Tax Working Group
Te Awheawhe Tāke

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1 November 2018

INTRODUCTION

1. The New Zealand Airports Association ("**NZ Airports**") welcomes the opportunity to make this submission on the Tax Working Group's ("**TWG"**) "Future of Tax: Interim Report" ("**Interim Report**").

2. The NZ Airports contact for this submission is:

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[1]

EXECUTIVE SUMMARY

3. NZ Airports believes that it is important for the TWG to recommend to the Government that deductions for depreciation for commercial and industrial buildings need to be reinstated. This is a significant issue for airports and the broader economy.

4. The growth of the tourism industry depends on airports providing world class facilities, with capacity to efficiently handle a growing number of aircraft and passengers over time. The Government has also made clear that it has a strategic objective to facilitate investment in airports to build greater connectivity with, and strengthen economic development in, the regions.

5. Currently, the taxation system runs counter to these interests. Not allowing taxpayers, and specifically airports, to deduct depreciation for buildings adds unjustified cost to infrastructure investment. In particular:

   (a) Commercial buildings do depreciate over time. All international evidence suggests that overseas buildings do depreciate – and there is no logical reason why New Zealand buildings would not follow this international trend.

   (b) This is especially true for airport passenger terminals. A 2010 report from Opus International Consultants Limited ("**Opus Report**") concluded that the estimated useful life of an international airport terminal in New Zealand is between 37 and 45 years

   (c) Economic regulation of airports treats land and buildings separately, and allows for depreciation of terminals as does International Financial Reporting Standards for statutory financial reporting.

   (d) There is a clear tax distortion where commercial building owners are overtaxed relative to other investors. The taxation system should promote productivity and

growth – and not advantage one form of investment over another – particularly if the incentive is against investment in strategic public infrastructure that supports New Zealand economic and social productivity (noting that tourism is our number one export earner).

(e) The current regime creates incentives that are contrary to the Government's environmental and social responsibility goals. For example, there is a tax disincentive against investment in seismic resilient structures or thermally efficient cladding or glazing as those components are non-depreciable for tax purposes. Whereas heating systems and energy costs are deductible and therefore favoured by the tax regime. Also, buildings are only deductible in the event that they are destroyed by an event beyond the owner's control, such as an earthquake.

(f) The current power for the Commissioner to set provisional rates for classes of buildings with expected useful lives of under 50 years is not an adequate remedy. NZ Airports was unsuccessful with an application to obtain a provisional rate for airport terminal buildings and airports do not enjoy tax depreciation deductions for the majority of buildings assets regardless of their expected useful lives.

6. We were pleased that the Interim Report acknowledges there is a case for reinstating depreciation deductions for commercial and industrial buildings.[1] If however the TWG were to ultimately decide against a broad change for all commercial buildings, then it should at least allow for the reinstatement of depreciation deductions for a narrower class that includes 'airport terminal' buildings (as described in the recommendation section below).

BACKGROUND TO THE ISSUE

7. As part of Budget 2010, the then Government decided that, from the 2011-12 income year, the depreciation rate on buildings with an estimated useful life of 50 years or more would be 0% (effectively removing deductions).

8. NZ Airports conveyed its disapproval about this proposal to the Minister of Finance and Minister of Revenue in early 2010, and was disappointed to find that the decision to remove tax depreciation was subsequently announced in the Budget.

9. We note the Commissioner's advice that the Generic Tax Policy Process was not followed, and consultation was limited. However senior tax practitioners, the Property Council of New Zealand, and the Housing New Zealand Corporation all expressed a strong view that buildings did depreciate.

10. On the basis that airport terminals have a useful life of less than 50 years, in December 2010 NZ Airports applied to the Commissioner for a provisional rate for airport terminals. This was unsuccessful.

DEPRECIATION SHOULD BE ALLOWED

Airport Terminals Depreciate

11. Despite the 2010 changes, as now recognised by the TWG, there is strong evidence that commercial and industrial buildings do depreciate over time. We agree with the recommendation expressed by the Commissioner in her *Depreciation on Buildings: Further*

[1] Interim Report, at 107.

information on potential revenue reducing options document that depreciation deductions should be reinstated.[2]

12. In particular, we agree with Inland Revenue's views that:[3]

    (a) International studies demonstrate that buildings do depreciate – with estimates ranging up to 9.9% per annum.

    (b) New Zealand is a clear outlier in the OECD in not allowing tax depreciation deductions for commercial or industrial buildings. This has produced a higher effective marginal tax rate than any other country in the OECD.

    (c) Despite the reliance on NZ data for the decision in 2010, there is no rationale for why buildings in New Zealand are less likely to depreciate than their international counterparts.

13. The fact that commercial buildings do depreciate is very evident for airports. Airport terminal buildings can and do lose value over time. In 2010, NZ Airports submitted extensively to the Commissioner on the reasons why airport terminal buildings decline in value, and these factors continue to remain the case today. The main factors are:

    (a) *Long term growth in air traffic volumes.*

        Airport terminal buildings must be adapted to accommodate increased passenger volumes and to prevent capacity bottlenecks.

    (b) *Changes over time in aircraft size and peak period passenger flow demands.*

        These changes require airports to undertake modifications to dimensions of spaces and corridors of terminal buildings, which has a consequential effect on building envelopes. Furthermore, different aircraft require different terminal configurations. As such, rapid changes in aircraft technology require airports to modify terminal configurations and corresponding safety requirements.

    (c) *Changes over time in the scale of baggage handling equipment.*

        Changes in capacity requirements for baggage handling mean that manual baggage handling systems become obsolete in light of more sophisticated automated baggage systems. This technology change has implications for room heights and dimensions of baggage handling spaces and a consequential effect on building envelopes.

    (d) *Changes in regulation over time affecting the useful life of the building.*

        Airport terminals operate in an environment where regulatory requirements can change rapidly and significantly. The following examples have had a significant effect on scale of building spaces and terminal configuration over time (and consequential effect on building envelopes):

        (i) Upgrades to security and the physical separation of passenger arrivals and departures due to international regulations.

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[2] Policy and Strategy, Inland Revenue "Appendix C: Depreciation on Buildings – Further information on potential revenue reducing options" (July 2018) ("**Appendix C**").

[3] Appendix C, at 19.

(ii) Changes to the security screening of passengers and carry-on baggage that did not exist in previous eras for departing and transit passengers.

(iii) Increased duration and complexity in screening procedure requiring more internal space to accommodate screening units and passenger queues.

(iv) Requirements for x-ray screening of outbound international baggage. This has had a dramatic effect on building dimensions including inter-floor heights in baggage handling areas and has resulted in the need for additional control and inspection rooms.

(v) Requirements for quarantine inspections and x-ray screening for arriving passengers.

(vi) Changes to:

(aa) building codes and regulations (for example, seismic and fire egress requirements);

(bb) the acceptability of materials (for example, insulation and roofing standards); and

(cc) expectations relating to the sustainability and environmental performance of buildings and building materials;

which can result in some buildings becoming uneconomic to modify, compared with building new.

(e) *Changes in the operation of the airline industry.*

Airports must be able to respond to fluctuations in the number of carriers operating in the New Zealand aviation industry. Furthermore, differences in operating models between low-cost and 'full service' carriers require airport terminals to accommodate a range of airline preferences. Changes to these operating models can therefore have a significant impact on the ability of airport terminals to function effectively.

(f) *Changes in the way airports undertake business.*

Like the airline industry, the business characteristics of airports have undergone change. Airports have become diverse commercial and privatised businesses – a development that is reflected in the subjection of aeronautical revenues to increasing degrees of regulation. These developments impact on terminal configuration and scale.

14. In 2010 NZ Airports also engaged Opus to prepare an analysis report on the useful or effective life of airport terminal building structure elements.[4] The Opus Report calculated that the structural elements of the international terminal buildings at Auckland International Airport and Dunedin International Airport had a useful life between 39 and 44 years, and that

[4] Opus International Consultants Limited "Report Final: New Zealand Airports Association: Depreciation Lives of Airport Terminal Buildings" (13 December 2010), at 20.

regional terminal buildings may also have a structure useful life below 50 years.[5] The Opus Report concluded:[6]

> it is clearly demonstrated that irrespective of size all airport terminal buildings are subject to frequent significant changes in the operating environment that often result in a need for development and reconfiguration work. There is no expectation that this rate of change will abate in the near future.

15. Queenstown Airport's recent development of its terminal building demonstrates this point. Since 2010, Queenstown's rapid tourism growth has resulted in an upgrade of its domestic gates, an expansion of its international facilities and now a major revamp of its domestic terminal. This includes changes to its check-in, baggage make up, security and domestic gate lounges driven by changes in capacity requirements and security regulation.

16. Accordingly, there is clear evidence that our airport members do suffer a legitimate non-cash expense after constructing terminal buildings. According to the purpose of the depreciation regime, they should be entitled to claim deductions that the taxation system currently denies.

Buildings and land are separate

17. The original decision to remove depreciation may have been influenced by a failure to clearly differentiate between the value of buildings and the value of underlying land. Inland Revenue has recently noted the failure to properly separate out land and buildings in the QVNZ data which was used in Treasury's analysis in 2010:[7]

> Limitations of the Treasury's analysis include (most of which were recognised in the 2010 Joint Report)
>
> …
>
> Difficulties in separating building value from land — this difficulty may be particularly pronounced during a period of rapidly appreciating property prices. This is also a limitation of the used asset price and rental data approaches.

18. It is evident that building and land are separate assets and should be treated as such by the taxation system. It does not follow that because land appreciates in value, buildings will as well.

19. For example, for airports regulated under Part 4 of the Commerce Act 1986, the input methodologies set by the Commerce Commission specifically separate out the value of land and the value of buildings. While land is not depreciated under that regime, airports are allowed to depreciate buildings and other non-land assets.

20. Accordingly, the tax system should be capable of ensuring that the rules for depreciating buildings are not unduly influenced by the appreciation of the underlying land.

Tax system should not undermine incentives to invest in critical infrastructure

21. The current depreciation deduction rules distort investment incentives. NZ Airports submits that it is particularly important that the tax rules do not deter investment in critical economic and social infrastructure such as airport passenger terminals.

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[5] Opus Report, at 20.
[6] Opus Report, at 20.
[7] Appendix C, at [3.12].

22. The Minister for Regional Economic Development has also signalled that the Government's priority focus is on developing regional airport infrastructure:[8]

> "The Government recognises that many regional airports are looking to improve their resilience and contribute to their region's economic development plans. This is why we are also considering the wider role that air connectivity can play and how we can measure its value to regions.

23. As such, we expect any obstacles to development of regional airport facilities will be of particular concern.

24. We note Inland Revenue's current view that:[9]

    (a) the current position for buildings is resulting in a tax distortion which means that investments that would be profitable in the absence of tax are not being made due to our tax settings;

    (b) this is reducing productivity, and likely reducing New Zealand's net welfare; and

    (c) horizontal equity is negatively impacted as building owners are overtaxed relative to other investors.

25. These concerns apply to airports. Despite incurring significant expenditure on assets that have clear national economic and social benefits, airports are being overtaxed relative to other investments because they are not entitled to recover depreciation deductions for tax purposes. Any limits on New Zealand airports' ability to attract equity investment to fund growth leads to a higher cost of capital and consequently higher prices to consumers.

26. The benefits delivered by airport investment include economic benefits for local, regional and national economies through the enabling of connections that allow and facilitate tourism and international trade.

27. The absence of tax depreciation deductions for buildings is also contrary to the Government's environmental and social responsibility goals. There is a tax disincentive against investment in seismic resilient structures or thermally efficient cladding or glazing as those components are non-depreciable for tax purposes. Heating systems and energy costs are tax deductible, thereby favouring energy usage instead of more environmentally sustainable insulation. Stronger building structures to protect against earthquakes are non-deductible for tax purposes, whereas building losses following an earthquake are deductible, again creating unintended tax incentives.

28. A 2013 study by Market Economics for NZ Airports concluded that activities associated with all airport operations in New Zealand contributed $39.1 billion to the national economy, with this figure increasing to $48.7 billion when the wider airport environment are taken into account. For the three main regulated airports, this study demonstrated that in 2013 Auckland, Wellington and Christchurch Airports together:[10]

    (a) supported 21,198 jobs in airports and aviation;

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[8] Hon Shane Jones, Minister for Regional Economic Development "$5.5m for Gisborne airport redevelopment" (press release, 7 September 2018).

[9] Appendix C, at [1.6].

[10] Market Economics "Limited Economic and Social Contribution of New Zealand's Airports" (17 December 2013).

(b) contributed $4.148 billion in economic output directly associated with airport operations and aviation activities; and

(c) contributed $3.186 billion to the national economy by way of value added, with $1.983 billion of this directly associated with airport operations and aviation activities.

29. NZIER in its report to *Depreciation and land tax* in 2010 noted that the removal of depreciation deductions would harm New Zealand's overall competiveness:[11]

> In addition, depreciation of commercial buildings is common practice in the OECD. Removing depreciation in New Zealand would make us an outlier and reduce our international tax competitiveness. **This could hamper already weak foreign direct investment into New Zealand, the health of the local capital market and erode export competitiveness.**
>
> This is clearly counter to government policy objectives of making New Zealand a more internationally competitive economy and would place us at a further disadvantage to Australia.
>
> (emphasis added)

30. In this context, the Government should be concerned about tax policy that adds cost to the aviation sector, and risks reducing its international competitiveness.

Black hole expenditure

31. NZ Airports is also concerned about the range of "black hole" expenditure that airports face. That is, business expenditure that is expected to result in an economic cost to an airport, but is neither immediately deductible for tax purposes, nor deductible over time.

32. As an example, the Commissioner denied Queenstown Airport depreciation deductions for its Runway End Safety Area.[12] This was despite:

(a) the core project cost to Queenstown Airport being approximately $5.5 million; and

(b) the fact that the project was required by the Civil Aviation Rules to make airports safer and was also necessary so that Queenstown Airport could continue to operate as an international airport, allowing increased tourism into the Queenstown region.

33. There is a clear ongoing risk that airports continue to be subject to black hole expenditure for airports for valuable social infrastructure. Changing the position on depreciation for airport terminal buildings would be a step in the right direction to mitigate these concerns.

Provisional rate is insufficient

34. Currently the only ability for an airport to seek depreciation deductions is to apply to the Commissioner for a provisional depreciation rate for a class of building.[13] The Commissioner can issue a provisional depreciation rate if she is convinced that a "class of buildings" have a

[11] NZIER "Depreciation and land tax – assessment of selected Tax Working Group recommendations" (5 February 2010), at 1.

[12] *Queenstown Airport Corporation Limited v Commissioner of Inland Revenue* [2017] NZCA 20.

[13] Section EE 35 of the Income Tax Act currently provides for the Commissioner to set a provisional depreciation rate is under section 91AAG to 91AAJ of the TAA 1994.

useful life of less than 50 years and she does not have an applicable economic rate in her table of depreciation rates.[14]

35. NZ Airports submits that the current discretionary procedure is not producing satisfactory outcomes. This is because:

    (a) There is always (natural) uncertainty about what is the expected life of most assets. When the Commissioner receives an application for a provisional rate, she often receives her own expert assessment which disagrees with the taxpayer's expert assessment. This means any application for a provisional rate often spirals into an expensive and time consuming factual dispute even when a taxpayer can demonstrate robust evidence for an asset's expected useful life. For example, NZ Airports commissioned an expert to draft a report on the expected useful life of passenger terminal buildings which concluded that it was between 39 and 44 years for international terminal buildings. Despite this, the Commissioner still declined to set a provisional rate.

    (b) The current 50 year useful life standard is also arbitrary in nature – even if an asset does decline in value over a longer useful life than 50 years, the taxpayer still suffers an economic loss that should entitle them to a tax depreciation deduction. For instance, the Commissioner's own depreciation schedule also notes assets with an estimated useful life of up to 100 years (such as bridges, tunnels and dams) which are entitled to receive depreciation deductions. It is inconsistent therefore for buildings to only be depreciable if their useful lives have been proven to the satisfaction of the Commissioner to be less than 50 years.

36. Importantly, the Commissioner does not look at broader factors when exercising her discretion about whether to set a provisional rate. We consider that the social value of the class of assets should be an important tiebreaker when there is conflicting expert evidence as to the expected useful life of an asset. Put another way, the Commissioner should give the benefit of the doubt to the taxpayer when determining whether depreciation deductions should be awarded to class of assets that have a clear economic benefit to the broader public.

37. Overall, this shows that the discretion from the Commissioner is not sufficient to address the issue and legislative reform is required to allow depreciation deductions to reflect the economic reality that of buildings do indeed depreciate.

RECOMMENDATION

38. NZ Airport's proposal is that the TWG should:

    (a) In the first instance, reinstate depreciation deductions for all commercial and industrial buildings.

    (b) If that is not accepted, allow depreciation deductions specifically for a new class of building that could be defined as 'airport terminal' buildings.

39. If TWG chooses to allow a depreciation deduction for 'airport terminal' buildings, a potential legislative definition could be:

[14] Commissioner of Inland Revenue "Changes to building depreciation" (13 August 2010).

> A building located at an airport whose primary function is to facilitate the passage of travellers (whether international or domestic) arriving at and departing from that airport.

40. Supporting material and guidance could provide that an airport terminal will include spaces to facilitate this primary function and also activities which are ancillary to it. These may include:

    (a) passenger check-in, bag drop and ticketing activities;

    (b) arrival and departure spaces (including airline and hospitality lounges);

    (c) retail and duty free shopping, bars, safes and restaurants;

    (d) transportation booking/collection (e.g. rental car, taxi or public transport); and

    (e) baggage processing and collection.

41. The cost of assets which constitute the building fit-out or plan would not form part of the airport terminal building as these are already separately depreciable.