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By PwC Deutschland | 22. Mai 2012

Four-year carry forward for replacement reserve

The Supreme Tax Court has held that a replacement reserve for assets lost through accident should be carried forward for the same four-year period as allowed by the roll-over relief provisions.

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Traditionally, the courts and tax authorities have allowed deferment of a gain on the loss of an asset by fire or other catastrophic cause (act of God) in order to allow replacement of the asset with a similar item with the full proceeds received from the insurance company or other body offering compensation for the damage. The gain is deferred with a “replacement reserve” to be written back against the capitalised cost of the replacement asset once acquired. Future depreciation or amortisation is thus reduced accordingly. Although there is no statutory basis for this replacement reserve, the official Income Tax Guidelines accept it, setting a replacement period of two years. If the asset is not replaced within that time, the reserve must be released back to income and taxed.

The Supreme Tax Court has now held that the replacement period should follow the provisions for roll-over relief on the sale of land, buildings and boats used on inland waterways. These provisions are designed to enable a business to move or otherwise reorganise its operation without having to tax a gain on sale if the full proceeds are needed for a replacement asset. The replacement period is the four business years following the year of sale for assets purchased, extended to six years for newly constructed buildings provided construction is started by the end of the fourth year. The court pointed out that both forms of relief serve the same purpose, so there is no reason to require earlier replacement of an asset lost through act of God than of one sold. On the contrary, the act of God necessarily catches the business unprepared, whereas a sale is generally planned in advance with thought being given to the asset’s replacement before the sale is made.

The roll-over relief provisions penalise failure to utilise the gain deferral for asset replacement with a premium of 6% of the amount released back to income for each year in which the reserve was carried. The Supreme Tax Court has not extended this penalty to apply to a replacement reserve, too, but has required release of that reserve as soon as the replacement intention is dropped. Creation of the reserve is sufficient evidence of the intention in the first year and there is a presumption that the intention remains during the following four years. However, this presumption can be upset by concrete indications of a change in business planning.

Supreme Tax Court judgment IV R 4/09 of January 12, 2012 published on May 9

Schlagwörter

replacement reserve, roll-over relief provision