Tax Working Group
Te Awheawhe Tāke

Tax Working Group Information Release

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The advice represents the preliminary views of the Secretariat and does not necessarily represent the views of the whole Group or the Government.

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Coversheet: **Expenditure**

Position Paper for Session 21 of the Tax Working Group
26 October, 2018

Purpose of discussion

The purpose of this paper is to provide the Group with further information and analysis to assist the Group with decisions regarding the treatment of expenditure on capital assets.

It also proposes draft text for inclusion in the Final Report (Appendix A).

Key points for discussion

This paper:

a. summarises the decisions already made by the Group on the treatment of expenditure on capital assets generally;

b. provides advice on options for the treatment of feasibility and "black hole" expenditure;

c. provides advice on options for the treatment of expenditure on seismic strengthening;

d. provides further advice on options for the treatment of expenditure on buildings more generally.

Recommended actions

We recommend that you:

a. **agree** that further consideration of cash flow assumptions be referred to officials to be considered as part of the Generic Tax Policy Process.

b. **agree** to a method for dealing with feasibility/black hole expenditure.

c. **agree** to a method for dealing with expenditure on seismic strengthening, and buildings more generally.

Expenditure

Position Paper for Session 21
of the Tax Working Group

October 2018

Prepared by Inland Revenue and Treasury

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Executive summary

The purpose of this paper is to provide the Group with further information and analysis to assist the Group with decisions regarding the treatment of expenditure on capital assets.

The Group has already made a number of general decisions regarding the deductibility of expenditure on capital assets. In particular, the Group has concluded that as a general proposition, expenditure incurred in acquiring a capital asset, or on improving the asset, would be deductible from the sale proceeds at the time of sale. However, there are some more particular deductibility issues that the Group may wish to consider further, particularly in the context of creating a revenue neutral package.

The Secretariat considers that creating settings that are as neutral as possible on the capital expenditure side will be an important part in addressing business concerns with any decision to more comprehensively tax capital gains.

Inland Revenue has been working on resolving the issue of non-deductible feasibility/ black hole expenditure for a number of years. There has been significant consultation with stakeholders on this issue. A decision to extend the tax base to include more capital gains strengthens the existing case for allowing deductions for feasibility/black hole expenditure.

This paper outlines the work already completed in relation to non-deductible feasibility/black hole expenditure, and the options that have been considered. The Secretariat recommends that feasibility/black hole expenditure should be deductible, but that the deductions be spread over a period of time. Officials have suggested a period of 7 years may be appropriate. To reduce compliance costs on taxpayers, with small-to-medium sized businesses in mind, the Secretariat also considers that there should be a safe-harbour threshold to allow upfront deductions for low levels of feasibility expenditure.

The Group has specifically noted that it wants to consider the treatment of expenditure on seismic strengthening. This has also been requested by the Government. This paper sets out three options for dealing with this type of expenditure. The Secretariat recommends that the Group consider dealing with this issue by allowing costs of seismic strengthening to be added to the cost of a building and depreciated over time.

The weight of empirical evidence strongly suggests that some types of buildings do, in fact, depreciate over time, even with regular repairs and maintenance. Depreciation is a business cost, and the case for allowing a deduction for depreciation is the same as allowing deductions for other costs. Not allowing depreciation will affect incentives to invest where those decisions are marginal. On that basis, the Secretariat recommends that building depreciation be brought back for industrial, commercial, and multi-unit residential buildings.

1. Introduction

1.1 Purpose

1. The purpose of this paper is to provide the Group with further information and analysis to assist the Group with decisions regarding the treatment of expenditure on capital assets.

1.2 Content and scope

2. In Appendix B to the Group's Interim Report, the Group made a number of interim decisions regarding the treatment of expenditure on capital assets generally. This paper:

   - summarises the decisions that have already been made;
   - provides advice on options for the treatment of feasibility/black hole expenditure;
   - provides advice on options for the treatment of expenditure on seismic strengthening; and
   - provides further advice on options for the treatment of expenditure on buildings more generally.

2. Interim decisions

2.1 General decisions

3. In Appendix B to the Group's Interim Report, the Group made a number of interim decisions regarding the treatment of expenditure on capital assets generally.

4. The Group concluded that, as a general proposition, expenditure incurred in acquiring a capital asset would be deductible from the sale proceeds at the time of sale. Similarly, costs incurred subsequent to acquisition on making improvements to the asset would also be deductible from the sale proceeds.

5. The Group concluded that current law could continue to be used to identify costs that are costs of acquiring or improving an asset, versus those routine costs relating to assets that are deductible when incurred (for example, repairs and maintenance expenditure).

2.2 Land used for private purposes

Treatment of holding costs

6. The Group has concluded that all land (other than the "excluded home") will be subject to tax on sale, even if held for private purposes. The general principles above will apply to the sale of land, so that expenditure incurred in acquiring or improving land will be deductible on sale.

7. Where income is derived from the land (for example, the land is used as a rental property), costs incurred in connection with holding the land will usually be deductible when incurred. This includes costs such as interest, rates, and insurance. However, the Group has concluded that where the land is used for private purposes (for example, as a family bach), those costs will not be deductible.

8. Although improvements to land may depreciate while they are used for private purposes, the Group has concluded that no depreciation adjustment should be made. While it can be argued that there is, in principle, a case for making such an adjustment which would tend to increase tax liabilities, the Group decided to make no adjustment due to the complexity and compliance costs this would involve.

Losses

9. The Group has decided that, where land is used for private purposes, no losses can be claimed on sale on the basis they represent private consumption.

10. The Group has asked for advice on whether this approach is consistent with the treatment in other countries. Our research indicates that some countries (US, Canada) do follow this approach. In these countries, any capital gains on the sale

of private use land are taxed, but any losses that are made are disregarded. However, this approach is not taken in all countries.

11. While all countries the Secretariat looked at had rules that prevent taxpayers from utilising losses on some personal use assets (e.g. cars, boats etc), some countries (Australia, South Africa, UK) do not deny losses on personal use land. The reason for this approach is not clear.

2.3 Cash flow assumptions

12. In the case of fungible assets (for example, shares) where a holding can be acquired or disposed of in a number of transactions, identifying the cost of a particular item requires assumptions about the identity of the item sold (referred to as a "cash flow assumption").

13. In Appendix B of the interim report, the Group identified a number of cash flow assumptions, and concluded that further consideration needed to be given to which of those assumptions should be applied for the purpose of determining the cost of fungible assets if capital gains are taxed more comprehensively. The Secretariat recommends that this issue be referred to officials to be considered as part of the Generic Tax Policy Process.

3. Feasibility or black hole expenditure

3.1 Introduction

14. "Feasibility" expenditure is generally understood as expenditure incurred to determine the practicability of a new proposal. Incurring feasibility expenditure is common for a large majority of firms that are considering making an investment in a new asset, process or business model.

15. Where the taxpayer's ultimate goal is the acquisition or development of a capital asset, feasibility expenditure will not be immediately deductible (as a result of the application of the capital limitation). However, if the feasibility expenditure results in a depreciable capital asset, then the expenditure is capitalised into the cost of the asset and depreciation deductions can be taken over the life of the asset. If the asset is not depreciable, and capital gains are taxed more comprehensively, a deduction for its cost could be taken when the asset is sold in accordance with the principles discussed above.

16. However, where feasibility expenditure is incurred and no capital asset is ultimately acquired or developed, then no deduction is currently allowed. This results in what is referred to as "black hole expenditure".

> **Example**
>
> Company C, a water management company, is working on ways to meet demand in times of low-aquifer inflows and drought without having to resort to water restrictions. It is exploring the viability of desalination. The company carries out a number of studies on the practicality of building and operating a desalination plant and secondly, how water from the plant could be connected to the wider network. Work on the projects is abandoned after an assessment determines it is uneconomic, in terms of energy needs and water output, for the plant to meet forecast demand. The project is shelved pending future advances in desalination nanotechnology.
>
> Tax impact
>
> The costing and initial scoping work in developing the asset does not give rise to immediate deductions under the Income Tax Act.
>
> As the expenditure does not relate to an existing tax asset or creates a new tax asset, there is no tax deduction for the purpose of the deprecation rules in the Income Tax Act.
>
> Current result: Company C incurs black hole expenditure and receives no tax deductions.

3.2 Background

17. Inland Revenue has been working on resolving the issue of non-deductible feasibility/black hole expenditure for a number of years. Policy work was commissioned and included on the Government's tax policy work programme in response to strong private sector concerns about the possible implications on business investment following the Supreme Court's decision in *Trustpower Ltd v Commissioner of Inland Revenue*[1] (the *Trustpower* decision) in 2016. An outcome of the Supreme Court's decision was that the normal test for tax

[1] *Trustpower Ltd v Commissioner of Inland Revenue* [2016] NZSC 91.

deductibility of expenditure was more restricted than many taxpayers had previously assumed.

18. Taxpayers (particularly the large corporate and utilities sectors) consider there is a greater risk of black hole expenditure when expenditure is expected to create an asset that declines in value but does not create such an asset. In this case, the expenditure is neither immediately deductible, nor deductible over time (via the tax depreciation rules), resulting in black hole expenditure.

19. Black hole expenditure is considered a policy concern as it undermines economic efficiency. It means that the expected pre-tax rate of return of an investment that potentially involves some black hole expenditure must be higher than the expected pre-tax rate of return for a project that does not include such expenditure. Another way it can reduce economic efficiency is that businesses may be incentivised to complete projects that do not make economic sense, to avoid black hole treatment for sunk capital expenditure (as after completion, a depreciable asset will have been created).

3.3 Stakeholder views

20. Corporate taxpayers are very concerned about the practical implications of the *Trustpower* decision in that it increases the likelihood of expenditure not giving rise to tax deductions. While Inland Revenue's revised interpretation[2] in response to the *Trustpower* decision has softened some of the more harsh results that could flow from the Supreme Court's decision, there is a strong desire from the private sector for the Government to seek a legislative solution.

21. The previous Government released a discussion document on 25 May 2017 as part of Budget 2017, proposing to improve the tax treatment of feasibility and other black hole expenditure.

22. The discussion document contained proposals to:

- Allow upfront tax deductions for feasibility expenditure, as defined, by largely following accounting principles overlaid by tax principles based on the capital/revenue boundary; and
- Allow tax deductions for fully abandoned assets, to reduce the extent to which the income tax system created black hole expenditure.

23. Twenty-three submissions were received on the discussion document. A number of submissions, while supporting the policy direction of the discussion document, raised issues of concern. For example:

- **The restrictions in the proposed deduction test for feasibility expenditure were too complex and should be removed.** This suggests that taxpayers

[2] "Interpretation statement 17/01: Income tax – Deductibility of feasibility expenditure", Tax Information Bulletin, Vol 29, No. 3 (April 2017).

had an expectation that a greater class of expenditure should be immediately deductible than was envisaged by the discussion document proposal.

- **Partial write down of assets needed to be recognised for tax purposes.** The proposed tax deduction for full abandonment of assets meant that black hole expenditure could still be a persistent problem for partially impaired assets, such as network or infrastructure assets, that are not fully abandoned.
- **Alternative solution.** A few submitters suggested that the Government should consider alternative approaches, such as a version of the Australian rules which would spread feasibility expenditure over a period of years.

24. In general, the comments made in submissions supported the idea of using accounting principles to determine when expenditure could be deducted. However, accounting was not preferred when it applied to partially completed assets, as it imposes tighter tests on when assets should be written-off. Submitters identified limitations with accounting standards that would result in significant amounts of feasibility expenditure still receiving black hole treatment if the asset was unsuccessful. Instead, submitters sought specific tax rules to allow deductions for tax purposes. The need for certainty was a constant theme in all the submissions.

25. Officials carried out a second round of consultation on a revised proposal on 12 October 2017. The revised proposal relaxed the basis on which tax deductions could be claimed on partially impaired assets but suggested that the tests for upfront deductibility should be based on Inland Revenue's revised interpretation statement.

26. Feedback was generally supportive of the revised approach, but was concerned (again) with the degree of complexity with the proposal. Concerns were voiced that tax principles were too restrictive when applied to tax deductions for feasibility expenditure and (again) that the application of the revised proposal was too uncertain. Submitters recommended that officials consider developing a *de minimis* test for low levels of feasibility expenditure to reduce tax compliance costs for small-to-medium-sized businesses that incur feasibility expenditure. Others welcomed that partial impairment of assets would be recognised for tax purposes under the revised proposal. Again the main theme in the 11 submissions received by Inland Revenue was the need for certainty. A complicating factor with submissions is the diversity of fact situations that taxpayers wanted addressed.

27. Resolution of the tax treatment of feasibility expenditure is viewed by the private sector as a high priority.

3.4 Implications of the proposal to tax capital gains more comprehensively

28. A decision to extend the tax base to include more capital gains strengthens the existing case for deducting feasibility expenditure. If income is being taxed more comprehensively, this conceptually allows a degree of movement towards relaxing some of the existing limitations on tax deductibility for assets that give

rise to unexpected capital losses and otherwise result, under current policy settings, in taxpayers incurring black hole expenditure.

3.5 Analysis

29. As stated above, black hole expenditure is business expenditure that is expected to result in an economic cost to a taxpayer, but is neither immediately deductible for tax purposes, nor deductible over time. Under current policy settings capital expenditure on assets that are not expected to decline in value (e.g. land) is not black hole expenditure, despite the fact that it is not deductible immediately or over time. This is because the taxpayer does not expect to experience an economic loss when it purchases an asset that does not decline in value.

30. While assets that are not expected to decline in value sometimes do, it would only be appropriate to provide deductions for this expenditure if gains in assets that appreciated are taxed. Further, the tax system is more economically neutral if it allows deductions for unexpected capital losses, provided that it also taxes capital gains.

31. As noted above, black hole expenditure can create economic distortions as it requires projects potentially involving black hole expenditure to have a higher expected pre-tax rate of return to go ahead. It can also incentivise businesses to continue investing in a project even after it has been established the project does not make economic sense (in the absence of tax) to avoid black hole expenditure by creating a depreciable asset. In either situation, the tax system has introduced an investment distortion that lowers economic efficiency.

32. In the context of feasibility expenditure, there will be black hole expenditure where there is feasibility expenditure at or beyond the "material advancement" or "tangible progress" stage (see the revised interpretation statement), if the project is subsequently abandoned, and if the feasibility expenditure was directed at a project or asset that was expected to decline in value. If expenditure were before that stage, it may be immediately deductible. If the project is completed and the expenditure capitalised to the asset, there would be depreciation deductions provided that the asset was depreciable property that was expected to decline in value.

33. The following diagrams illustrate, in a simplified project timeline, when black hole expenditure arises in the context of feasibility expenditure under the older "commitment" test (figure 1), and the newer formulation that refers to "material advancement" or "tangible progress" (figure 2).[3] The length of time during which expenditure is subject to black hole risk is greater under the "material advancement" or "tangible progress" formulation.

[3] Ibid footnote 6.

Figure 1 – Feasibility expenditure in a project timeline – "commitment" test

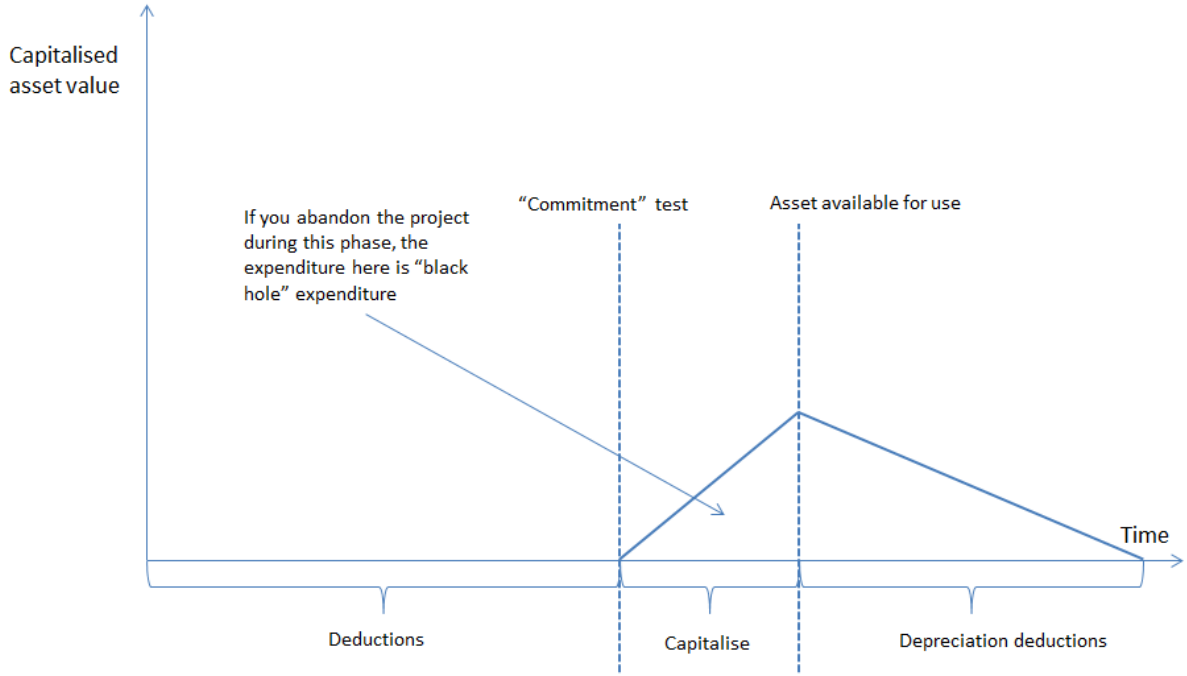
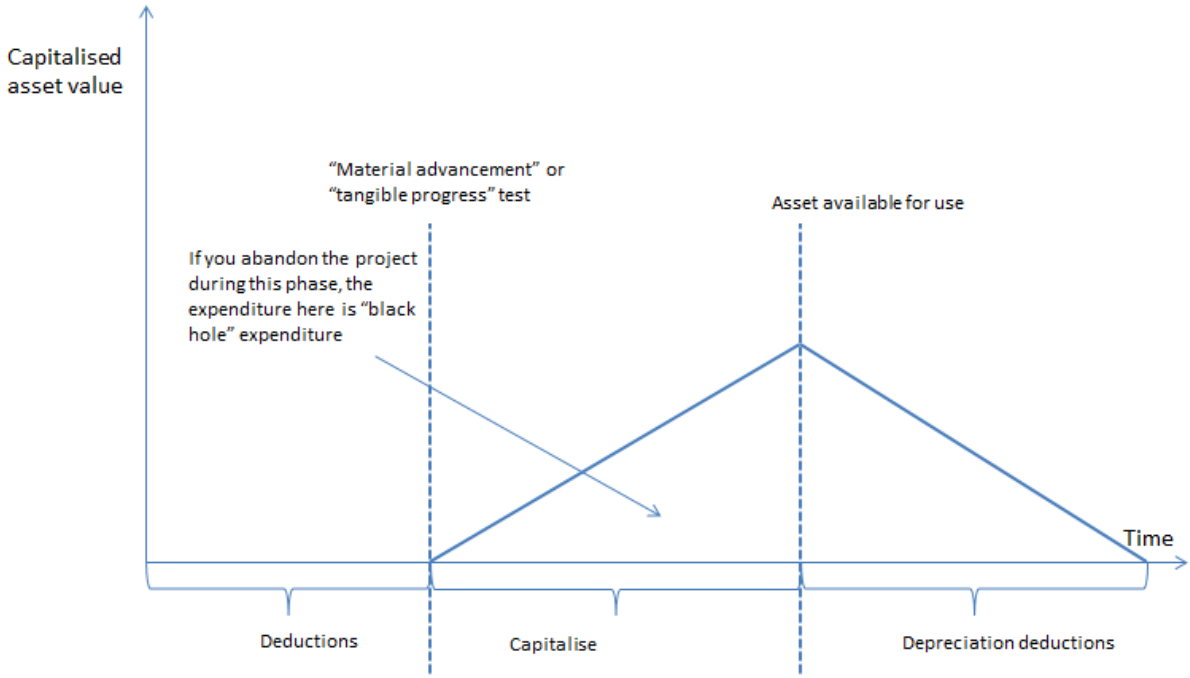


Figure 2 – Feasibility expenditure in a project timeline – "material advancement" or "tangible progress" formulation



3.6 Options

34. Over the course of the policy development process a range of options have been considered and presented for consultation. Broadly the options can be grouped as:

    - **Status quo**. Tax law would remain unchanged and tax deductions would be based on Inland Revenue's current interpretation statement.
    - **Allow up-front deductions for qualifying deductions** (not currently officials' preferred option). Deductions would be available in an income year during which an project was abandoned or fully or partially impaired if:[4]
        - the expenditure is directly related to a project, asset, or proposal that is abandoned in whole, or materially altered;
        - the expenditure is impaired (partially or fully) and expensed; and
        - the expenditure would have formed part of the cost of depreciable property (excluding buildings), had the project, asset, or proposal not been abandoned in whole, or materially altered.[5]
    - **Allow deductions to be spread over a specified period.** This change would largely adopt an approach used in Australia, whereby expenditure not otherwise deductible on uncompleted assets or projects that are expected to decline in value (if they had been completed), can be deducted and spread over a specified period. The detailed operation of this option has not been fully developed or tested with stakeholders.

3.7 Impacts

35. Stakeholders broadly agree that the status quo is not a desired state and that legislative change to the Income Tax Act is needed.

36. Initial responses by officials to solve the tax treatment of feasibility expenditure focused on complementing the existing deduction rules, the effect being that upfront tax deductions would be available for certain qualifying expenditure.

37. Stakeholders have voiced concerns over officials' approach in terms of scope, application and general uncertainty over such upfront deduction proposals. The need to blend tax principles and accounting concepts to achieve a desired outcome have been identified by stakeholders as complex and creating the risk that the legislative reform would fail to produce a satisfactory remedy. Note that

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[4] Inland Revenue's interpretation statement would determine if expenditure had been incurred on depreciable property, had the project not been abandoned. In our view, by the time "tangible progress" or "material advancement" has been made, it seems very unlikely that it would not be known whether expenditure from that point would have formed part of the cost of depreciable property. Impairment is not intended to include changes in market interest rates or other market rates of return and decrease the asset's recoverable amount materially, or market prices of commodities or other assets change such that future expected revenues from the asset are reduced.

[5] "Proposed reform: tax treatment of feasibility and black hole expenditure" consultation letter from Inland Revenue to selected stakeholders, dated 12 September 2017.

accounting concepts are restrictive on what expenditure can be expensed in the case of partial write-down of assets.

38. A range of tax administration concerns have also been identified with allowing upfront deductions and Inland Revenue and some stakeholders have suggested that spreading the deductions for such expenditure is the better policy response.

39. Officials have also reconsidered the merits of the initial proposal and consider that:

- Feasibility expenditure typically accrues to a work in progress asset account (spreading tax deductions for the expenditure recognises that they may be residual economic benefits that should be matched against future taxable income).
- Allowing upfront deductibility for unsuccessful expenditure may incentivise decisions to abandon incomplete assets earlier than would otherwise occur (in the absence of tax).
- Spreading could allow for a more simplified solution for expenditure on assets that would, assuming they had been completed, decline in value. A similar approach is applied in Australia and allows such expenditure to be spread over a 5 year period. The 5 year period used in Australia appears concessionary and a longer period could be appropriate for New Zealand. A longer period, say of 7 years, recognises:
    - possible revenue constraints in terms of what can be immediately afforded by the government during the transition period for extending the taxation of capital gains (see table on next page);
    - allowing deductions for assets that have been partially impaired, but not necessarily expensed under IFRS, is arguably more generous in effect than the equivalent Australian approach; and
    - that the proposal has application to expenditure on a wide range of abandoned or impaired assets. Seven years is therefore a rough approximation (simplification).

The Group may have its own view as to what is an appropriate time span.

Revenue implications

40. Inland Revenue does not collect information on taxpayer asset formulation and our indicative figure is based on 2017 information on private sector asset formation.

41. Officials have made a number of adjustments to the figure to:

- remove government spending on asset formulation and private sector and government spending on non-wasting assets; and

- include assumptions over behaviour factors such as the likelihood of taxpayers in loss situations and taxpayers who are deducting the expenditure already.

42. The likely revenue impact of the options currently being analysed by officials is illustrated below (Table) and assumes a 3% growth rate in expenditure. The table assumes the change would apply to new expenditure incurred on and after the introduction of the rule and would not be retrospective or retroactive in effect. The status quo is not considered.

Table: Estimated revenue impact of options under consideration

	Effect on tax revenue ($millions)				
	Year one of implementation	Year two	Year three	Year four	Year five
Upfront deductibility	(36.78)	(37.89)	(39.02)	(40.19)	(41.40)
Spread expenditure over 7 years	(5.25)	(10.82)	(16.72)	(22.97)	(29.57)
Spread expenditure over 5 years	(7.36)	(15.15)	(23.41)	(31.15)	(41.40)

3.8 Recommended proposal

43. Officials propose that the Income Tax Act provide a code to ensure taxpayer deductions for feasibility and other black hole expenditure that would have the features discussed below. The solution we are recommending is intended to meet a wide range of fact situations identified by submitters and give business taxpayers the certainty they are seeking.

Main deduction rule

44. The deduction tests in the Income Tax Act would be supplemented with a rule that would allow businesses to deduct expenditure in connection with determining the practicality or viability of a project or asset. It would not apply to expenditure which should be capitalised into the cost of the development or asset, as per Inland Revenue's existing interpretation statement, unless and until the development or asset is wholly or partially impaired.

45. Importantly, the test would not allow a deduction for expenditure on investigating the practicality or viability of developing or acquiring assets that do not decline in value or have an enduring nature, such as land or shares. These exclusions ensure that tax deductions are not available for non-depreciating assets.

46. In situations where an abandoned asset or project is subsequently restored, any corresponding tax deductions would be clawed back (returned as income) and the taxpayer would capitalise the value of those deductions. The capitalised value of

the asset would be deductible over time according to the tax depreciation rules in the Income Tax Act.

Spreading requirement

47. Earlier this year, officials' initial preference was for expenditure to be spread over 7 years. This was primarily for revenue impact reasons.

Feasibility expenditure by small-to-medium-sized businesses

48. Stakeholders noted that any proposed reform of the tax treatment of feasibility expenditure needed to have a safe harbour. A threshold of $10,000 was often suggested.

49. To reduce compliance costs on taxpayers, with small-to-medium sized businesses in mind, officials consider the final component of the proposal should include a safe-harbour threshold to allow upfront deductions for low levels of feasibility expenditure, roughly defined as "expenditure to determine the practicality of a proposal". Not all business taxpayers will maintain a work-in-progress asset account for such expenditure given it occurs in the very initial stages of project development. Officials consider an annual expenditure threshold of $10,000 is appropriate. Comparable thresholds exist elsewhere in the Income Tax Act. Such expenditure would not be subject to any claw back.

50. Expenditure greater than $10,000 in an income year should be accrued to a work-in-progress account (asset), given the probability of future economic benefits, and any tax deduction spread under the main rule discussed in this paper or the tax depreciation rules if the asset is completed.

51. Officials note that the Group is being asked to consider a range of simplification measures, including an option for raising the threshold for automatic deductions for legal fees from its current base of $10,000. The Group's decision on this matter would influence where the safe harbour decision for feasibility expenditure is ultimately set.

4. Costs relating to seismic strengthening

4.1 Introduction

52. In Appendix B of the Interim Report, the Group made the following comment about significant expenditure remediating damage to property, such as costs of remedying seismic or weather-tightness issues:

> The Group is also considering whether a person who incurs significant expenditure remediating damage to property might be treated as having partially disposed of that property, so that the person could claim a deduction for the cost of the remediation at the time it is incurred, rather than having to wait for a deduction on sale or by way of depreciation. Examples would be buildings with high seismic strengthening costs or weathertightness issues. Such costs would be included in the cost base for calculating any taxable gain or deductible loss. In many cases the magnitude of the costs is likely to lead to an overall deductible loss if the building is sold. It may be seen as problematic to require such buildings to be sold merely to access that loss.

53. This Chapter discusses options for dealing with seismic strengthening expenditure on buildings and adds to the Secretariat's earlier advice on building depreciation and seismic costs.[6] It also addresses the point raised in the letter from the Ministers of Finance and Revenue to the Group:

> The Government welcomes the Group continuing to review the issue of the tax treatment of seismic strengthening of buildings that are in the tax base, particularly residential and heritage buildings as part of its consideration in recommending a package of measures.

4.2 Options to allow deductions for seismic strengthening expenditure

54. Costs of seismic strengthening are generally capital expenditure, with the effect that no deduction is available under the current law.

55. Estimating the fiscal cost of various options for allowing deductions is difficult because of the lack of data on the costs of earthquake remediation and seismic strengthening. That lack of data applies to work already done, and to work needing to be done in the future. The best estimates (and the estimate that is used by MBIE in its advice to the Government) are that the costs to strengthen earthquake-prone buildings to 33% of the new building standard will be, in total, $3.6 billion in 2012 dollars ($4.2 billion in today's dollars). The costs to strengthen earthquake-prone buildings to 67% of the new building standard will be, in total, $16.1 billion in 2012 dollars ($18.9 billion in today's dollars).

56. It is appropriate to apply a discount to these numbers to reflect the fact that not all of the earthquake-prone buildings will be in the tax base. The cost can also be spread given that that work is likely to take place over an extended period. This allows us to make estimates of the costs of allowing deductions for seismic strengthening.

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[6] *Potential revenue-reducing options* (Position Paper for Session 14, 19-20 July 2018), Appendix C: Depreciation on Buildings.

57. It should be noted that the forecasts below are based on the estimates of the costs of strengthening a building to 33% or 67% of the new building standard. We have not been able to find any robust existing estimates of the cost to remediate all earthquake damage. Furthermore, the forecasts below do not account for any future earthquakes.

58. The forecasts below are preliminary and rely on many assumptions, some of which are difficult to justify or verify, but in the absence of any data or consultation with the wider industry, are the best we have at the moment. If the Group recommends these options the Secretariat is of the view that officials should then consult with wider industry to test the accuracy of the forecasts.

Option 1: Immediate tax deductions for expenditure to strengthen earthquake-prone buildings

59. A number of submitters have suggested that deductions for at least seismic strengthening costs might be justified on the basis that improving building safety creates a positive externality.

60. Positive externalities provide a prima facie argument in favour of the Government supporting earthquake strengthening. If the buildings of most concern were mainly owned by taxpayers for income-producing purposes, a tax concession for earthquake strengthening might be a good public policy response. Even here, however, a potential concern is that subsidies through the tax system may have quite different effects for taxpayers in different circumstances (e.g. firms that are in profit compared with firms that are in tax loss).

61. The benefits of using the tax system become more questionable the greater the proportion of buildings that are owned by non-taxpayers (as non-taxpayers do not benefit from tax deductions). In particular, much strengthening work has been carried out on heritage buildings, many of which are not owned by taxpayers but by local authorities or non-profit organisations such as churches. If the goal is to incentivise safer buildings, the income tax system will be a poor tool to do that when many owners of earthquake-prone buildings are not taxpayers.

62. The Secretariat's view is that any externalities would be better addressed in a targeted way with direct subsidies or regulation.

63. If immediate deductibility were allowed, it would be important to consider how to treat prior expenditure. Fairness would suggest allowing deductions for those who have already undertaken earthquake strengthening. Otherwise those who were quickest off the mark in responding to a need for earthquake strengthening would be disadvantaged relative to those who have not yet undertaken the strengthening. However, for expenditure that has occurred in the past, it may be difficult to ascertain what portion of the expenditure was incurred for earthquake strengthening and what portion was incurred for other purposes. Even for earthquake strengthening that is yet to be undertaken there may be difficulties in making these distinctions, as strengthening can also be carried out in the context of wider building improvements.

64. We have forecast the costs on the simplifying assumption that no earthquake strengthening has yet been done (so it all qualifies for immediate deductibility), but that the work is carried out on an even basis over a 25 year period. Obviously, the annual cost will vary depending on when most of the work is carried out. However, we anticipate that the annual costs below may overstate the costs in early years if anything, given that MBIE predicts that a lot of the strengthening is likely to occur toward the end of the legislatively required period[7]. By law, strengthening is required to occur within 15 years in Christchurch, Gisborne, Napier and Wellington, 25 years in Hamilton, Invercargill, Tauranga and Whanganui, and 35 years in Auckland and Dunedin.[8]

	Costs in each income year ($m, rounded to nearest $5m)									
	2021/ 22	**2022/ 23**	**2023/ 24**	**2024/ 25**	**2025/ 26**	**2026/ 27**	**2027/ 28**	**2028/ 29**	**2029/ 30**	**2030/ 31**
Immediate deductibility to strengthen to 33%	30	30	30	30	30	30	30	30	30	30
Immediate deductibility to strengthen to 67%	130	130	130	130	130	130	130	130	130	130

Option 2: Capitalise costs and allow depreciation on entire building

65. A second option is simply to reinstate building depreciation and allow a building owner to add the costs of any capital costs, including costs of seismic strengthening or making a building weathertight, to the tax book value of their building. These costs should be included whether they are incurred before or after the transition date. Depreciation deductions for the strengthening work, along with the rest of building's cost, would then be allowed over time.

66. This option avoids any danger of those who have undertaken earthquake strengthening in the past missing out on government support. There would be no need to separate out strengthening costs from other capital costs. This option also removes the current tax disincentive to investing in buildings.

Option 3: Capitalise seismic strengthening costs to 67% of new building standard and allow depreciation on a straight-line basis over 30 years on those costs

67. This would have a lower upfront cost to option 1, but could still allow those who have already incurred the expenditure to deduct it over time, provided taxpayers could show the expenditure was incurred on seismic strengthening. As with

[7] See p 38 the Cabinet Paper: *Additional decisions to improve the system for managing earthquake-prone buildings* at https://www.mbie.govt.nz/publications-research/publications/building-and-construction/cabinet-paper-changes-epb-redacted.pdf

[8] https://www.mbie.govt.nz/info-services/building-construction/documents-and-images-library/safety-quality-epb/copy_of_questions-and-answers-may-2016.pdf

option 1, the difficulty will be disentangling seismic strengthening from other expenditure that was incurred on the building at the same time.

	Costs in each income year ($m)									
Capitalise strengthening up to 67% of NBS and depreciate over 30 years on a straight-line basis	**2021/22**	**2022/23**	**2023/24**	**2024/25**	**2025/26**	**2026/27**	**2027/28**	**2028/29**	**2029/30**	**2030/31**
	4	9	13	17	20	24	28	31	34	38

4.3 Secretariat recommendation

68. The Secretariat recommends that seismic strengthening costs be dealt with through allowing depreciation deductions for buildings (option 2). This is because it will allow taxpayers to receive a deduction (over time) of the costs of seismic strengthening, regardless of when it was undertaken, and does not require taxpayers (or the Commissioner) to attempt to separate out seismic strengthening costs from the costs of other capital improvements occurring at the same time.

69. On this basis, the following Chapter discusses various options and the Secretariat's recommendation on building depreciation.

5. Costs relating to buildings generally

5.1 Introduction

70. In Appendix B to the Interim Report, the Group concluded that all building related costs will be deductible on sale, if they have not already been deducted by way of depreciation (recognising that buildings are not currently depreciable).

71. This chapter:

- summarises the case for allowing building depreciation; and
- analyses options for phasing in building depreciation.

5.2 Building depreciation

72. There are many reasons why buildings may depreciate (i.e. decline in value) over time. Examples include: physical damage caused by earthquakes, natural disasters and fires, or obsolescence due to increased regulatory requirements or changing consumer trends.

73. The weight of empirical evidence strongly suggests that buildings do, in fact, depreciate over time. Depreciation is a business cost, and the case for allowing a deduction for depreciation is the same as allowing deductions for other costs.

74. Suppose a firm can produce revenue of $100 by employing someone at a cost of $80. If there is a tax rate of 30% and costs are deductible, it would provide after-tax profits of $14 and it would still be a profitable activity. Suppose, however, expenses are not deductible. Then, this hiring decision would provide an after-tax loss of $10 ($100 minus $80, minus tax of $30). The hiring decision would not go ahead because the lack of a deduction for a true business expense has made the activity unprofitable on an after-tax basis.

75. In exactly the same way, if business activities involve the use of assets which fall in value, this fall in value (or economic depreciation) is part of the true cost of doing business. Not allowing deductions for these expenses can discourage firms from undertaking productive investments by increasing the hurdle rate for investments that have these expenses.

76. This tax distortion does not only impact building owners. It also impacts any business that needs to use a building and the customers of such a business, and thereby impacts New Zealand's productivity more generally.

Example

A small retail shop on Courtenay Place has become dilapidated over time. The tax rate is 30%, and the before-tax return is 10%, so the after-tax return is 7%.

The estimated cost of fixing the shop up is $300 000. The landlord asks around some property-owning friends and expects that after the work, total extra rent would be $45 000 with the landlord's other annual costs being an extra $3 500.

The landlord runs the sums and sees that without building depreciation deductions, the return after tax on

the work is only 6.7%. This is lower than 7%, which is what the owner could earn passively after the tax of 30%:

Capital costs	Additional rent	Additional costs	Expected depreciation	Taxable income (no depreciation deductions)	Tax	Profit after tax (including depreciation cost)	Return
$300 000	$45 000	$3 500	$9 000	$41 500	$12 450	$20 050	6.7%

If depreciation deductions were allowed at a rate matching expected economic depreciation, the after-tax return would be 7.6%:

Capital costs	Additional rent	Additional costs	Expected depreciation	Taxable income (with depreciation deductions)	Tax	Profit after tax (including depreciation cost)	Return
$300 000	$45 000	$3 500	$9 000	$32 500	$9 750	$22 750	7.6%

With depreciation deductions matching the economic depreciation of the building, the investment makes economic sense. To illustrate the point that this is a worthwhile investment for society to make we can look at what would happen without a tax system.

The hurdle rate would increase from 7% after-tax to 10% (as without a tax system passive investments would earn 10%).

The landlord's calculation would be as follows, providing a return of 10.83%:

Capital costs	Additional rent	Additional costs	Expected depreciation	Net income	Tax	Profit after tax	Return
$300 000	$45 000	$3 500	$9 000	$32 500	-	$32 500	10.83%

By making this investment, the property-owner has created something more valuable than the cost.

The important point (illustrated originally by Samuelson (1964)[9]) is that tax can raise money to be used for public purposes and will not disincentivise decisions to invest if deductions for economic depreciation are allowed.

77. One argument against allowing building depreciation is that buildings are fixed to land, and land tends to increase in value. Accordingly, it may seem odd to allow building depreciation when the land and building 'parcel' taken together increases in value, particularly when land is not taxed on accrual.

78. However, if deductions are not allowed for depreciation on the building component, there will be an artificial bias discouraging development of the land. The owner of a vacant block would still benefit from appreciation of the land. To provide the right incentives for developing the land, deductions need to be allowed for depreciation on any improvements if the improvements actually depreciate.

Example

Rawiri is a property developer who owns several apartment buildings and a plot of bare land.

Rawiri is optimistic and expects the bare land to increase in value by 20% per year, but wonders whether

[9] Samuelson, P.A. (1964), "The Deductibility of Economic Depreciation to Insure Invariant Valuations", Journal of Political Economy, 72(6), 604-606.

he could make even more by building an apartment complex on it.

Rawiri thinks he could build 8 entry-level apartments for about $4m in total, but would want to hold onto the land and building rather than sell it.

Noticing that apartments that are more dated seem to decline in value over time, and looking at comparable apartments in the area he comes up with the following estimates without depreciation deductions:

Capital costs	Rental income	Annual deductible costs	Expected depreciation	Taxable income (no depreciation deductions)	Tax	Profit after tax	Return
$4m	$600 000	$60 000	$120 000	$540 000	$162 000	$258 000	6.5%

While 6.5% is lower than 20%, it is still a positive return and he expects to make great money on the investment in aggregate. In total he will have invested $10m, $6m of which (the land) he expects to make 20% per year, and $4m of which he expects to make 6.5%.

But Rawiri realises that he could invest the $4m that he was going to invest in the apartment building passively and earn 7% after-tax.

If depreciation deductions were allowed at a 3% diminishing value rate, the calculation would be different again:

Capital costs	Rental income	Annual deductible costs	Expected depreciation	Taxable income (no depreciation deductions)	Tax	Profit after tax	Return
$4m	$600 000	$60 000	$120 000	$420 000	$126 000	$294 000	7.4%

The outcomes are:

Choice	Return on the $4m
Build apartment block (no depreciation deductions)	6.5%
Hold bare land, invest passively	7.0%
Build apartment block (depreciation deductions)	7.4%

The result is that even if the overall land and building "parcel" is appreciating rather than depreciating (and at a rate far above the cost of capital in the economy), the denial of depreciation deductions means that investments in buildings that would otherwise go ahead will not go ahead.

79. New Zealand is one of only three countries in the OECD that does not allow any depreciation deductions for commercial or industrial buildings. The other two countries that deny depreciation deductions are Singapore and the United Kingdom, which have corporate tax rates of 17% and 19% respectively. As a result, New Zealand's effective marginal tax rates (EMTR) on buildings are higher than any other country in the OECD:[10]

    - **44.3%** New Zealand EMTR on manufacturing plants (proxy for industrial buildings) compared to OECD average of **25.2%**; and

[10] The calculations are made using the OECD's corporate tax rates as at 2015 and assuming economic depreciation of 2.47% for office buildings, 3.14% for manufacturing plants (per the BEA study), risk-free rate of 3% and inflation at 2%. Corporate tax rate data is taken from "OECD. (2017). *Corporate Effective Tax Rates: Model Description and Results from 36 OECD and non-OECD countries* CTPA/CFA(2017)85".

- **41.5%** New Zealand EMTR on office buildings (proxy for commercial buildings) compared to the OECD average of **26.63%**.

80. In other areas where we set tax depreciation in line with economic depreciation, EMTRs are higher than 28% because of the treatment of inflation, but are below 40%. As an example, if an asset declines in value by 10% per year (declining balance method) and we provide depreciation deductions in line with that decline in value, the EMTR is 36.2%.

81. The result of different EMTRs for different assets is different cost of capital hurdle rates. For manufacturing plants the pre-tax cost of capital is 5.1% and for the asset that declines in value by 10% each year the pre-tax cost of capital is 4.7%.[11] As a consequence, we would expect New Zealand taxpayers to invest more in assets that earn 4.7% and less in assets that earn 5.1%, resulting in a loss of productivity and income to the country.

82. There are at least two ways, in principle, for reducing these EMTRs. One possibility might be to reduce the company tax rate. The second is to allow deductions for building depreciation. In principle, a first priority should be to try to ensure that the tax system is as neutral as it can be across different forms of investment. This way the tax system will do as little as is possible to bias the way that firms invest away from decisions which would be most sensible in the absence of tax. It will help ensure that capital invested in New Zealand will be invested in the most productive ways.

83. It should also be noted that one of the key reasons why the *Tax policy report: Changes to depreciation — Budget 2010* (1 March 2010) ("2010 Joint Report") recommended tighter depreciation rules than other countries was because New Zealand did not tax capital gains comprehensively. That reason may no longer apply if capital gains become more comprehensively taxed. The removal of depreciation in Budget 2010 (which raised revenue) was part of a package that also lowered the company tax rate (which lowered revenue).

84. The current depreciation regime takes no account of inflation. It provides a rough proxy for the way in which assets might depreciate if there were no inflation. That is, depreciation deductions are generally set based on an estimate of the real depreciation of an asset's value, rather than the nominal depreciation. For short-lived assets, the effect is that it taxes income close to a nominal basis. For very long-lived assets, the effect is that it comes much closer to taxing assets on a real basis.

85. In a way, this partially inflation indexes depreciable property, and does so the longer the life of the asset. This provides a reason to be wary of giving the full economic depreciation rate to buildings, as the result is that short-lived assets will be taxed on a nominal basis, and long-lived assets (like buildings) will be taxed on a real basis, resulting in different cost of capital hurdle rates.

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[11] Assuming the real interest rate is 3% and the inflation rate is 2%, in line with the assumptions from the OECD study above.

86. In the Secretariat's view, this provides a good basis for allowing building depreciation at a rate lower than true economic depreciation. We have provided estimates of the cost of 1% depreciation below, and recommend that as the most appropriate overall rate given the points about inflation above.

5.3 Options for phasing in building depreciation

87. The fiscal costs of allowing building depreciation are significant. Based on data from Statistics New Zealand on capital stock and capital formation between 1972 to 2017, and applying broadly the same costing model used by officials in 2010, the Secretariat forecasts that reinstating depreciation from 1 April 2021 would result in the following decreases in tax revenue (rounded to the nearest $5 million):

Building type	$m increase/(decrease)				
	2021/22	2022/23	2023/24	2024/25	2025/26
Industrial	(255)	(225)	(205)	(185)	(170)
Commercial	(540)	(480)	(430)	(390)	(365)
Multi-unit residential	(95)	(95)	(90)	(90)	(90)
Total	**(890)**	**(800)**	**(725)**	**(665)**	**(625)**

The forecast above has assumed that taxpayers choose to depreciate on a 3% diminishing value basis.

88. If depreciation were given on an expected nominal basis of 1% diminishing value, the cost would be:

Building type	$m increase/(decrease)				
	2021/22	2022/23	2023/24	2024/25	2025/26
Industrial	(85)	(75)	(70)	(65)	(60)
Commercial	(180)	(165)	(150)	(140)	(130)
Multi-unit residential	(30)	(30)	(30)	(30)	(30)
Total	**(295)**	**(270)**	**(250)**	**(235)**	**(220)**

89. Note that the estimates in the above tables assume that, if capital gains are taxed more comprehensively, tax deductions would be allowed for capital losses, which would reduce the fiscal cost of allowing depreciation deductions.[12]

Option 1: Reinstate building depreciation in 2025

90. One option is to reinstate building depreciation at a later date, once reasonable amounts of tax revenue start being generated by taxing capital gains more comprehensively.

[12] This is one reason why these estimates differ from those in the *Potential revenue-reducing options* paper. Another reason is because as these estimates are modelled from the 2020/21 year (instead of the 2019/20 year).

91. If depreciation were reinstated from 1 April 2025 (instead of 1 April 2021), the estimated decreases in tax revenue would be (applying the same assumptions as above, and rounded to the nearest $5 million):[13]

Building type	$m increase/(decrease)				
	2025/26	2026/27	2027/28	2028/29	2029/30
Industrial	(300)	(265)	(240)	(215)	(200)
Commercial	(635)	(565)	(505)	(460)	(425)
Multi-unit residential	(120)	(115)	(110)	(110)	(105)
Total	**(1,055)**	**(945)**	**(855)**	**(785)**	**(730)**

92. As shown in the table above, the cost of reinstating building depreciation from the 2025/26 year will be greater than reinstating it from the 2021/22 year because the country's building stock will have 'built up' in the interim years and will not have been depreciated for tax purposes over that period.

93. If building depreciation is not reinstated but capital losses are allowed, rules may be needed to ensure that taxpayers could not simply access accrued losses by selling depreciated buildings to associated persons (even if the sale is for market value).

Option 2: Reinstate depreciation for multi-unit residential buildings first, and for other buildings later

94. Evidence of the actual rates of economic depreciation are mixed, but broadly show that:

- industrial buildings depreciate the most, followed by commercial buildings (BEA, 1997; Gravelle, 2000);[14]
- residential buildings tend to depreciate at a lower rate than industrial or commercial buildings (Gravelle, 2000); and
- there is some evidence that multi-unit residential buildings (e.g. apartment blocks) depreciate at a slightly higher rate than other residential buildings, such as houses.

95. It would make sense to reinstate depreciation for buildings that depreciate the fastest, as the absence of depreciation deductions for those buildings would be creating the largest tax distortion. It would therefore make sense, if depreciation were reinstated for a certain type of building first, to reinstate it for industrial buildings first, followed by commercial buildings, and lastly for multi-unit residential buildings. However, distinguishing between industrial and commercial buildings can be difficult at margins, and most of the fiscal cost of allowing building depreciation would be for commercial buildings.

[13] Note that the paper *Potential revenue-neutral packages* outlines an illustrative package that defers depreciation to 2023.

[14] US Department of Commerce, Bureau of Economic Analysis. (1997). *Fixed Assets and Consumer Durable Goods in the United States, 1925-99*. Washington DC: US Government Printing Office; Gravelle, J. (2000). *Depreciation and the Taxation of Real Estate*. CRS Report to Congress.

5.4 Secretariat recommendation

96. The Secretariat recommends that depreciation deductions be allowed for building depreciation. This is because:

- It will allow taxpayers to receive a deduction (over time) of the costs of seismic strengthening, regardless of when it was undertaken (as discussed above); and
- The weight of evidence suggests that buildings do depreciate, and not allowing depreciation will affect incentives to invest where those decisions are marginal.

97. The Secretariat recommends that building depreciation be brought back for industrial, commercial, and multi-unit residential buildings at a 1% diminishing value basis.

6. Recommendations

98. The Group has already made a number of general decisions regarding the deductibility of expenditure on capital assets. This paper considered some particular issues that the Group may wish to consider as part of a revenue neutral package.

6.1 Feasibility/black hole expenditure

99. The Secretariat recommends that feasibility/black hole expenditure should be deductible, but that the deductions be spread over a period of time. Officials have suggested a period of 7 years may be appropriate. To reduce compliance costs on taxpayers, with small-to-medium sized businesses in mind, the Secretariat also consider that there should be a safe-harbour threshold to allow upfront deductions for low levels of feasibility expenditure.

6.2 Seismic strengthening

100. The Secretariat recommends that the Group consider providing deductions for seismic strengthening by allowing costs of seismic strengthening to be added to the cost of a building and to be depreciated over time.

6.3 Costs relating to buildings

101. The Secretariat recommends that building depreciation be brought back for industrial, commercial, and multi-unit residential buildings on a 1% diminishing value basis.

Appendix A: Suggested text for Final Report

Expenditure

General rules

1. As a general proposition, expenditure incurred in acquiring a capital asset will be deductible from the sale proceeds at the time of sale. Similarly, costs incurred subsequent to acquisition on making improvements to the asset will also be deductible from the sale proceeds.

2. Current law will continue to be used to identify costs that are costs of acquiring or improving an asset, versus those routine costs relating to assets that are deductible when incurred (for example, repairs and maintenance expenditure).

Land used for private purposes

3. All land (other than the "excluded home") will be subject to tax on sale, even if held for private purposes. The general principles above will apply to the sale of land, so that expenditure incurred in acquiring or improving land will be deductible on sale.

4. Where the land used for private purposes (for example, as a family bach), costs incurred in connection with holding the land (for example interest, rates and insurance) will not be deductible.

5. Where land is used for private purposes, no losses can be claimed on sale, on the basis they represent private consumption.

Expenditure on buildings

6. **[To be added, depending on the Group's decisions.]**

Feasibility/black hole expenditure

7. The Group understands that the Government has been working with stakeholders on proposals to address the issue of non-deductible feasibility/black hole expenditure.

8. Feasibility expenditure is expenditure that a taxpayer incurs in determining the practicability of a new proposal. Incurring feasibility expenditure is common for a large majority of firms that are considering making an investment in a new asset, process or business model. Where feasibility expenditure is incurred in acquiring or developing a depreciable capital asset, that expenditure can be capitalised and depreciated over time. However, where feasibility expenditure is incurred and no capital asset is ultimately acquired or developed, then no deduction is currently allowed. This results in what is referred to as "black hole expenditure".

Example

Company C, a water management company is working on ways to meet demand in times of low-aquifer inflows and drought without have to resort to water restrictions. It is exploring the viability of desalination. The company carries out a number of studies on the practically of building and operating a desolation plant and secondly, how water from the plant could be connected to the wider network. Work on the projects is abandoned after an assessment determines it is uneconomic, in terms of energy needs and water output, for the plant to meet forecast demand. The project is shelved pending future advances in desalination nanotechnology.

Tax impact

The costing and initial scoping work in developing the asset does not give rise to immediate deduction under the Income Tax Act.

As the expenditure does not relate to an existing tax asset or creates a new tax asset, there is no tax deduction for the purpose of the deprecation rules in the Income Tax Act.

Current result: Company C incurs black hole expenditure and receives no tax deductions.

9. A decision to tax more capital gains, in our view, strengthens the existing case for deducting feasibility expenditure. If income is being taxed more comprehensively, this makes it easier to relax limitations on tax deductibility.

10. The Group recommends the Government adopt the following approach to tax deductibility for incomplete or abandoned assets:

- A new rule to recognise deductions for expenditure incurred by businesses, not otherwise dealt with under the Income Tax Act. This rule would also apply if an asset (that would, had it been completed, otherwise decline in value) is abandoned, either fully or partially, before its completion.
- Where an abandoned asset or project is subsequently restored, any corresponding tax deductions would be clawed back (returned as income) and the taxpayer would capitalise the value of those deductions. The capitalised value of the asset would be deductible via the tax depreciation rules in the Income Tax Act.
- Expenditure would be spread over 7 years.
- To reduce compliance costs on taxpayers, with small-to-medium sized businesses in mind, there would be a safe-harbour threshold of $10,000 to allow upfront deductions for low-levels of feasibility expenditure "to determine the practicality of a proposal".