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Property Council New Zealand – Submission to the “Future of Tax” review by the Tax Working Group

Introduction

Property Council New Zealand (“Property Council”) is a member-led, not-for-profit organisation that represents the country’s commercial, industrial and retail property owners, managers, investors, and advisors. Our primary goal is the creation and retention of well designed, functional and sustainably built urban environments that contribute to New Zealand’s overall prosperity.

Property Council supports the formulation and implementation of a statutory and regulatory framework that enhances economic growth and development. To achieve these goals, our advocacy and research focus on urban strategy, infrastructure, regulation and compliance, legislation and capital markets.

Over the years, Property Council has built and maintained a good rapport with central and local government agencies and is often relied upon for advice, comments and feedback on matters of local, regional and national importance. Our members drive economic and social growth – they are the infrastructure that houses the residential and commercial property sectors.

General comments and summary

Property Council is pleased to provide input into the “Future of Tax” review by the Tax Working Group. We agree that the tax system plays a vital part in supporting the wellbeing of all New Zealanders and it is important that it functions fairly, efficiently and is sustainable (both politically over time and in raising the required amount of revenue to fund government spending).

Simplicity

As an overarching comment, Property Council believes that it is highly desirable for New Zealand’s tax system to be as simple as possible for those participating in it to understand and comply with. We believe that the current system, in the main, achieves this objective. Therefore, when considering different reform options (and sets of tax polices), Property Council strongly urges this objective to be kept in mind.

Fairness and current inconsistencies

On the issue of fairness of the current tax system, we note that this appears to have become shorthand for “does New Zealand need a capital gains tax”? While we have considered whether New Zealand should implement a general capital gains tax (as well as certain other tax base broadening options), we are concerned that this has obscured other tax distortions and inconsistencies in the current system.

A key tax distortion, which disproportionately impacts Property Council’s members, was the 2010 removal of tax depreciation on non-residential building structures. That change has resulted in real economic costs for building owners, as there is no tax recognition for economic depreciation on building structure, unlike every other business asset, or for the cost of required capital upgrades – for example, to earthquake strengthen building structures to prevent loss of life or incorporate new building technologies.

In relation to the former, it is only since the devastating events in Christchurch that this serious and fundamental tax anomaly, which Inland Revenue officials have conceded exists with the removal of depreciation for the building structure, has come to light. It is therefore deeply concerning that, on present track, it continues to be ignored. Continuing failure to address this anomaly acts as a tax disincentive to earthquake strengthening and prolongs the uncertainty for property owners who are already incurring costs in the expectation of a future legislative fix, while making any fix increasingly retrospective so as to deal with past expenditure. Put simply, it is untenable that commercial property owners can currently claim a tax deduction for a building that collapses as a result of an earthquake (and maybe kills people) but tax law does not take into account the costs of strengthening a building so that it does not collapse (and saves lives).

More generally earthquake non-performance of current building stock clearly illustrates that building structures do face obsolescence over time. This is driven by both improvements in building standards but also increased expectations from tenants around health and safety (which will often exceed the minimum standards).

Similarly, demand for new building technologies and innovations, particularly “green” building technologies, mean that older stock faces technological obsolesce that requires a substantial outlay to remedy. Without such investment, the capital value of such buildings will be negatively impacted, as tenant demand is reduced. With the Prime Minister publicly stating that “climate change” is the nuclear issue of her generation, the demand for greater environmental sustainability in building design will only grow.

The tax system unfortunately does not provide any tax recognition for this additional cost, which contributes to New Zealand’s overall public good. In fact, the current system actively discourages further investment in building structures that enhance the public good by improving building safety and utility.

The 2010 changes have also, in Property Council’s view, resulted in unnecessary boundaries (such as what is “fit-out” and the building structure and what is feasibility expenditure and not) which have added to administrative and compliance costs. In our view, this has eroded the coherence of the tax system, as well as resulting in unfairness for commercial property owners in particular.

Finally, Property Council believes the 2010 tax change was largely the result of a fiscal balancing exercise by the then Government, rather than for principled tax policy reasons as non-residential building structures clearly do depreciate due to obsolescence and other factors. Therefore, we strongly urge the Tax Working Group to reconsider this current tax policy setting of no tax depreciation for non-residential building structures.

To be clear, this recommendation would not provide landlords with a tax incentive. It is simply about reflecting the true economic cost from technical obsolescence, for tax purposes, similar to any other business asset.

Other tax bases – capital gains tax, land taxes and stamp duties

One of the questions posed in the submissions background document is whether New Zealand needs additional tax bases, including to improve fairness in the system.

In principle, Property Council agrees that a comprehensive capital gains tax would improve fairness in the tax system. Our concern (borne out by international experience) is that real world capital gains taxes tend to be sub-optimal, both in terms of their coverage and ability to be a viable and stable revenue source.

At the outset, the consideration of a capital gains tax by the Tax Working Group is hamstrung by it not being able to be applied to the family home. This is the most tax advantaged asset, per the Tax Working Group's own analysis in its submissions background document. This is particularly relevant as one of the key questions asked is whether a capital gains tax would improve housing affordability. Property Council would like to draw a clear distinction between the residential property market and the non-residential (i.e. commercial, industrial and retail) property sector, which our members are engaged in. Addressing the housing affordability objective for the former should not result in a general application of any solution to the latter. This was unfortunately the experience with the 2010 tax changes and we strongly urge the Tax Working Group to take note to avoid a re-occurrence.

The practical design issues with a capital gains tax also cannot be extricated from whether a capital gains tax is an appropriate tax reform. In Property Council's view, key design issues that would need to be resolved are:

- over-taxation due to a capital gains tax taxing inflationary gains (particularly relevant for long-lived assets, such as property):
- double taxation of shares (in the absence of imputation or similar, to offer relief);
- integration with the current Portfolio Investment Tax regime;
- reinvestment of capital proceeds triggering tax labilities (which will be the case in the absence of any "rollover relief" in these circumstances); and
- potential ring fencing of capital losses (while this is the approach with offshore regimes, this will add to complexity and the unfairness).

Property Council does not consider that the trade-offs that would be required to make a general capital gains tax workable justify the fairness objective, which would be incremental at best in our view, or the alternative tax base objective. However, we acknowledge that this will be a balancing exercise for policy makers. Therefore, if a capital gains tax is considered necessary, on balance, to address fairness or other concerns, then its workability is paramount. The key design issues identified above should be clearly addressed.

Property Council has also considered other tax base broadening options, such as a land tax or stamp duties. Both of these suffer from similar drawbacks to a capital gains tax that excludes the family home (and the land below it) from the base. They have the added distortion that they would apply to only a single asset class – non-residential land or property – which raises significant fairness concerns. Property Council therefore does not support the introduction of either tax type.

Taxation of savings

The other area we have focussed on, in our submission, is the current taxation of savings. Property Council members include both NZX-listed and unlisted property vehicles. These give a range of New Zealanders (from institutional investors, such as Kiwi Saver funds, to super annuitants to ordinary "mums" and "dads") exposure to an asset class that they would not otherwise have access to. It should be noted that many investors, including retirees, typically favour NZ commercial property investment as it provides a relatively low-risk return and a regular income stream (rather than for capital returns, which can be volatile). This is important both for the diversification of their financial risk and New Zealand's macroeconomic risk from over exposure to housing.

We agree with comments in the submissions background document that the current differential tax treatment of different savings should be made more consistent. Property Council strongly supports the current Portfolio Investment Entity ("PIE") tax regime, in that regard, recognising that this was an attempt at the time to level the tax playing field. We note that the 2012 Savings Working Group concluded that this change did not go far enough. Property Council would support further changes aimed at improving the consistency in the taxation of different savings.

Tax Working Group objectives

Property Council fully supports the objectives the Tax Working Group has been asked to consider for the New Zealand tax system, including a tax system that promotes long-term sustainability and productivity of the economy, and treats all income and assets in a fair, balanced and efficient matter.

Housing affordability objective

We note that a specific focus of the Tax Working Group's terms of reference include the tax treatment of residential property, specifically, in the context of housing affordability.

The Tax Working Group's analysis (illustrated in Figure 21 of the submissions background document) also suggests that owner occupied housing and, to a lesser extent, rental housing appear to be tax advantaged relative to other types of savings, including PIE investments. We note that a number of Property Council members operate PIEs and comment later on about the importance of the PIE regime in helping to alleviate current taxation distortions.

Property Council does not have a view on whether the current tax treatment of residential property is adversely impacting on New Zealanders' access to affordable housing. For example, Property Council has not attempted to analyse whether there is a role for a narrowly targeted capital gains tax aimed at improving housing affordability. As that stated objective is not fairness or revenue-based, a capital gains tax that applies only to residential housing may or may not achieve that objective. Similarly, whether a land tax may be effective in reducing "banking" of residential land has not been analysed.

Property Council members provide critical infrastructure for "NZ Inc"

Property Council members own and/or operate predominantly non-residential buildings (office, retail, other commercial and industrial real-estate).

It is important that the dynamics impacting the residential property market are distinguished from those impacting non-residential property, which are business assets. While we are hesitant to use the distinction, Property Council members' assets comprise the productive sector, providing the infrastructure that supports a range of New Zealand businesses ("NZ Inc").

The reason we raise this is that past tax reforms have tended, for largely opportunistic reasons (discussed in detail later on), to conflate all land and property as being of the same type. This has resulted in non-residential property owners disproportionately, and in Property Council's view unfairly, bearing the cost of those reforms. We therefore urge the Tax Working Group to be objective in its analysis and bifurcate the issues facing the housing market (which it has specifically been asked to look at) from the wider commercial property market, which includes non-residential land and buildings.

Property Council and its members are therefore keen to ensure that any tax proposals that, for example, may be aimed at improving housing affordability, do not cause collateral economic damage to the non-residential property sector, which forms the backbone of NZ business.

Frameworks

Property Council acknowledges the challenges, risk and opportunities facing New Zealand identified in the submissions background document.

These include the impact of changing demographics, the nature of work, technological change, environmental challenges and concerns about inequality. While our submission does not directly address the impact of these issues on the tax system, our members play a vital role in providing the key physical infrastructure affecting the lives of all New Zealanders, be it where the work, study, shop, play or invest. Therefore, a number of these developments (be it changing work styles, greater focus on environmental sustainability, or social interaction) will directly impact the types of buildings and related infrastructure that New Zealanders (and the Government) will demand in future.

Property Council strongly supports tools like the New Zealand Treasury's Living Standards Framework in helping to analyse the trade-offs from different public policy settings, including tax policy. In particular, the acknowledgement that all public policy, including the tax system, is ultimately aimed at improving the wellbeing of New Zealanders, which is wider than just financial outcomes, but also encompasses more holistic concepts, such as New Zealanders mental and physical wellbeing (e.g. safety), a clean environment, and social trust and cohesion (through trust in and between communities, institutions and a strong rule of law). Property Council acknowledges wellbeing, applying these wide factors, can be difficult to measure quantitatively, but agree that their impact should be considered qualitatively.

We have outlined below two examples of how our members are responding to and, in some cases, driving these wider changes/challenges in their developments.

Earthquake strengthening to address structural obsolescence

Following the events of Christchurch in 2011/12, which tragically led to loss of life, and more recently the earthquakes in the Kaikoura/greater Wellington region, resulting in business disruption (which in some cases is still ongoing) there has been a strong drive to upgrade (i.e. earthquake strengthen) building structures. This is needed to address both actual and perceived public safety concerns around building structure performance and potential for injury and loss of life during earthquakes (and other natural disasters). This illustrates, in a very real sense, the obsolescence of building structures, counter to the view that non-residential building structures do not depreciate.

The retrofitting required to an existing building will often exceed the regulated new building standard, even accounting for upgrades to this minimum requirement following the Christchurch earthquakes. For example, in the case of the Recovery Plan for Christchurch, building owners were actively encouraged to exceed the code requirements for new buildings and when retrofitting existing buildings.

In Property Council members' experience, tenants are reluctant to renew existing, or enter new, leases unless buildings are retrofitted significantly above the new build standard. This is understandable given recent events and their consequences. At the same time, the ability to reflect these costs in rental returns is extremely limited. This economic cost is exacerbated by the tax system not providing any tax relief for these upgrade costs.

This results in the perverse result that property owners can currently claim a tax deduction for a building that collapses as a result of an earthquake (and potentially kills people) but tax law does not take into account the costs of strengthening a building so that it does not collapse (and saves lives).

Property Council members take their obligations as landlords extremely seriously. No one wants to see injury or loss of life. The concern is that while there is a clear public good to earthquake strengthening (and to above the minimum regulated standards), the tax system penalises building owners from actively doing so.

Driving innovation through "green" building innovations and technologies

"[Climate change] is my generation's nuclear-free moment, and I am determined that we will tackle it head on"

Prime Minister Jacinda Ardern, Labour Party 2017 election campaign launch

There is a clear imperative for building owners to innovate in constructing more environmentally sustainable ("green") buildings. This is typically driven by tenant demand, and the New Zealand Government is a key force in this regard. These developments reflect both societal and Government expectations about New Zealand's future economic development needing to be more environmentally sustainable.

This is not simply a case of being better for the environment, but also more cost efficient for building users (through more efficient use of lighting, heating and space and better amenities for habitants) and ultimately for all New Zealanders. The trend for "green" buildings again demonstrates that existing building structures, without green technologies and innovations, will become obsolete as tenant demand falls.

Again, there is both a private and public good element to such building innovation which isn't appropriately reflected in the return to building owners. And again, Property Council believes that the current tax system plays a role in increasing the overall economic cost by not providing appropriate tax recognition or relief for these additional costs.

Applying the Living Standards Framework

In Property Council's view, the application of the Living Standards Framework strongly supports the development of safe, healthy and environmentally friendly buildings and structures. This is because they improve the wellbeing of New Zealanders, not just financially but more holistically. This touches on all Four Capitals of the Living Standards Framework:

- *Natural capital* – by improving the quality of the natural environment, through buildings and structures that are efficient in their energy use and that promote a lower carbon footprint (helping New Zealand to meet its international climate change obligations).

- *Human capital* – by enabling inhabitants (be it when they are at work, at school, or during recreation) to have peace of mind that the buildings they are occupying (in many cases for a large part of their day and lives) are safe and secure.

- *Social capital* – buildings, unlike any other assets, are spaces for community engagement. Having confidence that the building structure is safe and environmentally sound improves not only connections between people (occupiers) but also trust in the "system" (i.e. that the Government and landlords are concerned for the common good).

- *Physical capital* – having buildings that are resilient and economically efficient is ultimately good for "NZ Inc". It allows Government to manage its risk, from not having to underwrite significant building non-performance in a natural disaster or fund this from existing fiscal baselines or borrowing. Similarly, business (from not having significant business disruption, which will impact their profitability and sustainability) is able to manage its risks. The business disruption as a result of the recent Kaikoura/greater Wellington earthquakes is an example of the potential economic risk. Accordingly, more resilient building stock should have a positive overall impact on NZ's GDP and economic growth. It enables all New Zealanders to better cope with economic shocks as a result of unforeseen events.

Property Council is not suggesting that the types of building expenditure outlined above are deserving of special tax treatment, although the Living Standards Framework would appear to support the case for such.

Instead, the key point is that the tax policy framework should not create disincentives and distortions which actively discourages additional investment in building structures that enhance the public good by improving building safety and utility.

Applying the traditional tax policy evaluation frameworks

Property Council believes that the above conclusion is clear whether the Living Standard Framework, or more conventional criteria, is applied for considering the costs and benefits of a tax policy. That is, if the traditional efficiency, equity, revenue integrity/adequacy, compliance/administrative cost, and coherence axioms are applied.

Economic efficiency

A tax system that does not reflect the economic deprecation of business assets will not be efficient, as it economically distorts investment away from those types of assets (to less productive, but nevertheless more tax-effective, ones). At the margin, it also means that expenditure that would otherwise be incurred may not be because of the taxation cost. I.e. a non-marginal pre-tax investment becomes marginal post-tax. This is clearly not optimal from a "NZ Inc" perspective.

Equity

From a fairness perspective, again using depreciation as an example, there is no equity argument for treating different business assets differently. (In fact, the Tax Working Group's objective is to ensure that all assets are treated fairly.) Property Council is aware of the argument that non-taxation of capital gains provides some support for not allowing depreciation on buildings. However, to apply this argument selectively to one asset class and not others is specious. The argument itself is flawed as other tax regimes operate tax depreciation/amortisation regimes alongside capital gain taxes.

Integrity, compliance and administration costs

Property Council is also concerned about the integrity of such a tax system, as it incentivises behaviours which are also not optimal from an administration or compliance viewpoint. An example is reclassification of otherwise capital (i.e. non-tax deductible) expenditure to revenue (deductible) expenses. This imposes both costs on Inland Revenue, from policing this boundary, and on taxpayers from seeking complex apportionments and advice to justify claims made.

We outline below two examples to illustrate:

Prior to removal of tax depreciation on buildings, many Property Council members simply depreciated "fit-out" items at the building rate. Post that change, additional measures (including a legislative definition of "fit out") needed to be introduced to prevent, as Inland Revenue perceived it, re-characterisation of the building structure into still depreciable fit-out. That change, in Property

Council's view, reduced the integrity of the system as it introduced a new boundary which would never have existed in its absence.

A similar issue arises in respect of the deductibility of "feasibility expenditure"[1]. At present, where the expenditure is incurred as part of a project to construct or acquire a building, its non-deductibility (if it is not preliminary enough in the decision making process to be a revenue expense or materially advances a particular project) makes a permanent difference to the tax treatment. Previously, if required to be capitalised, the cost while not immediately deductible would nevertheless have been able to be depreciated over time.

Coherence

As a matter of principle, Property Council believes that a coherent system should not have material differences in the taxation treatment of different asset classes. However, there is a difference between real and perceived coherence.

We use the oft-touted lack of a capital gains tax to illustrate this. As members of the Tax Working Group would be aware, a common misconception is that absence of a capital gains tax means that all such gains are tax-free. This is simply not the case, due to specific provisions in the Income Tax Act which re-characterise capital gains as ordinary income in a number of circumstances. Many Property Council members, for example, will be acutely aware of New Zealand's extensive rules for taxing certain land-based activities. More recently, the "bright-line" provision taxes residential investment property held for less than (previously two and now five) years. And as the terms of reference clearly point out, any form of taxation of the family home or the land sitting below it is outside the scope of the Tax Working Group's consideration. In these circumstances, to what extent is the introduction of a general capital gains tax merely a case of "virtue signalling", rather than a substantive reform. While this may increase perceived coherence, it is not clear that this will actually improve the system overall? Our submission considers the various practical issues of a capital gains tax in greater detail later on as that, in our view, directly affects its desirability.

Current tax disincentives

The key tax distortion the Property Council would like to highlight is the current tax depreciation treatment of building structures.

By way of background, the previous Government removed tax depreciation on all building structures, from the 2011/12 income year. This was part of its implementation of the 2010 Victoria University Tax Working Group's (the "2010 Tax Working Group") reform recommendations.

However, the specific recommendation of the 2010 Tax Working Group was:

> *Removing tax depreciation on buildings (or certain categories of buildings)* ***<u>if empirical evidence demonstrates that they do not depreciate in value over time.</u>***

(Emphasis added)

At the time, Property Council engaged KPMG to carry out a detailed analysis of whether non-residential building structures depreciate (a copy of which is attached as an appendix to this submission). That included a detailed review of the international evidence, including various

[1] This follows a NZ Supreme Court decision which narrowed the definition of (deductible) "feasibility expenditure", which is not a legislatively defined concept.

economic studies, and consideration of relevant qualitative factors (such as the impact on valuations of new building innovations including "green" technologies, changing occupant preferences, and technical obsolescence as evidenced by changes to building codes). The KPMG report concluded that international evidence (as well as Inland Revenue's own analysis in 2004) overwhelmingly suggested that non-residential building structures did depreciate in value. These factors have been supplemented by the evidence of structural obsolescence following the Christchurch and Wellington/Kaikoura earthquakes, which is discussed in greater detail below. The KPMG report also highlighted that New Zealand would be an outlier internationally from removing tax depreciation on the building structure.

Property Council also engaged with Inland Revenue and Treasury Officials, at the time, to provide New Zealand empirical evidence on commercial and industrial buildings, in support of the KPMG report findings.

Technical obsolescence

The technical obsolescence of building structures can be demonstrated by the need for a number of Property Council members to recently undertake significant seismic strengthening projects to ensure the continued economic viability of building assets.

By way of an actual example, one of our members experienced first-hand the impact of structural obsolescence in relation to a commercial property located in Palmerston North. The property was assessed at 1-10% of the New Building Standard following the Canterbury earthquakes, with the tenant immediately vacating resulting in a $300,000 per annum rental stream void, and a write-down in the building value of $1.2 million. In order for the tenant to re-occupy, our member had to engage in a 15-month $1.5 million upgrade of the building structure. No tax recognition was able to be claimed for any of these costs and the costs did not increase the value of the property above its pre-seismic assessment value. There are numerous other public examples of commercial property owners having to undertake significant capital projects, and incur millions of dollars in costs, simply to maintain the capital value of their properties.

While the previous approach to Officials was not successful, we understand, at least anecdotally, that the rationale for removing non-residential building structure depreciation was due to political/fiscal considerations. That is, it was necessary to partly fund the previous Government's Budget 2010 company and personal tax changes[2].

In Property Council's view, the 2011/12 removal of tax depreciation for non-residential building structures was therefore not a principled tax change. Building structures do depreciate. As a key objective of the current Tax Working Group is to consider fairness in the tax system, the removal of tax depreciation is explicitly counter to that objective.

A further consequence of removing tax depreciation on building structures is that no tax recognition is given for landlords when faced with the decision of whether to upgrade their buildings for new structural standards (that is, earthquake strengthening). The Inland Revenue's view is that earthquake strengthening expenditure is a capital expense[3]. This imposes all of the cost on building

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[2] Removal of building tax depreciation was estimated to result in a fiscal saving of over $1b, of which non-residential buildings comprised more than half.

[3] This is despite strong arguments that the effect of earthquake strengthening expenditure is to bring a building to a condition where it can safely be occupied (i.e. back to its original income earning condition), rather than improving the building. This is borne out by the market value of buildings considered to be at risk

owners. The capital commitment to upgrade will in the majority of cases be uneconomic, as there will be little to no financial return on the capital outlaid (i.e. it will typically not result in a higher rental stream over time) as evidenced by the example above. Financing the upgrade cost may also be an issue. This is notwithstanding there being strong public good reasons for encouraging this expenditure, let alone tax fairness considerations.

Recommendation: Property Council urges the Tax Working Group to recommend the reinstatement of tax depreciation for non-residential building structures.

To be clear, this recommendation would not provide landlords with a tax incentive. It is simply about reflecting the true economic cost from technical obsolescence, for tax purposes, similar to any other business asset. Therefore, reinstating tax depreciation for non-residential building structures would not be inconsistent with other reform options the Tax Working Group has been asked to consider, including a capital gains tax.

Responses to specific questions in the Tax Working Group's submissions background document

We attempt to address below some of the Tax Working Group's specific questions in its submissions background document. Please note that we have not attempted to answer all of the Tax Working Group's questions. While these are important and relevant, we do not confess to be experts in all matters referred to in the submissions background document.

Therefore, Property Council has limited its submissions to those areas where it is in a position to offer informed comment. Also, being a member-driven organisation, we are also cognisant of the need to highlight those issues which will directly affect our constituents and their investors, many of whom are ordinary New Zealanders.

Question 1: Should New Zealand introduce a capital gains tax (that excludes the land under the family home)? If so, what features should it have?

Property Council accepts that there is a strong equity (fairness) rationale for the introduction of a comprehensive capital gains tax in New Zealand. This is not a controversial statement. Most of the economic literature would support the inclusion of a capital gains tax, within a modern broad-based tax system. (We note there is an open question about relative taxation rates on capital and labour, from a tax efficiency perspective. However, that discussion is typically around the overall level of taxation of capital and labour, not the relative bases.)

2001 and 2010 Tax Review findings

Where the theoretically sound argument for a capital gains tax becomes problematic is the inevitable real-world overlay. We note that this is the challenge that confronted both the McLeod Tax Review in 2001 and the 2010 Tax Working Group.

The McLeod Tax Review's conclusion in its final report of October 2001[4] was:

> *3.14 Nothing we have received by way of submissions has altered our view expressed in the Issues Paper that **New Zealand should not adopt a general realisation-based capital gains tax.** We believe that such a tax would not necessarily make our tax system fairer and more efficient, would not lower tax avoidance and would not raise substantial revenue that*

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from a life safety perspective, in the event of an earthquake, being significantly reduced. Earthquake strengthening is required to simply maintain market values.

[4] https://treasury.govt.nz/sites/default/files/2007-11/taxreview2001-report.pdf

could be used to lower tax rates. Instead, any such tax would be more likely to increase the complexity and costs of our system. The experience of other countries (such as Australia, the UK and the US) supports that conclusion

(Emphasis added)

For completeness, we note that the McLeod Tax Review recommended that the tax system should address savings tax distortions. We note the subsequent PIE and Fair Dividend Rate taxation changes in 2007, the latter being based on the McLeod Tax Review's Risk Free Return methodology, were an attempt to address some of the savings tax distortions.

The 2010 Tax Working Group reached a broadly similar conclusion, albeit framed in the context of practical implementation issues with a capital gains tax, in its January 2010 Final Report – *A Tax System for New Zealand's Future*[5].

The most comprehensive option for base-broadening, with respect to the taxation of capital, is for New Zealand to introduce a comprehensive capital gains tax. While the comprehensive nature of this option is seen as attractive and therefore its introduction is supported by some, ***<u>most members of the TWG are concerned about the practical challenges and efficiency implications of introducing a CGT</u>****. These issues include the lock-in effects that can result from a realised CGT and the inherent complexity of a CGT.*

(Emphasis added)

Design issues with a capital gains tax

We discuss some of the practical challenges with implementing a capital gains tax below, as the case (or not) for such a tax cannot be separated from its design.

Tax base

Economists' version of a capital gains tax is one that is comprehensive. It applies to all asset classes. However, the Tax Working Group's terms of reference specifically excludes the family home and the land below it (which we refer to in this submission for ease of reference as "owner occupied housing"). The 2001 McLeod Tax Review initially suggested a form of capital taxation of owner occupied housing, but its final report steered well clear of this. The 2010 Tax Working Group, in its considerations, noted that a capital gains tax on owner occupied housing was not politically sustainable. This was another reason for its rejection of a capital gains tax[6].

These practicalities are also illustrated by the Labour Party's capital gains tax proposal at the time of the 2011 and 2014 general elections, which excluded the family home, personal assets and collectibles, and certain small business assets. While this is not to suggest that those assets should be excluded, it highlights the political realities and likely lobbying for further exclusions. The issue that poses is the risk that the actual base of assets on which a potential capital gains tax can be applied will be significantly reduced. This is the real-world capital gains tax: a relatively narrow tax

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[5] https://www.victoria.ac.nz/sacl/centres-and-institutes/cagtr/pdf/tax-report-website.pdf

[6] *A key concern with a CGT is the treatment of owner-occupied housing. If comprehensive base broadening is pursued through the introduction of a CGT, then in principle owner-occupied housing should be within the CGT base. However, the Group recognises that this is unlikely to be the case as evidenced by the exemptions which operate in other jurisdictions.* ***<u>Introducing a CGT that excludes owner-occupied housing would create a new bias in the tax system.</u>*** (At page 67 of the 2010 Tax Working Group Final Report.)

base. This is consistent with international evidence that capital gains taxes simply do not raise significant amounts of revenue.

Realisation basis for taxation

The economists' version of a capital gains tax also supports taxing gains on an accrual (i.e. unrealised) basis. This is to address the so-called "lock-in" effect, which incentivises deferral of capital gains that are taxed on realisation.

However, Property Council is not aware of any country that has an accruals based capital gains tax. (Ironically, New Zealand's financial arrangements rules and Foreign Investment Fund regime comes the closest to replicating such a tax.) For practical reasons, therefore, a realised based tax is the norm.

At a practical level, it is not clear how a realised capital gains tax could be made to work for multi-rate PIEs, including unlisted property owning investment vehicles and KiwiSaver funds. These are a not insubstantial part of the NZ savings landscape. Multi-rate PIEs are required to attribute their income to investors on a "real time" basis. These entities currently do not have to worry about realisation based taxes but would under a realised capital gains tax. This is one of the many operational issues that would need to be resolved and the answer is not simply to levy tax on an unrealised basis in these circumstances.

Other design issues

There are a number of other practical aspects of a capital gains tax and its application that are of concern to Property Council.

— A capital gains tax will tax both real and nominal (inflationary) gains, unless indexed. For assets that are held for the long term, such as land and buildings, the effective tax rate can be expected to be significant due to taxation of inflationary gains. This will be the case even with relatively low levels of inflation. Therefore, for a capital gains tax to be fair, it should tax the non-inflationary real gain, if any. However, this adds a layer of complexity which is why a number of countries with capital gains taxes either do not index at all (which is unfair) or apply differential (i.e. discounted) tax rates as a form of inflation adjustment. This discounting itself creates potential distortions. (For example, what is the correct discount rate?)

— Property Council Submits there will be double taxation if a capital gains tax applies to shares in the absence of an equivalent to the imputation regime or a "final tax" (e.g. PIE-like) regime for capital gains. A number of Property Council members are NZX-listed entities, whose shares are traded regularly, and whose shareholders would be adversely impacted if a capital gains tax that applied to disposal of the entity's underlying property assets was not creditable at the investor level. Again, this raises questions of fairness, but the trade-off for solving it is additional administrative complexity and compliance costs for shareholders.

— The submissions background document asks whether there should be "rollover" relief from a capital gains tax, if the gains are reinvested in similar assets. Property Council submits that, if a capital gains tax is recommended by the Tax Working Group, there needs to be rollover relief if the capital gain amount is not distributed to investors. Economically, that capital gain has not been realised for the benefit of investors/shareholders and should not be taxed at that point. This is particularly important if a mechanism to alleviate double taxation is not feasible and/or there is no indexation of gains, due to complexity. We note that our Property Council members who are NZX-listed entities distribute most, if not all, operating cash flows but do not distribute any realised or unrealised gains.

- The submissions background document notes that if capital gains are taxed on a realisation basis, there is a strong theoretical argument for "ring-fencing" of capital losses against capital gains only. This is due to the ability to bring forward realisation of losses, and defer tax on gains. The practical impact however is that it creates an artificial boundary between normal taxable losses (e.g. arising under the current land taxing rules) and capital losses, which could be problematic (particularly if the capital gains tax rate is lower than the normal income tax rate, to adjust for some of the issues noted above, such as lack of indexation). It also results in unfairness, particularly if the prospect of future capital gains is remote (e.g. if only a single capital asset is owned and that is disposed of for a loss). <u>Property Council submits that capital losses should be available without restriction, if a capital gains tax is introduced, for simplicity and fairness reasons</u>. However, if rollover relief is applied, the treatment should be symmetric – i.e. there should be a deferral of capital losses in the same way capital gains are able to be rolled-over.

- Finally, we note a common difficulty with a capital gains tax is its implementation. The submissions background document outlines three options: bringing in existing assets at (1) their initial cost; (2) their valuation on the date of introduction; or (3) limiting it to new assets only. There are practical difficulties with all three options. Respectively, these are: (1) over-taxation depending on how long the assets have been held prior to the application date of the tax, (2) requiring arm's length valuations without a sale or similar event, and (3) creating a class of capital gains tax "preferred" asset. Property Council's concern is that none of these approaches is particularly principled. Further, they lend themselves to application to assets which are considered easy to value (such as listed shares and property) to the exclusion of other assets which are considered more difficult. This would not be a principled application, in our view.

Conclusion

In summary, as noted above, the decision on whether or not New Zealand should adopt a "general" capital gains tax cannot be extricated from the design of such a tax. That reality, unfortunately, would appear to be far removed from the theoretical optimum for the reasons outlined above. These are the difficulties that confronted the previous tax reviews, which they were unable to satisfactorily resolve. Property Council believes these are still relevant today.

For that reason, Property Council questions the overriding objective for introducing a capital gains tax.

If the objective is greater fairness in the tax system, that has to be evaluated against: (1) what will be outside scope, with owner occupied housing likely to be the starting point, not the end point; (2) the complexity of ensuring that a capital gains tax does not over or double tax (i.e. inflationary gains and share gains, respectively); and (3) implementation coverage (recognising that there are no easy options).

If the objective is a sustainable alternative future revenue base to fund future government spending or to offset other tax reductions, the international experience is that a capital gains tax is not a dependable revenue source as revenue flows can be highly variable. This is much more so than other tax bases[7]. This is not conducive to Government budgeting, particular if an objective is to raise 30% of New Zealand's GDP to meet future spending commitments.

Property Council therefore does not consider that the trade-offs that would be required to make a capital gains tax workable justify the fairness objective, which would be incremental at best, or the alternative tax base objective.

However, Property Council acknowledges that the case for a capital gains tax (and all tax reform options) will be a balancing exercise. Views may diverge on the importance/weighting of different (and conflicting) factors. We would also emphasise the need for any recommendation to be politically sustainable over time.

If a capital gains tax is supported, on balance, by the Tax Working Group

If, on balance, the Tax Working Group reaches a view that a capital gains tax is an appropriate addition to the New Zealand tax system, then Property Council considers that it is imperative that the above design issues are addressed to make the regime workable. In particular, we highlight the need for:

- Rollover relief to ensure that any tax is only levied on actual distribution of capital gains by an entity to its investors.
- Any capital gains tax proposal to integrate fully with the current PIE taxation regime.
- Capital losses to be able to be offset against ordinary income.

Question 2: Should New Zealand introduce a land tax (that excludes land under the family home)? If so, what features should it have?

The case, as we understand it, generally put forward for a land tax is economic efficiency. The impact of a land tax is said by economists to be borne only by those who own the land at the time of introduction, with subsequent owners factoring this in by way of a lower purchase price. Note: this assumes the land tax applies on the unimproved value of land only, as applying the tax to improvements introduces inefficiency – i.e. it affects the decision to develop the land or not.

A land tax is also suggested as a way of raising significant revenue. However, that assumes a universal land tax base, at low rates. This will not be the case as owner occupied housing is excluded from any potential tax base. Property Council submits this would put pressure on the rate of any land tax, to make up for any lost revenue.

New Zealand's previous experience with a land tax suffered from a narrow base. The most recent version, introduced in the early 1980s, was abolished in 1992 due to various exemptions resulting in the tax being considered uneconomic and inefficient[8].

Another major concern with a land tax is the magnitude of any reduction in the price of affected land at the time of introduction. Work done for the 2010 Tax Working Group suggested a 1% land tax could result in a fall of anywhere between 16.7% and 26.4% in affected land values (with Inland

[7] For example see the volatility in Australian net capital gains income (refer Chart 1) in https://static.treasury.gov.au/uploads/sites/1/2017/06/03Clark.pdf. That paper concludes that *"Volatility in CGT is a major driver of aggregate revenue volatility and revenue forecasting error".*

[8] The McCaw Committee Report on tax reform noted that: *In 1982, only five per cent of total land value was taxed, agricultural land being explicitly exempted and residential land effectively exempted by the exemption of $175,000 for all landowners.*

Revenue concluding at the time the lower estimate could be optimistic)[9]. If correct, this would be a significant de-valuation of existing assets, and is likely to create a significant economic shock. If a land tax is aimed at improving housing affordability, this may end up having a much smaller impact on residential land prices as owner-occupied housing will be excluded, but non-residential land which is not an area of concern will bear the full brunt of the price effects.

This reflects the inherent unfairness of a land tax, as it targets a single class of capital asset (and non-residential land at that) and its holders. In this context, Property Council members (and their investors, which include super annuitants as well as ordinary "mums" and "dads") would be disproportionately impacted by a land tax compared to most other taxpayers. It is unfair that investors in the non-residential property sector should be used as a further "cash cow" to fund other parts of the tax system, particularly when previous tax reforms have resulted in significant costs already being imposed on this sector.

Conclusion

<u>Property Council strongly rejects the case for introducing a land tax for the reasons outlined above.</u>

For completeness we note that there was some support by members of the 2010 Tax Working Group, but this was subject to an important qualifier:

> *a low-rate land tax as a means of funding tax rate reductions and improving the overall efficiency of the tax system.* ***<u>However, [the TWG noted] there are concerns over the political sustainability of such a tax.</u>***

(Emphasis added)

Question 3. Is there a case to consider the introduction of any new taxes that are not currently levied?

In Chapter 6, the submissions background document notes that in previous reforms, New Zealand has eliminated land tax (considered above), estate duty, gift duty, stamp duty and cheque duty. The question is whether any of these alternative tax bases should be re-considered.

Ignoring estate duties (which we understand are outside the remit of the Tax Working Group due to being an inheritance tax), both gift duty and cheque duty were abolished due to their low revenue potential relative to the compliance costs imposed. It is unlikely, in Property Council's view, that this calculus will have changed since their repeal.

Property Council notes that stamp duties are popular overseas as a way of raising tax revenue. In Australia, for example, stamp duties are a key contributor to Australian state coffers. However, a large chunk of Australian stamp duty revenue is from residential properties (approximately three quarters in 2013-14[10]). A large part of that potential revenue base would not be available in New Zealand due to the carve-out of owner occupied housing from any tax reform. Therefore, the revenue potential (similar to a land tax excluding the land below the family home) is likely to be limited.

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[9] https://www.victoria.ac.nz/sacl/centres-and-institutes/cagtr/twg/publications/3-taxation-of-capital-gains-ird_treasury.pdf

[10] https://www.propertycouncil.com.au/Web/Content/Submissions/National/2016/Economic_impact_of_stamp_duty.aspx

At the same time, studies have shown stamp duties to have particularly high economic costs. This is borne out by research conducted by the Property Council of Australia[11].

Conclusion

<u>Property Council does not believe that the re-introduction of stamp duty is warranted.</u>

Value capture taxes

While not covered in the submissions background document, we note that the Government has expressed an interest in "value capture taxes". We understand the aim of such a tax is to capture that portion of profit (in the form of any increase in value of land/improvements) to private landowners from proximity or access to public investments (such as roading, sewage and other public infrastructure).

Property Council is unable to offer a view on the suitability of such a tax base, without any detail on how it may apply. If such taxes are likely to form part of the Tax Working Group's future thinking, we would appreciate the opportunity to consider our position at the time.

Question 4: Does the tax system strike the right balance between supporting the productive economy and the speculative economy?

Property Council has considered this question in the context of taxes on savings (we refer the analysis on page 39 of the submissions background document and on "tax and retirement savings" on page 26).

Effective tax rate analyses for different savings options

One of the questions asked is whether certain businesses are benefiting from low effective tax rates, because of non-taxation of certain types of income. While we consider Figure 21 to be a useful discussion of the different effective tax rates on different types of savings, at present, we are aware some analyses have sought to highlight the effect of the lack of a capital gains tax on property investment and have made leaps in their conclusions as a result.

One such analysis claims that NZX-listed property vehicles have considerably lower effective tax rates than the NZ statutory company tax rate (and their non-property NZX-listed peers) due to the lack of a capital gains tax. This is based on fair value revaluations of the underlying properties being "income" for accounting purposes but not tax purposes.

Property Council is concerned that such an analysis paints an overly simplistic and misleading picture as fair value gains/(losses) of members would not be taxable, other than in an unrealised capital gains tax world (which no country has). While this results in artificially low effective tax rates in a rising market, during the Global Financial Crisis, for example, the listed property sector had effective tax rates significantly higher than the statutory tax rate (and their NZX-listed peers), applying the same analytical approach, due to large unrealised losses.

In both cases, it is incorrect to say that the effective tax rate should be a function of unrealised property gains/(losses), which are not income under any sensible measure.

Our concern is such analysis has the potential to abstract from genuine debate about whether different types of savings are over-or-under taxed.

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[11] Ibid

Non-residential property is part of a balanced savings portfolio

Commercial and industrial property is an important part of a balanced savings portfolio. Property Council members, which include the NZX-listed property vehicles as well as unlisted property owning vehicles, have a range of investors. These include super annuitants and "mum" and "dad" investors, alongside institutional investors, which include KiwiSaver funds.

These investors typically invest for the safe (low-risk) and consistent rental return that non-residential property investment provides, rather than capital returns (which can be volatile). In the absence of collectivised investment options provided by Property Council's members, many New Zealanders would simply not have access to this asset class, which is important to diversify their portfolio risk (and also for New Zealand's overall macroeconomic risk, given the overexposure of New Zealand household balance sheets to housing assets).

Property Council agrees with the Tax Working Group's statement that "there is room for improvement to make our current system [for taxing different types of savings] more consistent". And that "consistent treatment should improve both fairness and efficiency".

The importance of the PIE regime to the savings tax landscape

Property Council notes that the PIE taxation regime has helped collectivised commercial and industrial property investment to operate on a level tax playing field with other types of collectivised investment.

It should be noted that, in the main, the objective of the PIE rules was to remove tax distortions that previously resulted in direct investment being tax advantaged relative to investing through a collective investment vehicle (in property and other assets). The tax disadvantage previously faced by collective investment vehicles included the "claw back" of amounts that would otherwise not be subject to tax at the entity level (e.g. the benefit of tax depreciation claimed) on distribution to investors. This resulted in effective over taxation of investors. Property Council believes the PIE regime is particularly important as New Zealand does not have any special regimes, such as Real Estate Investment Trust rules. (In other jurisdictions, these would allow the income of the REIT to be flowed through to be taxed at the underlying investor's level.)

The key constraint is that the Tax Working Group is unable to change the taxation treatment of owner occupied housing, which results in other forms of savings being relatively tax disadvantaged. The response should not be to further increase this disparity by, for example, reducing or removing the effect of the PIE taxation regime.

That tax distortion was considered by the 2010 Savings Working Group in its report – *Saving New Zealand: Reducing Vulnerabilities & Barriers to Growth & Prosperity*[12]. One of its recommendations was to reduce the inherent over-taxation of savings by, amongst other things, broadening and rationalising the PIE regime (refer page 81 of their report).

The Savings Working Group ("SWG") made the following comment about the PIE regime:

> *While the original justification for the PIE regime was to try to apply investors' expected personal tax rates on their direct investment income to income from investments held through collective vehicles, from a savings perspective it can be rationalised as a mechanism for reducing tax rates on income from a broad spectrum of saving.* ***The SWG notes the [2010***

[12] https://treasury.govt.nz/sites/default/files/2011-02/swg-report-jan11.pdf

> ***Tax Working Group] recommendation that the capped top PIE rate should have been aligned with the top personal marginal rate, but the SWG considers that from a savings context*** *(and absent Nordic and similar rate reductions on savings)* ***the top PIE rate should be maintained at a minimum of 5 percentage points below the top personal marginal rate (and preferably 10 percentage points below)****.*
>
> (Emphasis added)

Property Council strongly supports the above view of the Savings Working Group in relation to PIE tax rates.

The Savings Working Group noted that most other countries apply an "Exempt-Exempt-Tax" model for taxing savings. The current PIE regime, at best, is a "Tax-tax (small t) -Exempt" model. That is, it is not a highly concessionary taxation regime.

Conclusion

Property Council strongly supports the PIE regime and believes the current PIE policy settings are broadly appropriate. However, per the Savings Working Group recommendations above, there may be a case for further reduction in savings tax rates, including through a reduction in the PIE tax rate.