

Mr Jim Gordon  
Policy Advice Division  
Inland Revenue Department  
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6 March 2009

Dear Sir

**Proposed framework for the treatment of aircraft overhaul provisions and depreciation of aircraft**

This letter is written on behalf of the Aviation Industry Association of NZ (Inc) ("AIA") and sets out a proposed framework for the treatment of aircraft overhaul provisions.

**Background**

Aircraft operators have historically been allowed a tax deduction for overhaul provisions at the time the provision was established. Exposure draft QB0057 asserts that this treatment is incorrect.

As agreed with you, the AIA, with assistance from PricewaterhouseCoopers, has considered the appropriate tax treatment of overhaul provisions on a "first principles" basis, to develop a framework on which the tax treatment should be based. This essentially follows the economic position relating to aircraft operations.

**Economic cost of overhaul expenses**

Aircraft operators incur expenses in respect of scheduled inspection, overhaul and replacement of parts. The schedule is set by the manufacturer of the aircraft and must be followed to maintain its legal certification.

This scheduled expense is referred to in the industry as the *time-life component* of an aircraft.

The frequency and type of expenses incurred in respect of the *time - life component* is calculated with reference to time, cycles or hours and is dependant on the type of aircraft (e.g. helicopter or fixed wing aircraft), type of part in question (e.g. engine or transmission) and the use of the aircraft (e.g. short or long cycles).

The value of an aircraft is reduced in line with the proximity of a scheduled *time - life component* expense. When an aircraft is sold the proximity and quantum of the scheduled expense is taken into account in determining the sale price.

Mr Jim Gordon  
6 March 2009

For certain types of aircraft (particularly helicopters) the *time - life component* could consist of a large number of individually specified components, inspection or maintenance items.

Components are also interchangeable and taxpayers with a number of similar aircraft are able to exchange parts and engines between aircraft. The *time - life component* in respect of that part would sometimes follow the part or remain with the aircraft.

### **Characteristics of *time - life component* expenses**

The *time - life component* has the following characteristics:

- It can be readily determined;
- It reduces the value of the aircraft with reference to measurable parameters such as time, cycle and hours;
- It can be evidenced with reference to logbooks and other records required to be kept by law;
- It is specific to the type and model of an aircraft.

### **Current legislative provisions**

#### *Depreciation provisions*

Depreciation losses for aircraft are allowed under subpart EE of the Income Tax Act 2007 (2007 ITA) and are calculated by reference to section EE 29(2) and determination DEP 1.

The current methods and rates for calculating depreciation do not correctly reflect the real decline in value of the aircraft as it does not take into account the fluctuation in value by virtue of the *time - life component*.

The reduction in value of the balance of the aircraft (excluding the *time - life component*) can be calculated under the current depreciation provisions.

The current treatment of disposal of an aircraft results in distorted depreciation recovery income or loss.

The current Inland Revenue view is that amortisation of the *time - life component* is not deductible because the expense is not "*incurred*" (exposure draft QB0057), i.e. it is only at the time that the component is replaced or refurbished that a deduction is allowed.

Mr Jim Gordon  
6 March 2009

## Proposal

### *General*

We consider that a deduction for the amortisation of the *time - life component* falls within the policy intent of the Act. Subpart EE allows a deduction in relation to property that is expected to decline in value. Amortisation of the *time - life component* reflects the decline in value.

In our view it would be impractical to provide for depreciation rates in respect of the *time - life component* because of the variety of methods used by manufacturers (e.g. time, cycle or hours).

We therefore propose extending the general permission to include the amortisation of the *time - life component*.

In order to properly reflect the reduction in value of the aircraft, and to reduce the possibility that the same component is both depreciated under Subpart EE and amortised under the general permission we propose that the *time - life component* be treated separately from the value or cost of the remainder of the aircraft for the purposes of calculating depreciation.

When an aircraft is sold the adjusted tax value should include the *time - life component* to ensure that depreciation recovery income and loss on disposal is correctly calculated.

### *Structure*

We propose that the cost or value of an aircraft to be apportioned between the *airframe* and the *time - life component*.

The amount of the *time - life component* is the sum of the scheduled expenses on maintenance, overhaul, inspection or replacement that will be incurred by virtue of manufacturer's requirements.

The cost or value of the *airframe* will be the difference between the cost or value of the aircraft and the *time - life component*.

A deduction for the depreciation loss on the *airframe* will be calculated and allowed in the normal manner provided for in subpart EE.

A deduction will be allowed for the amortisation of the *time - life component* on the basis normally set by the manufacturer in respect of inspection, overhaul or replacement calculated on the basis of:

- Time;
- Cycle; or
- Hours.

When a scheduled overhaul, maintenance or replacement takes place the expected cost of the next scheduled overhaul, maintenance or replacement is capitalised to the *time - life component* and amortised on the same basis as above.

Mr Jim Gordon

6 March 2009

On disposition of an aircraft the balance of the *time - life component* is added to the aircraft's adjusted tax value for the purposes of calculating depreciation recovery income or loss.

It is recognised that the proposal would increase complexity and compliance costs. We propose that this framework be elective and that aircraft operators who do not wish to incur the complexity and compliance cost of calculating the *time - life component* and the annual amount of amortisation be allowed to claim deductions available under general principles.

#### *Transitional provisions*

If the basis to depreciate aircraft outlined above is acceptable, we propose the following transitional provisions in relation to existing aircraft owned prior to implementation date (suggested implementation date is in relation to the 2010/ 11 income year).

All operators that wish to claim deductions for the amortisation of the *time - life component* be required to:

- Calculate a current *time - life component* taking into account remaining time, cycle or hours to the next scheduled expense as per the manufacturers requirements;
- Reduce the adjusted tax value of the aircraft by the amount of the *time - life component* for the purposes of calculating depreciation under subpart EE of the 2007 ITA (unless previously reduced). This balance represents the *airframe*;
- Calculate depreciation on the *airframe* in the normal manner thereafter;
- Calculate the amortisation of the *time - life component* with reference to the amount of time, cycle or hours since the *time - life component* was originally calculated and deducted from the adjusted tax value of the aircraft.

#### **Examples**

Attached as an Appendix are practical examples of how this proposal would work in practice.

#### **Legislative amendments required**

We consider that the following legislative amendments would be required:

- A new section be added to subpart DW (Expenditure specific to certain industries):
  - to extend the general permission to include the amortisation of the *time - life component* from and to the extent of adoption of the regime by a taxpayer;
  - to provide for the calculation of the *time - life component* and the amortisation of the *time - life component* in accordance with manufacturers specifications and to the extent of the adoption of the regime by the taxpayer; and
  - to ensure that the regime is elective.

Mr Jim Gordon

6 March 2009

- A new subsection be added to section EE 60:
  - to allow the time - life component to be deducted from the base value of the aircraft for the purposes of calculating the depreciation loss under subpart EE;
  - to allow the balance of the time - life component to be added to the base value of the aircraft for the purposes of calculating depreciation recovery income or loss on disposal; and
  - to ensure that the regime is elective.

**General**

It may be appropriate for us to meet and discuss the proposal and we would be happy to do so if required. In the interim, if you have any queries, please do not hesitate to contact me or Riaan Geldenhuys of this office.

Yours faithfully

Kevin Best  
Partner  
Taxation Services

**Example 1 - New helicopter**

Purchase price \$100,000

*Time life component:*

Gearbox 6,000 hrs overhaul	\$5,000
Main rotor blade 3,000 hrs replace	\$5,000
Starter assembly 500 cycles replace	\$1,000
Bolts 365 days replace	\$500
	<u>\$11,500</u>

After 1 year the total deduction will be calculated as follows:

Depreciation	<b>Opening</b> \$100,000	<b>Adjustment</b> \$11,500	<b>Depreciation</b> \$10,620	<b>Closing</b> \$77,880
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	Opening	Additions	Life	Used	Amortise	Closing	Life
<i>Time life component</i>							
Gearbox	\$5,000	0	6,000 hrs	1,000 hrs	\$833	\$4,167	5,000 hrs
Main rotor blade	\$5,000	0	3,000 hrs	1,000 hrs	\$1,667	\$3,333	2,000 hrs
Starter assembly	\$1,000	\$1,000	1,000 cycles	700 cycles	\$1,400	\$600	300 cycles
Bolts	\$500	0	365 days	365 days	\$500	0	0
	<u>\$11,500</u>				<u>\$4,400</u>	<u>\$8,100</u>	

Total deduction - Depreciation \$10,620  
 - Amortisation \$4,400

**Example 2 – Existing helicopter - transition**

Original Purchase price	\$100,000
Depreciation to date	\$12,000

<i>Time life component:</i>	<i>Total Estimated Cost</i>	<i>Used</i>	<i>Balance</i>
Gearbox 6,000 hrs overhaul	\$5,000	1,000 hrs	\$4,164
Main rotor blade 3,000 hrs replace	\$5,000	1,000 hrs	\$3,333
Starter assembly 500 cycles replace	\$1,000	200 cycles	\$600
Bolts 365 days replace	\$500	0	\$600
	<u>\$11,500</u>		<u>\$8,600</u>

For the transition year the total deduction will be calculated as follows:

	<b>Opening</b>	<b>Adjustment</b>	<b>Depreciation</b>	<b>Closing</b>
Depreciation	\$88,000	\$11,500	\$9,180	\$67,320

<i>Time life component</i>	<b>Opening</b>	<b>Additions</b>	<b>Life</b>	<b>Used</b>	<b>Amortise</b>	<b>Closing</b>	<b>Life</b>
Gearbox	\$4,167	0	5,000 hrs	1,000 hrs	\$833	\$3,334	4,000 hrs
Main rotor blade	\$3,333	0	2,000 hrs	1,000 hrs	\$1,667	\$1,666	1,000 hrs
Starter assembly	\$600	\$1,000	800 cycles	700 cycles	\$1,400	\$200	100 cycles
Bolts	\$500	0	365 days	365 days	\$500	0	0
	<u>\$8,600</u>				<u>\$4,400</u>	<u>\$5,200</u>	

Total deduction	-	Depreciation \$9,180
	-	Amortisation \$4,400