

Tax Working Group Public Submissions Information Release

Release Document

September 2018

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SUBMISSION TO THE TAX WORKING GROUP

P. Brent Nahkies

To the Tax Working Group

Thank you for the opportunity to respond to your Background Paper “The Future of Tax”. It is not my intention to answer all the questions asked in Appendix 3 of the Background Paper but I wish to address the following:

- Taxes and behaviour
- Thinking outside the current system
- Specific challenges
 - Housing Affordability
 - Capital Gains Tax
 - Environmental taxation

Taxes and Behavior

While acknowledging the importance of the challenges and opportunities that are identified in this paper I wish to submit that there should be a greater role for the taxation system in correcting market 'failures' by incentivizing economic activity that has public good benefits. Examples of this include retirement savings, affordable housing and environmental improvements. However, the behavior that I advocate should be modified by taxation is the seismic mitigation of buildings now mandatory under the new Building (Earthquake-prone Buildings) Amendment Act.

As you point out in your Background Paper the taxation system should improve the well-being of those being taxed as measured by criteria embedded in the “Living Standards Framework”. The importance of the “Four Capitals” is stressed in your background paper and I strongly suggest that the earthquake-prone building crisis that we have in this country impacts significantly on three of the four Capital Stocks.

Natural Capital is negatively impacted by the creation of waste that is an inevitable outcome of new construction and the loss of the embodied energy in existing buildings.

Social capital is negatively impacted the loss of heritage buildings and the negative outcomes for many smaller towns and communities.

Financial/physical capital will also be significantly negatively impacted by the earthquake-prone buildings legislation with the demolition of significant numbers of both private and community owned buildings. The significant drop in property values will impact severely on significant numbers of building owners and flow on to impact on their communities.

The previous National Government has resisted efforts to discuss and debate the use of tax incentives as a public policy tool to complement regulatory methods of promoting seismic mitigation. Incentives were declared outside the terms of reference for the Royal Commission of Enquiry on the Canterbury Earthquakes and were outside the scope of the MBIE Review of the earthquake-prone buildings management system. Despite this, many efforts were made by submitters to discuss the need and use of tax incentives. For example, at the Royal Commission Hearings many presenters such as Local Government NZ and The Property Council of NZ raised the question of tax incentives.

Analysis of the various submissions made during the debate on this legislation clearly showed a strong desire for changes to the current taxation system. The tax relief sought in the submissions was of two main types. The first being to allow a total deduction of seismic strengthening costs when it occurred as is allowed for repairs and maintenance. Alternatively to allow the expense to be amortized as depreciation over the remaining life of the building.

Despite the strong lobbying the previous Government appeared to make little effort to seriously research and consider tax incentives as an option. The main policy advice commissioned on the subject appears to be a report prepared by SageBush whose findings are discussed later in this submission. The SageBush Report was not made public but had to be obtained under the Official Information Act.

However, despite efforts by the Government to keep tax incentives off the agenda the question of tax incentives was raised as part of the political debate around the Building (Earthquake-prone Buildings) Amendment Act. At the Third Reading of the Bill concerns were expressed by both the Green Party and New Zealand First for the need to revise the current tax system in order to provide incentives for earthquake strengthening.

Supplementary Order Paper Number 160 was introduced by the New Zealand First Party and sought to make an amendment to the Income Tax Act 2007 so that the expense relating to earthquake strengthening could be treated as an 'expense' and not capital work and thus would become tax deductible. When debated this appeared to have a degree of support from both the Labour Party and the Greens as well as the ACT Party. However, it was never put to the vote as it was ruled "out of order" as it was outside the scope of the bill.

Subsequent public calls for changes to the Income tax Act 2007 have been made by New Zealand First and Labour politicians. It is therefore surprising that there is no explicit acknowledgement of this issue in the Working Groups Terms of Reference or the Background Paper. I respectfully submit that the Working Group should consider the issue of earthquake strengthening buildings as part of their enquiry. In particular the Working Group should consider how owners can be encouraged by the taxation system to strengthen their buildings rather than demolish them. As was explained in the Background Paper the taxation system can be used to modify behavior by either punishing 'bad' behavior with additional tax or 'rewarding' good behavior by taxing at a lower rate or by subsidizing it. The current tax system as it stands is a disincentive to earthquake-strengthen buildings and if left unchanged will promote legal litigation rather than seismic mitigation.

Thinking Outside the Current System

The main inconsistencies in the current system are the treatment of buildings in terms of no depreciation allowances. The administration of the tax laws in New Zealand regarding property transactions and the assessment of taxable incomes has long been an area of known for its litigation and complexity. As the extensive case law illustrates each situation must often be treated on its merits and the decisions reached may differ materially in what appear to be the same circumstances.

Under current tax legislation and enforcement seismic strengthening is deemed to be a capital improvement that is not depreciable. New Zealand tax law is most unusual compared with other OECD countries in that no depreciation is allowed on buildings that are deemed to have an economic life of 50 years or more. When considering an items estimated useful life the "whole of life approach" applies such that a second hand asset will be treated the same in terms of expected life as a new asset. Thus an old building that is nearing the end of its economic life is treated the same as a new building with its entire economic life ahead of it.

The ability to claim depreciation on buildings was removed in the 2010 Budget. The removal was justified based on the argument that data showed that buildings did not lose value. This argument is flawed as clearly buildings do lose value over time otherwise they would never get to the end of their economic life and need replacing. The reasons buildings lose value is due to the following three factors:

- Physical deterioration
- Functional Obsolescence
- Economic Obsolescence

Physical deterioration is due to the passage of time and the impact of the environment (rain, sun, wind, chemicals degradation, earthquakes etc.) and the wear and tear of occupation. Good quality materials, good design and good workmanship during construction slow down this process as well as a good maintenance program over the life of the building.

Functional obsolescence is due to changing technology and market expectations which makes older buildings less 'functional' compared with new buildings. For example, poor energy efficiency of older office buildings compared with new 'green' buildings. Some functional obsolescence is curable by the process of building rehabilitation but some functional obsolescence may be incurable.

Economic obsolescence is defined as obsolescence caused by forces external to the building. It is also sometimes called external obsolescence or environmental obsolescence. Lack of demand or oversupply of a particular type of property, changes in the location or changes in legislation can all impact negatively on the value of a building. For example, a new building supplied into an oversupplied market may have a market value that is far lower than its initial cost to build. Even though the building is brand new and has suffered no physical depreciation or functional obsolescence it suffers a drop in value. Often a building undergoes a change of use as a way of reducing the impacts of economic obsolescence and also functional obsolescence.

The impacts of these three factors ultimately combine to set a limit on the economic life of a building. Often this economic life may be less than the physical life of the building. Physical deterioration and functional obsolescence result in the value of existing buildings being discounted in comparison with comparable new buildings. Where building costs are increasing this discount can be obscured by the inflationary building cost but never-the-less the drop in 'relative' value compared with a new building is real. This drop in value is realized at the point at which an old building must be replaced by a new building.

The removal of depreciation as an allowable expense for buildings in 2010 was based on the premise that buildings maintained their value over time and therefore allowing depreciation gave an unfair benefit to the taxpayer. This was despite the fact that no allowance was made for the inflationary effects which hid the real loss in value and that the tax was 'clawed back' at the time of sale of the property. In the case of buildings deemed to be earthquake-prone there is now substantial evidence to show that the buildings suffer an immediate and substantial drop in value that is in complete contradiction to the "no loss in value" assumption used to justify the 2010 tax changes. This raises serious questions regarding the equity and fairness of the current tax system in relation to earthquake-prone buildings and indeed to other building suffering from serious defects such as "leaky buildings".

The costs of repairing or maintaining a building will usually be immediately deductible at the time the cost is incurred as repairs and maintenance designed to offset and reduce the loss in value due to physical deterioration is an allowable tax expense. Generally, rehabilitation of

various types is deemed not to be repairs and maintenance but to be a capital improvement and thus not deductible for tax purposes. As a result there has been substantial efforts by taxpayers and their advisors to push the boundaries both in terms of what qualifies as repairs and maintenance and what building elements are not part of the structure. Many non-structural elements of buildings can be depreciated and often at comparatively high rates to reflect a comparatively short economic life. Examples of these non-structural elements include the building fit out and chattels.

It remains to be seen if owners take a similar approach with earthquake-strengthening costs as there are many costs involved that are non-structural in nature and also costs that could be realistically characterised as repairs and maintenance. It may also be the case that owners will break seismic strengthening down into stages and/or require separate invoicing from contractors. Where the owners carry out extensive repairs and maintenance in addition to earthquake strengthening then the apportionment of costs may also become problematic and litigious.

Advocates for tax relief for earthquake-prone buildings would argue that the costs of seismic strengthening should be tax deductible as they are the same as repairs and maintenance. The general test when determining whether expenditure is a capital item (and non-deductible) or an expense (deductible) is whether the work merely returns an item to its original condition or whether it improves it. The argument goes that seismic strengthening improves the ability of a building to withstand earthquakes and often extends the useful life of the building and thus should be treated as a capital improvement. However, the same argument could be applied to repairs and maintenance.

As mentioned previously the SageBush Report was commissioned by the Government to consider the use of incentives for earthquake-prone buildings. The report was not supportive of tax changes for a number of reasons which were set out in the report as follows:

Does not provide an incentive for not-for-profit and private (owner/occupier) building owners.

This is correct in terms of owner occupier residential owners but if the building is owned by a business then that is not the case as it will be an expense of the business.

Not targeted and therefore available to all building owners regardless of need or effectiveness in achieving the policy objective.

This does not appear particularly valid as it can be targeted to specific building owners in the same way as targeted grants. For example the same criteria used for the Heritage EQUP Grant Programme could be used for tax relief.

Defining and implementing tax incentives difficult and expensive from tax administration perspective.

There is no evidence supplied in the report to judge the accuracy of this statement. It would appear unlikely that the introduction of tax relief to earthquake-prone buildings would be anywhere near as complicated as a capital gains tax or land tax.

High cost with amount difficult to quantify.

This estimated cost figure appears excessive but no information is given in the report as to assumptions behind the high estimate of \$1 - \$2 billion. The eventual cost will also be related to the type and targeting of any tax relief.

May result in uneconomic buildings being retained

This appears to show a lack of understanding although it links back to the underlying assumption in the report that demolition is a good thing that should be encouraged as much as strengthening. The report explains that an unintended consequence might be to "encourage strengthening of EPBs when in the absence of tax incentives they would have been demolished and replaced by new buildings". Contrary to being a negative this should be seen as both a positive and intended consequence. The whole point of financial incentives is to change the economic equation.

May result in windfall gains to commercial building owners.

This is a valid point in terms of the concern expressed that commercial owners may receive a windfall gain where they receive a tax incentive for a building that they were planning on strengthening anyway. This is also the case with owners who receive a windfall gain by demolishing a heritage building thus increasing the development potential of the site. Any windfall can also be considered compensation for many owners who have suffered the destruction of their wealth due to the new legislation.

Inconsistent with the Government's Revenue Strategy

Current concerns as manifested by the Tax Working Group would indicate that the Government Revenue Strategy is not without flaws and distortions. This also ignores the valid use of tax to change behavior as well as gather revenue.

Tax treatment is inconsistent with other building related issues.

This is valid to the extent that it highlights that other building related issues such as 'leaky' buildings should also be looked at.

It is my contention that the tax treatment of earthquake-prone buildings is a serious issue that requires more research and debate than what was undertaken by the previous Government. The SageBush Report does not provide sufficient evidence to discount tax incentives for earthquake-prone buildings and this issue should be considered as part of the Tax Working Groups Terms of Reference.

In terms of thinking outside the current tax system the Tax Working Group appears constrained to look at the introduction of new or additional taxes. I contend that they should be looking at depth in the use of tax incentives as a positive means to reward behavior rather than merely looking at punitive taxes to discourage behavior.

There are numerous examples of this approach used overseas to create incentives for certain types of behavior. A good example is the Rehabilitation Tax Credit that has been used in the United States since 1976 to promote the rehabilitation of heritage buildings. A credit is given for a certain percentage of qualifying expenditure depending on the heritage status of the buildings. If the building is a certified historic building the credit is 20% of the costs while for buildings that are not certified but which were built pre-1936 the credit is 10%. This programme of tax credits has been recognized as being very successful at encouraging private investment in heritage buildings which has both saved buildings under threat and helped revitalize decaying urban areas.

The degree of incentive will vary depending on the proportion of costs and the criteria applied in terms of which costs qualify. In the UK for example, there is a Tax Credit of 150% given to owners who spend money on cleaning up contaminated sites.

Specific Challenges

Environmental Taxes

The Working Group should note that the environment is not just about the natural environment but also about the built environment. In terms of promoting sustainable development the goal of achieving seismic mitigation by the seismic retrofitting of existing building stock rather than their demolition is an important one.

As well as looking at punitive taxes so that the polluter pays they should also be considering incentives such as tax credits which could be used to encourage the cleanup of existing environmental contamination.

Affordable Housing

Most of the focus of the Working Party appears to be on using tax as a means of dampening down demand. Thought should also be given to encouraging supply by the use of incentives such as the “Low Income Housing Tax Credits” used in the USA.

Capital Gains Tax

Care should be taken in the introduction of any Capital Gains Tax that is does not create a disincentive to rehabilitate the existing building stock. If introduced it should be levied on the true capital gain and not one created by inflation and the efforts of the owners to improve their

buildings. For example an owner should not have to pay a capital gains tax because he has increased the value of his building by earthquake strengthening it.

Summary and Conclusions

At page 54 of the Background Paper which describes the Terms of Reference the point is made that "the Working Group will be able to recommend further reviews be undertaken on special issues which the group considers it has not been able to explore sufficiently, or that were excluded from its terms of reference but which could benefit from being considered in the context of its recommendations". In relation to this point I submit the following:

- The tax treatment of earthquake-prone buildings is a key issue that should be explored.
- The current tax system is a disincentive to earthquake-strengthening buildings and needs to be changed in relation to the tax deductibility of earthquake strengthening expenses.
- The use of tax credits would also be an effective way to promote seismic strengthening of earthquake-prone buildings and their use should be considered by the Tax Working Group.

I am happy to be contacted to discuss further any of the points raised in my submission.

P. Brent Nahkies

Senior Lecturer in Property

Lincoln University

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