CSUM 25/06: NZTCRA finds work to convert retail space to office space in commercial building was capital in nature

Decision date: 17 April 2025

CASE

P Ltd v CIR [2025] NZTCRA 03

LEGISLATIVE REFERENCES

Income Tax Act 2007 (ITA), ss DA1(1), DA2(1), DB22B.

LEGAL TERMS

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

Win for the Commissioner of Inland Revenue (Commissioner).

Summary

The Taxation and Charities Review Authority (TCRA) found in favour of the Commissioner, confirming assessments made in relation to the income tax years ending 31 March 2017 to 2019. The assessments disallowed deductions for construction and finishing work on a commercial property on the basis the payments were capital in nature. The TCRA found the evidence supported the Commissioner's position that the work was capital in nature and upheld the Commissioner's assessments.

Impact

The outcome of this case turns on its facts with the TRCA finding the work was an integral part of a major capital project and altered the character of the property.

Facts

The disputant owned large parts of a large commercial property constructed in 1986/87. From its construction until 2014, the property was leased to a major commercial retailer. When that first tenant vacated, the disputant spent $13,585,869 on construction and finishing work to accommodate a second tenant requiring office space. The second tenant entered into an agreement to lease that had options for renewal for up to 32 years (12 years with two 10-year rights of renewal).

There were several dimensions to the work carried out including:

- New building façade modernising the building appearance;
- Seismic (earthquake) strengthening;
- New and extended bathroom facilities;
- New atrium;
- Upgraded/safer glazing;
- Strengthening car park panels;
- Replacing some walls with windows.

The disputant filed Notices of Proposed Adjustment (NOPA's) proposing to adjust their income tax returns to include the costs of the work as deductible expenditure in their 2017 to 2019 income tax returns on the basis it was repairs and maintenance. The Commissioner considered the costs incurred were non-deductible as capital expenditure and rejected the disputant's proposed adjustments.

The disputant and the Commissioner agreed on categorising all but two aspects of the work prior to the hearing. Only the seismic strengthening and the ground level glass façade remained in dispute and was the subject of the litigation.

Issues

Whether the expenditure in relation to the glass façade and the seismic strengthening were appropriately categorised as repairs and deductible in the years it was incurred.

Decision

The TCRA noted the principles relating to the categorisation of work into deductible and capital expenditure is well settled. However, these principles require a substantial element of evaluation of the characteristics of the work and the asset on which the work was carried out, then considering matters of degree and proportion. Factors that may be considered included:

- Identifying the relevant asset on which the work was performed;
- Whether the work can be divided into categories or must be viewed as a whole;
- The scope of the work in relation to the asset as a whole;
- The appropriate accounting treatment for the work; and
- How the work changed the asset.

Relevant Asset

The TCRA found the relevant asset to consider was the property. The work on the glass façade and the seismic strengthening was part of a larger refurbishment and could not be separated from its other components. They were undertaken to achieve the objects of the project which was to modernise the property and convert it from retail to office space.

Extent of work

The TCRA considered the work went beyond the scope of repairs and improved or altered the character of the asset. The glass façade was replaced with a superior product functionally and aesthetically. It was an integral part of the building and contributed fundamental changes to its character improving its function and appearance.

Similarly, the Seismic strengthening was an important structural improvement making the property a far more useable and sounder asset. It created a safe lettable building from one that was not safe and likely not suitable in the market for its former use.

Other considerations

The project to refurbish the building was split into multiple contracts. The TCRA did not consider the separate contractual arrangements relating to the glass façade or the seismic work important in characterising the work. What was important was the coordinated way in which all the work was professionally structured and managed with proper cost control and allocation.

The disputant claimed the expenses were 'black hole' expenses if they were not deductible. The TCRA found a fundamental difficulty with that argument was that capital gains were not always taxed and that potentially applied to the disputant's property. The outcome was not demonstrably inequitable and was a result of deliberate tax policy choices.

During the dispute phase, the disputant and the Commissioner agreed that some of the works could be categorised as commercial fit out. Base works and commercial fit out have different tax treatment – the former non depreciable capital and the latter depreciable (see section DB 22B of the ITA). The disputant alleged it was the commercial fit out that altered the character of the property not the work completed before the fit out, however the TCRA did not accept the evidence supported that position. The work created substantial changes which accommodated the commercial fit out. While commercial fit outs could change with tenants this was of no significance to the issue to be decided.

To affect a repair, it may be necessary to use an improved component, either due to regulatory requirements or only new/improved parts being available (for example, owing to the passage of time). The TCRA did not see this factor as having any effect on its analysis. While improved standards may be necessary the consideration is on the extent of the improvement and scope of work. The reasons for improvements and better function are not particularly significant – it is the reality and extent of improvement and amount of work required that is the issue.

Conclusion

The TCRA accepted the expenditure on the glass façade and the seismic strengthening work were not repairs/maintenance that were deductible for income tax purposes but capital expenditure as the work was an integral part of a major capital project and the work altered the character of the property as a whole.