Submission

By

Business NZ

To

Inland Revenue Department

On

'Repairs and Maintenance to the Tax Depreciation Rules'

20 September 2004

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‘REPAIRS AND MAINTENANCE TO THE TAX DEPRECIATION RULES’
SUBMISSION BY BUSINESS NEW ZEALAND
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1. INTRODUCTION

1.1 Encompassing four regional business organisations (Employers’ & Manufacturers’ Association (Northern), Employers’ & Manufacturers’ Association (Central), Canterbury Employers’ Chamber of Commerce, and the Otago-Southland Employers’ Association), Business New Zealand is New Zealand’s largest business advocacy body. Together with its 56-member Affiliated Industries Group (AIG), which comprises most of New Zealand’s national industry associations, Business New Zealand is able to tap into the views of over 76,000 employers and businesses, ranging from the smallest to the largest and reflecting the make-up of the New Zealand economy.

1.2 In addition to advocacy on behalf of enterprise, Business New Zealand contributes to Governmental and tripartite working parties and international bodies including the ILO, the International Organisation of Employers and the Business and Industry Advisory Council to the OECD.

1.3 Business New Zealand’s key goal is the implementation of policies that would see New Zealand retain a first world national income and regain a place in the top ten of the OECD (a high comparative OECD growth ranking is the most robust indicator of a country’s ability to deliver quality health, education, superannuation and other social services). It is widely acknowledged that consistent, sustainable growth well in excess of 4% per capita per year would be required to achieve this goal in the medium term.

1.4 The health of the economy also determines the ability of a nation to deliver on the social and environmental outcomes desired by all. First class social services and a clean and healthy environment are possible only in prosperous, first world economies.

1.5 The tax system has a critical role to play in attracting investment and fostering a dynamic, productive and innovative economy. High tax rates and complex compliance requirements impose significant costs on the community, including lower investment, output, incomes, and employment as well as distortions in behaviour.

1.6 Business New Zealand welcomes the opportunity to comment on the officials’ issues paper *Repairs and Maintenance to the Tax Depreciation Rules*. We agree that it is timely for a review to be undertaken of the depreciation rules, particularly whether the current rules are reflecting the reality of economic life in times of rapidly advancing technology and ‘24-7’ business operations.

2. SUMMARY OF RECOMMENDATIONS

2.1 Business New Zealand recommends that:

(a) The Government should consider double-declining balance depreciation for plant and equipment and straight-line depreciation for buildings and other structures.

(b) The Government should consider an increased loading for shorter-lived assets matched with the lower loading on longer-lived assets.

(c) The number of depreciation bands should remain unchanged.

(d) The depreciation rules for plant and equipment should be flexible enough to adequately provide for changing usage.

(e) The proposals for technical changes, contained in Chapter 6 of the Officials' Issues Paper, should proceed.

(f) Asset disposal costs should be made fully deductible.

(g) The threshold for immediately deducting the cost of 'low value' assets should be increased from $200 to $2,000.

(h) The threshold for immediately deducting the cost of 'low value' assets purchased at the same time from the same supplier should be increased from $200 to $20,000.

(i) The proposed options for depreciation of rental housing, contained in Chapter 9 of the Officials' Issues Paper, should proceed.

3. GENERAL COMMENTS

3.1 Business New Zealand's comments on the officials' issues paper will be focused on the larger structural issues relating to the depreciation rules, rather than detailed commentary on the specific technical issues.

3.2 Depreciation rules should adequately reflect the reality of economic life and to do so they must have a sound basis in economic and business reality. The current rules have been in place since 1993, but the past decade has seen particularly rapid advances in technology and significant changes in business practices, such as increased plant utilisation through the adoption of '24-7' operations. It is therefore timely to review the current rules to ensure that they do in fact reflect today's reality.

3.3 Depreciation rules should not result in investment decisions being made primarily for tax purposes. As a matter of principle, the tax system should be neutral and should not seek to favour certain types of investments or activities over others. Providing specific tax incentives for certain favoured activities or sectors would only encourage other 'worthy causes' to argue that they should be given incentives, but more significantly doing so would lead to significant economic distortions and a higher tax burden for other taxpayers. New Zealand's approach should be to preserve its 'broad-base, low-rate' tax system and the depreciation rules should be consistent with this approach.

3.4 'Retaining the revenue' is not a good starting point for a review of depreciation rules. We have seen this unprincipled approach taken across a number of recent reviews of the tax system, including fringe benefit tax and other tax simplification initiatives. As a result we have seen positive proposals being counterbalanced by negative ones in order to claw back lost revenue from the former. While we understand the Government's motivation, the results are too often an unsatisfactory mixed bag and tend to add to, rather than reduce, the compliance burden. In any event, 'retaining the revenue' seems to be an odd approach to take for a review of the depreciation rules. Depreciation is more an issue about the timing of tax payments rather than the amount of tax that will be paid.

3.5 It is important to ensure that the depreciation rules are relatively simple and user-friendly, so that they do not impose significant compliance costs on businesses. It is unrealistic to expect the rules to provide an exact formula in every instance, so there will always be a need to make assumptions. The challenge is to ensure that the assumptions are reasonable and do not create significant distortions or increase the compliance burden.

3.6 The remainder of this submission comments on the specific chapters in the officials' issues paper.

4. COMMENTS ON SPECIFIC ISSUES

4.1 Business New Zealand has no substantive comment to make on the first four chapters of the issues paper. These chapters provide an introduction to the issues paper (Chapter 1); an overview of the current depreciation rules (Chapter 2); an illustration of economic depreciation, accelerated depreciation and incentives to invest (Chapter 3); and an explanation of the effects of the current rules (Chapter 4).

4.2 Our interest is more in the specific directions for reform set out in subsequent chapters. Our comments follow.

Chapter 5 – Directions of Reform: Structural Issues

4.3 The discussion in chapter 5 of the issues paper suggests that there is a prima facie case for replacing the current assumption that assets decline smoothly to 13.5% of their initial value. Instead, plant and equipment might be better depreciated on a 'double-declining' basis and buildings and other structures on a straight-line basis over their estimated economic lives. These changes would result in plant and equipment depreciating faster than at present and buildings and other structures depreciating more slowly. The aim would be to better reflect how assets actually depreciate.

4.4 Business New Zealand agrees in principle with this proposal. While it is true that there is a lack of detailed data on how assets depreciate in New Zealand, the discussion in the officials' paper makes a convincing case for the proposition that a combination of inflation and historical cost depreciation creates a bias favouring long-lived assets relative to shorter-lived assets. We are therefore concerned that the existing rules may be having a disincentive effect on the level of capital investment and are biased in favour of long-term investments (such as rental housing) against short-term investments (such as plant and machinery). Such a bias will have important consequences for economic growth.

4.5 There are two key contributors to economic growth – labour productivity and labour utilisation. It is well known that New Zealand's labour productivity growth rates have lagged behind those of the OECD average for many years. This is at least partly due to New Zealand having a relatively low capital-labour ratio. There are a number of reasons for this low ratio, but the tax treatment of different forms of capital investment is likely to be an important one.

4.6 Fortunately for New Zealand, growth in labour utilisation (i.e., increased employment) has been very strong. Unlike most OECD countries, increased labour utilisation has done most to drive New Zealand's economic growth over the past decade. However, more recently net migration has been slowing, the unemployment rate is down to just 4%, and the labour force participation rate is up to 66.7%. New Zealand is therefore getting close to a point where the potential for further growth in utilisation will become limited. As a result labour utilisation will not, on its own, be able to drive the higher rates of economic growth that New Zealand needs to achieve better living standards and quality of life for its people.

4.7 Higher rates of labour productivity will therefore be needed to drive economic growth in the medium term. A higher capital-labour ratio will be important for facilitating a higher sustainable rate of labour productivity. The Government should therefore implement policies that would reduce current biases in tax treatment of capital investment and therefore enhance the neutrality of the tax system.

4.8 While the depreciation rules are likely to be biasing investment in rental housing as opposed to investment in plant and equipment, there are other tax-related factors that are also important. These include having a tax deduction for interest on leveraged properties while not having a capital gains tax when rental properties are sold (providing the property is held long enough to avoid the 'trading' rules). Assuming that a capital gains tax will remain off the political agenda, making progress on the depreciation rules will take on added importance.

4.9 The officials' paper notes that international studies suggest allowing double-declining balance would be a more accurate way of measuring depreciation of plant and equipment. We do not consider New Zealand to be any different in this respect, although we accept that it is important for any decisions on the detailed implementation be based on information that is relevant to New

Zealand. However, the need for further New Zealand-specific research should not be allowed to unduly hold up much-needed change.

4.10 *Recommendation: Business New Zealand recommends that the Government should consider double-declining balance depreciation for plant and equipment and straight-line depreciation for buildings and other structures.*

4.11 *Recommendation: Business New Zealand recommends that the Government should consider an increased loading for shorter-lived assets matched with the lower loading on longer-lived assets.*

4.12 The officials' paper also asks whether there should be more or fewer depreciation bands (there are currently 14). We agree that the number of bands involves a compromise between simplicity and neutrality. We would be concerned if depreciation was to become more complex and increase compliance costs. A downside of adopting double-depreciation is that doing so would add to complexity and compliance costs (at least in the short-term while users become accustomed to the new rules). Increasing the number of bands would also have this affect and we are unsure whether an increase would result in significantly better results. On balance we would therefore favour the retention of the existing number of bands.

4.13 *Recommendation: Business New Zealand recommends that number of depreciation bands should remain unchanged.*

4.14 Business New Zealand also considers that the depreciation rules for plant and equipment should be flexible enough to adequately provide for changing levels of usage. This is a significant issue for the increasing number of manufacturers now operating on a 24 hour, seven days per week basis. In our view, reinvestment decisions should not be made more difficult by rigid rules that require the owner to justify their case to IRD for every change of usage.

4.15 *Recommendation: Business New Zealand recommends that the depreciation rules for plant and equipment should be flexible enough to adequately provide for changing usage.*

Chapter 6 – Suggested Technical Changes to the Tax Depreciation Rules

4.16 Business New Zealand has no comment to make on the suggested technical changes as discussed in chapter 6. We consider these changes to be reasonable and they should proceed.

4.17 *Recommendation: Business New Zealand recommends that the proposals for technical changes, contained in Chapter 6 of the Officials' Issues Paper, should proceed.*

Chapter 7 – Issues About Which More Information is Needed

4.18 Chapter 7 of the discussion document discusses two broad issues that IRD feels the need for more information on.

4.19 The first issue is whether any excess expenditure should be deductible for tax purposes when a depreciable asset is disposed of and the consideration derived is less than the costs incurred in disposing of the asset. We agree with the officials' paper that they probably should be.

4.20 *Recommendation: Business New Zealand recommends that asset disposal costs should be made fully deductible.*

4.21 The second issue is whether the thresholds for immediately deducting the costs of 'low value' assets should be raised from the current level of $200 to $2,000, with a total threshold of $20,000 for immediately deducting the cost of 'low value' assets purchased at the same time from the same supplier (currently $200 as well).

4.22 We disagree with the officials' paper that the fiscal cost is likely to exceed any compliance cost savings. The existing $200 threshold was adopted in 1993. Adjusting for cumulative inflation over the intervening 11 years would increase the threshold to around $250. At the very minimum, the threshold should be adjusted for inflation, but the treatment of 'low value' assets also imposes significant compliance costs on businesses (especially small businesses) and requires a more ambitious solution.

4.23 Having to account for low value items makes for considerable nuisance value and, it must be said, great income generation for accountants. Many of the 'low value' assets will be computer-related equipment, often peripherals worth a few hundred dollars. They have very short economic lives and will not necessarily have much of a residual value due to the rapid improvement in the technology of replacement equipment at prices that are falling steeply.

4.24 Nor are we convinced about the fiscal cost argument. Firstly, and related to the point above, the pace at which many low value items depreciate will mean they will be written off very quickly in any event. Secondly, the fiscal cost argument is an unprincipled way to carry out what should be a first-principles review of depreciation – if there is merit in an increase to the low value asset threshold then it should proceed. Thirdly, depreciation is largely a matter of timing – eventually it all gets written off. A compromise way to get around the Government's concerns about fiscal costs might be to increase the thresholds in stages to reach $2,000 and $20,000 respectively within a decade.

4.25 *Recommendation: Business New Zealand recommends that the threshold for immediately deducting the cost of 'low value' assets should be increased from $200 to $2,000.*

4.26 *Recommendation: Business New Zealand recommends that the threshold for immediately deducting the cost of 'low value' assets purchased at the same time from the same supplier should be increased from $200 to $20,000.*

Chapter 8 – Changes Officials Do Not Agree With

4.27 Business New Zealand has no comment to make on the changes the officials do not agree with.

Chapter 9 – Tax Treatment of Rental Housing

4.28 The officials' issues paper notes that there is uncertainty among residential rental property owners as to the extent to which different parts of a building – such as electrical wiring, plumbing and internal walls – can be split out and depreciated separately. The paper's suggested approach (providing owners of residential property with two options) seems fair and reasonable. The options would also provide clarity over what can and cannot be separately depreciated.

4.29 *Recommendation: Business New Zealand recommends that the proposed options for depreciation of rental housing, contained in Chapter 9 of the Officials' Issues Paper, should proceed.*

5. CONCLUSION

5.1 Business New Zealand welcomes the review of depreciation rules. A first-principles review should provide an opportunity to develop a more appropriate set of rules that better reflect economic life and address biases in the treatment of long-lived versus short-lived assets. Achieving these goals should help encourage innovation, make for better-informed investment decisions, and improve productivity. This should in turn help increase the sustainable rate of economic growth and improve New Zealanders' standards of living.