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Demolition provision accumulates straight-line over entire period

The Supreme Tax Court has held that a demolition provision to meet an obligation to return land to the owner in its original state at the end of the lease must be reduced as necessary to reflect the new expiry date, if the lease is extended.

A shopkeeper rented a site on a long-term lease. At the end of the lease term, he was required to demolish the building and clear the site for return to the landlord in its original, unbuilt condition. Accordingly, he accumulated a provision straight-line over the lease term expiring in 2003. In that year he agreed with the landlord to let the lease run for a further 15 years, to 2018. At year-end 2003, he discounted the provision at the satutory rate of 5.5% p.a. to the new expiry date, but otherwise made no adjustment to the amount, on the grounds that the obligation had been fully provided for over the prior periods on the basis of the facts as they then appeared. The tax office insisted on a partial release of the provision to reflect the new, extended lease term.

The Supreme Tax Court has now held that a cumulative provision must be build up in equal portions over the years up to the anticipated expense. If circumstamces change, the provision must be adjusted in the year of the change, in this case by partial release to the balance that would have accumulated, had the provision been accrued from the inception of the lease up to the new expiry date. This gross provision should then be discounted at the 5.5% statutory annual rate up to the date the obligation would have to be met. This was the new expiry date of the lease.

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