Date: 9 February 2010 SH-13-5

To: Mike Nutsford

AIDE MEMOIRE: PROPERTY COUNCIL REPORTS ON BUILDING DEPRECIATION

Removing depreciation on buildings is one of a range of options the Government is considering for Budget 2010. As with all these options, the Government will carefully consider the impact of changes to the depreciation rules across businesses and households, including their impacts on efficiency and growth, and on fairness. In relation to this particular option, the Government will consider carefully whether buildings do depreciate before coming to any decision.

Comments relating to the TWG report

- **In Treasury's opinion the TWG was correct- if buildings do not depreciate, depreciation should not be able to be claimed against them. This is essentially an empirical question: officials are analysing NZ evidence on this point.**
- The KPMG report implies that the non-residential property owning sector-as a tax-paying, productive sector- should be able to claim depreciation; and that even if buildings do not depreciate, businesses should be able to claim depreciation. Officials do not agree that this is a good policy reason to allow a deduction- other and better mechanisms are available.
- The report notes that there is no evidence in the TWG report or background papers about their considerations of whether properties depreciate. This is true (hence the way the TWG recommendation is worded); it was an area on which the TWG asked for further work from officials. Although officials were not able to provide the information to the TWG during the process, officials have continued to analyse the data.
- The report also comments that the TWG recommendation was its method of addressing imbalances in the rental property market, and thus that denying depreciation on all buildings is an illogical, too-broad solution. **The TWG recommendation did not relate to residential investment property only. The problem it sought to address was rather that the treatment of buildings may not match the economic reality; and as such, the solution should not be limited to any one sector unless the empirical evidence indicates otherwise.**

Do buildings depreciate?

- **We disagree with the conclusion that there is "considerable evidence" that buildings depreciate.** Generally, the report highlights international literature relating to depreciation; and possible reasons why buildings may depreciate. While helpful, New Zealand evidence is more useful in this case, and officials are continuing to analyse NZ data to answer this question.
- **The analysis focuses on property depreciation in isolation. The TWG proposals do not aim to promote or discourage any particular sector, but to tax New Zealanders' savings and investment in a more even-handed way. This improves our growth prospects by reducing tax-driven decision making and helping ensure business decisions are made on commercial, rather than tax, grounds.**

- The report lists several qualitative factors that suggest that buildings depreciate. Several of these are controlled for in our analysis of the data (see below.
- We agree with the report's conclusions that it is necessary to look at the value of buildings across time- not at capital (land plus buildings) value. Therefore, our analysis looks at building value separately from land value, across a range of property categories.
- Although most other countries allow depreciation on buildings, the report notes that the United Kingdom currently allows only an industrial building allowance- which is to be abolished from 2011.
- We disagree that using QVNZ data is unhelpful as it is possible to control for the addition of new stock and for significant improvements. **We are using QVNZ data to look at whether buildings in NZ depreciate. We have data as far back as possible for buildings that existed in 1993, and can control for building consents (this reduces the impact of new buildings and repairs on average values). Preliminary conclusions – that buildings across different categories do not on average depreciate- are presented in the attached note.**

Costings

- **The costing cited in the reports were the preliminary estimates provided to the TWG. The background paper to the TWG stated that "at the extreme" they could raise $1.3 billion.**
- The TWG costings were (as noted by the KPMG report) based on total capital value, rather than book value, the costs being developed by officials are based on a model which approximates the book value. The costings cited in the TWG are also based on current tax rates; and a reduction in personal or corporate tax rates would reduce the available revenue. Officials are continuing to refine the assumptions underlying the costings.
- The KPMG report states that approximately 70% of the revenue is from the commercial and industrial sector. **Our estimates for the proportion of the revenue from *all* non-residential buildings are lower at approximately 60% of revenue**.

Other impacts noted

- It is possible that rents may increase, particularly in the short term. Grant Scobie is starting to think this impact through. Our preliminary thinking is that the implicit increase in average tax rates will decrease yields, leading to higher rents in the short term, but in the long-term being capitalised into the value of the property, leading to no long-term increase in rents. In any event, our initial results suggest that any impact would be modest.
- We agree that the repairs and maintenance boundary would need to be looked at if depreciation rules are changed.

Other points

- **It is necessary to consider the impacts of the whole package on the productive sector, NZ's competitiveness, and rents. While depreciation changes may increase the effective tax rates applying to property owners, other tax changes may lower**

their effective tax rates. Consideration of the depreciation changes in isolation may overstate their impacts on the productive sector.

- The report assumes that losses would not be allowed; and that gains would not be taxed. Change of treatment in this way would change some of the conclusions in the report, e.g. the conclusion that capital expenditure would be permanently non deductible (which in any event, may not be a problem for the asset owner if it results in appreciation). This will be discussed in reports to Ministers.

Our preliminary analysis indicates the following average annual appreciation rates for improvement, land and capital values:

Nominal	1993-2008		
	Improvement value	Land value	Capital Value
Commercial	4.42%	7.64%	5.78%
Industrial	3.39%	9.94%	5.88%
Residential	5.37%	10.72%	7.77%
Rural	5.89%	11.54%	9.59%
All property	4.94%	10.78%	7.68%

Real	1993-2008		
	Improvement value	Land value	Capital Value
Commercial	2.04%	5.18%	3.37%
Industrial	1.04%	7.43%	3.46%
Residential	2.97%	8.19%	5.31%
Rural	3.48%	8.99%	7.09%
All property	2.55%	8.25%	5.23%

[deleted – privacy], Analyst, Tax Strategy, [deleted – privacy]
Steve Mack, Principal Advisor, Tax Strategy, [deleted – privacy]