, EK 16 or EK 19.

Clarifying the meaning of "industrial waste"

The previous environmental tax rules (section DB 37 of the Income Tax Act 2004 and section DJ 10 of the Income Tax Act 1994) applied solely to dealing with "industrial" waste. There was no definition of this term which led to ongoing uncertainty as to when tax deductions were available for environmental expenditure.

The word “industrial” has been removed from sections DB 37 and DJ 10 to protect taxpayers who have taken a wide interpretation of the term “industrial waste”. This clarifies that a tax deduction is available for dealing with all forms of waste.

This change to section DB 37 applies for income years (and expenditure incurred) beginning before 10 June 2005. The change to DJ 10 is retrospective (back to the 1995-96 income year) and applies where a taxpayer has filed a tax return, notice of proposed adjustment or response notice, or has requested a reassessment, before 16 November 2004, and the correctness of the tax position, notice or request depends on the interpretation of the meaning of “industrial waste”.

Application Dates

The majority of amendments apply for income years beginning on and environmental expenditure incurred after 10 June 2005. However, the removal of the distinction between industrial and non-industrial waste is retrospective to the 1995-96 income year. This protects businesses who have taken a wide interpretation of the term “industrial waste”, either in filing their tax returns or in raising a dispute with Inland Revenue. Businesses who have not taken a wide interpretation of the legislation will not be able to take advantage of the retrospective change.

Conclusion

The rules covering tax deductions for business environmental expenditure to avoid, remedy or mitigate the discharge of contaminants have been clarified and expanded from 10 June 2005 by:

- specifying categories of qualifying environmental expenditure and default deduction rates;
- giving the Commissioner the power to issue rates for other categories of environmental expenditure;
- removing the current distinction between industrial and non-industrial waste; and
- introducing a mechanism so that site restoration and monitoring costs can be matched against prior business income.

Businesses planning to take advantage of these changes to secure tax deductions for the investigation, remediation and aftercare of contaminated land should refer to the illustrative examples in Appendix 2 and the best practices for management of contaminated land set out in the Ministry for the Environment’s *Contaminated Land Guidelines* series and, in particular, the minimum reporting standards in *Guideline Number 1* of that series.

Appendix 1 – Deductible expenditure

Expenditure in avoiding, remedying, or mitigating detrimental effects of discharge of contaminant

Part A – Expenditure relating to activity or improvement to land

	General description of expenditure	*Rate*
1	Expenditure on investigating and testing locations and methods before a decision is made to use a location or method for an activity or improvement that is intended to avoid, remedy, or mitigate future detrimental effects on the environment from the discharge of a contaminant.	100%
2	Expenditure, in the construction of an improvement on land in New Zealand, incurred in order to avoid or mitigate future detrimental effects on the environment from the discharge of a contaminant.	Lesser of 1/35 or 1/consent period
3	Expenditure on screen planting on land in New Zealand incurred in association with the construction of an improvement to the land that is intended to avoid, or mitigate future detrimental effects on the environment from the discharge of a contaminant.	Lesser of 1/35 or 1/consent period
4	Expenditure on riparian planting on land in New Zealand incurred in order to avoid or mitigate future detrimental effects on the environment from the discharge of a contaminant.	Lesser of 1/35 or 1/consent period
5	Expenditure on an activity that is intended to avoid or mitigate the future discharge of a contaminant.	Lesser of 1/35 or 1/consent period

Part B – Expenditure relating to monitoring, remedies, and mitigation

1	Expenditure related to monitoring the discharge of a contaminant.	100%
2	Expenditure related to monitoring detrimental effects on the environment from the discharge of a contaminant.	100%
3	Expenditure incurred after the discharge of a contaminant, on avoiding, remedying, or mitigating detrimental effects on the environment from the discharged contaminant.	100%
4	Expenditure, incurred after the discharge of a contaminant, on removing an improvement to land in New Zealand for the purpose of avoiding, remedying, or mitigating detrimental effects on the environment from the discharged contaminant.	100%
5	Expenditure, incurred after the discharge of a contaminant, on the installation of impermeable surfaces on land in New Zealand with the purpose of avoiding, remedying, or mitigating detrimental effects on the environment from the discharged contaminant.	100%
6	Expenditure, incurred after the discharge of a contaminant, on replanting land in New Zealand in association with expenditure to avoid, remedy, or mitigate detrimental effects on the environment from the discharged contaminant.	100%
7	Expenditure, incurred in the cessation of a business, on disposing of a stored substance that is a potential contaminant in a way that avoids detrimental effects on the environment.	100%

Part C – Excluded expenditure

1 Expenditure related to land reclamation.

2 Expenditure relating to dredging, other than dredging for the principal purpose of remedying or mitigating detrimental effects on the environment from a discharged contaminant.

3 Expenditure related to the acquisition of land.

Appendix 2 – Illustrative examples

Example 1: No deduction available under other provisions

Parkways Limited builds and operates inner-city parking buildings. It has purchased a site in the central city for a new parking building and obtained the necessary resource consents. However, before construction can begin, Parkways Limited needs to deal with a contamination issue left by the previous owner. It will be necessary to remove contaminated soil, fill the area with clean soil and then construct an impermeable surface cap to prevent further contamination. Parkways Limited will then construct the normal car park surface on top of the cap.

The process of removing the contaminated soil and installing an impermeable surface cap should constitute expenditure on remedying, or mitigating detrimental effects on the environment. An immediate tax deduction should therefore be available under section DB 37. However, if a tax deduction were available under another provision, for example it if were not possible to separate the restoration activities from the construction of the car park, then a tax deduction would have to be claimed as tax depreciation rather than under section DB 37.

Example 2: Types of environmental expenditure

Green Limited is a plastics manufacturer. A number of by-products are produced as a result of its manufacturing processes. Green Limited is therefore looking at potential options for dealing with the by-products. These include changing its manufacturing process, immediate treatment of the by-products, and storing the substances for a period and processing at a later date. Green Limited pays for a report from an environmental consultant evaluating the different options. Alteration of the manufacturing process proves to be impractical and, due to its location and economies of scale, immediate treatment of the substances is not cost efficient. Green Limited therefore makes an application for a resource consent to store the by-products.

The expenditure incurred on the environmental report is expenditure on investigating and testing an activity intended to avoid, remedy or mitigate detrimental effects on the environment. Expenditure incurred prior to the date a decision is made to use one particular option, (likely to be the date that a resource consent application is made) is environmental feasibility expenditure and immediately deductible under section DB 37. Expenditure incurred from this date would constitute construction expenditure. If no other tax deduction is available (for example for tax depreciation) this expenditure would be deductible over the lesser of 35 years or the period for which the resource consent is granted. If Green Limited felt that this did not accurately reflect the life of the expenditure then they could apply to Inland Revenue for a category specific deduction rate.

Example 3: Types of environmental expenditure

Pinot NZ Limited runs a winery. A portion of a neighbouring property has been contaminated as a result of past business activities. Pinot NZ Limited is worried about the impact this may have on its own property, business reputation and income. The owner of the site and person responsible for the contamination cannot be identified. Pinot NZ Limited therefore works with the local council to rectify the contamination (removing and replacing the soil and replanting the area in native bush).

While Pinot NZ Limited is not responsible for the contamination and does not own the neighbouring site, this expenditure should qualify under section DB 37 for an immediate tax deduction. It is expenditure incurred by a business in remedying the detrimental effects on the environment from a discharged contaminant and expenditure on replanting land in New Zealand in association with expenditure to avoid, remedy, or mitigate detrimental effects on the environment.

Example 4: Calculating the correct deduction rate

Olivia Limited is a large multinational corporation. It applies for a resource consent regarding emissions from a new factory. While the factory will undertake all necessary steps to reduce emissions there will still be a small discharge made. To counter this, and as part of its resource consent process, Olivia Limited agrees to spend $50,000 planting and maintaining an area of native bush. A resource consent is granted for 25 years.

As the planting expenditure is incurred by Olivia Limited for the purposes of obtaining a resource consent for its new factory it is viewed as business expenditure. The planting expenditure is an activity that is intended to avoid or mitigate the discharge of a contaminant. As such, a tax deduction should be available under section DB 37. The annual deduction for the expenditure is calculated by multiplying the cost ($50,000) by the deduction rate. The deduction rate is calculated by dividing 100% by the assumed life. As the planting expenditure is associated with a business activity that requires a resource consent, the assumed life is 25 years (being the lesser of 35 years and the resource consent period). The closest straight-line rate in Schedule 11 is 4%. Alternatively, a diminishing value rate of 6% can be used.

Example 5: Closure of a business

After 10 years, Olivia Limited closes its operations in New Zealand. Up until the year of closure, Olivia Limited has claimed $20,000 of tax deductions under section DB 37 for its native planting expenditure. On the closure of its New Zealand factories, the operations for which the expenditure was incurred have come to an end. Olivia Limited is therefore able to claim the remaining $30,000 of expenditure in the year of closure.

Example 6: Claw-back

Forest Fields Limited runs a timber treatment plant. It spent $200,000 constructing a settling pond for dealing with the by-products of the treatment process. It has a five-year resource consent for operating the pond. As such it has claimed tax deductions of $180,000 under section DB 37 based on an assumed life of five years. At the end of five years, Forest Fields Limited applies for a 30-year extension to its resource consent.

If Forest Fields Limited had claimed tax deductions based on an assumed life of 35 years, the tax deductions claimed to date would have only been $30,000. Forest Fields Limited is therefore deemed to derive income of $150,000 in the income year in which the consent is extended (because the consent period was extended by more than 50%).

Example 7: Calculating the ERA payment

M.A.E. Limited has an accounting restoration provision in its audited financial statements for $2 million. This consists of $1 million for dealing with contaminated soil, $0.5 million for the removal of plant and equipment (necessary to clean up the contaminated soil) and $0.5 million for publicity costs to promote its “green image”.

Both the soil clean-up costs and removal of plant and equipment necessary to do this will constitute restoration expenditure under Part B of Schedule 6B. However, the plant and equipment removal costs will be deducted under the tax depreciation rules rather than section DB 37. This does not prevent M.A.E. Limited from making an ERA payment for these costs. Under section EK 2, a person can make a payment to an ERA for expenditure that is of a type listed Part B of Schedule 6B. It is not necessary for a deduction to be claimed under section DB 37 for a deposit to be made to an ERA.

No ERA payment is able to be made in respect of the publicity costs as these do not constitute expenditure that is of a type listed in Part B of Schedule 6B.

Example 8: Maximum account balance and maximum payment

DF Limited has a future site restoration liability as a result of its New Zealand manufacturing operations. To recognise this it has created an accounting restoration provision in its 2005-06 audited financial statements of $1 million.

DF Limited's maximum account balance is $330,000, being $1 million multiplied by 33% (the highest tax rate in Schedule 1 applying to a corporate taxpayer). DF Limited's maximum payment for the 2005-06 income year is $66,000 (being 0 + (1 x 0.2 x 330,000) – 0). Its maximum payment for the 2006–07 income year is $66,000 (being 0 + (2 x 0.2 x 330,000 – 66,000).

In the 2007-08 income year, DF Limited recalculates its restoration liability and increases its accounting provision to $1.5 million. DF Limited's maximum account balance is now $495,000. DF Limited's maximum payment for the 2007-08 income year is $231,000 (being (495,000 – 330,000) + (3 x 0.2 x 330,000) – 132,000).

DF Limited's restoration balance remains unchanged for the 2008-09 and 2009-10 income years and it makes maximum payments to its ERA of $66,000 for each of these years.

In 2010-11, it revises its accounting provision upwards again to $1.8 million. Its maximum account balance is now $594,000. It no longer needs to apply the five-year spreading calculation and therefore its maximum payment for the year is the difference between its ERA balance and maximum account balance ($594,000 – 495,000 = $99,000).

Example 9: ERA

Horace Co Limited has an accounting restoration provision in its audited financial statements of $600,000. Over the 2005-06 to 2009-10 income years it makes payments to its ERA of $198,000. This gives rise to total tax deductions over the period of $600,000 and a reduction in Horace Co Limited's tax liability of $198,000 (meaning there is no impact on Horace Co Limited's cash position).

In 2010-11, Horace Co Limited starts to wind down its operations and contracts with an environmental consultant to restore its site (obtaining the necessary resource consents and following Ministry for the Environment guidelines). The total cost of the site restoration is $500,000. Horace Co Limited writes to Inland Revenue to request a refund and supplies accounting records to verify that it has incurred the site restoration expenditure.

Inland Revenue issues a refund of $165,000 (being $500,000 multiplied by 33%). This gives rise to taxable income of $500,000 in the year of receipt. Horace Co Limited is able to offset the tax deductions for the restoration costs against the ERA refund income meaning that there is no further tax to pay.

When the remaining accounting provision is reversed (once Horace Co Limited has met the conditions of its resource consent), Horace Co Limited's maximum account balance will be zero and the remainder of the ERA balance of $33,000 will be refunded. This will give rise to taxable income of $100,000.