Inland Revenue
Te Tari Taake

THE TREASURY
Kaitohutohu Kaupapa Rawa

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To: Mike Nutsford, Office of the Minister of Finance;
Ainslie Fenwick, Office of the Minister of Revenue

AIDE MEMOIRE: FISCAL ESTIMATES OF DEPRECIATION CHANGES

Denial of deductions for building depreciation

Subsequent to the aide memoire dated 29 January 2010, officials have finalised the costing models for building depreciation deductions and can now provide indicative revenue estimates for policy options in this area. Figures are now smaller than those presented on 29 January because:

- only 80% (previously 100%) of non-residential buildings are now included in the tax-depreciable base, to allow for ownership by non-taxpaying entities such as government or charities.

- the tax rate (previously 30%) has been remodelled as a weighted average of personal and company rates, with a further allowance for some taxpayers being in loss and therefore not immediately providing extra revenue from a change in their deductions.

The following modelling assumptions underpin the building depreciation fiscal estimates presented here:

- all tax-depreciable buildings (except government or charitable-owned buildings) are included. Residential buildings contribute broadly 39% of the total cost. For non-residential buildings, the data is less reliable for splitting into components, but we estimate that commercial buildings such as offices and shops contribute an estimated 29% to the total cost, and industrial buildings or factories 8%.

- buildings owned by non-taxpayers such as charities, government, or owner-occupied housing, are excluded. A subset of residential rental properties are also excluded since not everybody chooses to depreciate their building.

- the model includes existing buildings with no grand-parenting, although recovery of “depreciation to date” still applies on their sale.

- the source data is public information on the market value of buildings in the economy, but the data has been converted within the model into historical cost price upon which depreciation is based.

- the tax rate used is 23.66%, a weighted average of the **existing** company tax rate and the **current scenario** personal tax rates**.** This average tax rate in the model also allows for some taxpayers being in loss.

Assuming application for the income year commencing 1 April 2011, the new estimates for denying deductions or building depreciation are:

1. removal of all building depreciation and no gain or loss on sale being taxable or deductible: $720 million per year, increasing in later years;

2012	2013	2014	2015
$720m	$725m	$730m	$740m

2. removal of all building depreciation and loss on sale being deductible but gains on sale not being taxable: $545 million, decreasing in later years;

2012	2013	2014	2015
$545m	$530m	$520m	$515m

3. removal of all building depreciation with gains taxable and losses deductible - $970 million, increasing in later years.

2012	2013	2014	2015
$970m	$990m	$1030m	$1080m

For the latter two estimates, we assume strong anti-manipulation rules would be applied. Even with anti-manipulation rules, we consider that with the last option, taxpayers may be able to structure their transactions so that losses are deductible but gains not taxable, so in practice option 3 may produce less revenue than indicated.

Depending on the degree to which the changes are picked up as provisional tax, first year revenue could be less due to lagged or part-year effects.

These final estimates are highly dependent on assumptions. They remain subject to change based on:

- the final package of tax rates, which will affect the average rate used in the costing model. For example a 1c change in the company tax rate will change the above three figures by $15 million, $15 million, and $20 million respectively;

- specific details of the chosen building depreciation policy option, such as the application date, or whether some buildings will be excluded.

Removal of the depreciation loading for new assets

The fiscal estimates for depreciation loading have also been refined since the work done for the VUW review, with much of the refinement in determining which components of gross fixed capital formation should or should not be included in the taxpayer base. The depreciation loading costing is also dependent on tax rates. For modelling purposes we have used the same average tax rate as applied to the above building depreciation costing. This is a smaller tax rate than was used for the VUW review.

The following modelling assumptions underpin the depreciation loading figures presented here:

- the costing is based on public information on gross fixed capital formation, excluding buildings. Subsequent to the VUW review, we have further excluded intangible property, and an estimate for capital formation attributable to government.

- the removal of the loading is applicable only to assets acquired on or after date of announcement, assumed to be 20 May 2010

- the tax rate used is 23.66%, a weighted average of the **existing** company tax rate and the **current scenario** personal tax rates**.** This average tax rate allows for some taxpayers being in loss.

- The fiscal estimates assume the change is captured immediately in provisional tax payments without any lag. In practice, the first year could be smaller due to timing.

The new estimates for the removal of depreciation loading for new assets acquired from 20 May 2010 are:

2011	2012	2013	2014
$140m	$260m	$330m	$370m

This estimate remains subject to change under any subsequent policy decisions relating to timing, and once the final package of tax rates is agreed. For example, a 1c change in the company tax rate will change the 2014 figure by $10 million.

<u>Removal of the depreciation loading for existing assets</u>

We are still modelling the removal of loading from all assets from the beginning of the 2011-2012 income year. We would expect that such an approach would raise significant revenue in the early years. We will include our estimate of the fiscal effect of this option in tomorrow's advice on the fiscal impacts of the overall budget package.

If you have questions on either set of estimates, you should contact Sandra Watson at IRD [deleted – privacy].

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