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WEEKLY COMMENT: WEDNESDAY 13 JUNE 2012

1. From the 2011-12 income year onwards, the tax depreciation rate for buildings is zero. I have reviewed the new depreciation rules in paragraphs 7 to 20 of the Larger Companies section.

2. The zero rate of depreciation makes the distinction between expenditure on repairs and maintenance ("R&M") and capital expenditure on buildings very important, as capital expenditure can no longer be depreciated. In fact capital expenditure on buildings will effectively be "black hole" expenditure: expenditure that can be neither deducted nor depreciated. Such expenditure could only be recovered through a capital gain or a deduction for the cost of revenue account property upon sale.

3. In his address to the IFA annual conference on 16 March the Minister of Revenue said:

   "The Government is aware of a number of black hole expenditure items that should qualify for a deduction….

   We have therefore decided to progress a number of remedial amendments in the area of black hole expenditure a matter of priority. These are in the areas of costs incurred on certain fixed life resource consents and certain company administration costs. Consideration of amortisation of capital raising costs is not on the new work programme…"

4. Black hole expenditure in the form of capital improvements to buildings and residential rental properties is not on the work programme. When added to the fact that GST is not recoverable on costs relating to residential rental properties, it becomes important to understand the principles involved in distinguishing between R&M and capital expenditure.

5. These principles have recently been set out by Inland Revenue in:

   - Draft Interpretation Statement: Income Tax – *Deductibility of repairs and maintenance expenditure* (which closed for comments on 23 March) which, when finalised, will replace and update an earlier statement published in Tax Information Bulletin Vol 5, No 9 (February 1994); and
   - Interpretation Statement IS 10/01: *Residential rental properties - Depreciation of items of depreciable property*, Tax Information Bulletin Vol 22, No 4 (May 2010); and
   - An earlier *Media statement issued on 29 May 2006*, stated as being consistent with the Commissioner's view in IS 10/01, which distinguished between the building and other assets in residential rental properties.

Large vs small assets

6. For expenditure to qualify as deductible R&M, it must not be for the reconstruction, replacement, renewal, improvement, or alteration in the character of, the asset.

7. In a broad sense, the larger the asset, the more likely it will be that expenditure is R&M, simply because there is a much higher likelihood of the expenditure not having renewed or improved the asset. For example, if a front door gets substantially weather-damaged and has to be replaced, and the replacement is not an improvement in any real sense (i.e. not a significantly improved type of door), the expenditure will be capital if the door is regarded as the asset. However, if it is the building that is the asset, the expenditure on the replacement door will be deductible R&M.

8. But, as already noted, expenditure on a building is not depreciable, whereas expenditure on smaller assets that can be differentiated from the building will be depreciable. On 29 May 2006 Inland Revenue issued a media release stating:

   "Inland Revenue advises that it considers it is unacceptable for residential rental property owners to break up their properties into smaller components in order to get higher depreciation rates for tax purposes….

   Property owners are still able to depreciate chattels such as carpets, drapes, light fittings, whiteware and so on, as separate assets. There is also provision to depreciate separately items such as water heaters, clotheslines and other fittings that are not part of the building…

   The items that Inland Revenue does not believe to be separate assets are internal walls, doors, electrical wiring and plumbing and so on, as well as furniture and fittings that are permanently attached and are regarded as being part of the building. These include items such as kitchen cupboards, bathroom vanities and built-in wardrobes."

9. Inland Revenue recognises that this approach could result in more deductible R&M expenditure. In IS 10/01 it is stated at paragraph 13 that:

   "… it is noted that some expenditure upon an item that may have been regarded as a separate asset under the "smallest asset" approach might be deductible as repairs and maintenance under the approach taken in this statement. This is because, whereas expenditure on a separate item of property may have to be treated as capital, if the item is more correctly characterised as a small part of a larger item, the expenditure may qualify as repairs and maintenance. *However, this does not mean that all expenditure on objects that are part of the building under the approach taken in this statement will necessarily be deductible as repairs and maintenance*. The Commissioner's view is that the conclusions in this statement do not affect the capital/ revenue distinction established by case law." (emphasis added)

10. The last two sentences in this quotation set out the "black hole" problem alluded to earlier.

R&M vs capital expenditure

11. In the draft IS on *Repairs and maintenance*, Inland Revenue set out a series of circumstances and examples differentiating between deductible repairs and maintenance and non-deductible capital expenditure. (The examples are numbered as in the draft IS.)

12. **Work done that results in an improvement to the asset will be capital expenditure**. Costs incurred to earthquake-strengthen a building were held to be capital and not deductible in *Case X26* (2006) 22 NZTC 12,315:

    Example 8 – insulation top-up: Peter and Alice own a 30-year old residential rental property. After a cold snap their tenants complain that the insulation is no longer effective. Peter and Alice arrange for new insulation. The cost of the insulation is deductible expenditure on the basis that it is a repair to the property and does not change the character of the asset. It only returns the property back to its former condition.

    Example 9 – new insulation improves house: Ralph and Bridget own a residential rental property that has never been insulated. Ralph and Bridget agree to their tenants' request and insulation is installed. The cost of this new insulation is not deductible as it is capital expenditure. It is not a repair to the rental property. It is an improvement that changes the character of the asset. (*This is "black hole" expenditure – neither deductible nor depreciable because the insulation would be regarded as part of the "fabric" of the building under Step 3 of the 3-step approach in IS 10/01 to determining what constitutes a building*.)

    Example 10 – replacement roof: Natalie and Albert own a residential rental property. The lean-to garage has an asbestos roof that has recently cracked and started leaking. It is no longer appropriate to use asbestos, so the roof of the lean-to is replaced with a pre-painted steel roofing product. The cost of replacing the roof is deductible. The fact newer, more modern materials have been used does not mean the work done has changed the character of the asset. The roofing materials selected reflect the building practices of the time and were not chosen to effect an improvement beyond restoring the lean-to to its original condition.

13. **Expenditure incurred to repair or maintain the asset, over and above making good wear and tear, that has the effect of changing the character of the asset will be capital expenditure**. When determining whether the work done has changed the character of the asset relevant factors to consider are the nature and the scale of the work done to the asset. These principles are obtained from the Privy Council's decision in *Auckland Gas Company v CIR* [2000] UKPC 24, [2000] 3 NZLR 6 (PC):

    Example 11 – leaky home repairs: Cath and Simon own a residential rental property. A few years ago they added a two-room extension, which has been leaking. The timber framing within the extension is rotten and needs replacing. To make the repairs the cladding and windows need to be removed from the extension and refitted. The cost of the repairs is deductible. The repairs will not change the character of the house. Nor is the house substantially renewed or replaced by the additional work done on the extension.

    Example 12 – leaky home improvements: Cath and Simon discovered that another of their rental properties is a "leaky home". In this case the solution is not as straightforward as in Example 11 and the remedial work required is extensive. They decide that the best way forward is to re-clad the house using a superior concrete block construction system. The cost of repairs will be capital expenditure because Cath and Simon have changed the character of their asset. In addition the work done renews and replaces a substantial portion of the house. (*This is black hole expenditure: neither deductible nor depreciable*.)

14. **The deferral of repairs will not in itself change the character of repair costs from being deductible expenditure to capital expenditure** (*Ounsworth (Surveyor of Taxes) v Vickers Ltd* [1915] 3 KB 267, *Rhodesia Railways Ltd v Collector of Income Tax, Bechuanaland Protectorate* [1933] AC 368 (PC)):

Example 13 – deferred repairs done all at once: Phil owns a rental property. A long period has passed since repairs were last made to the property but the tenants have recently vacated and Phil is taking the opportunity to restore the property to a good condition before letting it again. He has had to incur significant expenditure on the property. The work done included extensive cleaning, repainting, easing windows (ie, repairing windows to enable them to open and shut smoothly) and replacing cracked panes, sanding and re-varnishing the floors, replacing the kitchen bench top, fitting a new hand basin to replace a cracked one, and having a plumber check and repair all the taps. Although these costs are significant, they arose from repairs that had been allowed to accumulate and are deductible.

15. **Where repairs and maintenance expenditure is incurred as part of a single overall project that results in the reconstruction, replacement or renewal of the asset or substantially the whole of the asset, improves the asset or changes the character of the asset the expenditure will be capital expenditure**. There is no deduction for a notional amount that might have been spent on repairs had the work been carried out differently (*Colonial Motors Co Ltd v CIR* (1994) 16 NZTC 11,361 (CA)):

    Example 14 – earthquake-strengthening: Hi–Brow Limited has owned an older commercial building for 10 years. The building is looking shabby and the company has recently been informed that earthquake-strengthening work needs to be done to the building if it is to comply with council requirements for buildings of that age. Hi-Brow Limited decides that the building would benefit from a complete refurbishment, including structural changes that will extend the floor plan and enhance the common areas as well as earthquake-strengthening the building. All the expenditure incurred will be capital expenditure as it forms part of a single overall project to improve the building. No notional deduction is allowed for the cost of any repairs that are included within the project.

16. **No deduction is allowed for expenditure incurred to bring a newly acquired asset up to the condition necessary for it to be used in the taxpayer's business**. Such expenditure forms part of the capital cost of acquiring the asset (*Law Shipping Co Ltd v CIRs* [1924] 12 TC 621 (IH (1 Div))). A deduction may still be allowed for expenditure on repairs to a newly acquired asset if the purchase price of the asset was not affected by the fact that the asset was in a state of disrepair, and when the asset was acquired it could be used as intended despite its state of disrepair (*Odeon Associated Theatres Ltd v Jones* [1972] 1 All ER 681):

    Example 17 – newly acquired but damaged rental property: Anne and Jane bought a property at a discounted rate because of earthquake damage. The roof of the property has partially collapsed and a corner of the house has been damaged. Anne and Jane spend money fixing the roof and the damaged part of the house to put it in a tenantable state. The expenditure on the repairs is not deductible. Anne and Jane's costs in getting the property to a tenantable state form part of the acquisition costs of that asset, so are a capital cost.

17. **The nature of the expenditure does not change if the repairs are carried out as a result of a significant event, for example fire, flood or earthquake**. The same principles must be applied to repairs arising as a result of a significant event as are applied to repairs arising for other reasons (*Case F67* (1983) 6 NZTC 59,897):

    Example 18 – damaged and dilapidated commercial property: David and Angus own a commercial property that was damaged in an earthquake. David and Angus have owned the property for a long time. When David and Angus purchased the property it was in

excellent condition. Over time it has become dilapidated, so when the earthquake occurred the roof of the property was in a poor state and other repairs were necessary. The tenants are unhappy and request that the building be refurbished back to its original state. David and Angus spend money giving the building a refurbishment: inside the building the interior walls are re-plastered and repainted and the stairwells are repaired; outside the building the roof is replaced, cracked and broken windows are replaced, and the exterior walls are repainted. The work done brings the building back to the standard it was when David and Angus bought it. The building has not been improved or had its character changed as a result of the expenditure. The expenditure undertaken by David and Angus is for accumulated repairs and is deductible.

Example 19 – significantly damaged rental property: Jennifer and Peter own a residential rental property that was significantly damaged in an earthquake. Before the earthquake the property was in a good state of repair. After the earthquake to get the property in a tenantable state Jennifer and Peter replace the property's severely damaged foundations, rebuild two of the property's collapsed external walls and replace the badly damaged roof. Jennifer and Peter also demolish the property's partially collapsed chimney, which is a hazard. In this case, the cost of the work Jennifer and Peter have done is capital expenditure and not deductible. This is because the work results in the effective renewal of substantially the whole of the asset.

18. It must be remembered that this IS is still a draft and has not yet been issued in final form. However, anyone who expects to incur expenditure on a residential rental property should study the above examples carefully, to understand the tax treatment of the expenditure.

Arun David, Director, DavidCo Limited