# Tax Working Group Public Submissions Information Release

## Release Document

## September 2018

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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.



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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. However, when 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 (eg 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 (eg 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]

Yours sincerely,
[1]

Connal Townsend
Chief Executive