

CASE SUMMARY

High Court finds remediation work on rental property capital in nature

Decision date: 23 April 2024

CSUM 24/05

CASE

Lawrence v Commissioner [2024] NZHC 905

LEGISLATIVE REFERENCES

Income Tax Act 2007, ss DA1(1), DA2(1).

Tax Administration Act 1994, s138P.

LEGAL TERMS

Deductible expenditure; Capital limitation, Leaky Building, Repairs and maintenance, renewal of substantially the whole, change in character.

Summary

The High Court found in favour of the Commissioner, confirming assessments made in relation to income tax returns for the years ending 31 March 2018 and 2019 disallowing deductions claimed by Mr and Mrs Lawrence (together **the plaintiffs**) for remediation work on their Tauranga rental property. The Commissioner considered the payments were capital in nature and made assessments on that basis. The High Court found the evidence supported the Commissioner's position and the plaintiffs had not satisfied their onus to show the assessments were wrong and by how much.

Impact

The outcome of this case turns on its facts with the High Court finding the nature and extent of the work substantially renewed the whole asset and changed the character of the property.

Facts

The plaintiffs purchased the rental property in Tauranga in December 2014. Shortly after purchase, leaks were discovered, and minor repair work was undertaken to address the leaking. However, the leaking continued with further repair work in 2017 unable to address the issue.

An inspection of the property undertaken by a building company advised the leaking issues were mainly caused by the roof line at the gable ends of the house where there was no overhang and internal guttering (a jerkin head roof design). It was suggested an effective design solution was to change the gable ends and replace the internal guttering to external guttering.

The plaintiffs were given two design options for the remediation work. They elected to go with option two which included a roof extension to the gable ends and a full re clad (in case this was needed as opposed to a partial re clad only). A building consent (BC) application was made to the Tauranga City Council (TCC) which was issued in December 2017 and provided for complete replacement of fascia and internal gutter system, complete replacement of roof, addition of roof area, all board and batten to be removed, removal of all aluminium joinery (to be reinstated), and addition of Axon panel cladding on a 20mm cavity.

Two further amendments were made to the BC, firstly in April 2018 for a new deck as the original was discovered to be in a very poor state and secondly, in June 2021 for new storm water drainage which included a below ground retention tank for the stormwater to drain into.

A Code of Compliance certificate (CCC) for the work was issued by the TCC on 3 October 2022.

The plaintiffs included the costs of the remediation work as deductible expenditure in their 2018- and 2019-income tax returns on the basis it was repairs and maintenance. The Commissioner considered the costs incurred for the remediation work were non-deductible as capital expenditure.

Issues

The central issue to be determined was:

- Whether the expenditure incurred in the tax years ending 31 March 2018 and 31 March 2019 was deductible under section DA1 or whether the capital limitation in section DA2(1) applied.

Decision

The High Court noted the general principles that apply in determining whether expenditure is capital or revenue are well established and applied regardless of the nature of the object or the subject of the work. The answer depends on a close examination of the facts to ascertain the nature and purpose (effect) of the expenditure. In addressing the issue of nature and extent of the work, the following tests apply:

- Whether the work resulted in the reconstruction, replacement or renewal of substantially the whole of the asset;
- Whether the work changed the character of the asset; and
- whether the work formed one project of work.

The High Court found this was a very clear-cut case as the nature and scale of the remediation work resulted in the reconstruction or renewal of substantially the whole of the house and the works changed the character of the asset. The plaintiffs had failed to establish the Commissioner's assessments were wrong and that the capital limitation did not apply.

The High Court found the expenditure was incurred to address aspects of the original design and construction that placed it at risk of water ingress and was not ongoing expenditure. It was invested in the capital asset used to derive income and formed part of fixed capital rather than circulating. The expenditure related to the profit earning structure through which the plaintiffs carried out their income earning process. The extent of the work was substantial and included replacement of all exterior elements of the building envelope, design alteration of external elements and substantial replacement of internal elements.

Change of character

The High Court considered the remediation work improved the property from its original construction and changed the building in all aspects of its appearance, improving its performance, durability and usability. The cumulative effect of the following supported the finding that the work resulted in a change of character:

- Roof redesign: addressed design issues which improved its weathertight performance.
- Roof replacement: steel roofing material was replaced in its entirety with superior product.
- Gutter replacement: internal guttering system replaced with external gutter system.
- New cavity/cladding system: created a safe distance between cladding and framing allowing drainage and drying of moisture and is vastly superior to the original fixed cladding.
- New decks: clear improvement in terms of safety.
- New stormwater disposal: substantial enhancement in terms of directing water away from the building.

Reconstruction, replacement or renewal

The High Court considered the following factors supported its conclusion that the remediation works reconstructed and renewed substantially the whole asset:

- The extent of the work on the property was substantial.
- All external elements of the building were removed and replaced, and the roofline extended.
- External work including painting, replacement of 2 decks, structural retaining, drainage and installation of an engineer-designed stormwater drainage system.
- Significant work to internal elements of the building including extensive timber framing replacement and external walls and some replacement of internal walls.
- Work on the interior including replacement of flooring, tiling, insulation, stopping, electrical work, internal plastering and painting.

The remediation work was not merely replacement and renewal of defective parts as alleged by the plaintiffs. The scale of the works was significant and affected nearly every part of the property. The test is one of renewal or replacement of substantially the whole and the High Court considered that test was clearly made out.

The High Court also rejected the plaintiffs' submission that the remediation work did not create any new asset but simply restored it to a state which enabled it to continue to generate income. However, the test was not one of creating a 'new asset'. The remediation work resulted in substantial extension of the buildings useful life and the significant expenditure created advantages for the plaintiffs which were for the enduring benefit of their rental accommodation business.

While the plaintiffs may not have intended the significant scale of the remediation work carried out, that is not determinative. Regrettably, ongoing investigation throughout a project will often give rise to more extensive/expensive work. In any event, the original plans and the BC provided for a full reclad. While the plaintiffs were hopeful this would not be required it was always a possibility.

One Project

The work formed one overall project commencing with the engagement of the project manager in September 2017 and ended with the issuance of the CCC in October 2022. The work involved the reconstruction of substantially the whole house, not a sequence of repair work.

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