Tax Working Group
Te Awheawhe Tāke

# Tax Working Group Public Submissions Information Release

## Release Document

## February 2019

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Property Council
New Zealand

1 November 2018

Tax Working Group
Email: submissions@taxworkinggroup.govt.nz

Dear Tax Working Group members,

**Property Council Feedback on the Tax Working Group's (TWG) Interim Report**

## 1. Executive Summary

1.1. Property Council supports the concept that all forms of income are treated equitably for tax purposes. While we initially gave conditional support, we do not think that the benefits from generally extending the taxation of capital income, including to real property, would outweigh the costs and negative consequences. We have come to this conclusion based on working through the various design features of the capital income taxation options outlined in Appendix B of the Tax Working Group's Interim Report. Some of the key considerations for Property Council's members include the need to minimise (or avoid) double taxation where commercial property is held through a company structure and to ensure that commercial property can continue to effectively and efficiently remain part of the productive economy.

1.2. A better approach, in our view, is to continue with New Zealand's current practice of targeting specific problem areas, such as with the current bright line test for residential property (e.g. if the issue is housing affordability). For example, a targeted approach might be for listed companies with significant property assets, that are held for long term investment, to be taxed on share gains only (because that is where capital gains, if any, are typically realised) with those companies trading directly in property being taxed on property transaction but not share price gain. However, if the Tax Working Group recommends extending capital income taxation to commercial property, we outline some key design features that need to be given particular consideration.

1.3. Property Council strongly urges the Tax Working Group to follow through on its initial work which suggests that removal of tax depreciation on buildings in 2010 was the wrong tax policy. This has created significant tax disincentives to undertake much needed building improvements. We recommend that the Group's final report includes the reinstatement of tax deprecation on commercial building structures as a matter of priority.

1.4. We also recommend that some form of tax treatment of seismic strengthening costs is implemented.

## 2. Property Council Background

2.1. Property Council's goal is the creation and retention of well-designed, functional and sustainably built environments which contribute to New Zealand's overall prosperity. We support legislation that provides a framework to enhance economic growth, development, liveability and growing communities.

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2.2. 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.

2.3. Our membership 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.

2.4. Property Council membership canvasses a broad range of commercial property ownership and management models – from those who own one or two properties directly through to large institutional and listed property entities. Our membership's view on capital gains tax is equally broad and nuanced. As a consequence, our feedback focuses on the broad principles about the tax system's interaction with the commercial property sector and proposes solutions of broad relevance to the industry as a whole. Individual members and sub-sectors are likely to have slightly different views on matters of detail.

## 3. Introduction

3.1. Property Council wishes to thank the Tax Working Group for acknowledging our submission and engaging with our members through your development of you Interim Report. We again wish to offer our assistance in helping the Tax Working Group work through some of the issues to ensure a fair and equitable tax system moving forward.

3.2. Commercial property is an inextricable part of the productive economy. Almost all businesses need a building (or buildings) from which to operate. This is as true for manufacturing and logistics as it is for tourism and hospitality as it is for professional and financial services. Their machines, computer servers or kitchen/dining areas need to be housed somewhere. It is crucial that any extension of capital income taxation to the commercial property sector does not disincentivise the investment needed to house businesses in fit-for purpose buildings (and for those buildings to be regularly upgraded to remain fit-for-purpose). The ability for commercial property to evolve will become even more important as the economy transitions ever more rapidly as expected it will in the near to medium future.

## 4. Design of Capital Income Taxation

4.1. In looking at how to design a capital income system that will minimise disincentives for investment in commercial property, Property Council sees that there are a number of important 'factors' that need to be considered:

- Commercial property is part of the productive economy
- Commercial buildings depreciate and become obsolete

- Investment in commercial property undertaken via multiple vehicles and business structures, each with unique characteristics and challenges – a one size fits all approach will not work
- Commercial property tends to be capital intensive
- Commercial property investors target rental income (rather than specifically capital gains), in contrast to residential property investment which tends to be low rental yield, high capital gain

4.2. To consider those 'factors' Property Council considers that the important 'principles' when considering the design of a capital income tax should be:

- Double taxation should be avoided (or minimised) where investment in commercial property is via a corporate or other similar entity structure.
- Compliance and administration costs (for both the taxpayer and IRD) should be minimised to the maximum extent possible. In particular, the current ease of compliance for investors under the PIE tax regime should not be disturbed.
- Disincentives to upgrading assets should be avoided (or minimised), given the importance of safe and environmentally friendly building stock for New Zealand's economic and social prosperity.

4.3. We believe that it would be difficult, if not impossible, to design a general system of capital income taxation that would fully achieve the above objectives having regard to the various design issues outlined in Appendix B of the Tax Working Group's Interim Report. Therefore, we question the ability to deliver a workable system.

4.4. However, we comment below on the key design considerations if the Tax Working Group decides to recommend extending capital income taxation to encompass commercial property gains (and losses) in its February 2019 Final Report.

*When to Tax Capital Income*

4.5. Taxing capital income in relation to commercial property on realisation is the simplest and fairest option. We do not support taxing on an accrual basis (whether annual gains or under a Risk Free Return method (RFRM) basis).

4.6. The primary reason for this is that to pay the tax on an accruals basis will be an issue for many landlords. While this is true regardless of ownership structure, it will be particularly acute for small commercial property investors (including "mum and dad" investors who might hold one to two properties).

4.7. Similarly, an RFRM for commercial property is not supported on the basis that this would also create cashflow, valuation and ultimately fairness issues – with tax being charged regardless of actual commercial property value movements. We believe an RFRM would be akin to a "land tax" (albeit including on value of capital improvements), which the Tax Working Group does not support, and suffers the same drawbacks.

4.8. Taxing on a realisation basis would address the cash flow constraint for commercial property investors and be most consistent with other forms of income taxation. This would also be consistent with the Tax Working Group's intention of extending the income tax regime rather than introducing a new standalone tax regime.

4.9. The Interim Report appears to favour a "valuation day" approach, if capital income taxation on realisation is adopted. Property Council strongly supports grandfathering of any historical capital returns to ensure fairness – property owners should not be penalised via tax on past capital growth.

4.10. While a valuation date (coupled with a 'median' rule) would ensure that only gains from the application date are taxable, it will force all commercial property owners to seek independent valuations. This will come at considerable cost, and scope for dispute with Inland Revenue (including even if an independent valuation is sought).

4.11. One option to mitigate this risk is to apply any change only to acquisition of new property (i.e. on or after 1 April 2021). Alternatively, there needs to be flexibility – e.g. for valuations undertaken within a prescribed period, say 6 months, either side of the application date should be accepted. This will help avoid a rush on valuations (and the consequent price increases from valuers in sudden increased demand) and accommodate entities that do not have a 31 March balance date. It will also allow companies to 'align' their entry valuation with any pre-exiting valuation schedule they may already have for other commercial purposes. Companies (and individuals) should also have the option of using the 'Council valuation' if they do not wish to pay for a separate valuation. This may potentially under or over value their property at the application date. However, these "unders and overs" should net out such that Government is not unduly impacted.

4.12. An accrual basis would introduce a lot of risk and subjectivity to the tax system. Accrual taxation would require annual valuations which are not only costly but also subject to variation, whether accidental or otherwise. This could result in either a large windfall gain or unexpected loss for the taxpayer (and vice versa for Government's revenue stream).

4.13. This risk is exacerbated by the fact that commercial property values can move quite rapidly both up and down. An accrual-based capital gains tax could cause the tax take to vary widely, especially during down periods. Conversely taxing on realisation should better smooth the ups and downs. This will lead to greater stability in the tax take.

*Compliance Costs*

4.14. Overseas experiences with capital gains taxes has shown that most are complex, with multiple rules and exceptions that are costly to administer. That is contrary to key principles of the New Zealand tax system which is "simplicity" and "ease of compliance".

4.15. To date New Zealand has dealt with particular policy problems by devising specific rules to account for the issues specific to the particular type of asset. Property Council supports that philosophy in preference to a broad-based extension of capital income taxation that attempts to be a one size fits all approach. While at first glance having bespoke rules might seem complex and cumbersome, overseas experience shows that having a broad capital gains tax leads to many perverse consequences that require numerous exceptions (for example, we note the Tax Working Group's conclusion that most private assets should simply be excluded due to complexity). These exceptions lead to a greater risk of loopholes, tax avoidance and unintended outcomes than designing specific rules to address the specific issues at hand.

4.16. Compliance costs become even harder to predict when one tries to account for the large variety of different ways individuals or companies might own property. Taxing capital income might be quite simple for a single investor who owns one or two properties directly when they sell. It will be easy to assess who to tax and how much to tax on sale. It gets increasingly complex when more people own a portfolio of properties some of whom might use the income to retire on while others want to reinvest for rental income or long-term returns. The picture gets even more complex when the owner is a private company with multiple shareholders, especially if the income from the company and/or shares are also taxed – raising the spectre of double taxation (which we discuss below). Complexity increases again for listed companies and entities, which can be further muddied if they are PIEs, not to mention the different treatments of listed versus multi-rate PIEs. The sheer multitude of these different vehicles for commercial property investment makes it equally difficult for taxpayers to comply and Inland Revenue to assess compliance. It significantly increases the risk of loopholes and perverse consequences.

4.17. Additional compliance costs will also be incurred by the need for valuations of assets to ensure the correct amount of tax is paid. This will be particularly acute if an accruals-based capital taxation system is adopted, but will also be a problem under a realised gains system. We foresee potential disputes with Inland Revenue over starting valuations, unless any recommendation applies a "new assets acquired" only approach.

*Double Taxation*

4.18. A key concern for the commercial property sector is the high likelihood of double taxation under a capital gains tax regime that applies both to commercial property gains at the entity level and investors' share value movements. This is because the majority of commercial property investment is done through companies and other entities (both listed and unlisted), which are opaque for tax purposes. Those entities' share prices are linked to both the rental income from the properties as well as the overall value of their asset base. Taxing the entity on realised capital gains of its property assets, but also separately taxing the investor on their share price gains (which will be closely correlated to those property gains) will give rise to double taxation if investors are taxed before the property is sold.

4.19. A key feature of the current New Zealand tax system is avoiding (or minimising) double taxation. This is done through a variety of mechanisms including imputation and more successfully, in our view, the PIE rules for both listed and unlisted entities. In theory the risk of double taxation should be ameliorated through the imputation system, but in practice this will not be the case as it requires tax to be paid at the company level first for this to be available to minimise double tax for investors' gains. The actual tax situation of different property investment companies and different investors varies widely – for example, it is much more straight forward for private companies as they will have a greater degree of control over investment decisions to align with the activity of their shareholders.

4.20. The situation is not straight-forward for widely-held commercial property-owning entities (see below). Mechanisms to avoid double taxation will be needed but are likely to be complex. This will increase compliance and administration costs and the risks of non-compliance.

*PIE Regime*

4.21. Because of the capital intensive and long-term nature of commercial property it is a very risky asset class to invest in directly and can require significant capital investment over time. Given the critical importance commercial property plays in the productive economy (essentially housing all businesses) this is an economic risk. Taking a portfolio approach to commercial property investment sensibly spreads the short-term risk and allows realisation of predictable long-term income. This is a key reason why many superannuation funds, including Kiwisaver funds, take a portfolio approach to investing in commercial property.

4.22. The PIE taxation regime was introduced in New Zealand to help level the (tax) playing field for investment directly and through entities holding diversified investments (including diversified commercial property), recognising that tax should not disadvantage intermediated savings. Property Council membership includes both listed and multi-rates PIEs. While specific to New Zealand, it is a system that has worked very well and is simple for investors to understand. Property Council strongly supports continuation of the PIE regime and its key features and the need to address any double taxation risks.

4.23. The impacts from potential extension of capital income taxation to listed (and multi-rate) PIEs are varied and complex. We have not sought to deal with these issues in our submission. Property Council endorses and supports the separate submission made by some of our listed property PIE members specifically on the issues for the PIE regime.

*Roll-over Relief and Asset Lock In*

4.24. On the whole, commercial property investment is generally a long-term strategy. It tends to be driven by rental income returns rather than capital gains. Capital gains when assets are sold tend to be re-invested by buying more property and in upgrading existing assets rather than distributing the gains to shareholders. This is the way most Property Council members operate.

4.25. A key risk in introducing any form of taxation of capital gains is that building owners will be disincentivised to sell or upgrade their buildings to avoid a tax bill (asset lock-in). This is a drag on the productive economy as commercial property needs to remain fit-for-purpose to enable New Zealand businesses to improve their productivity and profitability. This is particularly risky given that we know the New Zealand economy will need to evolve and transition rapidly as the global economy, the nature of work and how it is carried out, and societal expectations around building safety and environmental impact, change rapidly.

4.26. A key way to prevent asset lock-in is through availability of rollover relief from capital gains tax liabilities provided the company or investor uses the proceeds of any sale to reinvest in a similar capital asset (through the acquisition or development of new assets or redevelopment of existing assets). This encourages commercial property owners to upgrade their properties, which may include selling one and buying a bigger and/or more fit-for-purpose property. Rollover relief is, we believe, important for commercial property investors, particularly smaller investors, who are buying into the same market they are selling in. Taxing the capital appreciation when the intention is to reinvest will compromise their ability to invest in a new, better, asset and act a disincentive to make investment decisions that are for the overall benefit of “NZ Inc” thus damaging the productive economy. We believe it is important to take this wider perspective, rather than just applying a tax lens.

4.27. Property Council acknowledges the downside for Government is that rollover relief will defer tax revenue. The incentive to reinvest the proceeds of sale will also increase as the accumulated tax liability increases over time. Putting some boundaries around what is needed to qualify for roll-over relief and how long that relief can be claimed may help mitigate the risk for tax collection purposes.

4.28. However, this again illustrates to us the difficulties of designing a capital income taxation regime that is workable, which raises sufficient revenue for Government but does not create skewed economic and investment incentives for commercial property owing businesses. Designing a rollover relief mechanism to suit the wide variety of investment strategies of various commercial property owners will be complex, especially since some will buy new high-quality properties, some will buy lower value properties to upgrade (using some of the capital) and others will use the capital to upgrade existing properties. Ensuring equity across these different but perfectly legitimate scenarios will be difficult and require trade-offs, increasing compliance and administrative costs with any proposals.

*Deduction of Capital Expenses*

4.29. A key principle underlining the Tax Working Group's suggestion that capital income taxation be extended to cover more assets is equity and consistency between asset classes. On that basis any capital gains tax on commercial property needs to allow deductions for capital expenses. This will ensure that property assets are treated similarly to expenses on all other business assets.

*Revenue from taxing commercial property capital income gain*

4.30. Property Council notes that any design of capital gains tax will be complex and likely involve high compliance costs for taxpayers. This will be especially true to avoid potential double taxation if both commercial property assets are taxed at the entity level and shareholders of these entities are also taxed.

4.31. Most commercial property companies sell assets for strategic reasons to implement a changed property investment strategy or to upgrade other properties in the portfolio. These strategic sales are often done regardless of whether the properties are sold at a profit or a loss.

4.32. Calculations by some Property Council members show that the majority of their strategic sales are neutral or at a loss when capital expenditure and other expenses are accounted for. Importantly where there have been capital gains, none of the companies distributed those profits to shareholders, rather the gains were reinvested in further commercial property or used to strengthen the balance sheet of the company through de-leveraging. This suggests that the revenue raised from the commercial property sector from extending capital income taxation may be small. In the case of listed property entities, it may also suggest that capital gains should be reflected in their share prices and any realised capital gains made on shares will be taxed at the shareholder level.

## 5. Depreciation

5.1. Property Council believes the previous Government's decision to remove tax depreciation on commercial building structures conflated residential and commercial property as a single asset type and did not recognise the different economic roles they play. We are pleased that Officials advice to the Tax Working Group supports the view that commercial property does in fact depreciate.

5.2. We think the case for restoring depreciation is strong, principled and stands on its own merits. In relation to the latter, it should not be linked to decisions around extending capital income taxation to commercial property.

5.3. Depreciation of business assets used to generate taxable income is a cost of doing business. We believe it is illogical for one business asset – commercial property – to be treated very differently from other business assets. New Zealand is currently one of only a handful of countries in the world that does not allow depreciation of commercial property.

5.4. 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.

5.5. While our primary focus is on the depreciation of commercial buildings (office, retail and industrial), multi-unit residential buildings also become obsolete overtime to a significantly greater degree than standalone residential buildings. This is because multi-residential buildings have similar building standard regulatory risk and are generally engineered and constructed to a similar high standard as commercial buildings.

5.6. 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 strengthening. This represents an economic cost in unrealised productivity increases and environmental gains that could be gained from the building stock being upgraded.

5.7. Property Council therefore strongly urges the Tax Working Group to recommend reinstatement of tax depreciation on commercial property structure in line with the officials recommendation "*that tax depreciation for commercial, industrial and multiunit residential buildings be reinstated at a 2% straight-line or 3% diminishing value rate*" (7.6 of Appendix C). This would recognise the contribution the commercial property sector plays in the productive economy, remove current tax disincentives to earthquake strengthening which is necessary to promote safe and sustainable buildings. To be clear, this recommendation would not provide landlords with a tax incentive. It is simply about reflecting the true economic cost from technical obsolescence, for tax purposes, similar to any other business asset.

5.8. Property Council recognises that there is a fiscal cost to reinstating depreciation on commercial buildings and in order to achieve the Government's objective of a 'revenue neutral package' that cost will need to be made up from revenue raising elsewhere. As noted above we do not believe extension of capital income taxation to commercial buildings is likely to generate a large amount to revenue. Therefore, the Tax Working Group will need to look at other ways to ensure restoration of tax depreciation can be revenue neutral. We appreciate this may appear self-interested, however, the 2010 tax changes disproportionately affected commercial property landlords who effectively funded a large chunk of the previous Government's tax cuts for individuals and businesses. This is simply correcting that previous tax policy error.

## 6. Seismic Strengthening

6.1. Property Council strongly agrees with the TWG finding that "*the current approach [to treatment of seismic strengthening] results in a counter-intuitive outcome: deductions may be claimed if a building collapses in an earthquake, but no deductions may be claimed on expenditure that will prevent the building from collapsing.*" It is a public good and a public safety issue as much as it is a private property issue. The treatment of seismic strengthening is an anomaly in the tax system that needs to be urgently corrected, regardless of whether the TWG recommends a capital gains tax or not.

6.2. If a capital gains tax is recommended, seismic costs can be dealt with either as expenditure deductions from the capital gain or through use of depreciation rules. The advantage of using depreciation rules is that that will work regardless of whether there is a capital gains tax or not. Depreciation of seismic strengthening costs can also be implemented immediately. The depreciation rules can be set to account for early movers who have already strengthened their buildings so they are not disadvantaged for making their buildings safe before the rules were changed.

6.3. The details of how a depreciation mechanism for seismic strengthening might work are set out in Property Council's letter to the TWG of 12 June 2018 and are not repeated here.

## 7. Transactional, Wealth and Land Taxes

7.1. Property Council supports the Tax Working Group's conclusions recommending against further consideration of financial transaction taxes and any form of wealth tax, including land taxes. We agree that these would be complex form of taxation that would likely reduce the integrity of the tax system.

## 8. Conclusion

8.1. In Property Council's view, having now worked through the various design issues for extending the taxation of capital income (in Appendix B of the Interim Report), we believe that it will be incredibly difficult to design a system that is workable, and acceptable – i.e. achieves the Government's fairness objectives, raises sufficient revenue, is simple for taxpayers to understand and apply and for Inland Revenue to administer, and does not double tax investors in companies or penalise investment decisions (including reinvestment).

8.2. On that basis, Property Council's revised view, is that the various costs of extending taxation of capital income more comprehensively are likely to outweigh the benefits. Therefore, we strongly urge the Tax Working Group to consider whether such a change is warranted and, importantly, sustainable over time. We believe that issues (e.g. housing affordability) could be better addressed through 'bespoke' solutions

8.3. If the Group's final recommendations do include further extensions to the taxation of capital income, we have outlined above the key design considerations which are of concern to Property Council's members.

8.4. Separately, the current tax system disincentivises the upgrading of commercial building stock. This is a drag of the productive economy and will limit the ability of the New Zealand economy

Property Council New Zealand

to evolve and transition rapidly to changing global and societal trends. To that end we recommend that tax depreciation of commercial property structures is reinstated as there is clear evidence that commercial properties do depreciate.

8.5. Property Council thanks the Tax Working Group for the opportunity to provide feedback on the Interim Report. We would also like to speak to our feedback and ask that the Tax Working Group consider this.

8.6. Any further queries do not hesitate to contact either Matt Paterson, Head of Advocacy, email [1] or Jane Budge, Senior Advocacy Advisor, email: [1]

Yours sincerely,

[1]

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