



## PROPOSED CHANGES TO THE DEPRECIATION RULES

It is time to start writing submissions on the proposed changes to depreciation and the following is aimed to assist you in making a submission

**THESE PROPOSED CHANGES WILL AFFECT YOU DIRECTLY AND WILL DECREASE THE CASHFLOW FROM YOUR INVESTMENT PROPERTY.**

Unfortunately to give you an appreciation of the background this overview is longer than what we would like (but considerably shorter than the 114 page full discussion document!) We suggest ....

grab a coffee (or a beer/ wine),  
have a read,  
then draft your submission/ letter.

Note there is no right or wrong way to put a submission together. It can be as short as a one page letter. There is no form that needs to be completed with your submission.

The discussion document is just that - the Government want to know what YOU think about the proposed changes. The Valuit document is to get you thinking about the issues.

**Your comments do count and can make a difference.** If you do not provide your thoughts to the IRD they are likely to assume that you have no issue with what they are proposing!

**THE MORE SUBMISSIONS THAT ARE MADE BY INVESTORS THE BETTER IT WILL BE FOR ALL INVESTORS.**

**The deadline for Submissions is 30 September 2004.**



## REPAIRS AND MAINTENANCE TO THE TAX DEPRECIATION RULES - AN OFFICIALS ISSUE PAPER

This is the discussion document that has been prepared by the Policy Advice Division of the Inland Revenue Department and the New Zealand Treasury. The full document can be found at:

[www.taxpolicy.ird.govt.nz/publications/index.php?catid=2](http://www.taxpolicy.ird.govt.nz/publications/index.php?catid=2)

The main part, which will affect you as investors, is Chapter 9 (page 95), which deals with “Tax Treatment of Rental Housing”.

The issues papers requests submissions on three specific issues:

1. Do major distortions arise from treating the structural components of a residential rental building as a single entity, and if so what are these distortions?
2. Should taxpayers who adopt the list approach be restricted to a slightly lower depreciation rate?
3. Are there better ways of defining the boundary between the building and other separately identifiable assets?

There are however three important points, which we believe, also need comment from investors:

- A. Why do New Zealanders invest in “Residential Investment property”? Is it because of the depreciation advantages? Will these changes reduce investment in property?
- B. What will investors do to counter the loss in income as a result of depreciation changes?
- C. Why is the door being left open to penalise us?

A range of issues have been put forward in the discussion paper by the officials to which they have requested specific submissions on as noted above. In addition we have extracted a number of points from the Discussion Paper and added our comments (in *small blue italic*). Where we have wanted to emphasise apart of the Officials comments we have underlined this.

**A. Why do New Zealanders invest in “Residential Investment property”? Is it because of the depreciation advantages? Will these changes reduce investment in property?**

New Zealand is a small, capital importing country. If we are to make the most of our opportunities and maximise growth, capital must flow to the most productive areas of our economy. In some cases, however, the tax depreciation rules appear to be distorting investment decisions towards tax-favoured but less productive investment.

Our starting point is recognition that in the absence of taxes, investment would flow to the most productive areas of the economy, maximising our welfare. Taxes, however, can distort people’s decisions, with the result that lightly taxed activities will attract more investment, even though they have lower risk-adjusted, pre-tax returns than other investments. Correspondingly, that investment will be at the expense of investment in activities with higher risk-adjusted, pre-tax returns but which are more heavily taxed.<sup>1</sup> The outcome is, as a society, we are poorer and we have lower growth than otherwise would have occurred.

**Example**

Rose has \$100 to invest and has a choice between two investments for a year, both with the same risk. The first investment provides a 5 percent tax-free return. The second investment provides a 7 percent return but is taxed.

As Rose has a 39% tax rate, her choice is between a 5 percent after-tax return from the first investment or a 4.27 percent after-tax return from the second. She therefore chooses the first investment.

In the absence of tax, she would, of course, have chosen the second investment, which had a higher return.

*It is not always about returns but more about what people know and understand. There is considerable education on property in the market from advertising, seminars, TV programmes and Banks. On the other hand there is no real promotion in the market on the other types of investment. Is the reason that we invest in property all about depreciation? – No.*

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<sup>1</sup> This change in investment patterns will cause the returns on investing in the lightly taxed activities to fall and the returns on heavily taxed activities to rise until, on a risk-adjusted basis, after-tax returns from investing in different sectors are equalised.

Research completed in 2002 on the net worth of New Zealand households<sup>2</sup> identifies the percentage of the population that own assets and the proportion of total asset value for a range of asset categories. Table 9.1 summarises the findings<sup>3</sup>.

**Table 9.1 Asset composition of economic units**

	<i>Population with asset (%)</i>	<i>Total value (million \$)</i>	<i>Proportion of total asset value (%)</i>	<i>Median (\$)</i>
Maori assets	3	8,790	2	15,000
Trusts	4	28,709	6	216,000
Farms	4	<i>Asset type</i>	9	350,000
Businesses	12	38,574	9	43,000
House, living in	48	159,205	36	160,000
Time share	1	137	0	8,000
Holiday home	2	4,361	1	80,000
<b>Rental property</b>	<b>6</b>	<b>18,887</b>	<b>4</b>	<b>135,000</b>
Overseas property	1	4,194	1	40,000
Commercial property	2	7,343	2	150,000
Other property	4	9,863	2	95,000
Superannuation	21	24,737	6	25,000
Life insurance	14	8,797	2	15,000
Credit cards (positive balance)	3	95	0	500
Bank deposits (including bonus bonds)	91	26,000	6	2,300
Shares	21	13,986	3	5,000
Managed funds	9	11,864	3	23,900
Other financial assets	5	5,792	1	30,000
Money owed to respondent	8	3,835	1	5,000
Motor vehicles	77	16,871	4	8,000
Cash	3	191	0	1,600
Collectibles	25	6,857	2	5,000
Other assets	44	6,685	2	3,000
<b>Total value</b>		<b>444,030</b>		<b>125,300</b>

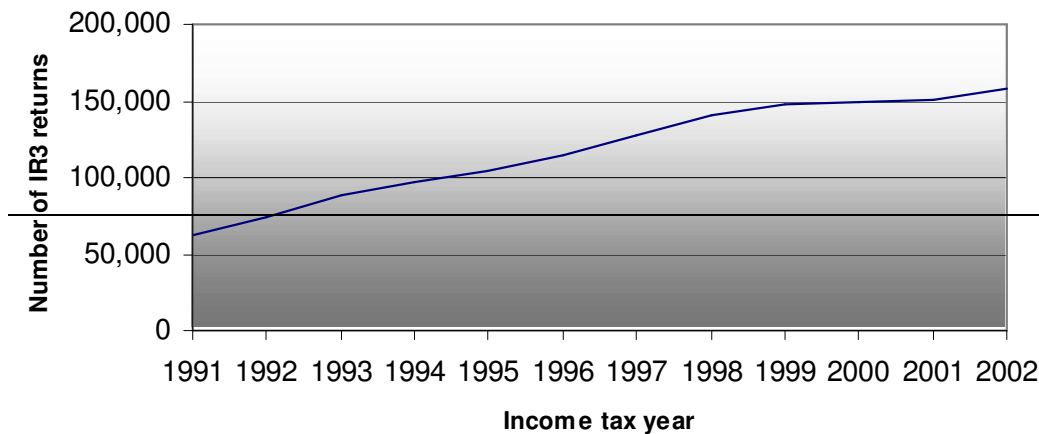
<sup>2</sup> *The Net Worth of New Zealanders*, Retirement Commissioner and Statistics New Zealand, 2002.

<sup>3</sup> Note that there may be some understatements of housing and rental investments owing to the use of trusts and companies for ownership purposes.

*Only a small percentage of investors are professional investors. When you look at the median asset worth which an investor has in rental property compared to Shares, Managed Funds or Superannuation there is very little incentive to invest anywhere but property (even for young investors). Those investing in “residential” property are predominately those heading toward retirement who have discovered that they will have very little to retire on and need to do something for themselves. They also have plenty of equity in their own homes.*

Figure 9.1 shows the numbers of taxpayers returning rental income between 1991 and 2002. Over the period, taxpayer numbers increased about 150 percent (or 95,000). The fact that more New Zealanders are now investing in rental properties increases the need for the tax rules for rental property to be broadly correct.

**Figure 9.1: Number of taxpayers returning rental income**



*Property is what investors know. There is a need to save and it is an investment that we can see, drive past and manage ourselves. It is tangible.*

Under Section 9.9 the officials note tax is only one consideration that influences decisions to invest in residential housing. A range of possible non-tax factors encouraging investment in rental housing includes - *and a list is provided. What is missed off this list are the biggest reasons:*

- *There is plenty of education and mentoring for potential investors*
- *Banks are willing to assist landlords*
- *Safer than other investments (for example - Access Brokerage). People nearing retirement can not afford these types of losses.*
- *The individual has direct control over their investment*
- *It is easy*
- *The returns are relatively consistent.*

## **B. What will investors do to counter the loss in income as a result of depreciation changes?**

- *One option is to increase rents, which will have an impact on tenants.*
- *Defer the replacement of chattels that need replacing which will lead to non-maintained properties and lower quality of living standards for tenants.*
- *When purchasing a new investment property the focus will be to ensure the desired yield is obtained. If the investor does not achieve this then they will not necessarily purchase that property but will look elsewhere. If the supply of new residential rental property does not meet the long-term demand for rental property this will also increase rents. It will dissuade private investors to provide housing stock at a time when the Government is looking to the private sector to provide additional residential rental housing stock. Particularly as more and more rental accommodation is required as New Zealand's home ownership rate declines.*

## **C. Why is the door being left open to penalise us?**

Given that this issues paper represents the start of the policy development process, it is too early to include any discussion on the possible application date of any reforms. This is especially the case in relation to the suggestions in the second part of the paper, which should be thought of as longer term possibilities only. In principle, we are of the opinion that, as far as possible, any changes should not affect existing investments. However, this would add to the complexity of transitional arrangements, and submissions are invited on the issue.

There are two exceptions, however, where there are strong reasons for any new rules to apply to investments that are in place at the application date of any new legislation. First, we are particularly concerned about the effects on investment in equipment. If faster depreciation rates for equipment are adopted, our view is that they should be available from the application date for all equipment purchased after the release of the issues paper, so that firms do not have artificial incentives to delay equipment investment.

The second exception is building fit-out for rental housing. Because some taxpayers have been using aggressive fit-out practices, we will recommend to the government that there be no "grandfathering" in this area should the change be implemented. This will not constrain the Commissioner from undertaking audit action for years prior to a change in law.



A special report created by Valuit – September 2004

*These so called “aggressive fit-out practices” have been implemented as a result of the instructions in IR260 as the “Process for finding the most suitable depreciation rate”. This discussion paper in Section 8 concludes “We consider that the current tax depreciation rules already provide a number of steps for selecting the most suitable depreciation rate in respect of an asset, having regard to factors such as use in different industries”. The officials state that no change is needed and yet they wish to hold it open for the Commissioner to penalise residential property investors for “aggressive fit-out practices” which simply follow the rules. There is no question over these rules and their interpretation for any other industry. Why should “residential property” be considered any different?*

**1. Do major distortions arise from treating the structural components of a residential rental building as a single entity, and if so what are these distortions?**

The officials have identified a number of specific problems:

“... second problem is that an increasing number of residential rental property owners are claiming separate depreciation deductions for different parts of a building. Examples include separate depreciation deductions for electrical wiring, plumbing, hot water systems, carpets and internal walls. In principle, the more assets which are depreciated separately at rates that exceed the building depreciation rate, the lower the appropriate depreciation rate on the remaining shell. There is some uncertainty as to what assets can be depreciated separately, and this can lead to substantial differences in deductions claimed by two landlords with identical properties”.

*This happens everyday in business. The more interest you have in what you are doing the more likely you are to understand what can and cannot be done, this will still happen regardless of the proposed rules. There was no uncertainty over what assets could be depreciated separately for almost 10 years, until the issue was raised by IRD. Investors and their financial advisors have followed the rules in IR260 for claiming depreciation. Confusion started with IR264; which was an overview for property investors and did not cover all of the rules and regulations regarding depreciation. This discussion paper accepts that there is no need for clarification of how the regime works but looks to introduce a completely different set of rules for “Residential” Investment property to those that apply to every other industry. Is this fair?*

The officials suggest “...making the rules more certain by providing landlords with two options. Under the first option, a set of separately depreciable assets would be identified, as happens in Australia. These would include lifts, domestic appliances, hot water cylinders, air conditioning systems, light fittings and carpets. However, the set of separately depreciable assets would be limited”.

*This has caused confusion in Australia and is still not clear. We have a far more detailed and accurate system than Australia and this would be a step backwards. This will cause problems when there are assets in the property, which are not listed. An example of this would be the like of rural properties that may have some degree of machinery or equipment with them. If these items were not specifically listed how would they be treated? Under the current system the investor would be able to locate the depreciation rates for these items from the relevant industry or asset category and claim depreciation accordingly. Any list would have to be incredibly detailed and would still not be exhaustive – this is the very strength of the current system with industry and/or asset categories that can be used.*



The officials continue to say "... and the remainder of the building – including wiring, plumbing and internal walls – would be depreciable at the building depreciation rate, as part of the building".

*Classifying some items such as electrical wiring as "buildings" will also cause confusion but certainly not as much as a separate list of chattels. This would however still be creating a new set of rules for "Residential" property investors to any other industry. The current schedule is easy to follow and it is only the publication of IR264 which has caused confusion for investors, this would not be resolved with a new set of rules for one industry. Confusion would only create a myriad of enquiries for IRD.*

As discussed in chapter 1, our goal is to ensure that effective tax rates are as even-handed and consistent across different forms of investment as possible. Any tax reforms ought not to be inconsistent or ad hoc when compared to the general tax system. Our starting position, unless there are good reasons to the contrary, is that the tax rules for rental housing should be consistent with the rules for rental of other buildings, the rules for business occupying their own building and the rules applying to other longer-lived assets.

*We believe creating a separate set of rules just for "Residential" investment property will not be consistent. Creating a separate way of handling depreciation purely for one industry could be interpreted as discrimination against that one industry.*

There appear to be two key ways in which investment in residential rental properties may be tax-advantaged. First, the depreciation rate on rental property and other buildings, more generally, may be excessive. Second, the growing practice of taxpayers splitting residential rental property into smaller parts is further increasing the overgenerous building depreciation rate.

*These do not give over generous claims to investors. It is stated that the rules will not change for any other industry – the assumption being that they are working well. Why is that the rules only give bias to one industry? Representatives of Valuit met with IRD officials in April 2004 to highlight where the real problems are as far as giving bias to property owners. This bias can give some investors huge depreciation deductions above what would be expected, but has been ignored in this discussion paper. The proposed changes in this document will only defer depreciation claims. It will not correct or alter the fact that some investors are able to claim "excessive" levels of depreciation.*

By breaking the building out into sub-categories (for example, claiming depreciation on electrical wiring, plumbing and internal walls), landlords are able to access higher depreciation rates and, in some cases, the 20 percent depreciation loading. Although it is accepted that there is some scope for identifying assets and depreciating them separately from the building itself, some of the parts or components currently being depreciated separately are arguably not separately identifiable assets.

*What is the difference between residential and commercial? They are separately identifiable in a commercial situation but not residential and where will this separation begin and end? Is a house being used for offices residential or commercial? Is a serviced apartment block residential or commercial? An identical apartment block could be classified differently based*



*on one being private owners and one being run as a serviced apartment and therefore having different rules.*

The effect of this practice is to reduce taxable income. Although the legislation provides that depreciation is clawed back by Inland Revenue when the property is sold, taxpayers are able to enjoy the timing advantages, and in some instances these advantages are permanent. There is a clear argument where this behaviour occurs that the depreciation rate accorded the remaining components of the building should be lowered.

Inland Revenue's interim operational view is the building depreciation rate is inclusive of structural items like electrical wiring and plumbing. Inland Revenue's *Tax Information Bulletin*, Volume 5, No. 9 (February 1994) sets out the following view of what is an asset.<sup>4</sup>

*If this is the case why are these assets even listed within the depreciation regime anywhere? This discussion paper will still allow these items to be separately identified for commercial property.*

In better defining the law in this area, we are confining our attention to residential accommodation. The reason for treating residential property differently from commercial property is that changes to the structure or the layout are thought to occur less frequently than they do for commercial buildings.

*What are replacement of kitchens and bathrooms, replacement of electrical wiring and other renovations in residences?*

In addition, commercial buildings are used for a diverse range of activities. Often these activities may require additional or specialised structural components.

*Is there any specific evidence of this? Residential property can also have specific requirements such as accommodation for the disabled (wheel chair access, wider doors as an example). The investment in residential property is a business, as is the investment in commercial property. As in any business your product must meet the requirements of the end consumer otherwise the business will not survive. In residential property the required end product is almost the same with regards to "additional or specialised structural components" with only slight differences between the end products offered (for example quality, number of bathrooms, number of bedrooms, apartment/ house/ unit). In commercial property the "additional or specialised structural components" will generally be the same depending on what your target end market is (for example office space, warehouse, retail). Within these target end markets the requirements will generally be the same with only slight differences between the end products. For example in office space, is it air conditioned, amount of available space, number of lifts).*

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<sup>4</sup> This statement was provided in the context of repairs and maintenance, but it is also relevant to determining an asset for depreciation purposes.

## **2. Should taxpayers who adopt the list approach be restricted to a slightly lower building depreciation rate?**

There is an argument that those who choose to list non-core chattels and fittings separately should be limited to a slightly lower depreciation rate. This is due to the inclusion of a wider range of assets, most of which will not have a 50-year economic life, being depreciated at more than the building depreciation rate. We invite submissions on this issue.

*This we assume is based on the 4% rate supposedly being inclusive of these items when determined. Is there any evidence of this? The fact that items such as electrical and plumbing etc. are separately identified within IR260 and with different rates to the building would suggest that they were intended to be included separately.*

## **3. Are there better ways of defining the boundary between the building and other separately identifiable assets?**

We suggest making the rules more certain by providing landlords with two options. Under the first option, a set of separately depreciable assets would be identified, as happens in Australia. These would include lifts, domestic appliances, hot water cylinders, air conditioning systems, light fittings and carpets. However, the set of separately depreciable assets would be limited,

*This has caused confusion in Australia and is still not clear. We have a far more detailed and accurate system than Australia and this would be a step backwards. This will cause problems when there are assets in the property that are not listed, This would happen regularly in area's like rural properties that may have some degree of machinery or equipment with them. If these items were not specifically listed how would they be treated? Under the current system the investor is able to locate the depreciation rates for these items from the relevant industry or asset category and claim depreciation accordingly. Any list would have to be incredibly detailed and would still not be exhaustive where as the current system details all assets – this is the very strength of the current system with industry and/or asset categories that can be used.*

and the remainder of the building – including wiring, plumbing and internal walls – would be depreciable at the building depreciation rate, as part of the building.

*Classifying some items such as electrical wiring as buildings will also cause confusion but certainly not as much as a separate list of chattels. This would however still be creating a new set of rules for "Residential" property investors to any other industry. The current schedule is easy to follow and it is only the publication of IR264 that has caused confusion for investors, this would not be resolved with a new set of rules for one industry. Confusion would only create a myriad of enquiries for IRD.*



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Currently within the depreciation schedule there are assets listed with a clarification that they are domestic i.e. “Washing machines (Domestic type) we believe this would be the answer. It would allow these items such as “Electrical wiring, Non-load bearing partitions, Plumbing to be listed as they are currently under “Building Fit out” but create a new listing with the suffix (Domestic dwelling – or similar) These items could then have a differing rate to that for commercial and even the same rate as the building shell if that proves correct. This would avoid all of the confusion that these proposed changes could potentially introduce.

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## **Submissions**

Your submission needs to be lodged by 30 September 2004, with direct reference to the discussion document, to:

Depreciation Review  
C/- The General Manager  
Policy Advice Division  
Inland Revenue Department  
PO Box 2198  
WELLINGTON

**Or by email:**

[policy.webmaster@ird.govt.nz](mailto:policy.webmaster@ird.govt.nz)