

Tax Working Group Public Submissions Information Release

Release Document

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In preparing this Information Release, the Treasury has considered the public interest considerations in section 9(1) of the Official Information Act.

30 April 2018

Tax Working Group

By email: submissions@taxworkinggroup.govt.nz

As a member of the Property Council New Zealand (**PCNZ**), Kiwi Property Group Limited (**Kiwi Property**) supports the attached submission made to the Tax Working Group by PCNZ.

Kiwi Property is the largest listed property vehicle and a member of the S&P/NZX 15 Index. Kiwi Property invests in a diversified portfolio of retail and office assets, with a total value of \$3.1 billion and has over 1,000 tenants.

Kiwi Property would like to reiterate the following points in support of the PCNZ submission:

Fairness and current inconsistencies

On the issue of fairness of the current tax system, a key tax distortion, which disproportionately impacts Kiwi Property and all other entities and individuals owning commercial property, 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 structures, unlike every other business asset, or for the cost of required capital upgrades – for example, to seismically strengthen building structures to prevent loss of life or to incorporate new building technologies. Local authorities in provincial areas rely on commercial property rates income from typically older building stock which is often unreinforced and lacking seismic resilience. If this building stock is not strengthened a significant portion of their rating base will be removed and these older buildings will potentially fall into disuse.

In relation to seismic upgrades, 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).

Commercial building structures do become obsolete over time and need replacement or upgrading. Obsolescence of commercial buildings occurs as business needs, tenant expectations, seismic and building resilience standards, environmental performance standards and technology changes over time.

Tenants, notably including central government tenants, expect existing buildings to meet seismic resilience standards equivalent to 80% of New Building Standard (**NBS**) or greater which is significantly above the minimum requirement of the Building Act of 34% NBS.



Tenants will not lease space in commercial buildings which they do not consider to be safe or seismically resilient and obsolete buildings do not meet this requirement. Increasingly tenants also have a desire for environmentally sustainable buildings.

Kiwi Property believes the 2010 tax change to remove tax depreciation of building structures 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, Kiwi Property strongly urge the Tax Working Group to recommend the reinstatement of tax depreciation for non-residential building structures.

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 tax system.

In principle, Kiwi Property 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. Kiwi would like to draw a clear distinction between the residential property market and the non-residential (i.e. commercial, industrial and retail) property sector. Addressing the housing affordability objective for the former should not result in a general application of any solution to the latter.

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 Kiwi Property'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 Entity tax regime;
- reinvestment of capital proceeds triggering tax liabilities (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).

Kiwi Property 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.



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

Taxation of savings

Kiwi Property agrees with comments in the submissions background document that the current differential tax treatment of different savings should be made more consistent.

Listed property vehicles, such as Kiwi Property, 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.

Kiwi Property recommends that the Tax Working Group differentiates between residential and commercial property investment. Commercial property investment provides the infrastructure of business and services the savings industry by producing rental returns (upon which income tax is paid). Investment in residential property is very often undertaken for the purposes of seeking capital gain, upon which historically little or no tax has been paid.

Kiwi Property strongly supports the current Portfolio Investment Entity 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. Kiwi would support further changes aimed at improving the consistency in the taxation of different forms of savings.

Kiwi Property would like to thank the Tax Working Group for the opportunity to submit on the discussion questions. If you would like to discuss any aspect of our submission with us, please do not hesitate to contact Gavin Parker on [1] We would also welcome the opportunity to meet with members of the Tax Working Group in person.

Yours sincerely

[1]

Gavin Parker
Chief Operating Officer

[1]

30 April 2018

Tax Working Group

Email: submissions@taxworkinggroup.govt.nz

Dear Tax Working Group members,

SUBMISSION: Tax Working Group Discussion Questions

1. Recommendations

- 1.1. Property Council New Zealand (“Property Council”) supports the intention of the Tax Working Group to review our current tax regime. We wish to thank the Tax Working Group for the opportunity to submit on the discussion questions.
- 1.2. We understand the complicated task of meeting all the needs of a good tax system. To assist your consideration of the system, Property Council’s key comments and suggestions are:
 - a. We support the ‘broad-based, low-rate’ approach recognising that all economic activities are broadly taxed on a similar basis;
 - b. Commercial and residential property are different. The tax system should recognise commercial property as a business asset and it should be treated as such;
 - c. Reinstating depreciation on commercial property. By not recognising that commercial building structures become obsolete and depreciate, our current tax law is acting as a disincentive to continuous improvement of New Zealand’s building stock, particularly in relation to seismic performance;
 - d. We conditionally support a capital gains tax if it were to account for capital losses and allowed for depreciation of commercial property;
 - e. We strongly support the current PIE taxation regime and recommend that the findings of the Savings Working Group 2010 in relation to the PIE tax rates be considered;
 - f. We do not support other transactional taxes as they are inefficient and insufficient funds are likely to be collected to make them viable; and
 - g. Land taxes could be a blunt instrument likely to have many negative unintended consequences, including a significant drop in property values. If the Working Group were to consider other taxes targeted at property, such as value capture taxes to fund infrastructure, Property Council would like to discuss how those taxes could be made to work with minimal perverse consequences.

2. Introduction

- 2.1. Property Council is a member-led, not-for-profit organisation offering a collective voice for the commercial property industry. The property industry is currently the largest industry in New Zealand with a direct contribution to GDP of \$29.8 billion or 13%. In a sense the property sector is a foundation of New Zealand’s economy and caters for growth by developing, building and owning the buildings that house businesses.



- 2.2. Our membership is broad and includes some of the largest commercial property holders in New Zealand, including several significant NZX listed companies. These companies own commercial property providing reliable rental income return on savings invested by retirees through Kiwisaver and other superannuation funds. Our members include companies that undertake a range of large-scale residential and commercial development projects, including large commercial buildings, industrial parks, and retail precincts.
- 2.3. Property Council suggests that any changes to the taxation of such an important economic sector should be carefully considered.
- 2.4. Our views on the tax system are set out below. We have also attached more detailed analysis in support of our submission (Attachment A: *Property Council TWG Detailed Analysis Submission – April 2018*).

3. Overall Design of the Tax System

- 3.1. Property Council supports the ‘broad-based, low-rate’ approach being that all economic activities are broadly taxed on a similar basis. We also note that our broad-based approach is simple and particularly attractive to offshore investors.
- 3.2. By its nature the commercial property sector is extremely capital intensive, with developments and buildings worth billions of dollars. Overseas investment is an important source of capital given the limitations of New Zealand’s small capital market. Our simple tax system can be attractive to this overseas investment and we would be reluctant to see this change.

4. Differentiating Commercial Property

- 4.1. Commercial and residential property are different, both as property and why investors typically invest in property. Commercial property squarely fits in the physical capital sphere of the productive economy. It is designed to meet the needs of the businesses and industries it accommodates. Property Council recommends that the Tax Working Group differentiates commercial and residential property in its considerations.
- 4.2. Commercial property investors typically invest to secure a rental or income return. A large proportion of the capital invested in commercial property comes from retirees (Kiwisaver and superannuation funds) investing savings to produce regular income to support their retirement. Commercial property investors provide the infrastructure of business and, in exchange for that accommodation, those businesses pay rent which provides the desired income return that investors are seeking and upon which income tax is paid.
- 4.3. However, some investors in residential property may do so for the purposes of capital gain in a market. This can come about through demand exceeding supply for housing or house prices steadily increasing over time. Investing in residential property for rental or income return often makes little sense because rental returns on residential property are typically very low as a percentage of the property’s value. After the costs of ownership, the net income return can be even lower. Investors in residential property are motivated by the historical significant capital gains that can be available, which often has no tax paid.
- 4.4. Property Council recommends that the Tax Working Group also differentiates between residential and commercial property investment. Commercial property investment provides the infrastructure of business and services that the savings industry uses to produce rental returns (upon which income tax is paid). However, investment in residential property is often



undertaken for the purposes of seeking capital gain, upon which historically little or no tax has been paid.

5. Depreciation

- 5.1. As the Tax Working Group will be aware the previous government removed the ability to depreciate commercial property. Property Council believes the decision conflated residential and commercial property as a single asset type and did not recognise the different economic roles they play. Property Council does not believe that it was a principled tax decision because depreciation of business assets used to generate taxable income is a cost of doing business. We believe it is illogical for one business asset to be treated very differently from other business assets. The decision made New Zealand one of only a handful of countries in the world that does not allow depreciation of commercial property.
- 5.2. Commercial building structures, like machinery and durable consumer goods, become obsolete over time and need replacing or upgrading. Building structures, including their services and fitouts all become obsolete over time. Obsolescence of commercial buildings occurs as business needs, tenant expectations, standards (building and environmental) and technology changes over time.
- 5.3. An obvious demonstration of this obsolescence was the failure of many building structures during the 2011 Canterbury and 2016 Kaikoura earthquakes.
- 5.4. Further, research following the Canterbury earthquakes has shown that a yellow sticker on an at-risk building can lead to a significant devaluation instantly of up to 50 per cent of its original value, *“First, buildings that have been declared earthquake-prone prior to the time of sale experience a statistically significant reduction in sale price following the Christchurch earthquakes. Second, this effect was more pronounced in the CBD than in suburban areas”*.¹. Yet the tax system disincentivises building owners from earthquake strengthening their buildings. A perverse outcome of the current tax system is that if a building falls down in an earthquake the loss is tax deductible but work to strengthen a building is not.
- 5.5. Tenants, including central government tenants, expectations around existing buildings have also changed since the earthquakes. They now expect buildings to meet seismic resilience standards equivalent to 80 per cent of the New Building Standard (NBS) or greater, which is significantly above the minimum requirement of the Building Act of 34 per cent NBS. Tenants will not lease space in commercial buildings which are not considered safe or seismically resilient. Obsolete building structures do not meet this requirement.
- 5.6. Commercial building structures also become obsolete as business needs and tenant expectations around what they need from their commercial space change. Such changes include, desire for modern services, better inter-tenancy connectivity, better building energy and other environmental performance, and general functionality. It is common for buildings that were considered ‘prime’ when built to slowly descend the building quality matrix to ‘A’ grade, then ‘B’ grade etc. As this happens, the building’s rental income and building value typically declines, when absent of any further capital improvements.
- 5.7. By not recognising that commercial building structures become obsolete and depreciate, current tax law is acting as a disincentive to continuous improvement of New Zealand’s building stock. This has hindered building owners undertaking building upgrades and seismic

¹ Timar, L., Grimes A., and Fabling R., Motu Working Paper, *Before a Fall: Impacts of Earthquake Regulation and Building Codes on the Commercial Building Market*, October 2015, pg 12.



strengthening. This represents an economic cost in unrealised productivity increases and environmental gains that could be gained from the building stock

- 5.8. The previous Government removed depreciation on commercial building structures it said it was open to reconsidering if evidence showed that commercial buildings did depreciate. There is ample evidence from around the world and New Zealand, including research by KPMG and the New Zealand Institute of Economic Research (NZIER), which shows that non-residential buildings do depreciate (Attachments B and C: *KPMG - Tax Depreciation - Non-residential buildings (8 February 2010)* and *NZIER report (8 Feb 2010)*).
- 5.9. Property Council recommends that the Tax Working Group recommend reinstatement of depreciation on commercial property structure. This would recognise the contribution the commercial property sector plays in the productive economy, remove current disincentives to earthquake strengthening created by current tax law and promote safe and sustainable buildings.

6. Capital Gains

- 6.1. For a capital gains tax to work effectively in practice it needs to be universal. We note one of the key overriding drivers out of scope for the Tax Working Group's terms of reference is that the family home is not to be considered. Given the complexity of designing a capital gains tax with all its intricacies, including carve-outs, Property Council doubts the benefits would outweigh the administrative and economic costs.
- 6.2. Property Council notes that significant consideration is being given in the Tax Working Group's work to a potential capital gains tax. Property Council could conditionally support a capital gains tax if the tax system were to account for capital losses (and expenditure on capital upgrades) and allowed for depreciation of commercial property.
- 6.3. On balance if a capital gains tax were to be implemented we suggest it be triggered when a property is sold, with appropriate roll-over provisions. This would be the easiest to implement and would avoid adjustments required if estimates of unrealised gains are made. Property Council would also not like to see capital losses ring-fenced as it could disincentivise capital shifting from one asset class to another.

7. PIE Regime

- 7.1. Property Council is a strong supporter of the PIE taxation regime. This regime has helped collectivise commercial and industrial property investment to operate on a level tax playing field with other types of investment.
- 7.2. We also support the findings of the Savings Working Group 2010 in relation to the PIE tax rates recommending that the top PIE rate should be maintained at a minimum of five percentage points below the top personal marginal rate, and preferably 10 per cent points below.
- 7.3. Property Council also suggests that our current PIE regime approximates a "Exempt-Exempt-Tax" or a "Tax-tax-Exempt" models for taxing savings of other countries which helps keep New Zealand competitive and attractive to overseas investment.

8. Stamp Duties and Similar Taxes

- 8.1. Property Council notes that the Tax Working Group has asked questions considering other taxes such as stamp, cheque, gift and estate duties, and land tax. We note, due to it being an inheritance tax, estate duties are unlikely to be considered.



- 8.2. Stamp and cheque duties, being transactional taxes, have high efficiency costs although are unlikely to raise sufficient revenue to justify their administration if owner-occupier housing is excluded. We note New Zealand previously had these taxes and repealed due to insufficient funds collected and suggest nothing has changed currently to make them viable.

9. Land Tax, Rates, Value Capture Tax and Housing Affordability

- 9.1. Land taxes although believed by economists to be a leveller in any tax system, because taxing land is more efficient compared to taxing other things. Property Council believes this is not the case. 2010 IRD analysis suggested a land tax could potentially lead to a decrease in property values by up to 20 per cent.
- 9.2. Any land tax would need to interact with the local government rating system. Rates are a tax on real estate property used to fund local government services (in lieu of using general taxation). They are a significant portion of a council's operating revenue. Introduction of a central government land tax could negatively impact that important stream of local government funding.
- 9.3. Land taxes could be used to counter land-banking to address one of the causes of housing affordability. However, a national land tax that applies to all land would be a blunt instrument likely to have many negative unintended consequences. Other more targeted instruments could better achieve that outcome.
- 9.4. We note that one such option, value capture taxes, is not discussed in the discussion document. Value capture is one way to fund infrastructure that enables both residential and commercial development. Value capture could be considered a form of a capital gains tax that allows the government to recoup value from the decisions (e.g. zoning) or investments (such as provision of infrastructure) that have driven, at least in part, capital appreciation of land. Value capture taxes can be complicated to design and risk unintended consequences.
- 9.5. If the Tax Working Group proposes changes to how property is taxed Property Council would like the Tax Working Group to provide more detailed analysis of all the taxes faced by property, including rates, and consult further on the design of any proposed changes (e.g. value capture) that will affect property. Our members are happy to work with the Tax Working Group to assist with this analysis.

10. Conclusion

- 10.1. Property Council thanks the Tax Working Group for the opportunity to submit on the discussion questions. We would also like to speak to our submission and ask that the Tax Working Group consider an oral submission.
- 10.2. We also wish to note our support for the BusinessNZ submission.
- 10.3. Any further queries do not hesitate to contact Jane Budge, Senior Advocacy Advisor, email: [1] or cell [1]

Yours sincerely,

[1]

Connal Townsend
Chief Executive

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 policies), 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 obsolescence 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 liabilities (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 inhabitants) 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 depreciation 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) if empirical evidence demonstrates that they do not depreciate in value over time.

(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 changes².

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 expense³. This imposes all of the cost on building

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 2001⁴ 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*

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, **most members of the TWG are concerned about the practical challenges and efficiency implications of introducing a CGT.** 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 tax⁶.

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

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. **Introducing a CGT that excludes owner-occupied housing would create a new bias in the tax system.** (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). Property Council submits that capital losses should be available without restriction, if a capital gains tax is introduced, for simplicity and fairness reasons. 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 bases⁷. 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 inefficient⁸.

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

Property Council strongly rejects the case for introducing a land tax for the reasons outlined above.

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. **However, [the TWG noted] there are concerns over the political sustainability of such a tax.***

(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 2013-14¹⁰). 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.

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 Australia¹¹.

Conclusion

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

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.

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.



Tax Depreciation – non-residential buildings

Report to Property Council
New Zealand

8 February 2010

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1 Introduction

The Tax Working Group (“TWG”) in its report, *A Tax System for New Zealand’s Future*, considered that one (targeted) option for broadening the tax base would be:

Removing tax depreciation on buildings (or certain categories of buildings) if empirical evidence shows that they do not depreciate in value.

This analysis is prepared to help answer the question: do buildings (or certain categories of buildings) depreciate? It has been prepared on behalf of the Property Council New Zealand (PCNZ), a not for profit organisation that represents New Zealand’s commercial, industrial, retail, property funds and multi unit residential property owners, managers and investors.

PCNZ represents all forms of commercial property and property investment in New Zealand. Its membership ranges from NZX-listed property trusts (“LPTs”) to smaller commercial property investors. The commercial and industrial property sector is an important part of the New Zealand productive sector, providing vital infrastructure for New Zealand businesses (i.e. New Zealand Inc).

2 Summary of findings

We believe the answer to the question posed by the TWG: *do buildings depreciate*, is they do depreciate, at least in the context of non-residential buildings (i.e. commercial and industrial property), which is the focus of our analysis. This conclusion is based on:

- Our understanding of the international evidence, including the various economic studies since the late 1970s which have concluded that commercial and industrial buildings broadly depreciate at rates of between 2-4% per annum. These studies were noted in an Inland Revenue and Treasury issues paper on tax depreciation, released in 2004, which concluded that buildings do depreciate.
- More recent international evidence that supports officials’ 2004 analysis. These studies suggest that rates for commercial and industrial rates could be higher (and the useful lives of buildings appear to be shortening). We have not found any studies that suggest buildings do not depreciate.
- Qualitative factors, such as: the high-rates of re-development of commercial buildings (particularly in the Auckland and Wellington CBD areas); changes in building technology (i.e. the need to comply with new building standards); and changing tenant preferences (i.e. “Green” buildings for Government and changes in configuration over time, due to the move from individual offices to open plan) which mean that buildings can and do economically lose value over time. Buildings also move across different segments of the market, over their economic life (a prime building in the 1970s will typically be sub-prime property today, all other things held constant).

We believe that the economic cost of removing depreciation on buildings will be borne primarily by the New Zealand business sector. This is based on a high-level breakdown of the \$1.3 billion revenue estimate for removing depreciation. We understand approximately 70% of this estimate relates to non-residential property depreciation. In our view, property investors will account for a very small fraction of this (e.g. we have estimated the largest four LPTs, which are a fair representation of the New Zealand institutional property investor market, hold around 3 to 4% of the total building capital stock).

The flow-on implications, from removing depreciation on buildings, will be lower quality of infrastructure (as there would be lesser incentives to reinvest in capital) or higher rents (as landlords look to recover the lost tax deductions). Neither will be a particularly desirable outcome.

New Zealand would be an outlier internationally. We note that the majority of our trading partners, including Australia, Germany, Japan and the United States allow depreciation on (some or all) non-residential buildings. In the race to attract and keep capital, New Zealand would be at a significant disadvantage.

3 Scope of our analysis

The scope of our analysis is limited to the depreciation question around non-residential buildings – broadly commercial and industrial property, such as office buildings, warehousing, manufacturing plant and shopping centres. This reflects the typical asset holdings of PCNZ members.

We have not considered whether residential rental properties depreciate in value (note: hotel buildings and other buildings used for commercial residential accommodation would be treated as non-residential buildings under our definition). We note that there are different dynamics in the residential property market, the most significant being the owner-occupier versus rental dynamic, which may mean the results may be different for this sector.

Our definition of building is the “shell” or physical structure. It does not encompass any chattels, including those attached to the building (such as lifts). We note that chattels are separately depreciable and would be unaffected by any changes to the depreciation of buildings.

This paper also does not explicitly consider the various other property/land-centric taxing options considered by the TWG, such as a land tax or RFRM on residential property investment.

The focus of this paper is purely on whether non-residential buildings depreciate, to answer the question posed by the TWG.

4 Depreciation for tax purposes

Depreciable property is defined in the Income Tax Act 2007 as “*property that, in normal circumstances, might reasonably be expected to decline in value while it is used or available for*”

use in [either] deriving assessable income; or in carrying on a business for the purpose of deriving taxable income.”

A number of the international studies, which are discussed later on, separate out the depreciation attributable to physical wear and tear (i.e. the deterioration in physical capacity of the building asset) with so-called economic depreciation (which relates to the ageing of an asset and is attributable to factors such as obsolescence). Depending on which type of depreciation is being discussed, the economic profile of loss in value may vary – we note the references to “one hoss-shay”, “straight-line” and “geometric” depreciation profiles in the literature. Similarly, we note that the economic literature discusses a range of available depreciation methods, including the “double declining balance” method, depending on the appropriate economic depreciation profile. The different international studies also use different methodologies – some use asset price models, which consider the price of used assets (estimating depreciation as the change in the price of the asset as it ages), while others use a retirement approach (which estimates retirements and withdrawals from the capital stock and use these to estimate the depreciation pattern and rate).

Our definition of depreciation encompasses both the physical deterioration of a building and other environmental factors. As noted above, environmental factors can include changes in building technology, i.e. obsolescence, as well as changes in tenant preferences such as the configuration and internal specification of a building, which will affect a property’s value over time. We believe that our comprehensive definition is consistent with the tax definition.

In summary, the value of a building is, broadly speaking, the net present value of the future cash-flows (or rents) that are expected to be derived from a property. Both physical deterioration and environmental factors will impact on this NPV calculation over time.

In theory, the cost of repairing or maintaining a building should be treated as a deductible expense in the year such expenditure is incurred. However, if the work adds to or improves the asset, this may constitute capital expenditure, with the cost having to be capitalised and depreciated over future years. The issue of what constitutes repairs and maintenance and what is a capital improvement is, however, a significant area of concern which needs to be clarified.

5 Separating buildings from land

One popular argument for removing depreciation on buildings is that when combined land and buildings generally appreciate in value; therefore allowing tax depreciation on the structure seems unreasonable.

Such an argument is a significant oversimplification. Land is not depreciable property for tax purposes. To suggest that any appreciation in the value of land is somehow a justification for denying depreciation on the structure is wrong, from a policy perspective. The two should be considered as separate issues. We note that officials have previously supported this approach.

6 TWG analysis

No empirical data on building depreciation rates is presented in the TWG report and there is very little analysis on the costs versus benefits of removing tax depreciation on buildings. We are also unable to find any TWG background papers, prepared by Inland Revenue or Treasury, on this issue. (We discuss in the next section some analysis carried out by officials in 2004.)

6.1 *The rental housing tax bias*

The TWG's depreciation recommendation appears to be linked to a perception by the Group that rental property investment is tax advantaged – we refer to the statement in the TWG report, widely quoted in the media, that:

There is ... a very large investment in rental properties, where overall this \$200 billion sector of the economy had a negative taxable return of about \$500 million in 2008.

In our view, the TWG's building depreciation recommendation appears to be aimed squarely at addressing the perceived shortcomings in the taxation of residential rental housing. As noted earlier, consideration of whether residential rental investment is tax advantaged is outside the scope of our analysis. If there is an issue with the taxation treatment of rental housing, this should be addressed as a specific targeted measure. (We note, for example, that some other jurisdictions differentiate between residential and non-residential buildings, allowing tax depreciation only on the latter.)

We believe a clear distinction needs to be drawn between the residential rental sector and the commercial and industrial property sector, which provides the core infrastructure for New Zealand's businesses. In contrast to residential rental property owners, we understand the commercial and industrial property sector is a net tax payer and contributor to the New Zealand economy.

Unfortunately, the perception is that all buildings should be included in the scope of any depreciation change. This is not helped by the fiscal implications being based not only on removing depreciation on residential rental properties, but all buildings – we discuss the costings in greater detail later on. This seems an illogical leap from the “solution” the TWG appears to be recommending to a very narrow problem. This is particularly so, given the various overseas studies which show that buildings do depreciate. We discuss some of this international evidence below.

7 Evidence from the 2004 officials' issues paper on depreciation

Our starting point has been to revisit the 2004 Inland Revenue and Treasury officials' issues paper, *Repairs and Maintenance to the Tax Depreciation rules*.

The issues paper reviewed the overall coherence of the tax depreciation framework with a focus on ensuring that the overall structure of the depreciation rules is as good as is practicable and that the detailed design of the rules can cope with the complex, real-world issues that arise. Among the issues considered were the competing investment biases created by inflation and depreciation loadings in favour of long-lived and short lived assets, respectively.

Chapter 5 of the issues paper considered the tax depreciation treatment of structures. A key constraint was the lack of New Zealand studies on economic depreciation of buildings and/or sufficiently robust New Zealand data for modelling depreciation on building.

In the absence of New Zealand data, a number of international studies were relied upon. The key international study relied upon was Hulten and Wykoff (1980)¹ which supports the view that buildings do depreciate.

Hulten and Wykoff estimated diminishing value rates of depreciation for various building types, excluding rental housing of: 2.02 percent for retail stores, 2.47 percent for offices, 2.73 percent for warehouses and 3.61 percent for factories.

A paper by Fraumeni (1997)² is also referenced. It indicated that the United States Bureau of Economic Analysis had estimated economic depreciation rates of 3.14 percent (based on a 31-year economic life) for industrial buildings and 2.47 percent (based on a 36-year economic life) for office buildings.

Other international studies considered in the issues paper were a study by Deloitte and Touche (2000)³, which estimated economic depreciation rates of between 2.10 and 4.48 percent for different classes of building and a survey of various studies on economic depreciation for buildings by Gravelle (2000)⁴, which concluded that buildings probably depreciate at rates in excess of 2 percent, but probably less than 4 percent.

In summary, none of the international studies quoted in the issues paper found that buildings (particularly non-residential structures) do not depreciate.

Officials' conclusion (in Chapter 9 of the issues paper), expressed in the context of removing depreciation on residential rental housing, was that depreciation for buildings should not be removed:

¹ *The Measurement of Economic Depreciation Using Vintage Asset Prices: An application of the Box-Cox Power Transformation*, Hulten, Charles R. and Franck C. Wykoff, *Journal of Econometrics* 15 No. 8 (April 1981).

² *The measure of depreciation in the US national income and production accounts*, Bardara M. Fraumeni, *Survey of Current Business*, July 1997.

³ Deloitte and Touche, *Analysis of the Economic and Tax Depreciation of Structures*, Washington DC, June 2000.

⁴ *Depreciation and the Taxation of Real Estate*, Gravelle, J. CRS Report to Congress (October 2000).

*Officials do not support the option of denying depreciation deductions for rental housing altogether, as such a measure raises a number of concerns. Property prices are typically made up of land and improvements (the asset – house – on that land and any improvements to that asset or the land itself). Denying depreciation deductions entirely might be suggested because properties often appreciate rather than depreciate, although depreciation deductions are aimed at reflecting changes in the value of improvements over time. If the overall value of a property does not change but improvements depreciate while land appreciates, failure to allow for depreciation deductions will discourage economically efficient investment in new improvements. Buildings are scrapped on occasion, and it is clear that at least these buildings have fully depreciated. **The evidence presented in chapter 5 provides a rationale for some reduction to building depreciation rates but not for denying depreciation deductions altogether.** [Our emphasis added]*

If the above analysis holds for rental housing, we believe it is no less applicable to non-residential buildings (it is arguably more applicable given the international evidence that commercial, retail and industrial buildings typically have higher rates of economic depreciation than residential property.)

We note that concerns that the tax depreciation rate for buildings was too high, based on the international economic literature survey at the time, resulted in the 2005 rate change, from 4% to 3% (on a DV basis) (and 3% to 2% on a straight-line basis). In our view, this should be the extent of any change to the depreciation regime for non-residential buildings.

We do not believe that there have been any developments since 2004 which rebut the international findings above on depreciation of buildings. (In the next section we provide some recent research which suggests that the building depreciation rate may in fact be too low in the case of commercial and industrial properties.)

One of the ways forward identified in the issues paper was:

“...using New Zealand data, if feasible, to test the reasonableness of depreciation rates. One option that is currently being explored is to use New Zealand valuation data on a sample of properties for which no consents for structural improvements have been given. This may be a way of finding how the value of improvements has changed over time without the data being biased as a result of structural improvements to existing properties.”

Unfortunately, we note that the data issues that existed at the time of the 2004 review persist today – we discuss these constraints later on.

8 Other international evidence

In addition to the literature on economic depreciation rates for buildings identified in the 2004 issues paper, we have conducted a new search focusing on non-residential buildings. The results of our review are summarised below:

8.1 Patry, A. (2007) *Economic Depreciation and Retirement of Canadian Assets: A Comprehensive Empirical Study*. Statistics Canada.

Patry provides a comprehensive empirical study of the economic depreciation of a range of Canadian assets, including various types of non-residential buildings. Patry also provides a useful summary of the depreciation rate estimates from the literature (the rates for buildings are outlined in the table below)

Table 2.1.1 Depreciation rate estimates from the literature (%)

Assets/Studies	Rate	Range	
		From	To
Office Buildings			
Hulten and Wykoff (1981a, 1981b, 1996)	2.5		
Deloitte and Touche (2000)	3.5		
Baum and McElhinney (1997)		1.6	2.9
Tanguay (2005)	5.9		
Gellatly, Tanguay and Yan (2002)	7.6		
Gellatly, Tanguay and Yan (2007)	7.4		
Industrial Buildings			
Hulten and Wykoff (1981a, 1981b, 1996)	3.6		
Deloitte and Touche (2000)	2.1		
Tanguay (2005)	9.1		
Gellatly, Tanguay and Yan (2002)	13.0		
Gellatly, Tanguay and Yan (2007)	9.7		

Patry’s empirical study of Canadian assets include a breakdown of 25 various types of commercial and institutional buildings, as well as 13 types of industrial buildings. The study estimates that the average ex-ante service life (similar to our estimated useful life concept) is around 32 years for buildings (however, more recently – between 1995 and 2001 – the average service life has fallen from nearly 36 years to 28 years).

The ranges of diminishing value depreciation rates for commercial buildings vary from 6.2% to 8.9% with major outliers being a 4.4% rate for religious buildings and 10.6% for post offices. The depreciation rate for industrial buildings vary in range from 7.0% to 12.6% with the major outliers being warehouses at 6.0%, mine buildings at 17.5% and bunkhouses/dormitories and camps estimated at 16.1%. (The full estimated results are available in Annex D of the Patry paper).

In summary, the average depreciation rate for office buildings is found to be 5.9%, with 6.4% for shopping centres and 9.9% for manufacturing plants – refer table below. The average depreciation rate for all non-residential buildings was found to be around 7.3%.

Table 6.1 Economic depreciation rates for major asset categories

	Depreciation rate		
	Estimated	Updated	Official
Buildings			
Office Buildings	6.2	5.9	2.2
Manufacturing Plants	8.7	9.9	3.0
Shopping Centres, Plazas and Stores		6.4	2.4
Farm Buildings		8.3	2.5
Warehouses, Refrigerated Storage and Freight Terminals	6.3	6.0	2.5
Maintenance Garages, Workshops and Equipment Storage Facilities	6.8	6.8	3.0
Restaurants, Fast Food Outlets, Bars and Nightclubs		8.5	3.4
Hotels, Motels and Convention Centres		5.5	2.2
Indoor Recreational Buildings		6.3	2.5
Passenger Terminals - (such as air, boat, bus and rail)		6.0	2.8
Total 10 average (representing 87% of building capital stock)	7.1	7.2	2.5
Building average	7.1	7.3	2.6

Patry finds that depreciation rates for buildings are on average almost triple the official rates used by Statistics Canada and the United States Bureau of Economic Analysis, which are largely based on the Hulten and Wykoff results. The increases are across the board with office buildings and shopping centres depreciating at close to 6.0% per year and manufacturing facilities depreciating close to 10% (compared to 2% and 3%, respectively under the official rates).

Patry concludes that a valuation bias in older buildings caused by accumulated improvements may explain the lower economic depreciation rates in the existing literature, including Hulten and Wykoff. The model used to sample the data was similar to the other depreciation literature, including Hulten and Wykoff.

8.2 *Baum, A. and McElhinney, A. (1997) The Causes and Effects of Depreciation in Office Buildings: a Ten Year Update*

This paper compares a study undertaken in 1986 by the same authors and estimates depreciation rates in office buildings in Central London ten years later.

The 1986 study found that the average rate of rental depreciation of the 125 buildings in the study's sample set was 1.1% while capital value depreciation was 1.6%. The most significant and important determinant of depreciation in rental value was found to be the configuration of the building, followed by the internal specification and external appearance (i.e. obsolescence related factors). Physical deterioration was found to be the least important. For explaining depreciation in capital value, internal specification and external appearance were most important; deterioration was again least important.

In 1996, the average rental depreciation rate had increased to 2.2% with capital value depreciation increasing to 2.9%. The sample of 128 buildings included 82 buildings in the 1986 study. The highest period of depreciation in the 1996 study was found to be much earlier in the life of a building (ages 7 to 12) than in the 1986 study (ages 17 to 26 and 20 to 29 for rental and capital values, respectively).

The study concludes that building lives are getting shorter (falling from around 40-45 years in 1986 to around 25 years in 1996) with depreciation for older property lower than depreciation on new property because older properties are closer to the end of their building lives and therefore close to their site (i.e. land) values.

8.3 *Gort, M., Greenwood J. and Rupert, P. (1999) Measuring the Rate of Technological Progress in Structures*

The study analyses the degree of technical progress in structures; it notes that as each decade passes new technology enables advances to be made. The study uses price data to determine the impact of technological change on building rents, the hypothesis being that newer office buildings have new and improved technologies embodied in their structures and should therefore rent for more than old ones, when holding the general physical condition of the building constant (i.e. assuming buildings are continually kept in good repair).

The study concludes that the rate of structure-specific technological progress is about 1% per annum. Due to technological progress buildings eventually become obsolete and need to be replaced. Economic depreciation in the model is estimated at 6.6% (compared to 1.9% for physical depreciation).

8.4 *Gellatly, G., Tanguay, M. and Yan, B. (2002) An Alternative Methodology for Estimating Economic Depreciation: New Results Using a Survival Model*

This paper develops depreciation profiles and life assets for 8 different types of structures. Gellatly, Tanguay and Yan determine depreciation on office buildings at a rate of approximately 7.6% and industrial buildings at a rate of 13.0%.

It is noted that substantial reductions in economic value are apparent early in life for many of the sampled structures. This study differs from Hulten and Wykoff, in that the model has a component included which calculates the 'survival ratio' of assets. It therefore incorporates the issue of retired assets, previously addressed as a limitation of Hulten and Wykoff in the work by Gravelle.

8.5 *Dixon, T., Crosby, N. and Law, V. (1999) A critical review of methodologies for measuring rental depreciation applied to UK commercial real estate*

This paper provides an analytical review of the methodologies and results of a number of past depreciation studies, including Hulten and Wykoff. The paper provides a breakdown of

depreciation rates on buildings from the studies examined and show a range of 1.1 to 3.0% for office buildings and 0.52 to 3.3% for industrial buildings.

9 Summary of the additional international evidence

The additional evidence outlined above confirms the results of the international studies referenced in the 2004 officials' issues paper – namely that buildings, and specifically commercial and industrial buildings, do depreciate. Importantly, we have not come across any studies which suggest that buildings do not depreciate.

While there are differing ranges for depreciation rates (and estimated useful lives) for non-residential buildings, the studies indicate that the current 3% DV rate (and 2% straight-line) rate is broadly appropriate. The recent comprehensive Patry study suggests that depreciation rates for commercial and industrial buildings should be much higher. However, we note that the consensus appears to be around the (lower) Hulten and Wykoff estimates.

10 New Zealand evidence and issues

One of the key constraints identified in the officials' issues paper, which persists today is the lack of New Zealand data, or empirical analysis, on building depreciation rates.

A potential concern with relying solely on international evidence may be that depreciation profiles for buildings may differ by geographic location (e.g. office buildings in London versus central Auckland or Wellington). However, we do not believe that any geographical differences would be sufficient to justify tax depreciation being removed for New Zealand buildings.

This is because the factors underlying tenant (and owner-occupier) demand for non-residential buildings in New Zealand should be the same as in Australia, Canada, the United Kingdom, or the United States.

We provide some qualitative analysis of the New Zealand commercial property sector below, supporting the international evidence that non-residential buildings do depreciate. This is based on our discussions with various PCNZ members on factors impacting on the New Zealand commercial and industrial property sector.

10.1 Higher rates of redevelopment for commercial buildings

We note that a clearly observable phenomenon with commercial buildings in New Zealand is the high rates of redevelopment (or capital reinvestment) – note for example, how few office buildings in the Auckland and Wellington CBDs are older than 30 years, let alone ones which have not undergone any significant capital improvements to the building structure.

This suggests that the average useful life of a commercial building is likely to be significantly less than the 50 year economic life used to set tax depreciation rates (we note that a number of

international studies have found the average service life of buildings today to be lower than in, say, the 1980s).

More importantly it shows that non-residential buildings are regularly being demolished to make way for newer buildings, when the opportunity cost exceeds the market value of an existing building. This strongly supports the assertion that these buildings depreciate due to obsolescence factors.

10.2 *Changes in preferences and technology impact on capital values*

The impact of changes in tenants' preferences on building values can also be readily observed.

By way of example, we understand the New Zealand Government has recently introduced new "Green" (energy efficiency) requirements for office buildings leased by the various Government departments. Compliance with these requirements has required significant capital improvements by commercial landlords (including a majority of the LPTs) to a number of existing buildings. Similarly, the move away from individual offices to an open plan office environment has required reconfiguration of certain structures, to meet occupiers' needs. In the absence of these improvements, the expected return on these properties will fall significantly (in turn impacting on buildings' capital values).

Drivers of technical obsolescence, in the commercial property sector, include changes to building standards. For example, office buildings constructed in the 1980s will have had significant structural improvements to bring them up to compliance with earthquake standards. Where such improvements are not cost effective, the building would have been demolished and new earthquake standard compliant structures erected instead.

In our view, the above are very real examples of the economic depreciation of buildings.

10.3 *Buildings move between different market segments*

Buildings also move across different market segments over their economic life, depending on their condition and suitability for use. For example, an office building developed in the 1970s may have been prime real estate at the time. However, if unimproved (but nevertheless reasonably maintained) the same building in 2010 will typically be sub-prime property due to changes in technology and tenants' preferences. This lower status will be reflected in the much lower rental yields on the property compared to a newer, more technologically advanced, building.

This movement of buildings across different segments of the market, over time, means that the analysis of capital values in aggregate (using for example, Quotable Value or Government valuation data) is inappropriate. Instead, the analysis needs to be done on a building by building basis, which we note would be a prohibitive exercise not least of which because the valuation data available does not separate out the value of capital expenditure over the life of a building.

This makes any attempt to draw any conclusions from the changes in capital values inherently dangerous.

The PCNZ has discussed in depth with CBRE, the available valuation databases to undertake empirical testing of whether buildings depreciate. Unfortunately, the databases available (i.e. QV, Government valuations, and the PCNZ Property Index) omit a number of key variables necessary to undertake any meaningful analysis.

11 Impact if depreciation on non-residential buildings was removed

We provide below some analysis of the potential economic impact if tax depreciation on non-residential buildings is removed. We note that a more detailed report on the merits of the TWG's property tax proposals will be prepared by the New Zealand Institute of Economic Research.

11.1 Breakdown of the fiscal implications

Inland Revenue's estimate of the additional revenue that would be raised by denying depreciation deductions on buildings is \$1.3 billion per annum. We understand that approximately 30% of this revenue estimate relates to denying depreciation on residential properties (i.e. rental housing investment in the tax base). 70%, or approximately \$900 million, would be raised by denying depreciation deductions to owners of non-residential buildings, including members of the PCNZ. Applying a 30% tax rate, this suggests that annual depreciation deductions for non-residential buildings amount to approximately \$3 billion.

We understand that the costing has been constructed using Statistics New Zealand capital stock data and fixed capital formation data for the 2008 year with various assumptions around the proportion of residential and non-residential buildings in the tax base (approximately 20% and 100%, respectively). The net capital stock of residential buildings in 2008, in current prices, was valued at approximately \$267 billion, while non-residential buildings comprised approximately \$110 billion.

We have not seen the detailed costing work, but would assume that the above estimate is likely to (perhaps significantly) overstate the additional revenue from denying depreciation on non-residential buildings. For example, we note that capital stock is valued in current prices, whereas the depreciation base is historical cost (it is unclear whether any adjustment has been made to capital stock to compensate). Also, the assumption that most, if not all, non-residential property is in the tax base discounts significant property holdings by non-taxpayers (including the charitable sector and local and central government).

If the revenue impact is unclear, there is a risk of policy decisions being made without the full costs and benefits being understood.

11.2 *The impact will be felt predominantly by New Zealand businesses*

The largest 4 LPTs in the New Zealand market, which can be used as a reasonable proxy for institutional investment in commercial property, hold approximately \$4.1 billion (excluding land value), or around 3 to 4%, of the total stock of non-residential buildings⁵. In total, these taxpayers have annual depreciation deductions of around \$65 to \$70 million per annum. This comprises approximately 2% of the \$3 billion gross depreciation deduction that would be disallowed under any depreciation change.

This leads us to conclude that the majority of the impact from removing depreciation on non-resident buildings will be felt by New Zealand businesses that own their premises. This will result in a real cash-flow cost to these businesses (which may or may not be compensated through other tax changes).

We understand that some business owners, particularly in the SME sector, own premises as a form of collateral to secure bank financing for their operations. The loss of tax depreciation could raise the cost of capital to such firms (to the extent the tax benefit of depreciation deductions reduce their net financing costs) or reduce availability of credit.

It also possible that removing a tax deduction in one area will simply refocus attention on other areas (e.g. the interest deductibility rules). To the extent gearing can be increased, the same after tax return profile may be able to be achieved. This would not be desirable from an economic perspective.

11.3 *Impact on cost of, and investment in, commercial property infrastructure*

Removing depreciation on non-residential buildings will either reduce re-investment in this sector or increase rents for occupiers.

Office buildings, manufacturing plant, warehousing, etc, are all part of the infrastructure of New Zealand Inc. Reduced investment in this infrastructure or a higher cost associated with its use will adversely impact on the competitiveness of New Zealand business.

12 **Tax depreciation treatment in other jurisdictions**

The appendix to this report compares the tax depreciation treatment of buildings in a number of other countries – based on a survey of KPMG’s international network of member firms on depreciation and other land taxes. We note that, as a general rule, non-residential buildings receive some depreciation tax benefits (either as an explicit tax depreciation deduction or by way of capital allowances).

⁵ Kiwi Income Property Trust, Goodman Property Trust, AMP NZ Office Trust, ING Property Trust, based on First NZ Capital data.

In particular, we note that the majority of our trading partners, including Australia, Germany, Japan and the United States allow depreciation of (some or all) non-residential buildings.

The United Kingdom currently allows depreciation in respect of industrial buildings (called an industrial building allowance); however this is to be abolished from 2011.

Removing tax depreciation for non-residential buildings would make New Zealand an outlier from a global taxation perspective. At a time when countries are increasingly competing for internationally mobile capital, the New Zealand tax system needs to provide the right incentives for business to stay in New Zealand and relocate here. Removing tax depreciation, when there is clear international evidence that buildings do depreciate, would be contrary to this objective.

13 Pressure on capital/revenue boundary

The boundary for what is a capital expense and repairs and maintenance will need to be addressed.

While an ongoing issue, currently, if maintenance expenditure (which should be deductible under ordinary principles) is not immediately expensed because it is classified as capital expenditure for tax purposes, it can nevertheless be claimed under the depreciation rules.

If depreciation is removed, these amounts will be permanently non-deductible putting significant pressure on the boundary between what is, and is not, repairs and maintenance of a building. For the commercial property sector this is significant given the substantial sums that are spent on refurbishment and maintenance.

14 Conclusion

The findings of the 2004 officials' issues paper, and other international research on the tax depreciation of buildings, strongly suggest that buildings do depreciate. This is also supported by various anecdotal evidence on the need to replace and improve buildings. Further we have not found any studies which suggest buildings do not depreciate.

We recognise that the Government is constrained fiscally, and any changes to the tax system will need to be self-funding. Removing depreciation on buildings would seem to be an easy (or at least an easier) option, to fund changes to tax rates.

We do not dispute the need for reform of the tax system to address the various anomalies in the tax system (including rental housing, if there is a tax bias there). As far as we are aware, tax depreciation on non-residential buildings was not an area of concern for the TWG.

There needs to be a compelling reason for change. Removing depreciation on buildings simply to fund other changes in the tax system, when there is considerable evidence that buildings do economically depreciate, is not such a reason.



15 **Disclaimers**

This report has been drafted specifically in response to a request by PCNZ for advice on the TWG's tax depreciation recommendation. Accordingly, neither KPMG nor any member or employee of the firm undertakes responsibility in any way whatsoever to any person, other than PCNZ, for any errors or omissions in the report, however caused.

The analysis contained in this report includes information provided by PCNZ members, and other third parties, to KPMG. Neither KPMG nor any member or employee of the firm undertakes responsibility in any way whatsoever to any person for any errors or omissions in third party information provided to us.

16 Appendix – Summary of responses from KPMG’s global member firms (Depreciation and Land Tax Rules)

	Ireland	Singapore	United Kingdom	Japan	Germany	Hong Kong	The Netherlands	Malaysia	Thailand	United States	Australia
<p>1. Does your jurisdiction allow depreciation on non-residential buildings to be claimed for taxation purposes and, if so, are there special rules for depreciating structures?</p>	<p>Industrial buildings which are used for qualifying manufacturing activities can claim tax depreciation at a rate of 4% p.a. straight-line.</p>	<p>No. Tax depreciation is only allowed for industrial buildings that are used for qualifying activities (e.g. mill, factory, manufacturing, processing, warehousing, etc – this list is defined in the Income Tax Act). Such tax depreciation is known as industrial building allowance or IBA in short.</p>	<p>No. Previously, tax relief was available in respect of expenditure on industrial buildings (known as industrial buildings allowance) but this is now being phased out and will be shortly abolished with effect from 6th April 2011.</p>	<p>Yes, buildings are depreciated on a straight line basis.</p>	<p>Yes, generally, 3% (in case of a building application till 31 March 1985: 4%) or the effective time of usage or declining-balance method (exception for some old cases)</p>	<p>Tax allowances in respect of non-residential buildings and/or structures located in Hong Kong are available under the profits tax regime, but not the property tax regime.</p>	<p>The general rule for calculating the annual depreciation for tax purposes is to take the historical cost price minus the rest value divided by the lifespan of the building. It is not allowed to depreciate on land. As of 1 January 2007, based on Dutch tax law, limited depreciation rules apply on buildings. The limitation entails that depreciation may be taken up to a certain value. For investment properties (such as residential, office and commercial real estate), this minimum depreciation value equals the value established by the municipality under the Valuation of Immovable Property Act ("WOZ"), whereas for properties used as part of one's own business (business premises), it will equal half the value under the WOZ. It is also possible to depreciate buildings to their lower value in use. It is also possible to depreciate investments in tenancy rights.</p>	<p>In Malaysia, depreciation on buildings is generally not allowable for tax purposes. However, industrial building allowances (i.e. a form of tax depreciation) may be claimed on the cost of a building which qualifies as an 'industrial building'. Examples of these include, amongst others, a factory/warehouse associated with a manufacturing activity, and by extension hospitals, hotels, buildings used for research, welfare or living accommodation for workers. Note however that the Minister of Finance is empowered to prescribe a building as an 'industrial building' which will qualify for industrial building allowances and to determine the rate of the allowance as well. In general commercial or residential buildings would not qualify as 'industrial buildings'.</p>	<p>Yes - In general, buildings (except temporary/non-durable buildings) are depreciated at the rate of not more than 5% of the acquisition cost for corporate income tax purposes. There are no special rules for depreciating buildings.</p>	<p>Non-residential buildings are depreciated on a straight-line basis over 39 years. IRC Section 168(b)(3)(A) Depreciation on most other types of depreciable property is claimed on a double (or in some cases 150%) declining balance method, switching to the straight line method only in the year in which the straight line method will yield a larger deduction. IRC Section 168(b)(1)</p>	<p>Yes – Australia's income tax rules allow depreciation on both residential and non-residential buildings and structural improvements (referred to as "capital works"). Broadly, the following requirements must be satisfied in order to be eligible:</p> <ul style="list-style-type: none"> the capital works must be used in a deductible way (i.e. used to produce assessable income or carry on R&D activities); the general rule is the legal owner of the capital works is entitled to depreciate (although if the costs are incurred by a lessee, the deduction will be available to the lessee); the deductions are not available for taxpayers who hold the capital works as trading stock; the deductions are not available until the construction of the capital works is complete. <p>The quantum of deductions is based on actual cost (rather than purchase price) and, upon sale, a previous owner is required to provide details regarding capital works to the new owner. Various rules regarding what type of capital expenditure qualify for eligible expenditure. The rates are outlined at 04.</p>
<p>2. Does your jurisdiction allow depreciation on residential rental properties?</p>	<p>Generally no. We had special incentives which are now being phased out which provide for tax relief on residential property that was located in certain areas</p>	<p>No.</p>	<p>No.</p>	<p>Yes.</p>	<p>For buildings used for accommodation (residential rental property), the annual straight-line depreciation rate is 2% (for buildings constructed before 1 January 1925: 2.5%) or effective time of usage. The alternative declining-balance method rates are according to the current tax law: - first 10 years: 4.00% - following 8 years: 2.50% - remaining 32 years: 1.25% The declining-balance method of depreciation is no longer available for buildings used for accommodation if the building was acquired or constructed after 1 January 2006.</p>	<p>Residential rental properties in Hong Kong should qualify for commercial building allowances for profits tax purposes. No tax allowance, however, is available for property tax purposes.</p>	<p>There is no restriction in offsetting losses from investments in residential property against other types of taxable income. Losses can in principle be offset against the profit of the previous year as well as the nine following years. In 2009 and 2010 a prolonged carry back facility has been introduced from one to three years. If this facility is used, the carry forward period will be decreased to six years.</p>	<p>No.</p>	<p>If the residential properties are rented out as part of the company's business, then it should be allowed a deduction for depreciation at the general rate for buildings (5% of the cost value) for the purpose of corporate tax calculations. However, depreciation deductions on residential property for personal use/non-business purpose is not permitted.</p>	<p>Yes, residential rental properties are depreciated on a straight line basis over 27.5 years. IRC Section 168(b)(3)(B)</p>	<p>No - there are currently no restrictions in place. In the past, there has been various speculation as to whether the 'negative gearing' benefit associated with rental properties should be abolished again (having been abolished briefly in the 1980s and then reinstated shortly thereafter in response to significant political backlash</p>
<p>3. Is there any restriction on offsetting losses from residential property against other types of taxable income?</p>	<p>Rental losses can only be offset against rental income. They cannot be offset against any other type of income.</p>	<p>Losses from residential property are generally confined to being set-off against income from residential properties. However if the taxpayer is in the trade of renting both commercial and residential properties, the losses from residential property may be set off against gains from commercial properties</p>	<p>For an individual letting property as part of a property business, losses cannot generally be set off against general income. Limited relief is available if the loss includes a capital allowances claim. Capital allowances cannot be claimed, however, in respect of residential property, so the point would not arise.</p>	<p>There are baskets that segregate types of income for individual tax purposes. However, generally residential losses can be offset against salary and wages income. For corporations there are no baskets and everything is essentially taxed at the full corporate rate of approximately 42%.</p>	<p>Yes, there are restrictions concerning the usage of tax losses in case of special tax models ("Steuerfindungsmodelle"), see Section 15b ITL. Besides this special regulation, the general rules are applicable including minimum taxation pursuant to Section 10d ITL, which is applicable for Corporate Income Tax purposes and Trade Tax purposes, too.</p>	<p>For profits tax purposes, rental losses arising from residential (and non-residential) property can be offset against other types of taxable income of that taxpayer. However, if a special purpose company is incorporated to hold the property, any income/loss of that special purpose company cannot be offset against the income/loss of any other group entities (i.e. there is no group relief available). Losses can be carried forward indefinitely for offset against future assessable profits, but cannot be carried back.</p>	<p>Generally, losses from residential property would not be available to be set off against other types of taxable income unless viewed as losses arising from a business source (in limited circumstances).</p>	<p>Deduction for depreciation of residential property used for business purposes is limited up to the amount of taxable income in that period (loss carry forward for 5 years).</p>	<p>Yes, with respect to individuals, estates, trusts, personal services corporations and certain closely held corporation. The passive activity loss rules under IRC Section 469 limit such a taxpayer's ability to offset other types of income with net passive losses. Any excess loss is carried forward to the following year or years until used, or until deducted in the year such a taxpayer disposes of its entire interest in the activity in a fully taxable transaction. Rental real estate is generally considered a passive activity, giving rise to passive income or passive loss, with few exceptions. An individual who actively participates in the rental business may deduct up to \$25,000 of rental loss against other income, even though the loss is passive. This deduction is phased out as the individual's income rises and is subject to various other limitations.</p>	<p>No - there are currently no restrictions in place. In the past, there has been various speculation as to whether the 'negative gearing' benefit associated with rental properties should be abolished again (having been abolished briefly in the 1980s and then reinstated shortly thereafter in response to significant political backlash</p>	
<p>4. Are there different tax depreciation rates depending on building type and/or use (e.g. different rates for office buildings, factories, warehouses etc.) and, if so, what are the broad categories and rates?</p>	<p>As noted above, industrial buildings qualify at a straight-line rate of 4% p.a. unless the office/warehouse is less than 10% of the total sq footage attributed to the industrial building no tax depreciation is available. In certain circumstances, other types may qualify and for ease, I attach a copy of the Revenue publication on this. Please note that a lot of these incentive allowances are being phased out.</p>	<p>If the building qualifies for IBA, the taxpayer may claim an initial allowance of 25% of the capital expenditure incurred in the year and an annual allowance of 3% over until the expenditure is written off.</p>	<p>No depreciation is available.</p>	<p>I will follow up but yes. It doesn't actually differentiate on the use but rather construction method etc. For example concrete steel construction is about 40 years. I will follow up with some details on Monday.</p>	<p>See answer to (2) above. According to the official publication of the German fiscal authorities, there exist special depreciation rates for immovable assets (other than buildings), for example: warehouse = 16 years light-metal-designed halls = 14 years silo = 17 - 33 years</p>	<p>Buildings or structures are broadly classified into "industrial buildings or structures" and "commercial buildings or structures", based on their usage. Generally, industrial buildings or structures qualify for an initial allowance of 20% and annual allowances of 4% over 20 years. On the other hand, commercial buildings and structures qualify for an annual allowance of 4% on a straight-line basis, but no initial allowance</p>	<p>With regards to industrial building allowances, the rate of initial allowance (broadly given in the year of purchase) is generally 10% of qualifying expenditure and the rate of annual allowance is generally 3%. An initial allowance is claimed in the year the capital expenditure is incurred and the annual allowance is claimed annually until the tax written-down value (TWDV) (which is equal to the cost of the asset less allowances claimed) is nil or the asset is disposed of. Note however that certain specific categories of industrial buildings qualify for increased allowances. Examples of such industrial buildings include, amongst others, a warehouse used solely for the purpose of storage of goods for export/imported goods which are to be processed and distributed/re-exported, buildings used as schools/educational institutions, buildings used for the provision of living accommodation for individuals employed in the business and etc.</p>	<p>There are special rates for factory buildings owned by companies whose fixed assets (excluding land) do not exceed THB 2 million and employs not more than 200 workers to have an initial deduction of 25% of the acquisition cost, with the remaining cost value deducted in accordance with the general rate (i.e., 5%).</p>	<p>Not generally. However, certain specified types of real estate may be depreciated more quickly. It is difficult to categorize these exceptions into broad categories or rates. For example, single purpose agricultural or horticultural buildings are depreciated over 10 years, retail motor fuel outlets are depreciated over 15 years, and gas pipelines are generally depreciated over either 7 or 15 years, depending on when placed in service and where located. Other special purpose structures may be depreciated at different rates. IRC Section 168(e)(3). We can provide a more detailed list if requested. Depreciation on such buildings is generally claimed using the double-declining (or 150%) balance method, switching to the straight line method only in the year in which the straight line method will yield a larger deduction. IRC Section 168(b)(1)</p>	<p>Refer to summary table</p>	
<p>5. How are tax depreciation rates set (e.g. has the tax authority undertaken studies of depreciation rates for buildings, or are rates set by reference to international evidence on building rates or rates for accounting)?</p>	<p>They are set out in legislation on the above basis.</p>	<p>(Answer N/A)</p>	<p>N/A</p>	<p>The underlying principle is useful life. The rates set for tax are an attempt to estimate the useful life of the building. Hence, for example wooden structures have a much shorter depreciation life than steel and concrete. Whether that is actually correct from a life perspective may be debatable but that is the underlying philosophy. In the case of listed REITs for example they seek to limit depreciation so that they can increase the amount of accounting income. In such a case they typically try and get engineering reports to show that the life is say 50 years and depreciate over the longer of the default tax life or the life detailed in the engineering report. In that case tax would use the longer rate. It is possible for tax to use longer rates as it is increasing taxable income but the limiting factor is accounting.</p>	<p>According to our understanding, the tax depreciation rates, set by the German fiscal authorities, are based on experiences during the tax audit of the German fiscal authorities.</p>	<p>As the tax allowances for industrial/commercial buildings or structures have been in place for many years, we are unable to locate the consultation papers, if any, in respect of the determination of the rates of allowances.</p>	<p>There is no fixed depreciation rate applicable. This is decided by a case approach and is depending on the type of real estate, state of maintenance, etc. Generally speaking, the annual depreciation rate is between the 0% and 4%</p>	<p>It is envisaged that further research would be necessary in order to ascertain the basis by which the tax depreciation rates are set by the tax authority.</p>	<p>No information - requires further research</p>	<p>The depreciation rates, when enacted, were generally intended to match useful life. The Department of the Treasury is charged, under IRC section 168(i)(1) with monitoring and analyzing actual experience with respect to all depreciable assets. We are not, however, aware of the results of such monitoring or analysis (if it has been conducted). We could conduct additional research on this point if requested.</p>	<p>The rates are legislated in Australia's Income Tax Assessment Act.</p>
<p>6. Are there rules for recovery of tax depreciation when a building is sold for more than its depreciated book value?</p>	<p>There is a drawback of the tax depreciation claimed up to the original cost of the building and this is taxed at the trading rate (generally 12.5%). Where there is a gain in excess of the cost of the building, this is taxed at a rate of 25%. New rules have been recently introduced to tax windfall gains at 80% that arise as a result of rezoning but I can send you something on this separately if required</p>	<p>When a building is sold, a clawback of the allowances claimed will be made</p>	<p>N/A</p>	<p>The depreciated value becomes the basis for determining the gain on sale.</p>	<p>There are no special rules for a recovery of tax depreciation for Corporate and Trade Tax purposes. However, in case of a sale of immovable property that is not used for business purposes, the tax depreciation, deducted in the past, increases the capital gain on the level of the individual for German Income purposes, see Section 23 ITL.</p>	<p>If the sales proceeds arising on the disposal of an industrial/commercial building or structure exceed the tax written down value of the property, the excess amount (limited to the total allowances claimed in prior years) will be clawed back and treated as taxable in the year of disposal.</p>	<p>If a building is sold for more than its book value, the profit will be taxable against a CIT rate of 25.5%. It is however, under circumstances, possible to form a reinvestment reserve. In general the reserve needs to be used with the next three years and needs to be used for the purchase of real estate which has the same economic use as the sold real estate.</p>	<p>For Malaysian tax purposes, the disposal of a building (for which industrial building allowances have been claimed) to a third party would trigger balancing adjustments depending on the TWDV of the asset and the disposal price/market value, whichever is higher. A balancing allowance arises when the market value or the sale price of the asset exceeds the assets TWDV. A balancing charge arises when the market value or sale price of the asset exceeds the assets TWDV. However the amount of the balancing charge to be imposed will be limited to the amount of allowances claimed on the asset prior to disposal. Any gain that is in excess of original cost may attract Real Property Gains Tax where the period of ownership is less than 5 years.</p>	<p>Depreciation recapture (the difference between book value of asset and sale price) treated as taxable income for corporate tax purposes (no separate tax on capital gains).</p>	<p>Not generally with respect to many buildings. IRC Section 1250. Note, however, that with respect to individual taxpayers, IRC Section 1(b)(1)(D), taxes any gain realized (the amount realized in excess of the depreciated basis) at a rate 10% higher than the normal long term capital gains rate of 15%. This additional tax may be thought of as a proxy for recapture. Corporations are subject to the same tax rate on capital gains and ordinary income so the entire gain (amount realized in excess of the depreciated basis) will be taxed at the same rate. In addition, for all taxpayers, any depreciation claimed in excess of the straight line method is recaptured and taxed as ordinary income. Such excess depreciation may be claimed in the case of buildings with a useful life (depreciation period) of less than 27.5 years and in some other cases.</p>	<p>The disposal of buildings which have been depreciated by an owner will trigger a capital gains tax ("CGT") event. Broadly, for buildings acquired post 13 May 1997, the building depreciation claimed by the owner will reduce the CGT cost base of the building, thereby increasing the amount of taxable capital gain to effectively recapture building amortisation. There are no such adjustments for buildings acquired pre 13 May 1997.</p>

<p>7. Does your jurisdiction have a land tax (being an annual tax levied on the value of land)?</p>	<p>At present we don't have a land tax though rates are paid annually to the local county council.</p>	<p>There's property tax in Singapore. This tax is on all immovable properties in Singapore (land and buildings). Its currently at 10% of the annual value of the property. The annual value is the average annual rent that the property can fetch in the market.</p>	<p>Local business rates are payable by the occupiers of commercial property (and council tax in respect of residential properties)</p>	<p>Yes but they also levy one on the building portion. Every land and building (and apartment) in Japan has what we call a fixed assets tax assessment value. This is the basis for the charge. For land is not necessarily a reflection of the market price as it is done using a benchmark piece of land (which is valued) and adjustments are made based on a prescribed formula. In most cases it will be less than the actual value (for land). For buildings the value is based on the materials used and a rule of thumb is that the value is 70-80% of what it cost to build. This can be a real problem where you have something where the builder went overboard and you buy cheap because the assessment value does not change just because the asset is sold at a price significantly lower than its assessment value. One other thing that is useful to keep in mind in the context of Japan is that buildings (particularly residential but also true of office and other asset classes) have typically not been made to last. This is changing now but when you buy residential there is in fact a significant discount in most cases for older buildings in fact for residential houses the building is often not assigned any value where it is older and people just look at land value. Office too has tended to age very significantly in Japan. In that context it is very different from New Zealand (which I am assuming is like Australia) in that older houses in Japan are typically assigned no value. There are obviously exceptions where for example the building has some historical value but most of the home builders have not built things to last like they do in New Zealand. One of the reasons for this is to keep things turning over and the other is that they tend to spend a lot more money on gadgets in the home than western countries and the gadgets tend to age. The other is simply that the house is more integrated with the various attachments (rather than being more of a shell the inside of which can be updated).</p>	<p>Yes.</p>	<p>There is no land tax in Hong Kong. However, rates are charged at a percentage (currently 5%) of the rateable value and, for properties in the certain regions of Hong Kong with Government leases granted on or after 27 May 1985, Government rent calculated at 3% of the rateable value of the properties is also payable. The rates for the first two quarters of the 2009/10 financial year (i.e. the quarters ended 30 June and 30 September 2009) have been waived, subject to a ceiling of HK\$1,500 per quarter.</p>	<p>Based on Dutch tax law, land tax does not exist. There is however a property tax based on the above mentioned WOZ value which is annually established by each municipality.</p>	<p>In Malaysia there is property tax in the form of assessment rates and quit rent which are levied at varying rates. The amount of assessment tax and classification of properties varies from one local authority to another and the basis for calculating assessment tax may also differ from state to state. The amount of quit rent also varies from state to state.</p>	<p>Yes - a House and Land tax is levied at the rate of 12.5% of the assessed rental value of the property. There are also land transfer fees/tax on the transfer of immovable property</p>	<p>In the United States, property tax on real estate (an annual tax levied on the value of real estate, including land and buildings) is levied by local government, usually at the municipal or county level. The federal and state governments do not levy property tax.</p>	<p>Yes - each Australian State and the Australian Capital Territory imposes annual land tax, payable on the unimproved value of land at certain dates. The rates vary from jurisdiction to jurisdiction.</p>
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Depreciation and land tax

Assessment of selected Tax Working Group recommendations

Report to Property Council of New Zealand

5 February 2010

About NZIER

NZIER is a specialist consulting firm that uses applied economic research and analysis to provide a wide range of strategic advice to clients in the public and private sectors, throughout New Zealand and Australia, and further afield.

NZIER is also known for its long-established Quarterly Survey of Business Opinion and Quarterly Predictions.

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Key points

The Property Council of New Zealand (PCNZ) has engaged NZIER to assess the merits of two policy recommendations by the Tax Working Group: removal of depreciation on buildings and introduction of a land tax.

Our analysis¹ shows that these recommendations:

- (i) Are inconsistent with the ‘good tax policy’ criteria set out by the Tax Working Group.
- (ii) May work against over-riding government objectives to become more internationally competitive in order to close the income gap with Australia by 2025.

Removing depreciation on buildings would raise tax expenses for businesses. It would increase the effective marginal corporate tax rate from 30% to 32%. This is clearly against the Tax Working Group’s “critical concern” that “New Zealand relies heavily on taxes most harmful to growth – particularly corporate and personal taxes on capital.”

In addition, depreciation of commercial buildings is common practice in the OECD. Removing depreciation in New Zealand would make us an outlier and reduce our international tax competitiveness. This could hamper already weak foreign direct investment into New Zealand, the health of the local capital market and erode export competitiveness.

This is clearly counter to government policy objectives of making New Zealand a more internationally competitive economy and would place us at a further disadvantage to Australia.

A land tax would be efficient and fair only if broadly and uniformly applied. New Zealand has a long history of land taxes beginning in the late 1800s. Exemptions and reductions have made land taxes politically unsustainable. They were finally repealed in 1990. We see no reason why a land tax in the future should be any more politically sustainable, particularly given the strong views of key stakeholder groups such as farmers, retirees and Iwi.

A land tax would also impact on land prices. This would impact on banks – at least 2/3 of bank lending is to land based and housing segments. This could impact on the cost and availability of capital - and consequently on economic growth – perhaps for a protracted period.

Our initial analysis strongly suggests that far more detailed analysis and rigorous debate is required before these ideas progress further. Otherwise potentially damaging policy decisions could be made.

¹ Our analysis looks at these policy suggestions in isolation and not in the context of potentially offsetting policies.

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1. Introduction

The Property Council of New Zealand (PCNZ) has engaged NZIER to assess the merits of certain policy recommendations by the Tax Working Group (Buckle et al, 2010). We consider the merits of two particular recommendations in this report:

- *“Removing tax depreciation on buildings (or certain category of buildings) if empirical evidence shows that they do not depreciate in value.”*
- *“...introduction of a low-rate land tax as a means of funding other tax rate reductions.”*

2. Removing tax depreciation on commercial buildings

“Removing tax depreciation on buildings (or certain category of buildings) if empirical evidence shows that they do not depreciate in value.”

We assume that tax depreciation is removed from commercial property. Our analysis shows that:

- depreciation of commercial buildings is common practice among OECD countries
- removal of depreciation on commercial buildings would effectively increase the marginal corporate tax rate from 30.0% to 32.1%
- to keep the tax bill for businesses the same, the corporate tax rate would have to be cut from 30.0% to 28.0%.

The removal of commercial property depreciation would:

- raise tax costs, which is clearly against the Tax Working Group’s *“critical concern”* that *“New Zealand relies heavily on taxes most harmful to growth – particularly corporate and personal taxes on capital.”*
- violate some of the key criteria set out by the TWG, in particular economic efficiency and growth by reducing the incentive to invest
- violate one of the key objectives of the Capital Market Development Taskforce (CMD) by effectively raising the cost of capital
- violate the spirit and intent of the CMD and 2025 Taskforces by reducing New Zealand’s international competitiveness, by removing depreciation which is commonly in place in the OECD.

2.1 Depreciation of buildings common in the OECD

A compilation of OECD country tax practices, summarised in Figures 1 and 2, show that New Zealand is similar to the OECD in the treatment of building tax depreciation. The real divergences appear to be in the absence of a capital gains tax, harmonisation of various tax rates and a higher value added tax.

The analysis of OECD countries suggest New Zealand’s current rules on building depreciation are the norm. Removing this depreciation would impose a cost on New Zealand businesses that is not commonly found in the OECD. New Zealand would be less competitive in the global scene, and in particular less attractive relative to our

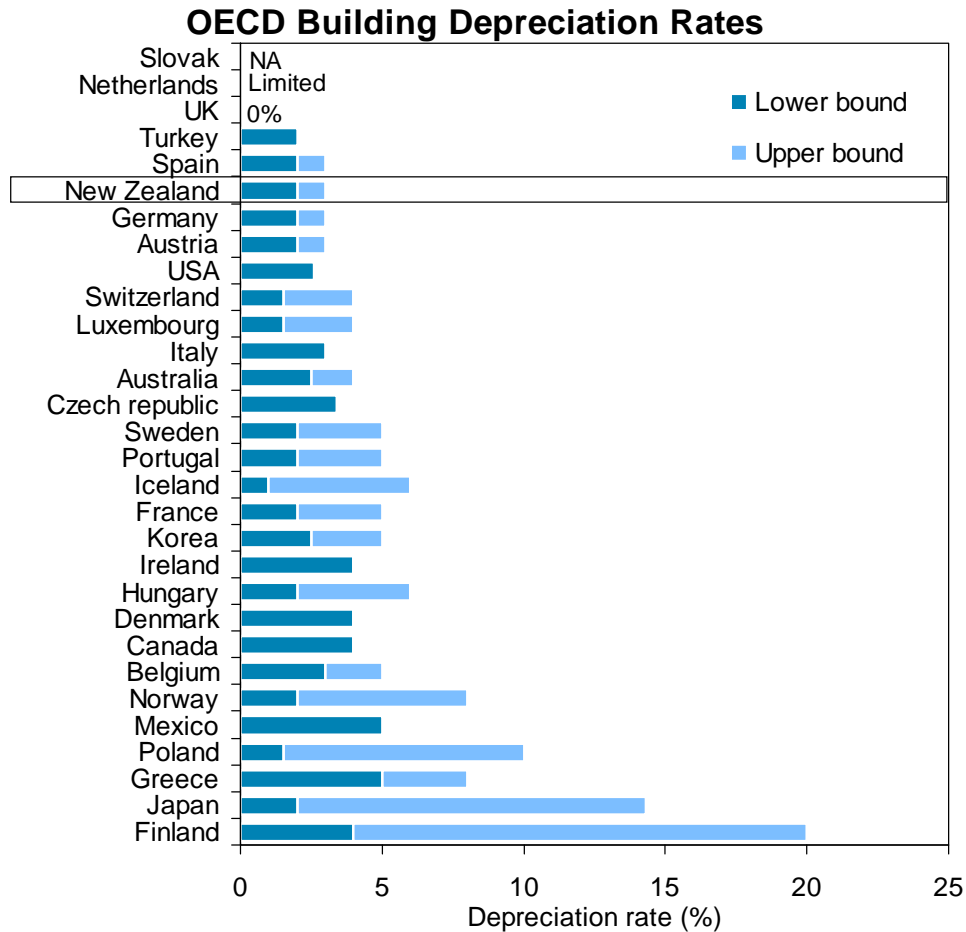
closest competitor Australia. New Zealand already allows less depreciation on buildings (2%) than Australia (2.5%-4.0%). This has the potential to weigh on foreign direct investment into New Zealand (which is already low).

Figure 1: Selected tax information of OECD countries

	Main corporate tax rates			Value added tax		Building depreciation	
	Corporate	Capital gains	Branch	Main	Selected	Straight line	Accelerated
Australia	30	30	30	10	-	2.5-4	-
Austria	25	25	-	20	10	2-3	-
Belgium	33	33	33	21	-	3-5	-
Canada	19	9.5	19	5	13	-	4
Czech republic	20	0/20	20	19	9	3.4	-
Denmark	25	25	25	25	-	4	-
Finland	26	26	26	22	-	-	4-20
France	33.33	0/15/33.33	33.33	19.6	-	2-5	-
Germany	15	14	15	19	7	2-3	-
Greece	25	25	25	19	3-13	5-8	-
Hungary	10/16	10/16	10/16	20	5	2-6	-
Iceland	15	15	15	24.5	7	-	1-6
Ireland	12.5	22	12.5	12.5	0-13.5	4*	-
Italy	27.5	0/27.5	27.5	20	4-10	3	-
Japan	30	30	30	5	-	2-14.3	5-35.7
Korea	25	25	25	10	-	2.5-5	-
Luxembourg	21	21	21	15	3-12	1.5-4	-
Mexico	28	28	28	15	0-10	5	-
Netherlands	25.5	25.5	25.5	19	0-6	Limited	-
New Zealand	30	-	30	12.5	-	2	3
Norway	28	28	28	25	8-14	-	2-8
Poland	19	19	19	22	0-7	1.5-10	-
Portugal	25	25	25	20	4-14	2-5	-
Slovak Republic	19	19	19	19	10	na	na
Spain	30	30	30	16	4-7	2-3	-
Sweden	26.3	26.3	26.3	25	6-12	2-5	-
Switzerland	12.7-25	-	12.7-25	7.6	2.4-3.6	1.5-4	3-8
Turkey	20	20	20	18	1-8	2	-
UK	28	28	28	17.5	0-5	0% from 2011	-
USA	35	35	35	Various	Various	2.6	-

*Source: Ernst & Young (2009) (*Industrial only)*

Figure 2: Building depreciation rates among OECD countries



2.2 Removing depreciation lifts tax costs for business

Depreciation is a non-cash expense for businesses, which spreads capital expense over the life of the investment. The effect of depreciation is to reduce the tax burden (by reducing the taxable income by the depreciation amount) and lift after tax cash income.

Removing depreciation on buildings would lift the effective corporate tax rate from 30% to 32%. Removing all depreciation (not just buildings) would lift the effective corporate tax rate to 42%.

2.2.1 Removing building depreciation lifts effective tax rate to 32%

We estimate the removal of commercial building depreciation would levy large costs on New Zealand business (around \$1 billion in 2008). This equates to effectively increasing the marginal corporate tax rate from 30.0% to 32.1%. Keeping the business tax bill the same would require a corporate tax rate of 28.0%.

Figure 3: Removal of building depreciation scenario

Data in \$b	2008 actual	Without depreciat ion	Change	
			%	\$b
Income	561	561	0%	0
Expenses	513	510	-1%	-3
Building Depreciation	3	0	-100%	-3
Other depreciation	16	16	0%	0
Other expenses	494	494	0%	0
Taxable income	47	51	7%	3
Statutory tax rate	30%	30%	0%	
Cash income pre tax	67	67	0%	0
Tax paid	14	15	7%	1
Cash income	52	51	-2%	-1
Effective marginal tax rate	30.0%	32.1%	+2%pt	0

Source: Statistics NZ, NZIER

The data on depreciation and taxable structures is limited in New Zealand. While due care has been taken, the estimates are illustrative. We estimate the 2008 building depreciation amount by assuming it is 3% of the market value of non-residential buildings (the statutory rate is 4%, but this applies to historical cost, not market value). All data in Figure 3 relate to all businesses in New Zealand as recorded by Statistics New Zealand in the 2008 Annual Enterprise Survey.

2.2.2 Removing all depreciation lifts effective tax rate to 42%

We also analysed a scenario where all depreciation is removed. While this was not a recommendation of the TWG report, it serves to highlight the significant divergences between industries. Capital intense buildings may face marginal tax rates in excess of 50%.

Without any depreciation net cash income by businesses in 2008 would be \$6b (or 11%) lower. This equates to an increase in the marginal tax rate from 30.0% to 42.2%. Supporting tables can be found in Appendix A.

2.3 Assessment against criteria

Removing depreciation on commercial property does not stack up against the criteria and objectives set out by the TWG, Capital Market Development Taskforce and 2025 Taskforce. We consider the policy in isolation and not in the context of potentially offsetting policies.

Figure 4: Stacked against criteria

Group and criteria	Meet?	Comments
Tax working group		
Efficiency and growth	N	Reduce economic efficiency and growth. Depreciation allowance typically promotes investment in capital. New Zealand's low productivity growth and demise in economic leader-boards is in part explained by low capital intensity. Policies that discourage investment can be detrimental to economic growth.
Equity and fairness	N	Puts NZ businesses at a disadvantage in an international context, given depreciation of buildings is generally allowed offshore. Fair within a domestic context as it does not discriminate by property type.
Revenue integrity	Y	Removal of depreciation allowance on property would reduce a bias in investment in residential property.
Fiscal cost	Y	Raise revenue by around \$1.3b (about \$1b from commercial property).
Compliance and administration cost	Y	Would likely reduce compliance and administration.
Coherence	N	Removal of depreciation on commercial property would move NZ away from the 'norm' in the OECD, and importantly Australia.
Capital market development workforce		
Minimise the cost of capital	N	Removing depreciation would reduce future income from investments in property (due to reduced future income streams) and lower NPV (due to lower cash-flows in early years). This means the required rate of return for a given investment would rise.
Capital flows to most valuable uses	N	This would create an artificial distortion to invest in other forms of assets (such as plant and machinery) relative to property. This is against the intent of a level playing field for all investments.
2025 Taskforce		
Sharpening private incentives to invest, to save and to work	N	Removing depreciation reduces the incentive to invest, as it lowers the future stream of income from the asset.
Minimising the regulatory obstacles the government puts in the way	-	Na
Managing the public sector's own huge assets much more effectively	-	Na
Source: NZIER		

3. Imposing a low-rate land tax

“A land tax is a highly efficient tax mechanism which could be introduced as part of a package of reforms to the New Zealand tax system.” (Policy advice division, IRD and The Treasury, 2009).

A land tax is only efficient if it is applied broadly and uniformly. In the event of exemptions, the tax ceases to be efficient and becomes distortionary with economic costs. While it may begin as a broad and exemption-free tax, New Zealand’s long history of land taxes shows (Figure 5) that tinkering and changes are difficult to resist.

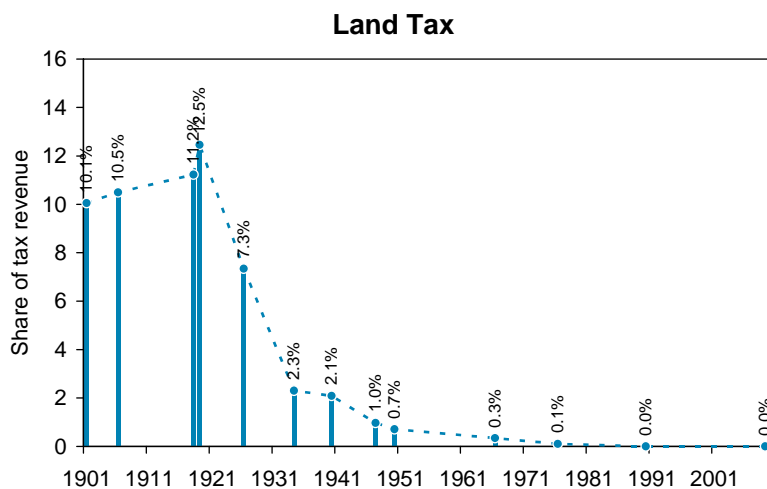
A land tax would be a burden for the asset-rich-cash-poor segments of society, including farmers, lwi and retirees. A greater immediate concern would be a loss of land value and its impact on the banking system. At least 2/3 of bank lending is to land based industries and residential property, so the impact on availability and cost of credit and the economy may be large.

The land tax only stacks up under very special circumstances. Looking at it objectively against the criteria set out by the TWG, CMD Taskforce and the 2025 Taskforce, it seems unlikely that the main criteria can be satisfied over a reasonable timeframe.

3.1 Long history of land taxes

New Zealand has a long history of land taxes. These became smaller through time as other taxes were introduced and exemptions were created. Even if introduced in a efficient fashion now, it is unclear if it can be politically sustainable.

Figure 5: New Zealand Land tax through time



Source: McKay, L, April 1978, New Zealand Universities Law Review, Volume 8, "Historical aspects of the estate tax"

3.2 Assessment against criteria

The land tax meets the TWG's criteria only under very special circumstances. In particular, the policies need to be applied broadly and uniformly. Otherwise, distortions create economic loss. Even if enacted as such in the beginning, it is unclear if it can remain free from political interference in the future.

More worrying is the prospect of land value declines and the impact on the banking sector. This could impact on the cost and availability of capital and restrain economic growth for a protracted period of time.

Group and criteria	Meet?	Comments
Tax working group		
Efficiency and growth	N	A land tax would be efficient only if applied uniformly. This is unlikely over the medium term given vote-sensitive and asset-rich-cash-poor segments such as farms, lwi and retirees. In the presence of exemptions the tax would be inefficient and distortionary.
Equity and fairness	N	There could be a large impact on the banking sector, with at least 2/3 of their loans to land based industries and housing. This could raise the cost and availability of capital, weighing on future economic growth. It would be equitable and fair only if applied uniformly. However, it would adversely impact on the groups identified above. In the presence of exemptions, as happened historically, the tax would not meet this criterion.
Revenue integrity	Y	If properly implemented revenue integrity should be maintained.
Fiscal cost	Maybe	The impact is ambiguous, as it would depend on the rate of tax, if the tax is a deductible expense and how much land prices fall. There may also be wider financial and economic ramifications which cannot be predicted accurately.
Compliance and administration cost	Maybe	Would likely reduce compliance and administration.
Coherence	N	Only targets one class of wealth and is thus not coherent.
Capital market development workforce		
Minimise the cost of capital	N	Declines in land prices could impact on the banking sector and thus the cost of capital.
Capital flows to most valuable uses	N	Creates a distorting incentive to hold wealth in assets other than land.
2025 Taskforce		
Sharpening private incentives to invest, to save and to work	N	Creates a distorting incentive to hold wealth in assets other than land. Does not give specific incentives to invest, save or work.
Minimising the regulatory obstacles the government puts in the way	-	Na
Managing the public sector's own huge assets much more effectively	-	Na
NZIER, TWG Land tax background paper, Sep 2009		

Appendix A - Removing all depreciation

Figure 6: Removal of ALL depreciation scenario

Data in \$b	2008 actual	Without depreciati on	Change	
			%	\$b
Income	561	561	0%	0
Expenses	513	494	-4%	-19
Depreciation	19	0	-100%	-19
Other expenses	494	494	0%	0
Taxable income	47	67	41%	19
Statutory tax rate	30%	30%	-	-
Cash income pre tax	67	67	0%	0
Tax paid	14	20	41%	6
Net cash income	52	47	-11%	-6
Effective marginal tax rate	30.0%	42.2%	12%pt	-

Source: Statistics NZ, NZIER

Figure 7: Tax effect of depreciation removal by industry

Industry	Change in -		Effective tax rate	
	Tax bill	Net cash income	Scenario	Increase
Education and Training	139%	-20%	72%	42%pt
Information Media and Telecommunications	99%	-18%	60%	30%pt
Public Administration and Safety* Electricity, Gas, Water and Waste Services	94%	-17%	58%	28%pt
Transport, Postal and Warehousing	82%	-16%	54%	24%pt
Retail Trade and Accommodation	72%	-15%	52%	22%pt
Agriculture, Forestry and Fishing	67%	-15%	50%	20%pt
Manufacturing	61%	-14%	48%	18%pt
Arts, Recreation and Other Services	57%	-13%	47%	17%pt
Construction	46%	-12%	44%	14%pt
Rental, Hiring and Real Estate Services	46%	-12%	44%	14%pt
Mining(1)	44%	-12%	43%	13%pt
Health Care and Social Assistance	44%	-12%	43%	13%pt
Wholesale Trade	41%	-11%	42%	12%pt
Professional, Scientific, Technical, Administrative and Support Services	21%	-7%	36%	6%pt
Financial and Insurance Services	20%	-7%	36%	6%pt
Total	4%	-2%	31%	1%pt
Total	41%	-11%	42%	12%pt

*2007, as 2008 year the sector made a loss, resulting in distorted calculations

Source: Statistics NZ, NZIER

Appendix B - References

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