

Property tax changes - a mixed bag

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The Budget, as expected, changes the tax depreciation rules for buildings (both residential and non-residential). The twist is that depreciation will be removed for buildings with an estimated useful life of 50 years or more. From the 2011/12 income year, a zero percent depreciation rate will apply to such buildings.

The proposed change will mean that most commercial and industrial property will lose out on depreciation come 1 April 2011.

The Government has not grandfathered existing buildings from the change, nor introduced an elective tax depreciation regime, as suggested by some commentators. Repairs and maintenance on buildings will continue to be deductible, and Government has signalled that the treatment of commercial building fit-out will be reviewed (and if necessary amended before 1 April next year) to clarify the split between buildings and fit-out.

The Minister of Finance's Budget Speech makes reference to building owners being able to apply to Inland Revenue for a provisional depreciation rate if a class of buildings should qualify for depreciation. However, this will need to be in respect of a class of building asset, not for individual buildings (and circumstances) and importantly will be limited to buildings with effective lives of less than 50 years.

The proposed changes are not wholly unexpected given the concerns around the rental property sector. However, that commercial property (key infrastructure for NZ businesses) has also been targeted is somewhat disappointing. The new depreciation regime for buildings will mean that New Zealand is out of step with our major trading partners. Most OECD countries allow depreciation on commercial property, such as office buildings. The international economic evidence suggests that such buildings do decline in value.

The investment property sector's fears seem to have been realised - the removal of depreciation will be a clear negative. The proposed review of the separation between fit-out and buildings will add to the concerns. On the positive side, the reduction in the company rate (to 28% from 1 April 2011) and PIE tax rates (to align with the company rate, but from 1 October 2010 for most PIEs) will dull some of the sharper edges. Overall, however, the investment property sector is being asked to bear the cost of some of the tax cuts being spread around.

In targeting the "tax advantages" enjoyed by the residential property sector, the Budget does not introduce measures, such as limiting interest deductibility (negative gearing) or loss ring-fencing of rental losses. The fact that Government has resisted such ad hoc measures is to be welcomed. New Zealand has previously had loss ring-fencing rules, which were ineffective. Similarly, rules around limiting interest deductibility can be structured around due to the fungibility of funding.

Instead, the changes are more diverse and include:

- * Preventing those with rental losses from using the losses to access family assistance (Working for Families tax credits) and other benefits. From 1 April 2011, such losses will no longer be offsettable when calculating entitlements to benefits.

- * Greater funding for Inland Revenue to target gains made by property speculators.

- * The alignment of the top personal rate with the trust rate.

- * Changes to the current qualifying company tax regime and loss attributing qualifying company (LAQC) rules, to make them flow through entities for tax purposes (effectively partnership tax treatment) to reduce opportunities for tax structuring.

Measures to prevent sheltering of income, to access social assistance benefits, has been well-signalled pre-Budget. Removing the scope to use rental losses to boost benefit entitlements is keeping with this objective. Similarly, the extra funding to boost Inland Revenue audit resources in the property speculation area is not unexpected, given the Department's recent activity in this sector.

The alignment of the top personal rate with the trust rate, which is part of the general tax cuts on offer, will remove tax incentives for use of trusts.

Perhaps the biggest change is the move to restructure the qualifying company and LAQC rules to have attribution of both income and losses at investors' marginal tax rates. At the moment, losses can be attributed at investors' marginal tax rates, but income is taxed at the company rate. This provides opportunities to defer tax on income at higher marginal rates, while still accessing losses at those higher rates.

While addressing the concern around rental property owners using LAQCs to get losses out, and defer tax at full marginal rates on income, the move to flow-through tax treatment will also have a number of wider simplification benefits. By taking tax out of the equation, it will provide greater choice over use of company structures. This benefit should not be underestimated.