Inland Revenue
Te Tari Taake

POLICY ADVICE DIVISION

Tax policy report: Further depreciation issues - Budget 2010

Date:	28 April 2010	**Priority:**	**High**
Security Level:		**Report No:**	T2010/716 PAD2010/045

Action sought

	Action Sought	**Deadline**
Minister of Revenue	Agree to recommendations	30 April 2010
Minister of Finance	Agree to recommendations	30 April 2010

Contact for telephone discussion (if required)

Name	**Position**	**Telephone**	
Carolyn Palmer	Senior Policy Advisor	[deleted – privacy]	[deleted – privacy]
Steve Mack	Principal Advisor	[deleted – privacy]	[deleted – privacy]

28 April 2010

Minister of Finance
Minister of Revenue

Further depreciation issues — Budget 2010

Executive summary

Ministers agreed in tax policy report (PAD 2010/032, T2010/299 refers) to make changes to the tax depreciation rules as part of a tax reform package as part of Budget 2010. This report seeks your agreement to several consequential amendments regarding changes to the tax depreciation rules to address concerns regarding taxpayer certainty and compliance costs.

Capital contributions

It is common practice for New Zealand infrastructure companies to charge a fee, or contribution, towards the cost of expanding their networks. Under current tax rules, capital contributions do not constitute gross income for tax purposes and taxpayers who receive capital contributions are entitled to depreciate the entire costs of their assets, even when these costs are funded by another party. This treatment is much the same as allowing businesses to deduct the cost of capital assets too quickly. This is both inefficient and distorts behaviour.

Officials recommend a consequential amendment to the proposed tax treatment of capital contributions. Taxpayers would be given the option of spreading the capital contribution as taxable income over ten years or reducing the depreciation tax base for capital contributions made after 20 May 2010. This option would address concerns regarding taxpayer compliance costs but still encourage taxpayers to adopt the correct economic treatment of reducing the asset's depreciation cost base.

The fiscal implications associated with amending the tax treatment of capital contributions are already included in the Budget package.

Grandparenting of structures reclassified as buildings

Before 30 June 2009, Inland Revenue had treated certain structures as not being buildings for depreciation and disposal purposes. On 30 June 2009, Inland Revenue released a draft interpretation saying that those assets would be treated as buildings for tax purposes. In order to ensure continuity of tax treatment for existing investments, the Minister of Revenue agreed, in policy report PAD2009/119, to amend the tax law so that the current tax treatment would

continue to apply to buildings and structures affected and held before the date that the draft statement was released. The Minister of Revenue issued a press statement on 30 July 2009 to this effect.

Assets covered by this press statement would now be affected by changes to the tax depreciation rules as part of the tax reform package. In particular, car park buildings, no matter when acquired, would lose their allowance for tax depreciation.

Ministers could choose to override the earlier decision and make no allowance for the change in tax treatment as a result of the new interpretation statement. However, this is likely to have negative implications in terms of investor confidence and reliance on government press statements in the future. Officials therefore recommend that Ministers confirm the earlier decision to grandparent buildings and structures affected and held before the date that the draft statement was released.

The fiscal implications associated with grandparenting the treatment of certain buildings are expected to be immaterial and within the margin of uncertainty of the overall revenue forecasts of the change to building depreciation and will not impact on the financial implications of the Budget package.

Commercial Building "Fitout"

Inland Revenue has just finalised and released an interpretation statement IS10/01 concluding that that many items in a residential rental property cannot be treated as separate items of depreciable property. The combination of the interpretation statement and changes to building depreciation as part of the Budget-2010 tax package is likely to create uncertainty over whether commercial building "fitout" that is currently being depreciated as separate assets will still be eligible for tax depreciation deductions post-Budget 2010.

To address taxpayer uncertainty, it is recommended that Ministers announce as part of Budget-2010 the intention to review the treatment of commercial building "fitout" and if necessary amend the tax rules prior to 1 April 2011 to clarify the law.

This announcement will not impact on the financial implications of changes to building depreciation included in the Budget package. However, there could be a fiscal gain or loss depending on the outcome of the review. If you agree to the review, we recommend a specific fiscal risk be disclosed in the Budget 2010 documentation.

If Ministers agree with the recommendations in respect of capital contributions, grandparenting the treatment of certain buildings and commercial building "fitout", these will be included in the Budget Legislation Cabinet Paper going to the Cabinet Business Committee on 10 May 2010.

Changes to the tax rules to amend the treatment of capital contributions and grandparent the treatment of certain buildings will be included in the tax bill to be introduced on Budget day.

Recommended action

It is recommended that you:

Capital contributions

(a) **Note** that Cabinet agreed to reduce the depreciation cost base to the extent that this base is funded through capital contributions made after 20 May 2010 (CAB Min (10) 12/10 refers).

Noted Noted

(b) **Note** that Cabinet authorised the Minister of Finance and Minister of Revenue to propose any necessary minor consequential amendments that relate to the Budget 2010 tax reform package (CAB Min (10) 12/10 refers).

Noted Noted

(c) **Agree** to amend the tax treatment of capital contributions by allowing taxpayers to elect to reduce the depreciation cost base to the extent that it is funded through capital contributions or to treat the receipt of a capital contribution as taxable income, spread over a ten year period.

Agreed/Not Agreed Agreed/Not Agreed

(d) **Note** the financial implications of (c) are already included in the Budget package.

Noted Noted

Grandparenting structures reclassified as a building

(e) **Note** that the Commissioner of Inland Revenue is about to finalise and release an interpretation statement on the meaning of "building" in the tax depreciation rules that will change the tax treatment of certain investments already held by some taxpayers.

Noted Noted

(f) **Note** that the Minister of Revenue issued a press statement on 30 July 2009, at the time the draft interpretation statement was released for comment, advising that the tax law would be amended so that the tax treatment applying to buildings and structures affected and held before the date that the draft statement (30 July 2009) was released would continue.

(g) **Confirm** the earlier decision (PAD2009/119 refers) to grandparent buildings and structures affected and held before the date that the draft statement was released.

Confirm Confirm

(h) **Note** that the fiscal cost of (g) is expected to be immaterial and within the margin of uncertainty of the overall revenue projection for the removal of building depreciation and will have no impact on the fiscal forecasts.

Noted Noted

Commercial Building "Fitout"

(i) **Note** that the Commissioner of Inland Revenue has just finalised and released an interpretation statement concluding that many items in a residential rental property cannot be treated as separate items of depreciable property.

Noted Noted

(j) **Note** that the finalisation of this statement creates uncertainty about whether some items that form part of commercial "fitouts" that are currently being depreciated as separate assets will continue to be eligible for tax depreciation deductions post-Budget 2010.

Noted Noted

(k) **Agree** to announce as part of Budget-2010 the intention to review the treatment of commercial building "fitout" and if necessary amend the tax rules prior to 1 April 2011 to clarify the law.

Agreed/Not Agreed Agreed/Not Agreed

(l) **Note** that the fiscal cost of (k) will not impact on the financial implications of the change to building depreciation included in the Budget package. However, there could be a fiscal gain or loss depending on the outcome of the review.

Noted Noted

(m) If you agree to recommendation (k), **agree** to the following specific fiscal risk statement being included in Budget 2010 documentation:

Review of Fitout of Commercial and Industrial Buildings (Unquantified fiscal risk)
The government has announced a review of the appropriate tax treatment for "fitouts" of commercial and industrial buildings in light of Inland Revenue's interpretation statement IS10/01 on the treatment of residential building fitout. Depending on the outcome of that review, there could be a fiscal gain or loss over the forecast period.

Agreed/Not Agreed Agreed/Not Agreed

(n) **Note** that if Ministers agree with recommendations (c), (g) and (k) that these will be included in the Budget Legislation Cabinet Paper going to the Cabinet Business Committee on 10 May 2010**.**

Noted Noted

(o) **Direct** Inland Revenue to give effect to recommendations (c) and (g) (if agreed) by including in the tax bill to be introduced on Budget day.

Directed Directed

Steve Mack
for Secretary to the Treasury

Carolyn Palmer
Senior Policy Advisor
Policy Advice Division

Hon Bill English
Minister of Finance

Hon Peter Dunne
Minister of Revenue

Background

1. Ministers agreed in tax policy report (PAD 2010/032, T2010/299 refers) to make changes to the tax depreciation rules as part of a tax reform package as part of Budget 2010. The changes include reducing the tax depreciation rate for all buildings with an expected useful life of 50 years or more to 0% from the beginning of the 2011/12 income year and requiring the depreciation cost base to be reduced by the amount that is funded from capital contributions made after 20 May 2010.

2. Cabinet subsequently agreed to this proposed treatment and authorised the Minister of Finance and Minister of Revenue to propose any necessary minor consequential amendments that relate to the Budget 2010 tax reform package (CAB Min (10) 12/10 refers).

3. This report seeks your agreement to several consequential amendments regarding changes to the tax depreciation rules to address concerns regarding taxpayer certainty and compliance costs.

Capital contributions

4. A capital contribution is a contribution made by a customer to the costs of the recipient's depreciable property where the payment is not otherwise gross income, and the payment is not in respect of a contract of insurance.

Current treatment

5. It is common practice for New Zealand infrastructure companies (for example, electricity distribution companies) to charge a fee, or contribution, towards the cost of expanding their networks. These charges are known as capital contributions. A common situation when capital contributions are paid is where, to obtain a power supply, a farmer might need to have power lines between the farmhouse and the farm boundary installed. The lines company may charge the farmer to install the new lines. These charges offset the cost of constructing extensions or enhancements, to existing networks so that a new customer (the contributor) can be serviced by that company. These charges are common, and not limited to electricity lines companies.

6. Infrastructure companies are treated like any other company with the tax treatment of capital contributions determined under ordinary income and expenditure sections of the Income Tax Act 2007.

7. As a general rule, payments that are revenue in nature, such as receipts incurred in the ordinary course of business, are considered to be income and are therefore taxable. Payments that are capital in nature, such as receipts incurred outside the ordinary course of business, are not considered to be income and are therefore not taxed.

8. Following this rule, capital contributions are not taxable as they are capital in nature. Businesses that charge and receive these contributions are not in the business of connecting

new customers to a network; instead, the capital contribution is funding an upgrade or extension to a capital asset of the company, its network.

9. Under the current tax depreciation rules, the recipient can also claim the full cost of the subsidised assets under the tax depreciation rules. In other words, they can claim deductions for expenditure that they have not borne the cost of.[1]

10. The result of this treatment is that capital contributions do not constitute gross income for tax purposes and taxpayers who receive capital contributions are entitled to depreciate the entire costs of their assets, even when these costs are funded by another party.

11. This treatment for capital contributions can be contrasted with the treatment of government grants and subsidies. As with capital contributions, the subsidy is capital in nature and therefore non-taxable to the recipient. However, in the case of government grants and subsidies, the Income Tax Act provides that where such amounts are paid by a local or public authority to someone so that they can purchase depreciable property, the recipient must deduct the amount of the subsidy from the depreciation base of the acquired assets.

12. The tax treatment for the customer or payer of the capital contribution depends on the person's status. In general, the person making a capital contribution will not be able to claim a tax deduction. This is because the payment is made in a private capacity or because it is considered capital expenditure. However, land developers and farmers will be able to claim a tax deduction, either at the time the land is sold (for land developers) or amortised over 12 years (for farmers).[2]

Policy issue

13. A key goal for tax policy design is to tax different forms of investment as closely as possible. To accomplish this, depreciation deductions should mirror economic cost. If depreciation deductions exceed economic cost, it will be economic for taxpayers to acquire assets that would be uneconomic for non-taxpayers to acquire. This distorts investment decisions, as it means that investments that are marginal (where the investor is indifferent between investing and not investing) before tax will not be marginal after tax.

14. The current tax treatment of capital contributions is much the same as allowing businesses to deduct the cost of capital assets too quickly. This is both inefficient and distorts behaviour. Investments that would not otherwise be worthwhile can become so because of their current tax treatment. In other words, there is effectively a tax subsidy (and fiscal cost) in respect of capital contributions.[3]

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[1] This does not apply to contributions in kind where a customer extends the network themselves and then gives the infrastructure company the resulting network asset for no consideration. In such a case the depreciation base of the new extension for the business is nil, as there was no cost to the infrastructure company. Therefore, the infrastructure company cannot claim depreciation deductions for the new extension.

[2] The amortisation deduction for farmers is a historic provision intended to provide certainty around the deductibility of farm improvement expenditure.

[3] Arguably that is not the case where the payer receives no deduction for the payment but would have been able to depreciate the asset if owned by the payer. The infrastructure company then simply receives the depreciation deduction that the payer would otherwise have qualified for. The result is economically neutral provided the payer and company have the same effective tax rate. The proposals in this paper would then introduce a tax penalty on the transition. However, the circumstances in which this is likely to arise are considered to be relatively rare.

15. There are two possible policy responses to address concerns over how capital contributions are taxed.

16. The first option is to deny excess tax deductions by reducing an asset's cost-base by the amount that it has been funded by way of capital contribution. This option produces the correct economic result, as it means deductions for the *true* cost of the asset to the business is spread over the asset's useful life. This is illustrated in an example in the attached Appendix.

17. However, while it produces the correct economic result, it may be difficult to accurately apportion the capital contribution where it relates to a number of different assets, particularly if this does not accord to the accounting treatment adopted. There is also a related risk that businesses could apportion too much of a contribution to assets with the slowest depreciation rates. This would allow them to claim deductions faster than intended.

18. The second option is to treat the capital contribution as income. This is a simple option that does not have the same practical problems as reducing the depreciation base. It is also less likely to be manipulated. However, it has the disadvantage that it is likely to result in over-taxation of the capital contribution, as illustrated in the appendix.

19. This over-taxation could be addressed by giving taxpayers the option of spreading the taxable income over a number of years if it is too difficult to alter the depreciation tax base. For example, if a business received a $100 contribution in their 2010-11 income year, they could return $10 extra income in that year, and continue to do so until their 2019-20 income year. This option would still encourage taxpayers to adopt the correct economic treatment of reducing the assets depreciation cost base, but would allow them to adopt a simpler option if this is impossible or outweighed by the associated compliance costs.

International treatment

20. There does not appear to be a consistent international treatment of capital contributions. Some countries reduce the depreciation base of assets (option one), while other countries deem them to be income (option two) but without the spreading alternative.

21. In the United States, the Internal Revenue Code provides that a grant received by a corporation that is considered to be a capital contribution is generally excluded from gross income, but in such a case no tax deduction is allowed for the expenditure that has been funded by the grant.

22. In the United Kingdom, capital contributions are generally not taxable. However, tax deductions are not allowed in respect of any expenditure that has been funded through capital contributions.

23. In Australia, subsidies received in relation to carrying on a business, such as a capital contribution, are ordinarily assessable as income. There are specific legislative provisions that recast subsidies that are capital in nature as assessable income.

24. Canadian legislation sets out that capital contributions received are taxable income. However, taxpayers are able to elect to instead reduce the depreciation base of their assets to the extent that this was funded through capital contributions.

Recommended policy response

25. On the basis of the above analysis, officials recommend a consequential amendment to the proposed tax treatment of capital contributions. Taxpayers would be given the option of spreading the capital contribution as taxable income over ten years or reducing the depreciation tax base for capital contributions made after 20 May 2010. This option is a variant of the Canadian scheme, although more generous in that it allows the spreading of income when capital contributions are treated as taxable income. This option would address concerns regarding taxpayer compliance costs but still encourage taxpayers to adopt the correct economic treatment of reducing the asset's depreciation cost base.

26. In most cases, a business payer would be allowed a tax deduction (assuming they are a land developer or farmer) for the capital contribution. However, a small number of business taxpayers may incur "black hole" (non-deductible) expenditure. Private individuals would not be entitled to a tax deduction.

Grandparenting of structures reclassified as buildings

27. The Commissioner of Inland Revenue is about to release an interpretation statement on the meaning of "building" in the tax depreciation rules that changes the tax treatment of certain investments already held by taxpayers. The types of investments affected are:

- Car park buildings;
- Milk powder drying buildings;
- Chemical works;
- Fertiliser works; and
- Barns

28. Under the interpretation statement, some items that were previously treated by Inland Revenue as structures will now fall within the meaning of building. This will change how these investments are treated under the tax depreciation rules. As buildings, they will not qualify for losses when sold or otherwise disposed of, and would not be eligible for depreciation loading. As a consequence, for assets that are buildings and not structures under the interpretation statement, post-tax rates of return would decrease, effective from the date that the interpretation statement applies.

29. Of the affected buildings, all have an estimated useful life of less than 50 years except for car park buildings. This means those assets would be allowed to depreciate regardless of whether they are considered buildings or not. Car park buildings, however, have an estimated useful life of 50 years, and so would not be allowed to depreciate (post-Budget 2010) if they were considered to be buildings.

Policy issue

30. Before 30 June 2009, Inland Revenue had treated certain structures as not being buildings for depreciation and disposal purposes. On 30 June 2009, Inland Revenue released a draft interpretation saying that those assets would be treated as buildings for tax purposes. In order to ensure continuity of tax treatment for existing investments, the Minister of Revenue agreed in policy report PAD2009/119 to amend the tax law so that the current tax treatment would continue to apply to buildings and structures affected and held before the date that the draft statement was released. The Minister of Revenue issued a press statement on 30 July 2009 to this effect.

31. Assets covered by this press statement would now be affected by changes to the tax depreciation rules as part of the tax reform package. In particular, car park buildings, no matter when acquired, would lose their allowance for tax depreciation.

32. Ministers could choose to override the earlier decision and make no allowance for the change in tax treatment as a result of the new interpretation statement. However, this is likely to have negative implications in terms of investor confidence and reliance on government press statements in the future.

33. Officials therefore recommend that Ministers confirm the earlier decision to grandparent buildings and structures affected and held before the date that the draft statement was released. This would involve changing the tax law to preserve the current tax treatment for these assets. Ministers should note that other assets affected by the changes to the tax depreciation rules as part of the tax reform package will not be grandparented because these are part of a broader tax package that includes offsetting tax rate adjustments.

34. The practical implication of agreeing to this is that the following types of structures would be treated as not being a building for tax purposes if acquired by the taxpayer before 30 June 2009:

- Car park buildings;
- Milk powder drying buildings;
- Chemical works;
- Fertiliser works; and
- Barns

35. As the treatment of car park building depreciation is immaterial and within the degree of uncertainty in the context of the overall revenue projections from removal of building depreciation, no change to the forecasts for revenue from that policy will be made regardless of this decision on grandparenting.

Commercial Building “Fitout”

36. The Commissioner of Inland Revenue has just finalised and released an interpretation statement IS10/01 concluding that that many items in a residential rental property cannot be treated as separate items of depreciable property.

37. The interpretation statement on residential rental properties sets out a three step test to determine whether something is part of a building:

a. Is the item attached or connected to the building in any way?

b. Is the item an integral component of the building, such that the building would be unable to function without it?

c. Is the item built in such that it is part of the fabric of the building? Factors to consider are the degree of attachment, difficult of removal and whether there would be damage to the building or item if it were removed.

38. If an item satisfies condition a. and either of conditions b. or c., the item is part of the building rather than being a separate asset. Otherwise it is a separate asset. The test seems to work well in the context of residential buildings, but if it is applied to commercial buildings it is likely to substantially alter the current accepted tax practice of “fitout”. Non-residential buildings are often designed as an empty shell that is fitted out for tenants’ needs. This means that the internal layout of a non-residential building is often tenant specific.

39. The combination of the interpretation statement and changes to building depreciation as part of the Budget-2010 tax package is likely to create uncertainty over whether commercial building “fitout” that is currently being depreciated as separate assets (such as lifts and internal partitions) will still be eligible for tax depreciation deductions post-Budget 2010.

40. To address taxpayer uncertainty, Ministers could announce as part of Budget-2010 the intention to review the treatment of commercial building “fitout” and if necessary amend the tax rules prior to 1 April 2011 to clarify the law. This is officials recommended response.

Consultation

41. Due to the need for Budget secrecy, and the short time frames involved in developing a tax reform package, the ability to consult in the usual manner has been severely constrained.

42. This lack of consultation is likely to result in some criticism and increase the risk of unintended consequences. The risk of unintended consequences is increased given that the new treatment for capital contributions will apply immediately to contributions made after Budget day. It is envisaged that any problems that arise would be fixed by way of urgent post-Budget legislation.

43. If Ministers agree, post Budget 2010, consultation will be undertaken in respect of the treatment of commercial building “fitout”.

Fiscal costs

44. The fiscal implications associated with amending the tax treatment of capital contributions are:

$ million (without company tax rate changes)	2010/11	2011/12	2012/13	2013/14
Denying deductions for capital contributions (recommendation (m)	5	5	5	10

45. These amounts are already included in the Budget package.

46. The fiscal implications associated with grandparenting the treatment of certain buildings are expected to be immaterial and within the margin of uncertainty of the overall revenue forecasts of the change to building depreciation and will not impact on the financial implications of the Budget package.

47. Announcing as part of Budget-2010 the intention to review the treatment of commercial building "fitout" and if necessary amend the tax rules prior to 1 April 2011 to clarify the law, will not impact on the financial implications of changes to building depreciation included in the Budget package. However, there could be a fiscal gain or loss depending on the outcome of the review.

48. If you agree to the review, we recommend the following specific fiscal risk statement be disclosed in the Budget 2010 documentation:

> **Review of Fitout of Commercial and Industrial Buildings (Unquantified fiscal risk)**
> The government has announced a review of the appropriate tax treatment for "fitouts" of commercial and industrial buildings in light of Inland Revenue's interpretation statement IS10/01 on the treatment of residential building "fitout". Depending on the outcome of that review, there could be a fiscal gain or loss over the forecast period.

Next steps

49. If Ministers agree with the recommendations in respect of capital contributions, grandparenting the treatment of certain buildings and commercial building fitout, these will be included in the Budget Legislation Cabinet Paper going to the Cabinet Business Committee on 10 May 2010.

50. Changes to the tax rules to amend the treatment of capital contributions and grandparent the treatment of certain buildings will be included in the tax bill to be introduced on Budget day.

51. Officials will draft an announcement for Budget-2010 in respect of commercial building "fitout".

Appendix

Capital contributions: numerical example

The examples below assume a 10% discount rate, 30% tax rate, and therefore a 7% after-tax discount rate.

In summary, reducing the depreciation base of an investment that has been funded by way of capital contributions produces the right result; that is, a pre-tax marginal investment is also marginal post-tax.

If there is no reduction in the depreciation base of assets funded through capital contributions, marginal pre-tax investments are above-marginal after tax. On the other hand, if capital contributions are counted as income, marginal pre-tax investments become sub-marginal post-tax.

Base case – $100 asset

A $100 depreciating asset which has straight-line economic depreciation over five years. The asset generates revenue of $30, $28, $26, $24 and $22 at the end of years 1 to 5, respectively. This asset has economic depreciation of $20 per annum. This is equivalent to contributing $100 into a bank deposit and withdrawing $30, $28, $26, $24 and $22 (i.e. interest plus $20 of principal) at the end of years one to five. The investment will be marginal on a pre-tax basis as:

$$100 = 30/1.1 + 28/1.1^2 + 26/1.1^3 + 24/1.1^4 + 22/1.1^5$$

This investment will also be marginal on an after-tax basis.

Year	1	2	3	4	5
Income	$30	$28	$26	$24	$22
Economic Depn	$20	$20	$20	$20	$20
Taxable income	$10	$8	$6	$4	$2
Tax	$3	$2.40	$1.80	$1.20	$0.60
ATCF	**$27**	**$25.60**	**$24.20**	**$22.80**	**$21.40**

The net present value of the after-tax cash flow (ATCF) is:

$$100 = 27/1.07 + 25.6/10.07^2 + 24.2/10.07^3 + 22.8/10.07^4 + 21.40/10.07^5$$

This investment is therefore also marginal on an after-tax basis.

Case 2 – Capital contribution with reduced depreciation
Now consider a business that purchases an asset that costs $300, of which $200 is funded by way of a capital contribution. In other words, the economic cost to the provider is $100. The asset produces cash flows for five years of $30, $28, $26, $24 and $24.

Again, this investment is marginal on a pre-tax basis, as the net present value of the asset's cash flow is equal to its cost, $100.

If the business is able to deduct depreciation based on the economic cost to them, i.e. $100, then this investment will also be marginal on an after-tax basis.

Year	1	2	3	4	5
Income	$30	$28	$26	$24	$22
Depreciation	$20	$20	$20	$20	$20
Taxable income	$10	$8	$6	$4	$2
Tax	$3	$2.40	$1.80	$1.20	$0.60
ATCF	**$27**	**$25.60**	**$24.20**	**$22.80**	**$21.40**

As before, the net-present value of the after-tax cash flow is $100, and hence this investment is marginal.

Case 3 – Capital contribution without reduced depreciation
If the business of *case 2* is able to deduct depreciation based on the full cost of the asset, i.e. $300, then this investment becomes much better than marginal.

Year	1	2	3	4	5
Income	$30	$28	$26	$24	$22
Depreciation	$60	$60	$60	$60	$60
Taxable income	-$30	-$32	-$34	-$36	-38
Tax	-$9	-$9.60	-$10.20	-$10.80	-$11.40
ATCF	**$39**	**$37.60**	**$36.20**	**$34.80**	**$33.40**

The net present value of this investment's after-tax cash flow is:

$$\$149.20 = 39/1.07 + 37.6/1.07^2 + 36.2/1.07^3 + 34.8/1.07^4 + 33.4/1.07^5$$

Case 4 – Capital contribution as taxable income
The final case is where, like in *case 2*, the business is able to deduct depreciation based on the full cost of the asset, *but* the $200 capital contribution is counted as taxable income. In other words, in year 1 the service provider will have a taxable income of $170 (= $30 income + $200 capital contribution - $60 depreciation).

In this case, this investment becomes sub-marginal after-tax.

Year	1	2	3	4	5
Income	$30	$28	$26	$24	$22
Depreciation	$60	$60	$60	$60	$60
Taxable income	$170	-$32	-$34	-$36	-38
Tax	$51	-$9.60	-$10.20	-$10.80	-$11.40
ATCF	**-$21**	**$37.60**	**$36.20**	**$34.80**	**$33.40**

The net present value of the after-tax cash flow is:

$$\$93.13 = -\$21/1.07 + 37.6/1.07^2 + 36.2/1.07^3 + 34.8/1.07^4 + 33.4/1.07^5$$