



Impact of tax depreciation changes and the NZACA response

15 September 2010

Today's agenda.....

- The Government's balanced budget
- The building depreciation change
- The NZACA response:
 - Quantify the cost to the ARC sector
 - Discussion with IRD Policy Advice officials
 - Formal submission
 - Meetings with Ministers
- Questions

Balancing the books...

\$ million	Increase (decrease) in operating balance				
	2010/11	2011/12	2012/13	2013/14	4-yr total
Personal tax rate cuts	(2,455)	(3,685)	(3,935)	(4,255)	(14,330)
Compensation for GST rate increase	(420)	(585)	(610)	(620)	(2,235)
Company tax cut to 28%	(20)	(340)	(450)	(305)	(1,115)
PIEs & savings vehicles capped at 28%	(15)	(40)	(55)	(60)	(170)
Administration associated with tax package	(10)	-	-	-	(10)
Sub-total of negative impacts on the operating balance	(2,920)	(4,650)	(5,050)	(5,240)	(17,860)
GST rate increase	2,040	2,840	2,985	3,160	11,025
Non-compensatory Working for Families changes	5	40	75	65	185
Depreciation measures	140	935	1,000	1,045	3,120
LAQC changes	-	70	65	55	190
Thin capitalisation 60% threshold	-	200	200	200	600
GST base changes	15	60	60	60	195
Tobacco excise rate increases	135	180	210	190	715
Increased audit and compliance activity (net revenue)	120	210	210	205	745
Sub-total of positive impacts on the operating balance	2,455	4,535	4,805	4,980	16,775
Sub-total of estimated static impact	(465)	(115)	(245)	(260)	(1,085)
Adjustment for macroeconomic effects	5	25	205	435	670
Total impact on operating balance	(460)	(90)	(40)	175	(415)

Depreciation changes

- **0% depreciation rate** for buildings from 2011-12 income year if estimated useful life of 50 years or more → all buildings currently getting 2% SL or 3% DV
- **No grand-parenting** for existing buildings
- **Provisional depreciation rates** can only be requested:
 - if estimated useful life < 50 years; **and**
 - If a new “class” of building
- If using SL consider shift to DV for 2010-11
- **No 20% depreciation loading** for new assets from 20 May 2010



A deadweight cost...

There is no tax deduction allowed for a loss on sale or scrapping of a building – it is a permanent difference

Review of Building fit-out: double the hit?

- Government announcement to also **review the treatment of fit-out**. This had the potential to double the amount of the hit for many building owners.
- Post-Budget **depreciation issues paper** released on 11 August 2010 by IRD and Treasury.
- Submissions made by 1 September 2010 – still being considered by officials

The issue for ARC providers

- Any increase in the costs of ARC providers would need to be met by a corresponding increase in funding as **ARC pricing is regulated**
- Between \$4.5 and \$6.1 billion of **additional ARC building stock required** by 2026 to maintain current level of care
- **Tax should not be a disincentive** for ARC providers

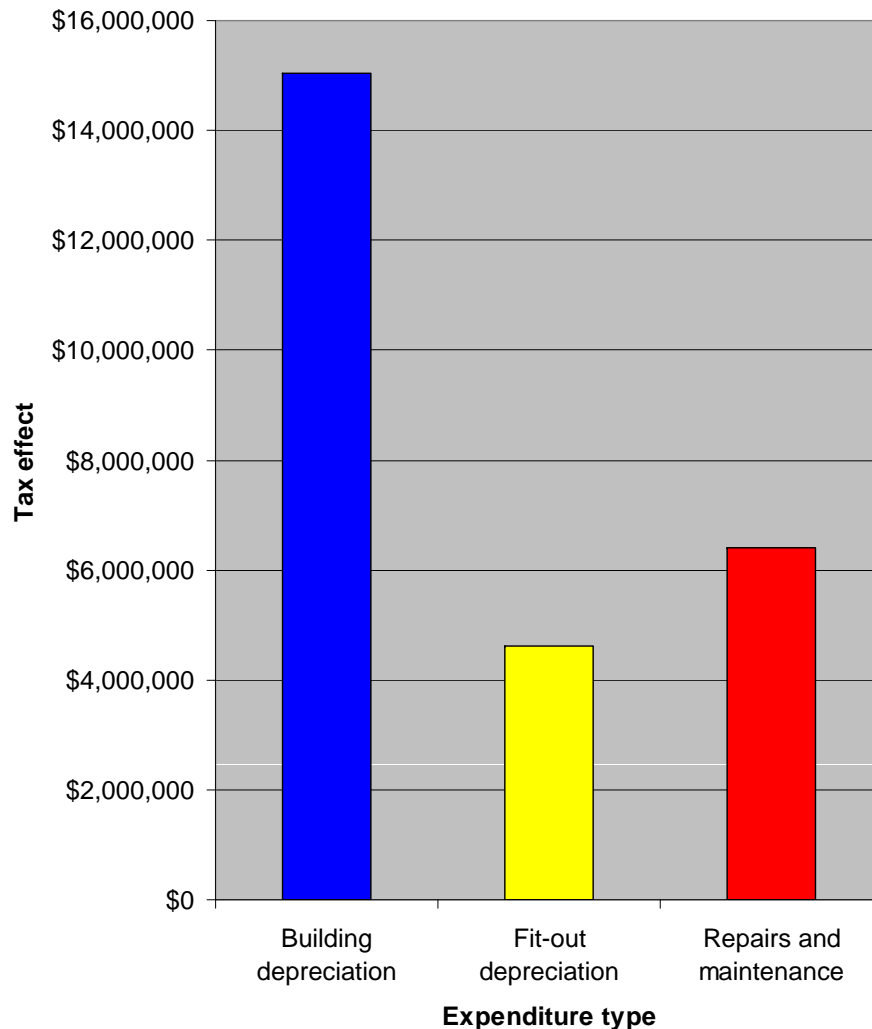
The NZACA response to the proposed change

- NZACA engaged KPMG to address:
 - The **cost to ARC providers** of building depreciation removal
 - The potential impact of **building v fit-out** boundary changes
 - The ability to **allow building depreciation or increase funding for ARC providers**
- Detailed submission prepared on the impact for the ARC industry
 - Surveyed NZACA members to quantify the cost
- Contacts:
 - Inland Revenue Officials
 - Ministers (Health, Revenue)

NZACA Depreciation Survey

- KPMG surveyed NZACA members to **quantify the potential financial impact of the depreciation changes**
 - Respondents to the survey provide 11,000 of the total ARC beds
- Obtained data on:
 - Annual building depreciation charge
 - Annual fit-out depreciation
 - Annual repairs and maintenance expenditure
- Extrapolated survey results to cover the whole ARC sector

NZACA Survey: \$15m tax cost



- A \$15m p.a. tax cost on a removal of building depreciation.
- Fit-out depreciation is approximately 23% of total building and fit-out depreciation for the ARC providers surveyed
- Fit-out value is only around 6% of total building and fit-out tax book value
 - Relatively low fit-out proportion indicating fit-out often not split out by ARC providers

NZACA Survey: increase in operating costs

Annual building depreciation per KPMG survey (11,036 beds)	\$22.8 m
Tax effect at 28%	\$6.4 m
Tax effect per bed per annum	\$580
Operating costs per bed per day	\$82
Operating costs per bed per annum	\$30.0 k
Proportion of operating costs	1.93%

Options for Government

- **Increased funding** to ARC providers under ARRC agreement
 - Neutralise depreciation impact
 - Increased funding for 'not for profit' sector
- **Carve out ARC providers** from tax depreciation changes
- Allow a **higher concession for fit-out**

Economic life of ARC facilities

- ARC facilities are single use, special purpose facilities.
- Historic evidence points to an economic life of between 20 and 30 years for ARC buildings
- Two options available at end of economic life
 - Significant refurbishment
 - Demolition and redevelopment
- ARC facilities cannot generally be converted to alternate use without significant loss in economic value

A provisional Building depreciation rate may need some political goodwill

- Can apply to Inland Revenue for a provisional rate for buildings with a less than 50 year economic life
- Must be a class of building that does not already have a depreciation rate
- Inland Revenue has already prescribed depreciation rates for buildings based on the type of materials used
 - Buildings with timber framing, steel framing, concrete framing, pre-fabricated skins
 - Unclear how the provisional rates will apply
- Also need to provide evidence that the new building class does not have a useful life of 50 years or more

Building vs fit-out

- Building depreciation is linked to ARC funding – a matter to be raised with Ministers
- The building vs. fit-out issue is a matter for officials

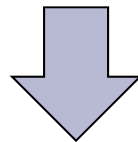
Rest Homes as “Residential Dwellings” would be a negative for fit-out depreciation.....

Interpretation statement 10/01 treats the majority of residential fit-out items as part of the residential building – **not** separately depreciable

Item	Building or Separate asset
Plumbing	Building
Electrical wiring	Building
Internal walls (fixed)	Building
Doors (internal and external)	Building
Furniture (fixed)	Building
Furniture (not fixed)	Separate asset
Bathroom fittings	Building
Carpets	Separate asset
Tiles and other fixed flooring	Building
Curtains/blinds	Separate asset
Heating systems	Separate asset
Air conditioning systems	Separate asset/Building

IRD Policy Advice – Rest Homes as Commercial dwellings

“Rest homes are residential with a bit of hospital thrown in”



The boundary between residential and non-residential is to be legislated with a definition of “**dwelling**” *“the definition will specifically **exclude** commercial dwellings such as hotels, motels, **rest homes** and hospitals”*

What currently constitutes 'fit-out'?

Common items of 'fit-out' found in ARC facilities:

- Electrical wiring and lighting systems
- Internal plumbing and toilet and bathroom facilities
- Cooling and heating systems (and associated ducting)
- Sprinkler systems, fire safety doors and fire alarms
- Partitions and internal walls
- Kitchen, laundry and other commercial facilities

Items generally considered part of the building:

- Foundations, building frames, floors, roof and external walls
- Cladding
- Windows and doors
- Stairs
- Load bearing structures

IRD/Treasury Depreciation issues paper

- **Positive for most building owners who have separately depreciated fit-out**

“We consider that the building structure includes: the foundations; the building frames; floors; external walls; cladding; windows and doors; stairs the roof; load-bearing structures such as pillars and load-bearing internal walls”

- Current fit-out treatment to be retained for non-residential buildings
- Rest homes included as ‘non-residential’ buildings

- **Less positive for building owners that have combined building and fit-out** and depreciated with either a 2% straight line or a 3% diminishing value building rate:

- **Issues paper allows for 15% of the adjusted tax book value of the building to be treated as fit-out (the “fit-out pool”)**
- **BUT only where all fit-out has been included as part of the building value**
- **AND fit-out depreciated at 2% straight line**

Availability of fit-out pool concession for NZACA members

- The proposed 15% 'non-residential building fit-out pool' option is **not available if any fit-out is separately depreciated**. This renders it useless to most NZACA members, in its current form.
- The KPMG survey of NZACA membership indicates the majority of respondents haven't typically split out much of their fit-out items from the building but most have done some. **Across all the members surveyed, the fit-out value was only around 6% of the total building and fit-out value**. For commercial buildings, fit-out is generally in the range of 30% - 40%.
- The KPMG/NZACA submission to IRD states the non-residential fit-out pool **should be available where the separately depreciated fit-out value is less than 5% to 10% of building tax book value**.

We also submitted for the fit-out pool...

- **15% of the total building value is too low for the fit-out pool component**
 - 30% is more appropriate based on survey results (for NZACA members that have separately identified fit-out from buildings)
 - Alternatively, allow independent valuations to determine correct fit-out component
- **The depreciation rate for fit-out pool component should be building fit-out default rate of 7% straight line or 10% diminishing value**

Repairs and maintenance

- **The boundary between R&M and capital improvements will not be changed.**
- The cost of repairing and maintaining assets is generally deductible when incurred.
- If the work adds to or improves a building, it may be capital, non-deductible and non-depreciable

Conclusion

- ARC providers are in a unique position due to building specifications, obsolescence, funding and pricing. **Government needs to allow depreciation on the building structure or increase funding to compensate.** A provisional depreciation rate may be an option.
- The IRD/Treasury building fit-out review is positive:
 - Endorsed availability of separate fit-out for rest homes
 - However, issues to be worked through with non-residential building fit-out pool option
 - The existing R&M boundary is retained
- NZACA will continue to press for a favourable outcome.

Questions...

Presenter's details

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