Regulatory Impact Statement: Removing building depreciation

Coversheet

Purpose of Document	
Decision sought:	*Analysis produced for the purpose of informing final Cabinet decisions*
Advising agencies:	*Inland Revenue*
Proposing Ministers:	*Minister of Finance* *Minister of Revenue*
Date finalised:	*7 December 2023*

Problem Definition
The Government is proposing to remove the ability to depreciate commercial and industrial buildings at the current rate of 2% diminishing value from the start of the 2024/25 income year (1 April 2024 for most taxpayers). This will support the Government's fiscal requirements by raising tax revenue.

Executive Summary
Depreciation deductions are a means of matching the cost (decline in market value) of buildings over their useful life while they are used to derive assessable income. The ability to claim depreciation deductions for commercial and industrial buildings with an estimated useful life of 50 years or more was reinstated in 2020. These buildings can be depreciated at a 2% diminishing value or 1.5% straight line. The changes in 2020 were part of a package of economic policy responses to COVID-19. Reinstating building depreciation was previously identified as a key priority for improving productivity by the Treasury and Inland Revenue. This was due to the weight of international evidence suggesting buildings do depreciate, together with studies suggesting that New Zealand had a high effective tax rate (and high cost of capital) for investments in buildings compared to most OECD countries. The Government is considering whether depreciation deductions for commercial and industrial buildings should be reduced to zero (a return to the settings that existed between 2010 and 2020) as a means of funding its overall fiscal package. Based on returning the depreciation deduction rules to previous settings, we estimate the change will generate $2.31 billion over the forecast period (2024/25 – 2027/28). Inland Revenue recommends retaining the status quo and recommends the Government reconsider introducing commercial and industrial building depreciation when fiscal conditions allow.

Limitations and Constraints on Analysis

The proposal is part of the coalition Government's fiscal plan. This RIS compares the proposal to the status quo. Due to time constraints, we have not considered other policy options.

Income tax principles suggest that business costs should be deductible when determining tax liability. Whether building depreciation is a business cost turns on whether buildings decline in market value over time (economic depreciation). Studies on the economic depreciation of buildings are complex and expensive to conduct. A Treasury analysis in 2010 of QV data on building values from 1994 to 2008 suggested that, on average, buildings have not depreciated in market value in New Zealand over that period. However, the weight of international evidence suggests that the depreciation rate is positive for commercial and industrial buildings.

Cabinet is expected to make decisions on 11 December 2023. We have not had an opportunity to engage with stakeholders. Some recent anecdotal comments from stakeholders have focused on: the fact that buildings do depreciate, ensuring consideration is given to building fit-out, and selecting an appropriate implementation date. Given a similar proposal was implemented in 2010, we consider the implementation risks are reasonably well known and the experiences have been reflected in this RIS

Responsible Manager(s) (completed by relevant manager)

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7/12/2023

Quality Assurance (completed by QA panel)

Reviewing Agency:	Inland Revenue
Panel Assessment & Comment:	The Quality Assurance reviewer at Inland Revenue has reviewed the regulatory impact statement (RIS) prepared by Inland Revenue. The reviewer considers that information and analysis summarised in the RIS *Removing building depreciation* partially meets the quality assurance criteria. The proposal being considered by Cabinet supports a broader tax reform package developed in response to the coalition government of the New Zealand National Party, ACT NZ, and New Zealand First. As such, the options under consideration were limited to the status quo and the removal of depreciation deductions for commercial and industrial buildings. Time constraints have applied to the policy development of the proposal and this has not permitted

	consultation on the various options, or refinement of the proposed option.

Section 1: Diagnosing the policy problem

What is the context behind the policy problem and how is the status quo expected to develop?

The purpose of allowing deductions for business costs

1. Building depreciation – the decline in a building's market value – warrants tax deductions for the same reasons that other business expenses like wages and depreciation on computers do.

2. Allowing deductions for business expenses ensures tax liability is based on ability to pay. It also ensures taxes are as neutral as possible across different forms of investment, ensuring investment flows to the most productive areas of the economy.[1]

3. Economic depreciation is the fall in market value of an asset. In the context of a tax on income, supporting productivity means that tax deductions for depreciation mirror economic depreciation as closely as possible. Failure to allow tax depreciation for assets which fall in value results in an effective tax rate for those assets that is higher than the statutory rate. On the other hand, allowing tax depreciation for assets which do not fall in value may result in an effective tax rate for those assets that is lower than the statutory rate.

Previous changes to building depreciation in New Zealand

4. New Zealand previously allowed tax depreciation on buildings on a widespread basis at a rate of 3% diminishing value (or 2% straight line) for buildings with an estimated useful life of 50 years or more. This changed following an announcement in the 2010 Budget to reduce the rate to 0% from the 2011-12 income year. The removal of depreciation deductions applied to both new and existing buildings. Depreciation remained available for buildings with an estimated useful life of fewer than 50 years.[2]

5. The decision in 2010 was supported by Treasury analysis of QV data on the value of land and buildings which suggested that buildings appreciated in New Zealand over the data period (1994 to 2008). Officials noted at the time that the weight of international studies indicated that buildings do depreciate.[3]

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[1] In the absence of taxes, investment would flow to the most productive areas of the economy, maximising total welfare. Taxes, however, can distort people's decisions, with the result that heavily taxed activities may receive less investment, even if they have higher risk-adjusted, pre-tax returns than other investments. The outcome is that capital is allocated less productively, and we are poorer and have lower income and growth than otherwise.

[2] These buildings include barns, chemical works, fertiliser works, powder dryer buildings, tanneries, and hydroelectric powerhouses (treated as plant rather than buildings).

[3] Probably the most widely quoted estimates are from the Bureau of Economic Analysis in the United States. These suggest economic deprecation rates of 3.14% for industrial buildings, 2.47% for commercial buildings, 1.14% for residential structures of 1 to 4 units and 1.4% for residential structures of 5 or more units. These

6. In 2019, the Treasury and Inland Revenue advised the government that reinstating building depreciation could improve productivity in New Zealand. This was supported by the weight of international evidence that long-lived buildings do depreciate, together with studies suggesting that New Zealand had a high effective tax rate (and high cost of capital) for investments in buildings compared to most OECD countries.[4]

7. In 2020, depreciation for long-lived buildings (other than residential buildings) was reinstated from the 2020-21 income year at a rate of 2% diminishing value (or 1.5% straight line). This change was introduced as a component of an economic policy response to COVID-19 to improve productivity and stimulate business activity.

What is the policy problem or opportunity?

8. The coalition Government's fiscal plan includes a commitment to end depreciation for commercial buildings that was introduced in 2020 as part of a COVID-19 business support package. The Government wishes to remove building depreciation as a revenue generating measure. Changes would apply from the 2024/25 income year (beginning 1 April 2024 for most taxpayers).

9. The changes in 2020 reintroduced depreciation for non-residential buildings which include commercial buildings and industrial buildings. Whether a building is a non-residential building is determined based on the building's predominant use. For more information on when building owners can currently claim depreciation see: Claiming depreciation on buildings (ird.govt.nz).

10. Since residential buildings are currently not depreciable for tax purposes, this would apply the same tax treatment to all buildings used for investment or business (other than certain short-lived buildings with an estimated useful life of less than 50 years).

What objectives are sought in relation to the policy problem?

11. The objective is to implement this change as part of the Coalition Government's tax changes which includes personal income tax reductions.

results are consistent with a number of other studies that have been undertaken in the United Kingdom and United States. Studies for Canada have tended to suggest higher rates of economic depreciation. For a comprehensive assessment as at 2018, see the following analysis from the secretariat to the Tax Working Group: Appendix C: Depreciation on Buildings: Further information on potential revenue reducing options - July 2018 - Information Release - Tax Working Group - New Zealand.

[4] This was explored in depth in Inland Revenue's Long-term Insights Briefing "Tax, foreign investment and productivity".

Section 2: Deciding upon an option to address the policy problem

What criteria will be used to compare options to the status quo?

12. The options will be evaluated against the traditional tax policy criteria of efficiency, equity, integrity, fiscal impact, compliance and administration costs, and coherence. These are described below.

    a. **Efficiency**: Taxes should be, to the extent possible, efficient and minimise (as much as possible) impediments to economic growth. That is, the tax system should avoid unnecessarily distorting the use of resources (e.g., causing biases toward one form of investment versus another) and imposing heavy costs on individuals and firms.

    b. **Equity**: The tax system should promote fairness. The burden of taxes differs across individuals and businesses depending on which bases and rates are adopted. Assessment of both vertical equity (the relative position of those on different income levels or in different circumstances) and horizontal equity (the consistent treatment of those at similar income levels, or similar circumstances) is important.

    c. **Revenue integrity**: The tax system should be sustainable over time and minimise opportunities for tax avoidance and arbitrage.

    d. **Fiscal impact**: Tax reforms need to be affordable given fiscal constraints, and the tax system must raise sufficient revenue to support the Government's fiscal strategy.

    e. **Compliance and administration costs**: The tax system should be as simple and low cost as possible for taxpayers to comply with and for the Inland Revenue Department to administer.

    f. **Coherence**: Individual reform options should make sense in the context of the entire tax system. While a particular measure may seem sensible when viewed in isolation, implementing the proposal may not be desirable given the tax system as a whole.

13. Some of these criteria trade-off with each other so there is some subjectivity to coming to an overall recommendation. The discussion under option 2 provides more information on the exact nature of how the proposal rates against the criteria which helps us to arrive at an overall judgement.

What scope will options be considered within?

14. Options are constrained by the coalition Government's fiscal plan which includes removing building depreciation. We have not been asked to provide advice on alternative options. In addition, we have only considered the impacts of this proposal compared to the status quo, not the suite of tax changes as a whole.

What options are being considered?

Option One – *Status Quo*

15. Continue to allow depreciation deductions for buildings (other than residential buildings) with an estimated useful life of 50 years or more at a rate of 2% diminishing value (or 1.5% straight line).

Option Two – Remove building depreciation

16. The proposal to remove building depreciation could be done in a similar manner to the removal of building depreciation in 2010 (including subsequent remedials). This would mean that:

    a. changes to depreciation rates for buildings would apply to existing and newly acquired buildings with an estimated useful life of 50 years or more.

    b. special depreciation rates would not be allowed for taxpayers who can establish that they have a different useful life than generally applies. However, depreciation would remain available for buildings with a shorter estimated life e.g., barns, chemical works, dairy sheds, fertiliser works, fowl houses, and tanneries.

    c. previous depreciation deductions on buildings would remain recoverable if the building is sold for more than its tax book value. This means building depreciation would technically be deducted at a rate of 0%.

    d. taxpayers would be unable to claim a disposal loss deduction if a building is sold for less than its tax book value (except for certain buildings acquired before August 2009). This is because land and buildings are usually sold together, and it is difficult to establish how much of a total loss or gain is attributable to loss on the building itself.

    e. building owners would be able to depreciate building fit-out.

17. The main difference between the current proposal and the changes in 2010 is that the depreciation rate for residential buildings is currently 0% and so does not need to change.

18. **Efficiency:** The denial of deductions for building depreciation will impact the profitability of investments and cause investors to underinvest in buildings relative to other investments where business costs continue to be deductible.

19. In our last Long-Term Insights Briefing, we noted that under some assumptions made by the OECD (including that non-residents demand a 3% real return on their capital), New Zealand was likely to have had the highest hurdle rate of return for investment in commercial and industrial buildings for the 38 countries in the OECD. This was when New Zealand allowed 2% depreciation on these buildings. Denying depreciation deductions will drive up these hurdle rates of return even higher and make New Zealand a less attractive location for investment.

20. This tax distortion does not only impact building owners. To the extent that the additional cost is passed on and there is less investment, it also impacts any business that needs to use a building and the customers of such a business. It thereby negatively impacts productivity more generally.

21. **Equity**: A fundamental principle of New Zealand's tax system is not to advantage any form of investment relative to other forms of investment, unless there is an over-riding reason for doing so. The goal is to ensure horizontal equity and reduce tax-driven distortions by ensuring that tax is as neutral as possible across different forms of investment.

22. Restricting building depreciation deductions may be considered unfair (violates horizontal equity) as it disallows a deduction for industries whose business rely more heavily on buildings. This tax outcome will have a corresponding negative effect on the balance sheets of those affected.

23. Users of buildings would be at greater risk if safety upgrades such as seismic strengthening are made less frequently due to the inability of the owner to depreciate the cost of the upgrade, although safety regulations are more likely to drive this investment than tax settings.

24. **Revenue integrity**: Based on the simplicity of the change and past experience implementing the change, it should have little overall impact on revenue integrity.

25. **Fiscal impact**: The expected revenue gain from this option is $2.31 billion over the forecast period (2024/25 to 2027/28). This estimate is based on a number of assumptions, such as the portion of buildings in some industries being outside of the tax base (e.g., owned by the government). To the extent these assumptions are wrong, the estimate of fiscal cost would also be incorrect.

26. **Compliance and administration costs**: In addition to paying more taxes, there may be some initial compliance costs for building owners as they separate building fit-out from the rest of the building for depreciation purposes. There will be a transitional rule for owners who have not previously recorded fit-out separately and do not wish to obtain a new valuation.

27. Historically, taxpayers who have elected not to separate out the fit-out costs from the building itself have done so to reduce their compliance costs. Their rationale is generally that while they may not get the full deductions for depreciation, the loss of a deduction is offset by the compliance cost savings. That logic no longer applies at a 0% depreciation rate for buildings, so there will be an increase in taxpayers' compliance costs. However, those costs are minimised by the transitional rule for fit-out.

28. If taxpayers decide to undertake a complete audit of their fit-out to record them separately from the building, Inland Revenue will need to be mindful of the valuation methodology used by taxpayers/valuers to ensure the costs are based on historic cost, less depreciation claimed to that point.

29. Removing building depreciation deductions would also involve increased initial administration costs for Inland Revenue. This includes providing guidance and support for taxpayers to comply with rules changes.

30. **Coherence**: Removing building depreciation deductions will decrease the coherence of the tax system. A principle underlying the tax system is that generally only the amount of income after deducting any associated costs is taxable. This policy would create an exception to that general rule.

31. It should also be noted that regularly changing the rules on building depreciation affects taxpayer expectation about the predictability of the tax rules and has the potential to undermine certainty in the tax system with flow-on effects to business investor confidence.

How do the options compare to the status quo/counterfactual?

	Option One – Status quo	Option Two – Remove Building Depreciation Deductibility
Efficiency	0	-
Equity	0	-
Revenue integrity	0	0
Fiscal impact	0	+
Compliance and administration costs	0	-
Coherence	0	-
Overall assessment	0	- -

What option is likely to best address the problem, meet the policy objectives, and deliver the highest net benefits?

32. We do not consider the removal of building depreciation to be a fair and efficient way of raising revenue. We are particularly concerned about the efficiency impacts which will make New Zealand even more of an outlier in pushing up cost of capital for commercial and industrial buildings. We therefore recommend the retention of the status quo. We note that this RIS is not evaluating the merits of the Government's tax package as a whole.

What are the marginal costs and benefits of the option?

Affected groups *(identify)*	**Comment** *nature of cost or benefit (eg, ongoing, one-off), evidence and assumption (eg, compliance rates), risks.*	**Impact** *$m present value where appropriate, for monetised impacts; high, medium or low for non-monetised impacts.*	**Evidence Certainty** *High, medium, or low, and explain reasoning in comment column.*
Additional costs of the preferred option compared to taking no action			
Regulated groups - commercial and industrial building investors	Denying building depreciation deductions would increase the tax cost of commercial and residential buildings compared to the status quo. All else being equal, this would put downward pressure on demand and therefore on building prices. The impact of the proposal on building prices would be very difficult to determine. For the marginal investor, the proposal could be the 'tipping point,' so they would forgo the purchase of, or possibly sell their existing building, as other alternative investments become relatively more attractive. This proposal could also reduce the investment in new buildings and capital improvement of existing buildings including investment which makes buildings safer, such as seismic strengthening. The value of commercial and industrial buildings used in our costing is $212 billion.	The additional tax paid by building owners is expected to be $2.31 billion over the forecast period (2024/25 to 2027/28). The compliance and administration costs on building owners would be modest. The changes will be more burdensome for owners who have not separated fit-out but still not significant.	Medium
Users of commercial and industrial buildings	The proposal may put upward pressure on rents through decreasing building supply in the long term. This means renters may be negatively impacted by the proposals.	Unknown	Medium

	Users would also be impacted by the quality of the building if capital improvements are made less frequently.		
Inland Revenue	Costs associated with providing guidance on the changes.	Unquantified costs which should only place marginal pressure on the business.	Medium
Total monetised costs			
Non-monetised costs		*(High, medium or low)*	
Additional benefits of the preferred option compared to taking no action			
Regulated groups			
Regulators			
Others (eg, wider govt, consumers, etc.)			
Total monetised benefits		$2.31 billion over forecast period	Revenue was forecast using a historical model. There are a range of uncertainties in the model.
Non-monetised benefits		*(High, medium or low)*	

Section 3: Delivering an option

How will the new arrangements be implemented?

33. It should be possible to make the change through an Amendment Paper to the Taxation (Annual Rates for 2023-24, Multinational Tax, and Remedial Matters) Bill at the Committee of Whole House stage. This Bill is expected to be enacted before the end of March 2024.

How will the new arrangements be monitored, evaluated, and reviewed?

34. **Monitoring**. Inland Revenue will monitor compliance with the tax change as part of its usual monitoring of taxpayers.

35. **Review**: Inland Revenue regularly reviews tax settings on an ongoing basis and provides advice and updates to the Government accordingly. Policy officials maintain strong communication channels with stakeholders in the tax advisory community, including through the generic tax policy process, and these stakeholders will be able to correspond with officials about the operation of the new rules at any time. If problems emerge, they will be dealt with either operationally, or by way of legislative amendment if agreed by Parliament.