

29 May 2026



Dear 

Thank you for your request made under the Official Information Act 1982 (OIA), received on 13 May 2026. You requested the following:

[...] any policy reports written on Multi-Unit Residential Buildings between 2020-2022. [...]

Information being released

I am releasing, one document within scope of your request to you as **Appendix A**. Some information has been withheld under section 9(2)(a) of the OIA to protect the privacy of natural persons.

As required by section 9(1) of the OIA, I have considered whether the grounds for withholding the information requested is outweighed by the public interest. In this instance, I do not consider that to be the case.

Right of review

If you disagree with my decision on your OIA request, you have the right to ask the Ombudsman to investigate and review my decision under section 28(3) of the OIA. You can contact the office of the Ombudsman by email at: info@ombudsman.parliament.nz.

Publishing of OIA response

We intend to publish our response to your request on Inland Revenue's website (ird.govt.nz) as this information may be of interest to other members of the public. This letter, with your personal details removed, may be published in its entirety. Publishing responses increases the availability of information to the public and is consistent with the OIA's purpose of enabling more effective participation in the making and administration of laws and policies and promoting the accountability of officials.

Thank you again for your request.

Yours sincerely



Felicity Barker

Policy Lead - Economics



POLICY AND REGULATORY STEWARDSHIP



Tax policy report: Allowing depreciation deductions on multi-unit residential buildings

Date:	30 September 2021	Priority:	Medium
Security level:		Report number:	[IR2021/401] [T2021/2481]

Action sought

	Action sought	Deadline
Minister of Finance	Agree to the recommendation of this report Note the contents of this report	[18 October 2021]
Minister of Revenue	Agree to the recommendation of this report Refer a copy of this report to the Minister of Housing for her information Note the contents of this report	[18 October 2021]

Contact for telephone discussion (if required)

Name	Position	Telephone
Matt Bengé	Principal Advisor, Inland Revenue	9(2)(a)
Bradd Forster	Policy Advisor	
Stephen Bond	Acting Manager, Treasury	

Allowing depreciation deductions on multi-unit residential buildings

Executive summary

Purpose

1. This report describes the effect of allowing depreciation deductions on MURBs. It provides an initial explanation of key issues, sets out recommendations from officials and asks whether Ministers want a more detailed report.

Analysis

2. There are two reasons for considering allowing depreciation deductions on multi-unit residential buildings (MURBs). Deductions may help ensure that taxes are raised as fairly and efficiently and do as little to distort investment decisions as possible. Depreciation deductions could alternatively be used to incentivise construction of new builds to support the Government's housing market objectives.
3. For income tax to be as efficient as it can be, depreciation deductions should be available for assets that depreciate. This will also have the benefit of being a better estimate of the true income of a taxpayer, helping to better match income tax with actual income, and therefore being more likely to be perceived as fair.
4. Inflation complicates the issue. If inflation is not taken into account when setting depreciation rates, longer-lived assets can be advantaged relative to assets that depreciate more quickly. The best available evidence from the Bureau of Economic Analysis (BEA), a US government data research organisation, is that MURBs depreciate at lower rates than commercial and industrial properties and at very slightly faster rates than standalone houses.
5. If inflation bias concerns were ignored and these BEA estimates used, there would be a case for allowing a depreciation rate of 1% - 2% for MURBs. When factoring in inflation and comparing to the economic and tax depreciation rates of commercial and industrial buildings, the case for allowing any depreciation deductions on MURBs would be weaker. There is, however, considerable uncertainty about the rates at which MURBs depreciate.
6. Setting aside neutrality and efficiency motivations, allowing depreciation deductions on MURBs may incentivise the construction of new MURBs for rental purposes, thereby increasing housing supply. Increased housing supply supports the Government's objective of ensuring that every New Zealander has a safe, warm, dry, and affordable home whether they are renters or owners.
7. **Inland Revenue** accepts that there is considerable uncertainty over how MURBs depreciate but considers that similar uncertainties will arise wherever borderlines are drawn. It considers that the efficiency benefits from restoring depreciation deductions for MURBs are doubtful and the measure is fiscally costly. One other important consideration is how the tax treatment of rental housing fits together as a coherent and easily-understood whole. In the context of recent changes, interest deductions are being denied for residential rental properties. This will apply not only to existing

properties but it will eventually apply to new build rental properties 20 years after their construction. It will be complicated to explain to stakeholders why depreciation deductions are being provided for new build rental properties while interest deductions will be removed for the same property in 20 years' time. In the context of these recent changes and the relatively weak case for introducing depreciation deductions on neutrality grounds, Inland Revenue recommends that depreciation deductions for multi-unit residential buildings not be progressed.

8. **The Treasury's** view is that there is a case for considering reinstating depreciation deductions for MURBs alongside other Budget priorities. The rate at which MURBs depreciate relative to other structures is highly uncertain, for example given the significant growth of larger rental buildings since the BEA estimates were made. Its view is that, given these uncertainties, there is a significant risk that the absence of depreciation deductions leads to non-neutral tax treatment of multi-unit residential property construction relative to commercial (and to a lesser extent, industrial) structures, which in turn could affect investment decisions. The Treasury would, however, not recommend reintroducing depreciation solely for the purposes of incentivising construction of new builds to support the Governments housing market objectives.
9. Te Tūāpapa Kura Kāinga – Ministry of Housing and Urban Development (HUD) was consulted on this report and supports reinstating depreciation deductions for MURBs, particularly new and larger MURBs. HUD agrees with the Treasury that there is a significant risk that the current lack of depreciation deductions for MURBs leads to non-neutral tax treatment relative to commercial buildings. This may be disincentivising investment in MURBs and reducing the supply of MURBs that would otherwise be delivered. Reinstating depreciation deductions for MURBs will remove a financial barrier to the delivery of new residential property at scale.
10. If Ministers want to proceed additional design work would be required. If you are minded to consider reinstating depreciation deductions then we recommend that you seek Budget funding to allow the policy to be considered alongside other Budget bids and Ministerial priorities.

Recommended action

We recommend that you:

11. **refer** a copy of this paper to the Minister of Housing:

Referred/Not referred	Referred/Not referred
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12. **note** a first cut at estimated costs for allowing depreciation on MURBs at the diminishing value rate of 2% with effect from 1 April 2022 is provided below. These costings assume that depreciation apply to all MURBs with four or more units. A tighter definition of MURBs would tend to reduce these costs.

Vote Revenue Minister of Revenue	\$m – increase/(decrease)				
	2021/22	2022/23	2023/24	2024/25	2025/26
Option 1: New MURBs only Tax Revenue		(5)	(85)	(110)	(140)
Option 2: New and existing MURBs Tax Revenue		(20)	(585)	(280)	(285)

Noted

Noted

13. **decide** whether you want further work on developing detailed rules for allowing depreciation deductions for MURBs [Treasury/HUD recommend further work; Inland Revenue recommends no further work]:

Further work/No further work

Further work/No further work

If Ministers wish for further work:

14. **agree** to seek Budget finance to allow this policy to be considered against other Budget bids and Ministerial priorities

Agreed/Not agreed

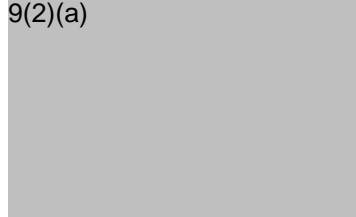
Agreed/Not agreed

9(2)(a)



Stephen Bond
Acting Manager
The Treasury

9(2)(a)



Matt Benge
Principal Policy Advisor
Inland Revenue

Hon Grant Robertson
Minister of Finance
/ /2021

Hon David Parker
Minister of Revenue
/ /2021

Purpose

15. An issue that was raised by the Government's Tax Working Group is whether depreciation deductions should be allowed for multi-unit residential buildings (MURBs). The Government has yet to receive advice or make a decision on this issue.
16. Allowing depreciation for MURBs is likely to promote the supply of new builds of this form of residential accommodation. It is also likely to increase the likelihood of MURBs being acquired by investors. Both of these effects will tend to support a greater supply of rental accommodation. At the same time, this is also likely to increase the cost of this form of accommodation to first home buyers. However, evidence suggests that while many renting households live in MURBs relatively few owner-occupiers do so. Thus, the upward pressure on prices is likely to affect only a relatively small proportion of first-home buyers. There are also potential impacts on standard tax policy objectives such as fairness and efficiency to consider.
17. The aim of this report is to discuss pros and cons of allowing depreciation on MURBs. It also outlines some high-level issues about how an amendment allowing depreciation deductions for MURBs might best be designed. If Ministers want to proceed with allowing depreciation deductions for MURBs, more detailed design work would be required. This report is seeking a decision from Ministers on whether they want to progress this issue.

Background

18. In Budget 2010, the Government removed tax depreciation on most types of buildings including commercial and industrial properties and residential rental properties. The Tax Working Group (TWG) which reported in February 2019 recommended that the Government consider restoring depreciation deductions for certain buildings. This advice was conditional on New Zealand extending its taxation of capital gains.¹
19. The TWG outlined that depreciation could be restored on a partial basis for:
 - seismic strengthened buildings, or
 - MURBs, or
 - commercial and industrial buildings in addition to MURBs.
20. In March 2019, a joint report from Inland Revenue and Treasury argued that restoring depreciation for only MURBs would encourage the supply of these dwellings but have little effect on efficiency and productivity. The report supported restoring depreciation deductions on commercial and industrial buildings as well as MURBs (T2019/244 IR2019/075 refers). It did not consider the possibility of restoring depreciation on commercial and industrial buildings but not MURBs.
21. The Government reintroduced depreciation deductions for commercial and industrial buildings in 2020. Motivation for the policy was twofold. In addition to promoting economic efficiency, the policy aimed to help businesses manage cash flow concerns caused by the COVID-19 pandemic. A diminishing value (d.v.) depreciation deduction rate of 2% was allowed for both commercial and industrial buildings.
22. However, there were no moves to allow tax depreciation on MURBs. A key reason why the TWG supported depreciation on MURBs was to boost housing supply rather than just mirror economic rates of depreciation - see, for example, p77 of the Final Report Vol 1 where the TWG "notes that restoring depreciation on multi-unit

¹ See Tax Working Group, *The Future of Tax: Final Report, Volume 1, Recommendations*, p. 18 and pp. 75-77.

residential buildings could support the Government's housing affordability goals by increasing the supply of housing and supporting greater intensification in urban areas – thereby putting downwards pressure on house prices and rents."

Analysis

23. There are at least two different possible reasons for considering allowing depreciation on MURBs. The first is that depreciation deductions may be needed to achieve the government's general objectives of ensuring that taxes are raised as fairly and efficiently as possible. The second is to incentivise the construction of new builds and support the Government's wider housing market objectives. If depreciation were to be introduced for MURBs, an important question is the key motivation for the change as this can have implications for the high-level design of the provision.

Depreciation on MURBs and neutrality of investment incentives

Normally depreciation deductions are set in an attempt to match economic depreciation

24. Depreciation is a real business cost. If deductions are not available for a true business expense, too little investment will take place. To minimise tax biases to investment decisions, depreciation should be deductible like other business costs.
25. There is always a question of the most appropriate depreciation rate to allow. In the absence of any inflation, tax depreciation would ideally mirror "economic depreciation" that is, how assets fall in market value.
26. There are two complicating issues. First, it is very hard to measure economic depreciation and there have been no reliable estimates of economic depreciation rates for buildings in New Zealand or most other countries. Second, the combination of inflation and an unindexed tax system can produce some tax biases which tend to favour investment in longer-lived assets such as buildings over assets which depreciate more rapidly such as machinery and equipment.² However, as with other biases caused by inflation, the inflation bias issue has normally been ignored when setting depreciation deductions.

Depreciation on other buildings – the 2020 tax changes

27. The inflation-bias issue is, however, a relevant consideration when considering depreciation settings for commercial and industrial buildings and was discussed in both the Tax Working Group and the March 2019 joint report from Treasury and Inland Revenue.
28. Probably the most widely cited studies of economic depreciation (and the studies used by the OECD in its work) are by the BEA in the United States. The BEA estimates that industrial and commercial buildings depreciate at rates of 3.14% and 2.47% respectively.
29. When depreciation was restored for commercial and industrial buildings, a diminishing value depreciation deduction rate of 2% was allowed for both types of buildings. This was on the low side of the BEA estimates (especially for industrial buildings) but constrained the fiscal cost of reintroducing depreciation deductions. It also provides some offset for the way that longer-lived assets can be advantaged

² This inflation bias issue was analysed in detail in the officials' issue paper "Repairs and Maintenance to the Depreciation Rules" released by the Policy Advice Division of the Inland Revenue Department and the New Zealand Treasury in July 2004.

relative to assets that depreciate more quickly in a tax system which takes no account of inflation.

Neutral depreciation deductions for MURBs

30. The BEA estimate that residential buildings with fewer than 5 dwellings (including stand-alone houses) depreciate at a rate of 1.14% and those with 5 or more depreciate at a rate of 1.4%. This suggests a considerably lower economic depreciation rate for MURBs than for industrial and commercial property, and a rate that is only moderately higher than the economic depreciation rate on stand-alone houses.
31. At the same time, the BEA estimates have been derived for the USA rather than for New Zealand and were estimated over a long period of time which goes back to the 1960s and 1970s. This raises questions about how reliable the BEA estimates are and whether they still reflect typical economic depreciation of MURBs in the 2020s. In the years since the BEA estimates were finalised, high-intensity MURBs have become much more common. For example, the Joint Center for Housing Studies of Harvard University has found that the proportion of newly completed apartments in structures with 50 or more units has steadily increased from 11 percent in the 1990s to 61 percent in 2018.³ As MURBs have become larger, they may have become more similar to commercial buildings like hotels than they were when BEA estimates of economic depreciation were originally devised.
32. The BEA estimates involve “on average” estimates for groups of different assets. There may be difference in economic depreciation rates within asset classes. For example, the BEA has distinguished buildings with fewer than 5 and buildings with 5 or more dwellings for the purposes of estimating economic depreciation. But different types of buildings with 5 or more dwellings built in different places or of different materials are likely to depreciate at different rates. This means that if the composition of an asset class is changing over time, there is a potential for bias in using estimates of economic depreciation made prior to these changes.
33. There are a number of other studies of rates of economic depreciation some of which have voiced concerns about the dated nature of the BEA studies or have raised questions about whether commercial property and apartments really do depreciate at significantly different economic rates.⁴
34. However, the BEA estimates continue to be widely used and do not appear to have been supplanted by other studies. Prior advice on depreciation for commercial and industrial buildings has drawn on the BEA estimates which continue to be the most widely used when estimating economic depreciation. Here we start by considering the implications of continuing with this approach and continuing to take the BEA estimates as the best available estimates of economic depreciation. We explore how depreciation deductions for MURBs might best be set in the absence of inflation and how allowing for potential biases caused by inflation would modify conclusions. We then discuss whether it makes sense to continue to work with BEA estimates given the real uncertainties about how reliable any estimates of depreciation are likely to be.
35. If inflation bias concerns were ignored and these BEA estimates used, there would be a case for allowing a depreciation rate of 1% - 2% for MURBs as the BEA estimated rate of 1.4% lies within this range. However, this would seem generous relative to depreciation allowed on commercial and industrial buildings.

³ https://www.jchs.harvard.edu/sites/default/files/Harvard_JCHS_Americas_Rental_Housing_2020.pdf

⁴ See, for example, Bokhari, S. and Geltner, D., 2014, 'Characteristics of Depreciation in Commercial and Multi-Family Property: An Investment Analysis.'

36. In Appendix 1, we estimate how costs of capital (or hurdle rates of return) would line up for commercial and industrial buildings, MURBs and stand-alone residential houses on the basis of BEA estimates of economic depreciation. With a 1% diminishing value depreciation rate, investment in MURBs would be incentivised relative to investment in either commercial or industrial properties. Estimated risk-adjusted hurdle rates of return would be higher for commercial or industrial buildings than for MURBs. Even under the status quo, with no depreciation allowed, investment in MURBs is still very slightly incentivised relative to investment in industrial buildings although it is disincentivised relative to investment in commercial buildings. It is important to note, however, that all of these estimates have a large degree of uncertainty and are sensitive to small adjustments in the BEA estimates. For example, were economic depreciation in New Zealand found to actually be 2.47%, the same as commercial buildings, a tax depreciation rate of 2% would clearly be required for there to be a level playing field between commercial buildings and MURBs.
37. If one were to think that the BEA economic depreciation rate of 1.4% were too low, there is an open question of how to settle on an alternative. If sufficiently large MURBs were indistinguishable from commercial buildings, an alternative would be to attempt to align the tax treatment of these large MURBs and commercial buildings. We might allow, say, 2% depreciation for large multi-unit residential, commercial and industrial buildings, while at the same time continuing to allow no depreciation for stand-alone houses. This would require drawing a borderline between those MURBs that were large enough to qualify for the depreciation deduction and those that were not. Decisions on the borderline would inevitably be somewhat arbitrary because there will not be good enough evidence on how differently sized MURBs are likely to depreciate.
38. The Minister of Revenue has asked how other tax settings might affect the pros and cons of allowing depreciation on assets that might sometimes rise in value. In particular, he has asked whether the absence of a tax on capital gains might provide grounds for being more restrictive in allowing depreciation deductions for MURBs. For example, if an asset has an economic depreciation rate of 1.4% and falls in real value by this amount each year, and we have 2% inflation, the asset would be gaining in nominal value by roughly 0.6%. We do not tax this nominal gain in New Zealand while many other countries do.
39. This issue is discussed in Appendix 2. In principle, as the Minister suggests, there can be biases in allowing depreciation on assets that depreciate very slowly in real terms in times of inflation. However, these biases can arise even for assets which depreciate slowly even if the rate of depreciation is slightly higher than the rate of inflation (for example, a depreciation rate of 2.5% when there is 2% inflation) and when there are no nominal capital gains. This is the inflation bias issue. If the BEA estimates of economic depreciation for MURBs were correct, it would be a reason for allowing little or no depreciation for MURBs.
40. A second issue is whether or not depreciation deductions should be allowed on buildings if the buildings fall in value, but the aggregate value of the buildings plus land rises in value. Counterintuitively, there is still a case to allow depreciation deductions for the part of the asset that depreciates if it does in fact depreciate. This is also discussed in Appendix 2.

Inland Revenue view

41. Given the real difficulties of estimating economic depreciation on assets, there will always be considerable imprecision in determining the most appropriate rates of tax depreciation and a large element of "rough justice" in any rates that are struck. The neutrality case for allowing depreciation depends on something that is ultimately unknowable – whether or not BEA estimates of economic depreciation are

reasonable proxies for depreciation on buildings in New Zealand and, if not, what would be a better estimate.

42. If we were confident about the BEA estimates of economic depreciation and wanted to define MURBs as buildings with 5 or more dwellings, Inland Revenue would think there is a strong reason to argue against restoring depreciation for MURBs. On the BEA estimates, allowing any depreciation is likely to be advantaging investment in MURBs relative to commercial and industrial buildings and depreciation rates for buildings accommodating 5 or more families are not very different from buildings accommodating fewer.
43. We accept, however, that there is considerable uncertainty about how MURBs depreciate. But the change is likely to have a significant fiscal cost and there is considerable uncertainty over whether allowing depreciation for all MURBs or for some group of MURBs and not others will be increasing tax neutrality and economic efficiency.
44. One other important consideration is how the tax treatment of rental housing fits together as a coherent and easily-understood whole. Coherence in a tax system is important in that it creates public buy-in to a tax system, and makes what can be a very complex area of law more understandable to people who have to interpret uncertain edge cases. Ideally, an informed practitioner should be able to step back and understand what the overall regime is trying to achieve. In the context of recent tax changes, interest deductions are being denied for residential rental properties. This will apply not only to existing properties but it will eventually apply to new builds of rental property in 20 years' time. It will be complicated to explain to stakeholders why depreciation deductions are being provided for new builds of rental property while interest deductions will be removed for the same property in 20 years' time. In the context of these recent changes and the relatively weak case for introducing depreciation deductions on neutrality grounds, Inland Revenue recommends that depreciation deductions for MURBs not be progressed.

Treasury view

45. The Treasury's view is that given that the rate at which MURBs depreciate is highly uncertain there is a judgement call about whether or not there is a case to reinstate depreciation allowances for MURBs. On balance, its recommendation is that there is, and if you agree you should consider this in the round alongside your other Budget and fiscal priorities.
46. While the BEA estimates find that MURBs depreciate less quickly than commercial or industrial structures (and not that much more quickly than standalone structures), there is compelling evidence to suggest that this would underestimate the current rate at which these buildings depreciate. In particular:
 - The BEA estimates referred to in this paper categorize MURBs as structures of 5 or more dwellings. This is unlikely to represent the depreciation of apartment blocks as we understand them, even in the time period the study covers.
 - As noted above, MURBs have grown significantly in size over time (and additional intensification is likely in NZ). To the extent that many compare in size and complexity to many commercial buildings, there does not seem to be any theoretical reason to assume that similar structures depreciate so differently purely on the basis of tenure.
 - As noted above, other studies have suggested higher rates of depreciation for MURBs, albeit lacking the comparability of the BEA estimates.

47. Non-neutrality in the tax system will have the greatest impact in those situations where it can most easily drive suboptimal investment decisions. If MURBs do depreciate more quickly than the BEA estimates, then the status quo of no depreciation allowances for MURBs risks incentivising investment in commercial (and potentially to a lesser extent industrial) rather than residential property, particularly given the substitutability of resources, labour, and land that are required for their construction.
48. There will always be unavoidable boundary issues and non-neutrality caused by the tax system. Reinstating depreciation for any category of MURBs would create its own challenges (for example, between smaller and larger residential structures).
49. Given the uncertainty in estimating rates of depreciation, we acknowledge that there is a risk that reinstating depreciation would “over-subsidise” the construction of MURBs relative to other property. In general, Treasury would recommend against using the tax system to encourage one kind of investment over another. However, in balancing these risks and uncertainty, your wider housing objectives would suggest erring on the side of encouraging, rather than discouraging, the construction of MURBs.
50. In order to minimise the risk of providing too high of a depreciation deduction for MURBs, and to manage the fiscal cost of the measure, it could be appropriate that depreciation is not reinstated for smaller MURBs, which may depreciate more slowly and at similar rate to standalone homes. For example, depreciation could be limited to MURBs with a larger number of units, although this does emphasise the boundary issues that reinstating depreciation allowances would cause. You could also consider reinstating depreciation at a lower rate than commercial or industrial buildings (for example, 1% d.v.).

Incentivising the construction of MURBs

51. A second possible motivation for allowing depreciation on MURBs is to incentivise the construction of new buildings to support the Government’s broader housing market objectives. On 8 March 2021 Cabinet confirmed a number of overarching policy objectives for the housing market (Cabinet Minute CAB-21-MIN-0045 Amended refers). These are to:
 - ensure that every New Zealander has a safe, warm, dry, and affordable home to call their own – whether they are renters or owners
 - support more sustainable house prices, including by dampening investor demand for existing housing stock, which would improve affordability for first-home buyers
 - create a housing and urban land market that credibly responds to population growth and changing housing preferences, that is competitive and affordable for renters and homeowners, and is well-planned and well-regulated.
52. Allowing depreciation on MURBs would incentivise the construction of new MURBs for rental purposes increasing housing supply, particularly denser housing typologies. This increased supply and intensification could support the first and third housing objectives.
53. At the same time, incentivising MURBs is likely to put upward pressure on the price of MURBs and reduce their affordability for first-home buyers. The goal of putting downward pressure on the prices that landlords are willing to pay for existing homes was one of the motivations for the recent tax changes. However, only 6% of owner-occupier households currently live in MURBs compared to 35% of renting

households.⁵ The relatively small proportion of owner-occupiers acquiring MURBs suggests that affordability concerns may not be as pressing when considering a tax change which makes investment in MURBs more attractive.

High-level design issues to be developed more fully if further reporting is required

54. When considering the pros and cons of restoring depreciation on MURBs there are a few high-level design issues that should be considered. We are not seeking decisions on these issues at this stage. These will be analysed more fully if Ministers want further work on restoring depreciation deductions for MURBs. But they are informing Ministers on important issues which would need to be worked through. The high-level design issues include:
- whether depreciation deductions should be limited to new buildings only or whether they should be available for both new and existing MURBs
 - whether the incentive should be temporary or permanent
 - how MURBs should best be defined
 - the rate of depreciation deduction
 - whether there should be any similar incentive for first-home buyers and other owner occupiers acquiring MURBs

New builds only or new and existing buildings

55. If the motivation behind allowing depreciation on MURBs is to incentivise the building of MURBs, there is a question of whether depreciation should be restricted to new buildings. Applying depreciation to all MURBs would have a greater fiscal cost and lead to a windfall gain to current landlords. Because it would make it more attractive for investors to acquire rental property, it would be putting upward pressure on the price of existing MURBs making them less affordable to first-home buyers. It would work in the opposite direction to the Government's other housing tax policy changes.
56. If, on the other hand, the motivation were to achieve greater neutrality of investment, there would be a stronger case for allowing depreciation not only to new buildings but also to existing buildings. This was the approach taken when depreciation deductions were restored for commercial and industrial buildings. If there is considered to be a neutrality case for allowing depreciation, there is an argument that the moves in 2010 which removed depreciation on MURBs were unfair and that restoring depreciation deductions for these buildings is appropriate at the same time as allowing depreciation deductions for new MURBs.

Temporary or permanent

57. If the aim of allowing depreciation on MURBs is to incentivise the construction of MURBs and address a current lack of housing supply, this might suggest a temporary rather than a permanent incentive for this type of building. For example, this incentive might be restricted to new builds constructed and first rented out within the next 10 years. It could apply throughout the life of these MURBs and not be switched off at the end of the 10 years but not available to new builds after that time. In 10 years' time it would be possible to reassess whether there was any ongoing need for a depreciation incentive for MURBs.

⁵ Housing Aotearoa 2020, Stats NZ, pg 74, <https://www.stats.govt.nz/reports/housing-in-aotearoa-2020>

58. At the same time, a permanent incentive would indicate a stronger commitment to support ongoing growth in higher density housing.
59. If the aim of allowing depreciation on MURBs was to increase the neutrality of investment decisions, it would seem appropriate to make any changes permanent.

How MURBs should best be defined?

60. If the motivation behind allowing depreciation on MURBs is to incentivise building of MURBs, the incentive should be aimed at targeting the key area of Government concern as efficiently as possible.
61. Exactly what is meant by a MURB is yet to be defined. The BEA has distinguished between residential buildings of 5 or more units and residential building of 4 or less units and estimated a slightly higher rate of economic depreciation to buildings with 5 or more units. But it would make little sense for tax policy design in New Zealand to be driven by this reasonably arbitrary distinction the BEA has made.
62. The existing depreciation rules for commercial and industrial buildings already create a distinction between buildings with 4 or more units and buildings with less than 4 units. A building with 4 or more units used for short-stay accommodation (that is, AirBnB, hotels or motels) is currently depreciable (however, the same building would not be depreciable if used for long-term residential accommodation). This pre-existing "4 or more units" criteria could be used as a definition for MURBs so that all buildings with 4 or more units are depreciable regardless of whether they are used for short or long-stay accommodation.
63. Although having the advantage of being a pre-existing boundary, the "4 or more units" criteria is also a reasonably arbitrary distinction. If depreciation deductions are to be restored on MURBs you may want to consider whether there is a better way to define MURBs. For example, if increasing housing supply and intensification is the primary goal of restoring depreciation deductions, you may want to consider more than just the number of units in a building and also look at how efficiently a parcel of land is being used. Building height and site coverage relative to what's allowed under the zoning for the site may also be relevant factors in deciding whether a MURB should be depreciable.
64. Basing depreciation deductions on the definition of MURBs which is best designed to support intensification makes most sense if the Government's motivation for the change is to incentivise the building of MURBs rather than to promote investment neutrality. If requested, officials can provide further advice on options for defining MURBs for the purpose of depreciation deductions.

The rate of depreciation

65. The higher the rate of depreciation allowed, the greater will be the fiscal cost and the upward pressure on property prices. One possibility would be to allow depreciation at a rate of 2% d.v. which would mean the same rate of tax depreciation as for commercial and industrial buildings. This approach would reduce boundary issues (for example, for buildings that are mixed commercial and multi-unit residential). This is the approach that New Zealand has taken in the past in depreciating buildings. However, now that interest is being denied on residential buildings including multi-unit residential buildings, boundary issues will sometimes remain.
66. There is no strong reason for having the same rates of depreciation for these different types of building if the main motivation for providing depreciation on MURBs is to incentivise the supply of higher density housing. Purely on neutrality grounds, the BEA estimates of economic depreciation would suggest a lower rate

for MURBs than for commercial and industrial properties. At the same time, reducing the number of depreciation rates would make things simpler.

A similar incentive if MURBs are acquired by owner occupiers

67. If depreciation deductions are to be allowed on new MURBs, this will incentivise the supply of MURBs for rental accommodation and encourage greater densification of housing. At the same time, it is likely to make MURBs less affordable for first-home buyers and other owner occupiers. An open question is whether there might be some similar incentive offered to owner occupiers of MURBs. This would be a more general way of incentivising the supply of higher density MURBs if that is the key policy motivation.
68. An alternative might be for the Government to provide a general subsidy which supports both owner-occupiers and investors acquiring MURBs instead of allowing depreciation on MURBs. An attraction of a general subsidy relative to a tax incentive is that it can provide similar incentives for different purchasers to acquire higher density MURBs. It would not, for example, provide greater incentives for investors on high marginal tax rates to acquire MURBs than for investors on lower tax rates, investors in a tax-loss position or owner-occupiers to acquire these dwellings. If Ministers want further reporting on allowing depreciation on MURBs officials could report further on possible measures which might incentivise owner-occupiers as well as investors to acquire MURBs.

Administrative implications

69. Allowing depreciation on MURBs is unlikely to present large administrative concerns provided the definition of a MURB is sufficiently clear. If Ministers are wanting further work on this, we would come back for further clearance once a final definition of MURBs is being suggested.

Fiscal implications and Budget process

70. A first cut at costing allowing depreciation on MURBs at a 2% d.v. rate is provided below on the assumption that this change takes place on 1 April 2022. If depreciation applies only to new builds, the revenue costing would rise to \$140m by 2025/26 and cost \$340m over the five years. If depreciation applies to both new and existing MURBs, the cost would rise to \$285m by 2025/26 and cost \$1170m over the five years.
71. The costings are based on an assumption that the buildings with 4 or more units are classified as MURBs. However, the costs will ultimately depend on the precise definition of MURBs. A narrower definition of what qualifies as a MURB would tend to reduce costs, so the costings are likely to be an upper limit.

Vote Revenue Minister of Revenue	\$m – increase/(decrease)				
	2021/22	2022/23	2023/24	2024/25	2025/26
Option 1: New MURBs only Tax Revenue		(5)	(85)	(110)	(140)
Option 2: New and existing MURBs Tax Revenue		(20)	(585)	(280)	(285)

72. Officials previously recommended (in IR2021/389) that the Minister of Revenue should seek an invitation to the Budget 2022 process for the proposal to allow depreciation on MURBs. This will ensure that the proposal can be considered through the Budget process, should Budget Ministers invite the initiative. However, Budget 2022 funding for this proposal would ultimately depend on the further policy work being completed in time, as well as your relative priorities for Budget and value for money relative to other Budget bids.
73. Seeking Budget funding would be preferable to seeking out-of-cycle funding given that the proposal is not urgent.
74. Further guidance on Budget timelines will be communicated to agencies shortly. Policy decisions on the design of the initiative and funding would need to be taken by approximately the end of this calendar year.

Consultation

75. Te Tūāpapa Kura Kāinga – Ministry of Housing and Urban Development (HUD) was consulted on this report and supports reinstating depreciation deductions for MURBs, particularly new and larger MURBs.
76. HUD agrees with the Treasury that the inability to claim depreciation deductions for MURBs, particularly larger MURBs, leads to non-neutral tax treatment relative to commercial and industrial buildings. This non-neutral treatment may disincentivise investment in MURBs and reduce the supply of MURBs. Residential property developers have raised concerns with HUD about MURBs being disadvantaged relative to commercial and industrial buildings owing to the absence of depreciation deductions.
77. Given New Zealand’s housing crisis, it is vital that barriers to new housing supply are removed. The National Policy Statement on Urban Development (NPS-UD) and upcoming legislation to introduce medium density residential standards (MDRS) will both encourage greater intensification, minimising negative externalities like traffic congestion, infrastructure costs and climate emissions and supporting greater productivity through the agglomeration benefits of intensification. Reinstating depreciation deductions for MURBs will remove a financial barrier to the delivery of new residential property at scale and encourage developers to take up the increased development opportunities being enabled by the NPS-UD and MDRS.
78. HUD notes that reinstating depreciation deductions for MURBs (particularly larger and new MURBs) is consistent with Cabinet’s housing market objectives (CAB-21-MIN-0018), notably to ensure that every New Zealander has a safe, warm, dry, and affordable home to call their own – whether they are renters or owners; and to support more sustainable house prices, including by dampening investor demand for existing properties.

Next steps

79. This report is seeking your decision on whether or not you want further advice on this issue. If you are wanting further advice, officials will provide a further report which works through design details more fully.

Appendix 1 – Costs of capital under BEA estimates of economic depreciation

80. In Table A1 below we examine costs of capital (or hurdle rates of return) for investment in different types of commercial and industrial buildings, MURBs and stand-alone houses assuming BEA economic depreciation rates. There would be a tax neutrality case for allowing tax depreciation on MURBs if current tax rules were leading to significantly higher hurdle rates or return for MURBs than for other buildings. We consider investment by a company taxed at a marginal tax rate of 28% and assume inflation of 2% per annum (the mid-point of the Reserve Bank target range). Costs of capital will depend on debt levels and we assume that companies are 40% debt financed. This is a realistic average debt level for New Zealand companies although changes in the assumed debt level don't significantly affect conclusions about whether or not MURBs are disadvantaged. We consider three possible real interest rates: 1%, 3%, and 5%. The 3% real interest rate is consistent with estimates that are used by the OECD in its modelling of costs of capital and reflects a real risk-free interest rate of 0% and a risk premium of 3%. The most appropriate real interest rate to use is open to debate so we also have examined the case of a 1% and a 5% real interest rate. These changes to real interest rate assumptions do not change the general conclusions.

Table A1 - Costs of capital for MURBs and other buildings

	Commercial buildings	Industrial buildings	MURBs			Stand-alone housing
d	2.47%	3.14%	1.40%	1.40%	1.40%	1.14%
d*	2%	2%	2%	1%	0%	0%
r = 5.0%	6.20%	6.39%	5.88%	6.11%	6.41%	6.30%
r = 3.0%	3.77%	3.95%	3.48%	3.67%	3.94%	3.84%
r = 1.0%	1.37%	1.52%	1.13%	1.25%	1.47%	1.37%

81. Consider the results for a real interest rate of 3% shaded in yellow. Commercial buildings are estimated to have an economic rate of depreciation of $d=2.47\%$ and are permitted tax depreciation of $d^*=2.0\%$. In the absence of tax they would need to generate a hurdle rate of return equal to what foreign investors demand, viz. 3%. Tax drives up the hurdle rate of return to 3.77%. After this is taxed, investors would obtain the 3.0% return they demand. Industrial buildings have a slightly higher cost of capital because they have a higher rate of economic depreciation but the same rate of tax depreciation.
82. By contrast, without any depreciation deductions, MURBs face a cost of capital of 3.94%. This is higher than the cost of capital for commercial buildings but just lower than the cost of capital for industrial buildings. Thus, without any depreciation, MURBs are within the bounds of the treatment for commercial and industrial buildings. Allowing tax depreciation of 1% d.v. would lead to MURBs having a cost of capital of 3.67% which would be lower than for commercial or industrial buildings, and allowing depreciation of 2% d.v. would lead to MURBs having a lower cost of capital still.
83. At the same time these results depend very sensitively on economic rates of depreciation. If MURBs were actually depreciating at the rate of 2.47%, they would face a cost of capital of 4.36% which is markedly heavier than either commercial or industrial buildings.

Appendix 2 – Depreciation deductions and assets which rise in value

84. The Minister of Revenue has asked whether New Zealand's lack of a capital gains tax provides a reason for disallowing depreciation deductions on assets which may end up rising in nominal value.
85. In setting depreciation deductions officials have set out to reflect 'economic depreciation' or how assets would fall in value over time. However, we have normally not taken account of inflation in doing so. In practice, this means that the depreciation deductions we have been attempting to come up with would reflect how assets would depreciate if there were no inflation.
86. There are a number of reasons why assets that receive depreciation deductions could rise in nominal value. These include the following:
- The depreciation rates are set wrongly because the assets in question should really be expected to be rising in real value.
 - Depreciation rates are set as intended to reflect how assets are expected to fall in real value but the depreciation rate is less than the inflation rate so that the asset has risen in nominal value despite falling in real value.
 - Depreciation rates are set as intended to reflect how assets are expected to fall in real value. The depreciation rate is greater than the inflation rate so the asset would normally be expected to fall in nominal value. But there will always be some assets that fare better than average and others that fare worse. The asset being looked at is just one which has fared better than average and this has led to its increase in nominal value.
87. In the first case when depreciation rates are set wrongly, this should clearly be corrected and depreciation deductions should be denied. The more interesting cases are the second and third which we analyse in turn. We examine whether there is a case for shaving depreciation deductions in each of these cases and, in particular, whether this case is greater in the absence of a tax on capital gains.
88. We also discuss a further issue, namely, whether depreciation deductions should be allowed for buildings if buildings fall in value but the aggregate value of buildings plus land rises in value.
89. Assets that depreciate in real terms but less quickly than inflation
90. This is very closely related to the inflation-bias issue discussed in the text. Suppose that (as in Appendix 1) we are considering the cost of capital or hurdle real rate of return for investments in different tangible assets and by companies taxed at a rate of 28% which are 40% debt financed. Again we consider three possible real interest rates of 5%, 3% and 1% but focus on the middle case. We initially assume that there is no inflation and that depreciation rates are correctly set to mirror economic depreciation. Costs of capital are outlined for assets with a variety of economic depreciation rates in Table A2.1 below.
91. The top row shows the economic rate of depreciation assumed and the second row shows the tax depreciation rate assumed. The critical assumption is that tax depreciation mirrors economic depreciation.
92. The table reveals a very attractive property. Irrespective of the rate of economic depreciation, taxes would be raising costs of capital uniformly. Thus, the tax system would be neutral and investments which generate the highest pre-tax rates of return would tend to be undertaken. For example, with a real cost of debt and equity funds of 3%, investments in all of these different tangible assets would need to generate a 3.70% real rate of return to be attractive on an after-tax basis. It might be noted that the company tax rate is pushing up the cost of capital by much less

than 28%. This is the consequence of the investments being partially debt financed and interest being deductible.

Table A2.1 – Costs of capital when inflation is 0%

	Costs of capital						
	Depreciable tangible assets						
d	50.0%	20.0%	10.0%	5.0%	2.5%	1.0%	0.0%
d*	50.0%	20.0%	10.0%	5.0%	2.5%	1.0%	0.0%
r = 5.0%	6.17%	6.17%	6.17%	6.17%	6.17%	6.17%	6.17%
r = 3.0%	3.70%	3.70%	3.70%	3.70%	3.70%	3.70%	3.70%
r = 1.0%	1.23%	1.23%	1.23%	1.23%	1.23%	1.23%	1.23%

93. Unfortunately this attractive equilibrium can be upset with minor rates of inflation. Suppose, for example that we have 2% inflation and, as is true in New Zealand, there have been no steps taken to inflation-index depreciation or interest deductions. The implications for costs of capital are outlined in Table A2.2.

Table A2.2 – Costs of capital when inflation is 2%

	Costs of capital						
	Depreciable tangible assets						
d	50.0%	20.0%	10.0%	5.0%	2.5%	1.0%	0.0%
d*	50.0%	20.0%	10.0%	5.0%	2.5%	1.0%	0.0%
r = 5.0%	6.58%	6.48%	6.36%	6.22%	6.09%	5.97%	5.86%
r = 3.0%	4.13%	4.05%	3.94%	3.81%	3.68%	3.54%	3.39%
r = 1.0%	1.67%	1.62%	1.55%	1.44%	1.31%	1.14%	0.93%

94. It is evident that minor rates of inflation upset the neutrality result significantly. Hurdle rates of return increase markedly for assets which depreciate very quickly such as software and computers and would fall for assets which depreciate very slowly like buildings. Assets with low economic depreciation rates become advantaged relative to assets with higher economic depreciation rates.
95. All assets are advantaged by being able to claim deductions for more than the real component of interest expense which is why costs of capital end up falling for assets with low depreciation rates. But there is an offsetting penalty because the real value of depreciation deductions also get eroded by inflation. For assets which depreciate very quickly the penalty from not being able to deduct real depreciation outweighs the benefits from interest deductibility so the cost of capital rises. For assets which depreciate very slowly, the benefits from being able to deduct the inflationary component of interest expense outweighs the loss of real depreciation deductions. Clearly, for an asset which does not depreciate at all (with an economic depreciation rate of 0.0%), there is no penalty from being unable to claim inflation-indexed depreciation deductions because depreciation is zero in any case.
96. There are two key points to note from this analysis. First, inflation and an unindexed tax system does tend to advantage assets that depreciate at very slow rates. For example with a 3% real interest rate, the cost of capital for tangible assets with a 1% depreciation rate will fall from 3.70% to 3.54%. These are assets which would be expected to be rising in nominal value because the inflation rate is greater than the economic depreciation rate. Some of this advantage might be offset in countries with capital gains taxes because when assets are sold, the nominal gain would be taxed. There is no tax on this gain in New Zealand. But the asset with the 1% economic depreciation rate is not as advantaged by our tax system as the asset which doesn't depreciate at all. Also there can be some advantaging of assets with

depreciation rates which exceed the inflation rate (such as the asset with the 2.5% economic depreciation rate). These will depend on the level of debt finance.

97. Thus, a second point to note is that while assets that are likely to appreciate in nominal terms are particularly advantaged, there is a general investment bias that cannot be solved by merely denying depreciation deductions on assets which are expected to depreciate less quickly than inflation. It is a problem that could be addressed by comprehensively indexing the tax system for inflation. However, this would make the tax system more complex and also is likely to come at a fiscal cost.
98. The inflation-bias issue is a broader concern than can be effectively addressed with a capital gains tax. Even in cases where assets are increasing in nominal value, capital gains will only be taxed in countries with capital gains taxes when assets are sold. This might not be for a long period of time in which case the present value of the tax may be small. Also capital gains are often taxed at discounted rates. This means that the capital gains taxes may often only partially offset the biases identified above. While they will tend to reduce these inflation biases, much of the bias is often likely to remain.

Assets which are expected to fall in both real and nominal value but which nonetheless increase in value

99. Now consider an asset which is reasonably expected to fall in real and nominal value but which ends up doing better than average and generates a nominal capital gain. For example, suppose that there is no inflation and an asset is expected to fall in value by 2% but this is because half of the assets fall in value by 10% and the other half of the assets increase in value by 6%. Also suppose that the asset qualifies for 2% diminishing value depreciation deductions.
100. For most assets, losses on sale are deductible. This means that if an asset is acquired for \$100 and depreciated by \$2 to \$98 but then sold for \$90 there is a deduction allowed for this further \$8 drop in value. By contrast, in New Zealand there would normally not be symmetrical treatment for assets that have risen in value. If the asset is sold for \$106, the \$2 of depreciation that has been claimed as a deduction will be clawed back but there will be no tax on the \$6 of capital gain. This can end up advantaging investment in this type of asset relative to an asset where capital gains on sale are very unlikely. This asymmetric treatment will be bigger in countries without a capital gains tax than in countries with capital gains taxes. Although even in countries with capital gains taxes, asymmetries can arise if capital gains are taxed at discounted rates. This asymmetry could provide grounds for considering shaving the depreciation rate allowed for assets which may often generate nominal capital gains.
101. There are, however, other possible approaches as well which can be used to address the issue without reducing depreciation rates. An alternative is to disallow a deduction for losses on sale for assets sold for less than their depreciated book value. This is the approach that New Zealand has taken for commercial and industrial buildings.

Buildings falling in value when the aggregate value of land plus buildings rises in value.

102. A further issue is whether or not depreciation deductions should be allowed on buildings if the buildings fall in value but the aggregate value of the buildings plus land rises in value. Counterintuitively, there is still a case to allow depreciation deductions for the part of the asset that depreciates if (and we note the evidence above is uncertain) it does in fact depreciate. To see this, consider an extreme example where land is expected to increase in value by 20% a year but a property

developer is also considering building an apartment building on the land, and the apartment building is expected to decrease in value by 2% a year.

103. Overall the land plus apartment will increase in value, but if we want the owner to make the same decision that they would in the absence of tax for a marginal apartment building, then we should allow depreciation deductions. Suppose the developer can earn 3% passively on any additional capital after buying the land, or earn 3% as net profit (5% gross rent less 2% of economic depreciation costs) before tax. A nontaxpayer would be indifferent between the two investments which both return 3% in net income. If we tax income but deny depreciation deductions, a 3% passive investment will be favoured over a 3% apartment building investment because the building owner will be taxed on 5% even though the building investment has only returned net income of 3%. If we allow depreciation deductions, the two investments which are equally good before tax will also be equally good on an after-tax basis. This will discourage productive investment in buildings. If we merely look at the overall return of the land plus building package (which will be higher than 3%), we will miss the fact that the profit-maximising decision for the landowner will be to hold the land vacant and invest any additional capital passively.