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DAIRY FARMING – DEDUCTIBILITY OF CERTAIN EXPENDITURE

SUMMARY

This interpretation statement sets out the Commissioner's view on the deductibility of certain expenditure relating to operating a dairy farm.

It involves considering capital/revenue principles as they apply to various repairs and maintenance/capital improvement situations that may arise in the context of a dairy shed complex. In regard to the key issues in this context, the Commissioner considers:

- Milking plant (as defined further below) is one single, identifiable asset. Generally, the cost of replacing a single component part of the plant (e.g. a pump or the pulsator units) is deductible. Depending on the scale and nature of the changes, in situations where a number of parts are replaced at, or about the same time, the cost is usually on capital account.

- In a rotary milking operation, the rotary platform system is considered to be a separate asset distinct from the surrounding dairy shed. The cost of replacing the entire platform, or drive mechanism is on capital account. The cost of replacing the electric motor is on revenue account. If individual subsidiary parts of each of those items are replaced or repaired, the cost is deductible.

- The piping used in the dairy shed complex is not a fence for the purposes of sections DO 3 or DO 4. The piping surrounds are part of the dairy shed complex comprising the shed and adjoining yard. Accordingly, the cost of the piping forms part of the total cost of the dairy shed which is a separate depreciable asset.

- The cost of undergrounding an existing overhead line system which supplies power to a dairy shed is capital.

A number of other conclusions regarding the deductibility of specific items of expenditure are addressed below.

To the extent that any issues considered in this statement have been the subject of earlier statements by the Commissioner (e.g. fencing and dairy shed complexes), this statement reflects the Commissioner's current view. This statement does not address depreciation issues. Depreciation rates for identified assets will be set in due course.

BACKGROUND

A number of issues have arisen regarding the correct treatment of various items of expenditure relating to the operation of a dairy farm. In particular, difficulties and inconsistencies regarding the treatment of costs involved in acquiring and maintaining the dairy shed complex and various items of equipment situated in the dairy shed.

The expenditure breaks down into four general categories, i.e. expenditure on or relating to the following:

- The milking plant and related plant and machinery
- Rotary dairy shed milking platforms and machinery
- The dairy shed, yard and surrounds
- Undergrounding of electricity reticulation systems to dairy sheds.

Milking plant and related plant and machinery

Comprising:

(i) the milking plant: consisting of a number of individual items, e.g. rubberware; pulsators; milk line comprising stainless steel and pvc piping; milk filters; the milk cooler; the milk receiver/air intercepter; pumps/electric motors
(ii) the cleansing plant: consisting of jetter washers; mixing bath; water pipes (stainless steel, ordinary steel or pvc); water pumps
(iii) the wash down unit: consisting of a water pump and piping (pvc and steel)
(iv) water heaters, including insulation wraps
(v) milk storage vats and associated plant.

A dairy shed may also contain:

(i) a refrigeration unit
(ii) a drenching system
(iii) a plant wash down unit
(iv) a yard wash down unit
(v) a vat washing unit.

Rotary dairy shed milking platforms and machinery

Comprising:

(i) the rotary platform, including embedded pipe work
(ii) the drive machinery: consisting of an electric motor and a drive mechanism.

Dairy shed, yard and surrounds

Comprising:

(i) the shed structure
(ii) the dairy shed yard: consisting of the concrete base, pipe railings, and other barriers
(iii) the pasture resting yards surrounding or adjacent to the dairy shed
(iv) the inlet and exit (outlet) race
(v) the stock races leading to the dairy shed.

Undergrounding electricity reticulation to dairy sheds

Relating to the electricity reticulation system running from the edge of a farmer's property to the dairy shed.

LEGISLATION

All legislative references are to the Income Tax Act 1994, unless otherwise stated.

Section BD 2(1) specifies the deductions allowable to a taxpayer, while section BD 2(2) provides for certain expenditure or losses to be excluded from allowable deductions:

BD 2(1) An amount is an allowable deduction of a taxpayer

(a) if it is an allowance for depreciation that the taxpayer is entitled to under Part E (Timing of Income and Deduction), or

(b) to the extent that it is an expenditure or loss

> (i) incurred by the taxpayer in deriving the taxpayer's gross income, or
>
> (ii) necessarily incurred by the taxpayer in the course of carrying on a business for the purpose of deriving the taxpayer's gross income, or
>
> (iii) allowed as a deduction to the taxpayer under Part C (Income Further Defined), D (Deductions Further Defined), E (Timing of Income and Deductions), F (Apportionment and Recharacterised Transactions), G (Avoidance and Non Market Transactions), H (Treatment of Net Income of Certain Entities), I (Treatment of Net Losses), L (Credits) or M (Tax Payments).

BD 2(2) An amount of expenditure or loss is not an allowable deduction of a taxpayer to the extent that it is

…

(e) of a capital nature, unless allowed as a deduction under Part D (Deductions Further Defined) or E (Timing of Income and Deductions).

Section DO 3 provides for certain expenditure on farm or agricultural land; the relevant part being:

Any taxpayer who in any income year is engaged in any farming or agricultural business on any land in New Zealand shall be allowed a deduction of the amount of any expenditure incurred by the taxpayer in that year, being expenditure that is not deductible otherwise than under this section or under section DO 4, in –

…

(g) The construction on the land of fences for agricultural purposes, including the purchase of wire or wire netting for the purpose of making new or existing fences rabbit proof.

Section DO 4(1) allows a deduction on an annual depreciated basis for expenditure incurred on certain land improvements specified in Part A of Schedule 7:

Any taxpayer who carries on any farming or agricultural business on any land owned by that taxpayer in New Zealand shall in any income year other than the income year in which that taxpayer sells or otherwise disposes of that land, be allowed a deduction in respect of any expenditure of any of the kinds specified in Part A of Schedule 7 incurred by the taxpayer or by any other taxpayer in preparing or otherwise developing that land, and being expenditure which is of benefit to the business in that income year.

Part A of Schedule 7 includes the following items:

6. The construction of access roads or tracks to or on the land.

…

13. The construction on the land of fences, including the purchase of wire or wire netting for the purpose of making new or existing fences rabbit proof.

14. The erection on the land of electric-power lines or telephone lines.

15. The construction on the land of feeding platforms, feeding yards, plunge sheep dips, or self-feeding ensilage pits.

…

17. The construction on the land of structures for shelter purposes.

APPLICATION OF THE LEGISLATION

Introduction

This statement considers:

- A brief background to the current taxation treatment of expenditure on "repairs and maintenance" ("R&M")
- The key authorities and principles for distinguishing between capital and revenue expenditure
- The significant cases dealing with R&M expenditure issues.

After this general discussion, the established principles are then applied to:

- Identify the particular dairy farm assets under consideration; and
- Determine in relation to those assets whether various types of expenditure are on capital or revenue account.

(In both of these sections the analysis is divided into a consideration of the four main categories of dairy farm expenditure identified above.)

Background to current treatment of R&M expenditure

Up until the 1993-94 income year, deductibility of R&M expenditure was governed by section 108 of the Income Tax Act 1976. Section 108 specifically provided for the deduction of amounts spent on repairs and alterations. An extensive body of case law exists relating to the deductibility (or otherwise) of R&M expenditure incurred under the old regime. To date, no cases have specifically considered the deductibility of expenditure under the new regime.

Since the repeal of section 108, the question of the deductibility of expenditure on R&M has essentially involved an application of the capital/revenue distinction. In the context of the 1994 Act, this means a consideration of the general deductibility test in section BD 2(1), and the prohibition on deductions of capital expenditure in section

BD 2(2)(e). A significant body of general case law (non-R&M cases) exists on the capital/revenue distinction.

However, this does not mean that the body of R&M case law that existed before the repeal of section 108 is no longer relevant. A number of these cases are relevant to identifying the particular asset under consideration. In addition, many R&M expenditure cases apply capital/revenue principles, and many are also helpful for the analogies they offer with the issues under consideration.

In summary, both general capital/revenue cases and R&M cases are relevant in determining the deductibility of the dairy farm expenditure considered in this statement.

The capital/revenue distinction

A large number of capital/revenue cases exist. Many make the point that each case must be decided on its own facts. A landmark case which outlines the proper approach to the subject of determining whether any outgoing is of a capital nature is the decision of the Privy Council in *BP Australia Ltd v FC of T* [1965] All ER 209. A leading New Zealand case that confirms the approach taken in *BP Australia* is the decision in *CIR v McKenzies New Zealand Limited* (1988) 10 NZTC 5233. At page 5,236 the Court said:

In deciding whether expenditure is capital or income the approach generally favoured by the courts in recent years is exemplified in the following observations of Lord Pearce in *BP Australia Ltd v Commissioner of Taxation of the Commonwealth of Australia* [1966] AC 244 at pp264-265:

> "The solution to the problem is not to be found by any rigid test or description. It has to be derived from many aspects of the whole set of circumstances some of which may point in one direction, some in the other. One consideration may point so clearly that it dominates other and vaguer indications in the contrary direction. It is a commonsense appreciation of all the guiding features which must provide the ultimate answer. Although the categories of capital and income expenditure are distinct and easily ascertainable in obvious cases that lie far from the boundary, the line of distinction is often hard to draw in borderline cases; and conflicting considerations may produce a situation where the answer turns on questions of emphasis and degree. That answer:
>
> 'depends on what the expenditure is calculated to effect from a practical and a business point of view rather than upon the juristic classification of the legal rights, if any, secured employed or exhausted in the process'.

per Dixon J in *Hallstroms Pty Ltd v Federal Commissioner of Taxation* (1946) 72 CLR 634, 648. As each new case comes to be argued felicitous phrases from earlier judgments are used in argument by one side and the other; but those phrases are not the deciding factor, nor are they of unlimited application. They merely crystallise particular factors which may incline the scale in the particular case after a balance of all the considerations has been taken."

Amongst the factors weighed by the judicial committee in *BP Australia* were: (a) the need or occasion which called for the expenditure; (b) whether the payments were made from fixed or circulating capital; (c) whether the payments were of a once and for all nature producing assets or advantages which were an enduring benefit; (d) how the payment would be treated on ordinary principles of commercial accounting; and (e) whether the payments were expended on the business structure of the taxpayer or whether they were part of the process by which income was earned.

The Court in *McKenzies* noted that the Privy Council decision in *BP Australia* was recognised by the New Zealand Court of Appeal in *CIR v LD Nathan and Co Limited* [1972] NZLR 209 and also in *Buckley and Young Limited v CIR* [1978] 2 NZLR 485. The principles from *BP Australia*, summarised by Richardson J in *McKenzies*, were adopted by Gallen J in *Christchurch Press Company Limited v CIR* (1993) 15 NZTC 10,206.

Deductions for repairs and maintenance – general principles

In the last year there have been three significant New Zealand decisions on R&M expenditure – *Hawkes Bay Power Distribution Ltd v CIR* (1998) 18 NZTC 13,685, *Poverty Bay Electric Power Board v CIR* (1999) 19 NZTC 15,001 (CA) and *Auckland Gas Co Ltd v CIR* (1999) 19 NZTC 15,011 (CA). Additionally, a number of other New Zealand and overseas authorities are recognised as being important decisions in this context, including:

New Zealand cases

- *Auckland Trotting Club (Inc) v CIR* [1968] NZLR 967
- *Case L68* (1989) 11 NZTC 1,398
- *Case L95* (1989) 11 NZTC 1,546
- *Case N8* (1991) 13 NZTC 3,052
- *Colonial Motors Co Limited v CIR* (1994) 16 NZTC 11,361
- *Sherlaw v CIR* (1994) 16 NZTC 11,290
- *Case T43* (1998) 18 NZTC 8,287.

Overseas cases

- *Highland Railway Co v Balderstone (Surveyor of Taxes)* (1889) 2 TC 485
- *Lurcott v Wakely & Wheeler* [1911] 1 KB 905
- *O'Grady v Bullcroft Main Collieries Ltd* (1932) 17 TC 93
- *Rhodesia Railways Ltd v Collector of Income Tax, Bechuanaland Protectorate* [1933] AC 368
- *Margrett v Lowestoft Water & Gas Co.* (1935) 19 TC 481
- *Samuel Jones & Co (Devondale) Ltd v IR Commrs* (1952) 32 TC 513
- *Phillips v Whieldon Sanitary Potteries Ltd.* (1952) 33 TC 213
- *FCT v Western Suburbs Cinemas Ltd* [1952] 86 CLR 102
- *Lindsay v FCT* (1961) 106 CLR 377
- *Conn v Robins Bros Ltd* [1966] 43 TC 266
- *Brown (I of T) v Burnley Football and Athletic Co Ltd* [1980] 3 All ER 244.

Summary of the key principles taken from these cases

From the above decisions it is possible to deduce a three-stage approach to the issue of whether or not certain expenditure is deductible:

1. Identify the relevant asset. If this is part of a larger asset, it must be a distinct physical unit capable of operating on its own, albeit that it forms part of the whole.

2. Ascertain the nature, extent, and cost of the work undertaken in relation to, or on, that asset.

3. Determine whether the work has remedied fair wear and tear (deductible repairs), or whether the asset has been improved, or altered, or so substantially changed that it amounts to a new, or substantially new, asset (capital).

Identification of the asset

The key points to note from the cases are:

- The first step is to identify the subject matter of the work. That is, the totality or entirety of the physical asset that is the relevant subject matter under consideration. (*Lindsay*; *Auckland Gas Co*; *Poverty Bay Electric Power*, *Hawkes Bay Power*).

- Put another way, it is necessary to identify "a physical thing which satisfies a particular notion" (*Lindsay*). The focus is on a "physical thing" – the consideration excludes the operational significance, or the economic value, of the subject matter. The fact that a particular physical thing realises its economic value only when used in conjunction with other "things" or business systems, does not mean it is not to be regarded as a separate asset whose replacement is on capital account (per Gault J in *Auckland Gas Co*).

- However, a single asset may be made up of a number of interdependent parts (*Auckland Gas Co*). There is always a danger of distortion if too large, or too small, a subject matter is identified (*Poverty Bay Electric Power*). If a subsidiary part of an asset is regarded as the subject matter and that part has been replaced, there might be a tendency to classify what has occurred as a matter of capital, possibly leading to an absurd result. A replacement of a mere component, even a vital component (even if an improved or modified version of that component is substituted), may still be correctly classified as a repair. Conversely, if the subject matter is seen as being too broad, then every replacement of a single unit that forms part of the total subject matter would be seen as merely a repair to the whole.

- Ascertaining whether a part of a wider asset is itself a separate physical thing or simply a component of a wider asset, includes considering: whether it is physically and functionally distinct from the wider setting, its relative size and value as regards the whole asset (is it "a principal capital item"? (*Hawkes Bay Power*)), its ability to be relocated elsewhere, and the process of the business in which the part is used (*Auckland Trotting*; *Case N8*; *Burnley Football*). Relevant also may be whether the part is itself a separate item of plant or equipment distinguishable from the surrounding premises (*Auckland Trotting*; *O'Grady*).

- It will always be a question of fact, degree, and impression as to what is included or excluded in an entity or asset (*Case N8*). However, the focus is on finding a significant physical asset that will either function by itself, or is clearly divisible in

size or function from other assets that make up the taxpayer's premises or business.

Deductibility

The key points to note from the cases concerning the availability of a deduction for expenditure incurred in relation to an asset are:

- This will also always be a question of fact and degree in the particular circumstances (*Auckland Gas Co*; *Case N8*). The borderline between a repair and an improvement of a capital nature may sometimes be difficult to determine. The test is whether the act to be done is one that in substance is the renewal or replacement of defective parts, or the renewal or replacement of substantially the whole (*Wakely & Wheeler*).

- Expenditure that does no more than restore an asset to an "as new" condition, rather than create a new asset, will be deductible whether this is completed in one income year or over a number of years (*Auckland Gas Co*). This applies even if the asset is "improved" in the sense of using more modern technology and/or being more efficient by being less susceptible to breakdown (*Conn v Robins Bros*, but c.f. *Western Suburbs Cinemas*).

- Expenditure on renewal, replacement, or reconstruction of substantially the whole of an asset goes beyond repair and is non-deductible capital expenditure, even if what was spent may have been less than the cost of on-going maintenance (*Wakely & Wheeler*; *Auckland Gas Co*; *Poverty Bay Electric Power*). This will also still apply even if the asset gives no greater performance and/or has no greater life span than that of the replaced asset (*Case L68*).

- The renewal of major components of the asset, rather than their on-going maintenance, can be indicative of the expenditure falling on capital account (*Case N8*). An assessment has to be made of whether the work is of sufficient substance to place the expenditure on capital account (*Wakely & Wheeler*). Any improvement to the asset will be relevant to that assessment (*Auckland Gas Co*; *Poverty Bay Electric Power*).

- In determining whether certain work, possibly comprising repairs and or replacements of a large number of component parts, is capital or revenue in nature, it is important to ascertain the taxpayer's overall intention, i.e. to repair or to totally improve or reconstruct (*Colonial Motors*; *Sherlaw*; *Case N8*). If the total work is substantial and is intended to produce a different and operationally superior asset, it must be regarded as a capital improvement (*Poverty Bay Electric Power*).

- Work resulting in a significant increase in the value of the asset, a change in its character or kind, or involving an amount not regularly incurred, is more likely to be capital expenditure (*Case N8*; *Auckland Gas Co*; *Highland Railways*). Similarly, an amount incurred that is substantial in relation to the value of the asset prior to the work is likely to be capital in nature (*Case N8*).

- In the context of a total project it may be artificial to dissect the work into capital and revenue categories, or to further dissect a purported revenue category into capital and non-capital items. It is necessary to look at the entire asset and see what was there before and after (*Case N8*; *Colonial Motors*).

- Some authority exists for the proposition that it is possible to carry out substantial repairs over time, provided they are not part of a wider reconstruction project (*Sherlaw*).

- No deduction is available for notional repairs (*Colonial Motors*).

Identification of the asset – specific dairy assets

Milking and other associated plant

It is possible to loosely group the various items of equipment and plant found inside a typical dairy shed into the following categories:

- ***"Milking plant"***: items of plant forming part of the milk extraction process; commencing with the cups placed on the cow and ending with the milk flowing from pipes into a storage vat for later collection. Included are items such as milking cups, clusters or claws (the items attached to the cow during milking), rubberware (including suction cups and hoses linking clusters to the milk lines or pipes), cup removers, stainless steel milk pipes or lines, other milk or air pipes, , vacuum pumps, pulsator units, the milk receiver/air intercepter, the milk pump, the milk filter, and the milk cooler.

- ***"Cleansing plant"***: items of plant for cleaning the milking plant by mixing water and detergents and pumping it through the plant. Included are items such as jetter washers, mixing bath, water pipes (stainless steel, ordinary steel or pvc), and the water pumps.

- ***"Wash down unit"***: items of plant for washing down the dairy shed surfaces and yards, including items such as a water pump, and pvc and steel piping.

- ***"Water heaters"***: one or more water heaters or cylinders for heating water for cleaning the milking plant, milk vat, etc.

- ***"Milk storage vats and associated plant"***: the vat into which the milk is pumped and stored until collected by the dairy company. This item is sometimes called a milk silo, milk storage tank or bulk milk tank. The vat has an attached refrigeration unit for keeping the milk cool and there may also be a vat washing unit. (In some, but not all cases, the vat is owned by the dairy company.)

The question then arises as to whether the above categories can be accepted as being separate assets or "entireties" for the purposes of considering the deductibility of expenditure incurred for items within these categories.

Milking plant

It is necessary to ask whether this satisfies the "entirety test" adopted in *Lindsay* and followed in New Zealand cases such as *Auckland Trotting Club*, *Auckland Gas Co*, *Hawkes Bay Power* and *Poverty Bay Electric Power*. That is, can it be said to be "a physical thing which satisfies a particular notion", not being a subsidiary part of anything else? Alternatively, do individually listed items that make up the milking plant category constitute separate assets, or entireties in their own right?

The "particular notion" in this case is the extraction of milk from the cows and its delivery to the storage vat to await collection. The plant satisfies this notion through its network of cups, pulsators, pumps, filter, milk cooler, and pipes.

Although consisting of a number of items or component parts, these parts are linked physically as one combined unit to extract milk from the cows. If one of the parts is removed, the unit cannot operate; each part is dependent on the others to perform its function, e.g. the releaser milk pump cannot operate without the milking cups, pulsators, vacuum pump or other parts of the milking unit. A part of the milking unit once removed cannot be used for any useful purpose other than in another milking unit. The conclusion to be drawn from this is that the milking unit network operates as a *physical thing* or single unit rather than as a number of separate stand-alone assets.

However, it is necessary to go a step further and consider if those items included in the milking plant constitute the "entirety" of the asset, or whether they are a component part of some larger asset. It might for example be argued that part of the milking process is the cleansing of the milking unit that is undertaken during each milking. In this connection, consideration has been given to whether the cleansing of the milking unit and the items of plant that carry it out (referred to above as "cleansing plant") can be separated from the core "milk extraction" plant, i.e. are they two or more separate assets or one "entirety"?

The cleansing of the milking unit is clearly a regular and integrated part of each milking. It is a fundamental hygiene requirement. As soon as milking of the dairy herd is completed, the milking unit is put through a cleansing cycle of flushing the milking unit with a succession of cold water, hot water and detergents and a final sanitising rinse. Many of the items that make up the two categories are either closely located or physically joined. For example, the water pipes through which the water and cleaning agents are pumped usually run alongside the milk pipes and other items of the milking unit in the milking area. They are suspended from or attached to the same framework or part of the shed structure.

Usually, the jetter washers (items of the cleansing unit) are the outlet for the water and detergents, and during the wash cycle the milking cups are attached to them. The cleansing agents are then sucked through the milking unit in the same way as the milk, but diverted immediately before reaching the milk storage vat.

It is accepted that some items of the cleansing unit, such as the mixing bath where hot and cold water and detergents are mixed for the wash cycle, and the water pumps that pump the water and detergents into the milking unit for the wash cycle, are not as closely linked physically to the milking unit. However, on balance:

- what is involved in each complete milking from a detailed process point of view; and
- the way in which the milk extraction and milking unit cleansing items are linked physically;

- the various items as a whole can be accepted as constituting "a physical thing which satisfies a particular notion".

In identifying the relevant asset or groups of assets within the dairy shed, it is necessary to also consider whether the milking plant can be said to be a "physical thing", that is an "entirety by itself" and not a "subsidiary part" of anything else. To some extent this has already been addressed, as it has already been concluded that the items that make up the milk extraction unit should not on their own be regarded as a "single physical thing". Rather they, along with the items making up the cleansing unit, are component parts that together form the physical asset: the milking plant. The milk extraction and cleansing units are subsidiary units of the milking plant and are linked both physically, and from the milking process point of view, to form an "entirety".

Having reached this view, it is necessary to consider whether this asset is a subsidiary part of anything else. In doing this we must consider the other items usually found in the dairy shed, i.e. the wash down unit; the water heaters; and the milk storage vats and associated plant.

As seen above, ascertaining whether a part of a wider asset is itself a separate physical thing or simply a component of the wider asset, includes considering: whether it is physically and functionally distinct from the wider setting, its relative size and value to the whole (is it "a principal capital item?"), its ability to be relocated elsewhere, and the process of the business in which the part is used. It may also be relevant to establish whether the part is itself a separate item of plant or equipment distinguishable from the surrounding premises.

The *wash down unit* is for washing down the dairy shed surfaces and yards and is not linked physically to the milking plant proper, although it is also situated in the dairy shed. The unit also performs an entirely different function from that of the milking plant, i.e. to clean the surrounding surfaces, rather than extract milk. It can also be relocated and used for other cleaning purposes. Given these factors, the wash down unit is a separate item of plant or equipment distinguishable from both the milking plant and the dairy shed setting.

The one or more *water heaters* heat the water for cleaning not only the milking unit but also the milk vat, and other plant. They may often be situated adjacent to some of the cleansing unit, and typically pipes run from the heaters to parts of the cleansing unit. However, pipes can also lead from the water heaters to other items of plant, and the hot water may be used to clean other plant. The heaters are therefore not regarded as part of the cleansing unit: they are capable of being operated on their own and are stand-alone assets. They are not dependent on the milking plant for their operation and could be shifted and used in any operation requiring hot water. In addition, the milking plant could operate without the hot water heaters by only using a cold water

wash cycle, albeit less effectively. Therefore, the water heaters are separate items of plant distinguishable from both the milking plant and the dairy shed setting.

The *milk storage vats and associated plant* simply store the milk arising from the milking process until its collection by tanker for delivery to the dairy factory. A vat is usually situated on an elevated platform or stand and located either in a "room" of the dairy shed separate from the rest of the dairy shed plant, or outside the dairy shed itself. Hygiene requirements may also dictate that the vat is sited separately from the milking plant.

From a process or functional viewpoint the vat is a storage asset, whereas the milking plant is involved in the extraction of the milk from the cows. A pipe may run from the milking plant to the vat to deliver the milk, but that does not mean the two units together form "a physical thing which satisfies a particular notion". The two pieces of plant have different roles to play, although they are interconnected. Compare with the various parts of the batching plant in *Case N8* (per Bathgate J at page 3,070):

> I consider the supervisor's office, the dispatch office and the control room, which were all housed in a separate and detached building from the ground bins, elevators and tower, to be a separate and distinct entity from the ground bins, elevators and tower plus its contents. The only connection between the two was the electrical wiring connections and the less tangible connections of electrical controls, administration and supervision from one to the other.

Or, similarly, the various aspects of the "network" in *Auckland Gas Co* as discussed by Gault J (at page 15,026):

> The fact that a particular physical thing realises its economic value only when used in conjunction with other "things" or business systems does not mean it is not to be regarded as a separate asset the replacement of which is on capital account.
> …
> Whether the network is of gas reticulation pipes, electricity wires, telephone lines or computer links it is in each case an assembly of physical things. That they all interlink does not mean that only the whole satisfies a particular notion any more than do all the elements of a production line in a factory.

Additionally, the fact that the vat is often owned separately by the dairy company – and presumably could be removed or replaced by that company – gives an indication that the milk vat is a separate asset to the milking plant.

These considerations indicate that the milk storage vat is a separate asset distinct from the milking plant and dairy shed setting.

Conclusion

The milking plant satisfies the "entirety test" adopted in *Lindsay* and followed in *Auckland Trotting Club*, *Auckland Gas Co*, *Poverty Bay Electric Power* and *Hawkes Bay Power*. "Milking plant" includes all items of plant commencing with the cups attached to the cow and ending with the pipe from which the milk flows into the storage vat, together with those items making up the milk extraction and cleansing units. The milking plant is capable of being considered an "entirety by itself" and not merely a "subsidiary part" of the entire collection of plant found in a dairy shed. These other items of plant, e.g. the wash down unit, water heaters, and the storage vats are separate plant performing distinct, albeit related, functions.

Rotary dairy shed milking platforms

Two main types of milking plant systems are the herringbone (the more conventional and cheaper) and the rotary. The latter is less common and more expensive, at least in terms of the initial set-up costs, but more efficient in that a platform system can handle and milk a larger number of cows more quickly. Here we look at whether the "rotary platform" and its associated machinery, is a single, stand-alone asset or part of the wider dairy shed complex.

Rotary platforms come in two types:

- Floating platforms, where the circular platform takes up virtually the entire area of the milking enclosure inside the dairy shed and floats on water. The whole platform, on which the cows and the operator stand during the milking process, constantly revolves during the milking cycle. Cows walk on to the platform through an entrance off the holding yard, to take the place vacated by the last milked cow that has left the platform at the exit race. The platform usually consists of a reinforced concrete pad, into which the blue galvanised steel pipe work used to enclose and separate the cows is set. The platform is rotated by an electric motor powering a rubber wheel, that in turn is in contact with the platform.

- Conventional rotary herringbone platforms, where the platform consists only of an area on which the cows stand, while the operator stands in a pit in the open centre. Here, the platform and cows rotate around the operator during the milking process with the cows walking on and off through entry and exit points. The platform, generally made of high quality specially treated plate steel, rests on a series of rollers, with the pipe work (to enclose and separate the cows) welded or bolted to it. The platform is rotated by an electric motor usually driving (through belts and drive chains) two large drive wheels, making contact with steel railings on the underside of the platform.

In deciding whether the rotary platform and associated machinery are distinct from, or part of, the dairy shed complex, both types of rotary platform are considered to be essentially the same.

It will always be a question of fact, degree, and impression as to what is included or excluded in an entity or asset. It may also be relevant to ascertain whether the part is itself a separate item of plant or equipment which is distinguishable from the surrounding premises. This issue arose when the Court in *Auckland Trotting* considered whether the track lighting system formed part of the track or was a separate asset in its own right. The Court there concluded that it was separate (at page 979):

Alternatively, Mr Barker submitted that the entirety of the "premises" comprises not only the race track itself but also the running rail and the floodlight standards. I am quite prepared to treat the running rail as an integral part of the track. Its inclusion would not influence the ultimate decision of this case one way or the other. As to the floodlight standards, there is not a great deal of evidence. It does appear that these floodlight standards were originally installed in 1958 at a cost of between £40,000 and £50,000. They were moved to their present positions during the year ended June 1960 at a cost of

£5,000. This is virtually all the information available to the Court. I infer that the floodlight standards are of considerable size and are erected at intervals in positions adjacent to the track itself. In these circumstances I am not satisfied that the floodlight standards should be regarded as forming a component part of "premises" which also include the track. Their cost and probable size suggest to my mind that as a matter of fact and degree they should be treated as a distinct and separate capital asset in the nature of plant or equipment. The mere fact that their purpose is to render the track useable as a night trotting track is not in itself sufficient to justify their inclusion along with the track as one entirety, for the same argument could be advanced in relation to various other buildings (such as stables) whose purpose is also ancillary to the use of the track, but which nevertheless are separate and distinct physical entities. Moller J. has held, on the evidence before him, that the physical thing which satisfies the notion of "premises" is the race track itself and "not any larger thing or aggregation of things of which it may be suggested to form part". I see no basis on which this Court should interfere with that finding…

From this it would appear to be relevant, in trying to distinguish items from the general premises, to take account of:

- their physical position
- whether they are integral to, or form a component part of, the premises (e.g. in the sense of a track rail to a track)
- their movability
- their size
- their relative value.

Conversely, the fact that an item's function may be necessary in the use of the wider premises, does not in itself mean the item forms part of those wider premises – it may still be a distinct capital asset in the nature of plant or equipment.

This issue is analogous to one considered by the Australian courts, i.e. the distinction between premises and plant for depreciation purposes under sections 53 and 54 of the former Australian Income Tax Assessment Act 1936, in dealing with deductibility of repairs and depreciation. [Note: This Act has been replaced by the completely rewritten Income Tax Assessment Act 1997: refer sections 25-10 and 42-15 respectively.] Under these provisions, only "plant or articles" were depreciable property. This wording resulted in a body of Australian case law discussing the difference between "plant or articles" and "premises" (premises not being referred to in section 54(1)), and drawing on earlier UK decisions, e.g. *Waratah Gypsum Pty. Ltd. v FCT* (1965) 9 ATR 570; *Broken Hill Proprietary Co. Ltd. v FCT* (1968) 10 ATR 481; *J. Lyons & Co. Ltd. v Attorney-General* [1944] 1 All ER 477; *Jarrold v John Good & Sons Ltd.* (1963) 40 TC 681; *Moreton Central Sugar Mill Company Limited v CT* (1967) 116 CLR 151; *Wangaratta Woollen Mills Ltd v FCT* (1969) 119 CLR 1; and *IRC v Barclay, Curle & Co Ltd* [1969] 1 All ER 732.

From these cases it is possible to see that plant is generally distinct from the surroundings in which it is used by virtue of being:

- a fixture, implement, chattel, or piece of machinery or apparatus that is actually used in the taxpayer's business in the sense of being part of some process

- something that is not merely part of the general setting in which a part of those operations is carried on.

A building or structure might be part of a taxpayer's plant, but only where it is more than simply providing shelter or housing working equipment – it must play a part in the manufacturing or other processes of the taxpayer. It must be more than simply a static and permanent feature of the place in which a business may be carried on, having no other function than to provide a convenient stand for the performing of work in the business. In general, to form part of a taxpayer's plant a building or structure must have some active role in the business, although not necessarily active in terms of having moving parts.

These principles are not dissimilar to those previously set out as regards the identification of entireties or assets in the context of R&M issues.

Taking the above into account, and looking at a typical dairy shed complex, it seems clear that the dairy shed is the "setting" or "premises" where the milking operations are carried out, and is not itself bound up with the plant or equipment used inside the shed (c.f. the approach taken in *Barclay, Curle & Co Ltd* as regards the concrete sides of the dry dock). A dairy shed typically consists of walls on some or all sides of the milking area to protect the milking equipment, operator, and cows from the elements during the milking process. The dairy shed is the "passive setting" for the milking process to be conducted within, and merely performs a "shelter" function. The dairy shed structure does not play an active part in the manufacturing (milking) process (as, for example, the dyehouse did in *Wangaratta*), but instead provides a protective cover for the plant, operators, and cows. It could be compared to the building cladding in *Wangaratta* which the court described (at page 11) as doing nothing more than exclude the elements. On this basis, the dairy shed structure is not "plant" but merely the "setting" for the milking process.

The next question is whether the rotary platform is also part of the "setting", or whether it is a separate asset in its own right. Having regard to the part the rotary platform plays in the milking process, it satisfies the definition of "plant" used by the above cases, i.e. machinery or fixtures used in carrying on an industrial process. The platform performs a positive function in the taxpayer's pursuits and is not merely a passive setting for those activities. The platform holds the cows in the position necessary for them to be milked, and is an integral part of the milking process: its rotation can be halted and the rate of rotation varied according to the needs of the process. If it were unable to rotate, the milking process could not operate.

The situation is somewhat analogous to the dry dock in the *Barclay* decision which was treated as being plant and not merely a building or structure. The dry dock in that case was a land based dock adjacent to a waterway and was formed by excavating a large "basin", lined with concrete. The dry dock was used to hold the ship in place while inspections and repairs were carried out (c.f. the finding in *Moreton Central Sugar Co* that a pit in the ground designed for servicing locomotives was not part of the taxpayer's plant).

Also, a rotary platform is a physical thing satisfying a particular notion (*Lindsay*). The "particular notion" is the holding and positioning of cows for milking during the milk extraction cycle. In addition, it is possible to remove a platform and relocate it, giving weight to the concept of the separateness of the platform from its surroundings.

As noted above, a rotary platform consists of both a platform and a drive mechanism and associated equipment. Given this, it might be suggested that the platform is a separate asset from the drive mechanism, etc. However, the more logical approach is to view them as one physical thing which satisfies a particular notion. This is because of the close proximity of the two items – they are physically linked by the drive wheels – and the fact that the platform cannot perform any function without the motor that drives it. The drive mechanism is an integral part of the rotary platform, as opposed to simply being another item used in conjunction with it – as is the milking plant. In this way, the rotary platform might be compared with assets such as a lift or escalator in a commercial building, a chair lift on a ski field, or a baggage handling conveyor at an airport. These other assets with their respective drive motors and mechanisms are each treated as one complete asset and not separated into lift compartment (or chair) and lift motor, escalator "steps" and drive mechanism, or conveyor and drive mechanism.

The rotary platform does not form part of, and is distinct from, the milking plant and the other equipment within the dairy shed. Although, the platform has some physical links to certain parts of the milking plant, it does so only to provide structural support for those items of plant.

Conclusion

The rotary milking platform is a separate asset from the dairy shed complex, the "premises" or "setting" where the milking operation is conducted, and is distinct from other pieces of equipment used in the milking process, e.g. the milking plant. The drive machinery forms a subsidiary and integral part of the platform and is therefore part of the larger asset. The milking platform (including its drive mechanism, etc.) is a physical thing forming a particular notion, i.e. the rotation of cows to assist in their efficient milking. It is physically distinct from both the dairy shed in which it is housed and from the equipment used to actually milk the cows. This conclusion is supported by the fact that platforms may be removed and sold as a single asset. It is also a significant item when compared with the other equipment used in a rotary milking operation.

Dairy shed, yard and surrounds

It has been concluded that the milking plant (including the cleansing unit) is a separate, single asset. The same applies to a number of other items used in the milking process, i.e. the wash down unit, water heaters, milk storage vats. It has also been concluded that the rotary platform and associated drive mechanism together form a separate asset. As these assets comprise essentially all the equipment used in the dairy shed, it follows that the balance is the dairy shed itself. In line with the authorities which considered the distinction between premises and plant, the dairy shed may be viewed as being the "setting" in which the milking operation is conducted, rather than part of the process itself. The dairy shed provides shelter, and houses the milking plant and other equipment used in the milking process.

It is acknowledged that for a herringbone system it might be argued that the dairy shed, in the sense of the barriers which are set in the concrete floor of the shed and formed in a herringbone shape to hold the cows ready for milking, has an "active"

role in the milking process. But even if this were correct, which might render the dairy shed "plant", this does not change the conclusion that it is a separate asset from the milking plant and other equipment. The distinction between setting and plant is useful in terms of drawing a distinction between different aspects of a taxpayer's business operation. However, it does not necessarily follow that where the setting is found to be plant it is indistinguishable from other items of plant.

Having determined that the dairy shed is a separate asset, issues then arise in identifying exactly what makes up the dairy shed complex. In particular, as to whether the concrete base of the shed and surrounding yards, and the pipe work railings generally used to enclose the yard which adjoins the shed, form part of the "dairy shed" or are separate items in their own right.

This is particularly important because it has been suggested that:

- the concrete is "hardstanding": listed as a depreciable land improvement in its own right by virtue of the definition of "depreciable property" and Schedule 16, and

- the pipe work railing surrounds of the yard are fences, in terms of section DO 3, or section DO 4 (and Schedule 7).

Is the dairy shed yard part of the dairy shed or a separate asset?

Initially, it is necessary to look at the layout and construction of a typical dairy shed complex. The dairy shed yard (sometimes called the "milking" or "holding" yard) is the enclosed area attached to the dairy shed, and extends beyond the entrance and exit of the bails of the shed where the cows are held before and after milking. The base of the yard is usually a concrete pad. The yard is generally bounded by galvanised steel piping uprights which are embedded into the concrete at intervals with either piping rails, or a top piping rail and stranded heavy gauge wire at lower levels. The piping rails and stranded wire link the uprights to form the barrier to contain the cows within the yard. There is usually a gate where the cows enter the yard from the stock race to keep them in the yard. As well, or instead, there may be a moving or revolving gate that keeps the cows moving towards the front of the yard and entrance into the shed proper. The revolving gate (usually found in circular yards) can also be used to keep two herds sharing the same shed separate. The gates are usually made of piping similar to the yard surrounds. Water pressure or a small electric motor operates the moving gates. In some dairy sheds instead of a moving gate, an overhead set of wires that carry a small electric charge are lowered behind the last cows, moving them forward by an electric-powered pulley system.

In the case of a herringbone shed, the concrete pad and piping barriers usually continue uninterrupted from the yard into and through the shed proper to form the base of the shed, the bails for holding the cows, and the outlet at the other end. With the rotary shed, the pad and piping while also usually continuing into the shed itself, generally have a natural break at the edge of the revolving platform.

It has been concluded that the dairy shed forms the "setting" or "premises" for the milking operations. The dairy shed yard is similarly part of the setting for the milking

operations. However, although part of the setting, it does not automatically follow that the yard is part of the dairy shed premises, with the shed and yard together constituting one single asset. To be so regarded, the yard must be an integral part of the dairy shed "premises" or an "entirety" with it and not a separate asset. Based on the reasoning in *Lindsay*, the dairy shed yard and dairy shed must be together "a physical thing which satisfies a particular notion".

Generally, the dairy shed yard adjoins the dairy shed. As already outlined, usually the concrete pad forms both the surface of the yard and the floor of the shed. Even with rotary sheds the concrete pad also forms part of the base or support for the rotary platform. Similarly, the piping barriers usually continue from the yard, through the shed, to also form the bails for holding the cows, and the outlet at the other end. Their uprights are set into the concrete base of both the yard and shed, except for the rotary shed where the piping making up the bails is attached to the rotary platform. Many sheds, particularly of the herringbone type, have several open sides, giving rise to even less of a division between the shed and the yard.

Therefore, the "particular notion" satisfied by the shed and yard is the provision of the setting for the milking operation. In other words the dairy shed complex, i.e. the shed and surrounding yards, is the premises where milking takes place, enclosing the cows and plant necessarily involved in that process.

With the rotary shed, the integrated nature of the yard and shed proper is arguably less clear because the platform forms the base on which the cows stand for milking – rather than the floor of the shed. However, the floor of the shed also forms a support for the platform, again suggesting that the yard and shed form one asset.

Further support for the conclusion that the yards form part of the dairy shed complex is found in the Dairy Industry Regulations 1990 that define a "farm dairy" as:

(a) Means a dairy where milking animals are milked; and

(b) Subject to paragraph (c) of this definition, includes -

> (i) Any stockyard, milking yard, stable, stall, or shed associated with a farm dairy; and
>
> (ii) Any dairy associated with a farm dairy where milk extracted in the farm dairy is collected, filtered, deposited, separated, cooled, or stored, or treated or stabilised to prepare for transport; but

(c) Does not include a place (not being a dairy where milking animals are milked) where milk is processed, or treated, otherwise than by being collected, filtered, separated, stirred, or cooled, or treated or stabilised to prepare for transport:

Stock races

A further point is whether it is possible to distinguish the dairy shed and its yard from its surroundings; in particular the races leading to and from the complex. The stock race is the track or path along which the cows walk from the paddocks to the dairy shed (and vice versa), ending at the entrance to the dairy shed holding yard. This race may run for some considerable distance through the farm and/or along farm road

frontages. It is designed to confine the herd during its daily treks to and from the dairy shed, and prevent undue damage to pastures.

The race may be constructed of a variety of materials. The surface is often shingle, although other materials such as compacted crushed limestone or pumice rock may be used. Part of the race near the dairy shed yard entrance or exit may occasionally have a concrete surface. The race is bordered on either side by a fence that is generally of post and wire construction.

The point at which the race ends and the dairy shed yard begins is fairly easily to see. This division exists not only physically but also in terms of functionality. The race is a form of road or path used for the herd to walk to and from the dairy shed complex. On the other hand, the dairy shed complex including the yard is the actual setting for milking.

The generally used construction materials and the purpose of the race distinguish it from the dairy shed complex. Although the race may be part of the general setting for dairy farming, this does not make it part of the actual milking operation. Its function can be compared with that of a forestry company road for transporting logs to the sawmill. Such a road is a separate asset from the sawmill and mill yard itself. It is adjacent to, rather than an integral part of, any other assets which together make up the wider premises. Similarly, this might be likened to the racing track that formed a separate asset within the wider racing complex in *Auckland Trotting* or the taxpayer's premises in *Case N8*, of which the concrete-making batching plant formed only part.

Is the yard or any part of it "hardstanding" in terms of Schedule 16?

Under section EG 1(1), a taxpayer is allowed a deduction in an income year for any depreciable property owned by the taxpayer at any time during an income year.

"Depreciable property" is defined in section OB 1 as:

in relation to any taxpayer, -

(a) Means any property of that taxpayer which might reasonably be expected in normal circumstances to decline in value while used or available for use by persons -

(i) In deriving gross income; or

(ii) In carrying on a business for the purpose of deriving gross income; but

(b) Does not include -

…

(ii) Land (**excluding buildings and other fixtures and such improvements as are listed in Schedule 16**): …

(vi) Property the cost of which is allowed as a deduction under any of sections BD 2(1)(b)(i) and (ii), DJ 6, DJ 11, DL 6, DM 1, **DO 3**, DO 6, DO 7, DZ 1, DZ 3, EO 5, EZ 5, and EZ 6, **or by virtue of an amortisation or other similar deduction allowed under any section of this Act such as sections** DJ 9, DL 2, **DO 4**, DO 5, and EO 2, other than sections EG 1 to EG 15 and section EG 18:

…

(viii) Property the cost of which was or is allowed as a deduction in any income year to any other taxpayer under any of sections **DO 3**, DZ 2, DZ 3 and DZ 4 of this Act (or any of sections 127, 127A and **128** of the Income Tax Act 1976 or sections 119, 119D and 119G of the Land and Income Tax Act 1954): (*Emphasis added*)

In this way depreciation is expressly not permitted for land (because land, as such, does not depreciate: see *Case G11* (1985) 7 NZTC 1,035). However, certain land improvements listed in Schedule 16 are depreciable. In addition, certain land improvement/development expenditure incurred in respect of farming, agriculture, aquaculture or forestry is deductible under the various amortisation provisions, including section DO 4. Land improvements qualifying for depreciation listed in Schedule 16 include "hardstanding".

The schedule of economic depreciation rates set out in Determination 1: "Tax Depreciation Rates General Determination Number 1" (see Appendix to Tax Information Bulletin Vol. Four, No. 9, April 1993, pp. 26–104) lists the basic economic depreciation rates for all depreciable property. Hardstanding is included in the "buildings and structures" section as having an estimated useful life of 50 years and DV rate of 4% or SL rate of 3%.

No definition of "hardstanding" is provided in the Act. *The Shorter Oxford English Dictionary* (Clarendon Press, Oxford, 1993) includes the following definition:

n. 1 **hard standing** an area of hard material for a vehicle to stand on when not in use.

It is understood that the rationale behind the reference to hardstanding in Schedule 16 was to provide for areas described as hardstanding within certain industry groups – such areas essentially being concrete or bitumen based "pads" on the ground, e.g. wharf tarmac, car pads, etc. The focus was on non-farming industries, but the intention was not to exclude hardstanding where it arose in a farming context, provided that a deduction was not available elsewhere under the Act, e.g. section DO 4. (This approach is borne out to some extent by an example included in TIB Vol. Five, No. 12 (May 1994) regarding the distinction between the "amortisation provisions" for farming, agriculture, forestry, etc., (including the precursor to section DO 4) and the general depreciation regime.)

Hardstanding is referred to in passing in *Case N8* in the context of the various valuations of the premises (to determine if there had been an increase in capital value) undertaken by the parties:

The Z plant including the batching controls had a replacement cost value of $1,142,500 and an indemnity value as at that date of $1,087,200. For insurance purposes Mr A valued the Z plant at 31 March 1988, at $1,000,000. In exhibit 3 he estimated the total replacement cost of the Z plant at $1,918,000. That excludes siteworks, drainage, hardstanding and building permit.

Areas around a farm may generally be thought of as being hardstanding in the sense that they have been made firm (usually by concreting) to prevent animals or vehicles from creating a "bog". Such areas might include parts or all of certain farm roads and tracks, areas adjacent to yards or farmhouses.

However, these do not include the concrete base of a dairy shed yard. In the usual case there is no demarcation between the concrete base of the dairy shed and the

concrete base of the adjoining yard. In addition, the pipe work is embedded in the concrete base of the yard and typically continues seamlessly inside the shed. It is also reasonable to assume that the concrete for the entire complex was laid at the same time that the shed was erected. The better view is that the yard, including its concrete base, is part of the dairy shed complex. Two further supporting reasons for this view are:

- the items listed in Schedule 16 are generally all "free-standing" assets, not usually situated immediately adjacent to, or as closely associated with, a building or buildings in the way the yard is in this case, e.g. bores and wells, bridges, culverts, dams, fences, reservoirs, retaining walls, roads, spillways, swimming pools, tanks, and tunnels. (Chimneys are perhaps the only item in the list more likely to be connected to a building. However, given that the Schedule is designed to include items which would otherwise be excluded from the regime as fixtures adhered to land, the better view is that the reference to chimneys is intended to cover free-standing, rather than integrated, chimneys such as those used in businesses involving the use of furnaces.)

- feeding platforms and feeding yards are separately referred to in Part A of Schedule 7 that relates to section DO 4. These platforms and yards often comprise concrete bases. It is reasonable to assume that these bases would not be dealt with separately under the general depreciation regime, suggesting that the base is an integral part of the yard, to be dealt with along with the yard. By analogy, the same reasoning applies to the concrete base of a dairy shed yard.

Are pipe railings part of the dairy shed yard?

Typically, in a dairy shed complex the yard adjoins the dairy shed and the concrete pad forms both the surface of the yard and the floor of the shed. The piping barriers are usually continuous, and have their uprights set into the concrete base of both the yard and shed. Inside a rotary shed the piping is attached to the rotary platform.

In *Auckland Trotting*, the Court of Appeal considered whether the rails forming the sides of the replaced track were an integral part of the track: concluding that they were. This was distinct from the lighting system that was merely adjacent to the track: a logical distinction as the track could not function as a running track without the rails to contain the horses. The lighting system, however, performed a wholly separate function – principally to provide for night racing. The sides of the yards are considered similar to the rails of the racing track – they form an integral part of the yarding system, whose function is to contain the cows before milking. A yard would not serve its purpose without that feature.

Whether items associated with a building were part of the building setting, or a separate item such as plant, was considered in *Case 101* (1964) 11 CTBR (N.S.) 587. In that case the Board, in relation to pipeline connections of a bakery building to a water supply, said (at page 603):

Rather are such things commonly regarded as part of the "setting" of a building - being such things so much appurtenant or incident to a building *simply as a building* that they cannot appropriately be described as "plant". … They are, I think, fairly described as an integral part of a building *as premises* from which, without disintegration or disconnection (sic) they are inseparable.

In the case of the dairy shed it can be argued that the pipe work surrounds of the yard and the pipe work bails are so much "appurtenant" to the dairy shed building as to be an integral part of it. They are inseparable from the yard. To remove them would require breaking up the concrete securing them into the yard. This suggests that they are not a separate asset but part of the yard, i.e. the pipe railings are lodged into and form an integral part of the function of the yard.

Similarly, in *Barclay* a majority of the House of Lords were satisfied that the sides of the dry dock, along with the associated machinery for winching etc., formed one asset. The majority were not satisfied that the two constituents of the dry dock facility could be separately treated.

In addition, in some situations the pipe work railings may extend into the dairy shed, providing even stronger support for the conclusion that the railings are part of the cowshed complex.

Are the pipe railings fences?

It has been suggested that the pipe work railings surrounding the dairy shed yard are "fences", for the purposes of sections DO 3 or DO 4. If the pipe work is accepted as being a fence for the purposes of section DO 3, all expenditure on fences is fully deductible and there is no need to consider the capital/revenue tests. If not a fence, those tests are still applicable.

Section DO 3 states:

Any taxpayer who in any income year is engaged in any farming or agricultural business on any land in New Zealand shall be allowed a deduction of the amount of any expenditure incurred by the taxpayer in that year, being expenditure that is not deductible otherwise than under this section or under section DO 4, in –

…

(g) The construction on the land of fences for agricultural purposes, including the purchase of wire or wire netting for the purpose of making new or existing fences rabbit proof.

Section DO 4 allows a deduction, on an annual depreciated basis, for expenditure incurred on certain land improvements specified in Part A of Schedule 7:

(1) Any taxpayer who carries on any farming or agricultural business on any land owned by that taxpayer in New Zealand shall in any income year other than the income year in which that taxpayer sells or otherwise disposes of that land, be allowed a deduction in respect of any expenditure of any of the kinds specified in Part A of Schedule 7 incurred by the taxpayer or by any other taxpayer in preparing or otherwise developing that land, and being expenditure which is of benefit to the business in that income year.

Item 13 of Part A of Schedule 7 states:

1. The construction on the land of fences, including the purchase of wire or wire netting for the purpose of making new or existing fences rabbit proof.

Schedule 7 sets out the percentage of diminished value of expenditure allowed as a deduction: the percentage stipulated for item 13 is 10%. Schedule 7 also refers to:

15. The construction on the land of feeding platforms, feeding yards, plunge sheep dips, or self-feeding ensilage pits.

No definition of the word "fence" is provided in the Act. The same phrase as appears in section DO 3, and Schedule 7, is used in section DZ 2 dealing with expenditure on land used for forestry purposes, and DZ 3 dealing with certain farming and agricultural expenditure for the 1990-1991 income year and earlier (it includes some items in section DO 3 and some additional items). "Fences" are also referred to in section DZ 4 which deals with expenditure incurred by persons engaged in aquaculture in the 1990-1991 income year or earlier.

The *Oxford English Dictionary* (2nd ed., 1992) includes the following definition:

Fence n…**5.** a. An enclosure or barrier (e.g. a hedge, wall, railing, palisade, etc.) along the boundary of a field, park, yard or any place which it is desired to defend from intruders. sunk fence: one placed along the bottom of a depression in the ground; sometimes applied to a ditch. Often preceded by a qualifying word, as: gun-, pale-, quick-, ring-, snake-, wire-, etc. fence, for which see those words.

The *Concise Oxford Dictionary* (9th ed., 1995) states:

Fence n. **1** a barrier or railing or other upright structure enclosing an area of ground, esp to prevent or control access.

Black's Law Dictionary (6th ed., 1990) states:

Fence: A hedge, structure, or partition, erected for the purpose of enclosing a piece of land or to divide a piece of land into distinct portions, or to separate two contiguous estates. An enclosure about a field or other space, or about any object; especially an enclosing structure of wood, iron or other materials, intended to prevent intrusion from without or straying from within.

Halsbury's Laws of England states:

Although fences are frequently used to mark the situation of boundaries, none the less they are primarily guards against intrusion, or barriers to prevent persons or animals straying out, and therefore in this sense the term includes not only hedges, banks, and walls but also ditches.

The *Fencing Act 1978* includes the following definitions:

"Fence" means a fence, whether or not continuous or extending along the whole boundary separating the lands of adjoining occupiers; and includes all gates, culverts, and channels that are part of or are incidental to a fence; and also includes any natural or artificial watercourse or live fence, or any ditch or channel or raised ground that serves as a dividing fence:

"Adequate fence" means a fence that, as to its nature, condition, and state of repair, is reasonably satisfactory for the purpose that it serves or is intended to serve:

The *Fencing of Swimming Pools Act 1987* states:

"Fence" means a fence that complies with the requirements of the [building code in force under the Building Act 1991 in respect of swimming pools subject to this Act;] and includes any part of a building and any gates or doors forming part of the fence; and "fenced" has a corresponding meaning:

The *Impounding Act 1955* states:

"Fence" means an adequate fence within the meaning of the Fencing Act 1978; and "fenced land" means land enclosed within such a fence:

The nature of "fences" has been considered by the courts. In the old case of *Ellis v Arnison* (1822) 1 B&C 70, 107 ER 27 the Court considered whether a ditch was a fence according to an Inclosure Act. The Court held that they could not "say that a ditch may not be in legal construction a fence". In argument it was stated that the "strict definition of the term 'fence' means nothing more than a sufficient guard to fend or keep off, or shut out." (pp. 27, 28). In *Nussey v Provincial Bill Posting Company and Eddison* [1909] 1 Ch 734, the Court held unanimously that the erection of a permanent advertising hoarding along the boundary of the plaintiff's premises was a fence in breach of the relevant fencing covenant.

In *Urban Housing Co v Oxford City Council* [1940] 1 Ch 70, the Court rejected (at page 81) the proposition that "the phrase 'fence or other enclosure'" would not include a wall.

However, in *Lahey v Hartford Fire Insurance Co* [1968] 1 OR 727 the opposite was found. That case involved a claim on a fire insurance policy for damage caused to a retaining wall after a fire in a nearby building. The insurance policy covered buildings that included fixtures, fences, and garden improvements. The Court held that the wall was not a fence as the parties when entering into the insurance policy had meant fence to mean "a structure which encloses wholly or partially some piece of property so as to impede ingress or egress. It may be composed of anything so long as it creates a line of obstacle serving this purpose." (at page 728) The wall was not a fence according to this definition, but rather "a retaining wall to prevent the subsidence of 654 into 656." (at page 729.)

From the above it would appear that the ordinary meaning of "fence" is very broad and essentially involves:

- Any enclosure, barrier, railing or other upright structure (including a hedge, wall, palisade, or ditch) situated along the boundary of a field, park, yard, or any place, especially designed to divide a piece of land or an area into distinct portions and/or to prevent or control access; that is, such a structure intended to prevent intrusion from without or straying from within. It appears that it may be made of any material, e.g. wood, iron, or other materials, as long as it creates a line of obstacle serving this purpose.

As the pipe work railings surrounding a dairy shed yard could be described as a "barrier or railing situated along the boundary of a yard designed to prevent straying from within", it is acknowledged that the pipe work railings are fences in the broad sense of that word. However, because "fence" has such an expansive ordinary meaning, it is necessary to consider the legislative background to the enactment of the precursors to sections DO 3 and DO 4 to determine whether it is reasonable to conclude that Parliament intended such a broad meaning to apply.

The background to sections DO 3 and DO 4 can be traced back to the 1950s and legislation designed to provide incentives to the farming industry. The provision for the deduction of certain development expenditure was first mentioned in the 1950 Budget. It was noted there:

As an incentive to increased primary production and a direct encouragement to the development of farm land the Government proposes that certain developmental expenditure be allowed as a deduction for taxation purposes. Under this provision expenditure such as the cost of clearing scrub, weeds, and other growth detrimental to the land and also the cost of cultivating and seeding additional pastures may be claimed as a deduction.

The Government will also make provision to enable farmers actively engaged in farming to claim as a deduction for taxation **an amount not exceeding £200** in any income year for expenditure incurred in such items as draining, **making fences rabbit-proof**, access tracks, earthen dams, repairing flood or erosion damage, and constructing landing strips to facilitate aerial top dressing. (*Emphasis added*)

These proposals were included in the Land and Income Tax Amendment (No. 2) Act 1950. Section 9 of that Act read:

9.(1) Notwithstanding anything to the contrary in section eighty of the principal Act, any taxpayer engaged in any farming or agricultural business on any land in New Zealand shall, in calculating the assessable income derived by him from that business in any income year be entitled to deduct -

…

(b) Any expenditure incurred in that business during the income year, and not deductible otherwise than under this section, in-

…

(vii) The construction on the land of fences, including the purchase of wire or wire netting for the purpose of making new or existing fences rabbit proof ...

There were two parts to this section – the first part gave a complete deduction for certain expenditure, the second gave a deduction up to £200 – fences were included in the second part.

The *Hansard* reports of the second reading to the bill state:

Clause 9 gives effect to another proposal in the Budget with regard to the allowance to taxpayers who are primary producers, of certain **developmental expenditure** as a deduction for income-tax purposes…Some of that expenditure would be deductible in the ordinary course as a recurring expense, but when **land is newly acquired or is being broken in for a farm** the existing law would regard such expenditure as being of a capital nature and not deductible. The underlying idea of this clause is to give **encouragement to the development of second-class land**, with consequent increase in production. (*Emphasis added*)

Prior to 1963, the upper limit of £200 for fencing and other developmental expenditure had been increased to £400. In the 1963 Budget it was noted:

Our best prospect of expanding agricultural production in the immediate future is to increase expenditure on the development of existing farms….farm investment and other development expenditure have fallen…To reverse this trend and to lay the foundations for continued growth of output, expenditure which will raise the productive capacity of our farms must be stimulated.

Tax Incentives for Farm Development

It has been decided therefore to treat all types of farm development expenditure that may be charged against income for tax purposes on a more liberal basis…

The present limit of £400 in respect of expenditure on fencing, drainage, irrigation, and similar projects will be abolished for three years….The limit of £400, which was necessarily arbitrary, has tended to restrain **development of the all-important marginal hill country** which often requires large expenditure to bring it to full production. (*Emphasis added*)

In this way the deduction limit of £400 was abolished, initially for three years but subsequently regularly extended.

Nothing further happened in this area until 1986. In that year the precursor to section DO4 (section 128A) was first inserted into the Income Tax Act 1976 by the Income Tax Amendment Act (No. 4) 1986, and applied from 1 April 1987. The policy behind the introduction of this section is noted in *Hansard*:

Taxation Reform Bill (No. 2), Introduction. Minister of Finance.

Clauses 6, 12,13, and 15 deal with farm development expenditure and forestry taxation. The current deduction allowable for farming and forestry development expenditure is to be phased out and replaced with a new depreciation regime on land improvements.

Taxation Reform Bill (No. 2), second reading. Minister of Finance.

Part I of the Bill also deals with the phase-out of farm development expenditure. It will be replaced by a new depreciation scheme, thus providing the same treatment of farm assets that is allowed to assets in other sectors. The Bill introduces a neutral tax system that will enable farmers to get on with the business of farming and make investments for the real reasons, without being attracted by the subsidies and concessional tax provisions that distort the tax base and force up costs and land values.

At the same time as section 128A was introduced, section 127 (now section DO3) was amended so as to phase out farm development expenditure deductions by April 1991. However, this action was reversed by the Tax Reform Bill (No. 3) 1990. [Note: The Tax Reform (No. 3) Bill was introduced in December 1990 and taken through the House in 1991 during which time it appears to have been referred to as the Tax Reform Bill 1991.] Although reversing the decision to completely phase out deductions for development expenditure, the Government was also keen to reduce the various incentives and deductions previously available to the primary production sector. In the context of the deduction for fencing, the intention seems to have been to reinstate a full deduction, but only when the fencing was for the purposes of subdividing land. The document "*Introductory Copy: Tax Reform Bill 1991*" included the following statements:

Clause 21 amends section 127 [now section DO 3] of the Act to allow full deductibility of certain types of expenditure incurred on land used for farming and agricultural purposes, such as…the fencing of land for the purpose of dividing use of the land.

The amending clause read:

21 Certain expenditure on land used for farming or agricultural purposes -….

(A1) Any taxpayer engaged in any farming or agricultural business on any land in New Zealand shall, in calculating the assessable income derived from that business in the income year

commencing on the 1st day of April 1991 or in any subsequent year, be entitled to a deduction of the amount of any expenditure incurred by the taxpayer in that year, being expenditure that is not deductible otherwise than under this section or under section 128A of this Act, in-

…

(f) The fencing of the land for the purpose of dividing the use of that land.

In December 1990 the Minister of Revenue had said in his introductory speech:

Clause 21 will provide immediate deductibility for expenditure incurred on…**the fencing of land for subdivision**. Under the present legislation, from 1 April 1991 those items of expenditure would have been required to be capitalised and written down by way of depreciation in accordance with the thirteenth schedule to the Act. (*Emphasis added*)

The Report to Finance and Expenditure Select Committee on Submissions on the Taxation Reform Bill (No. 3) noted that the following submissions had been made in relation to clause 21:

(n) As the manifesto proposal that the fencing of land for subdivision, or as in the legislation "the dividing the use of that land" is not clear so should just read fencing.

(o) To provide that all fencing of land should be deductible, such as holding paddocks and boundary fencing as the phrase fencing for "dividing the use of the land" is unclear.

The report commented that:

(n) and (o): It is agreed that the fencing deduction provision is not clear. It is recommended that the provision be clarified by referring to the construction of a fence thus excluding temporary fencing such as electric fences. However the issue of subdividing the land cause most concern. **It is not clear whether this includes boundary fences dividing land between farms, only new fences dividing existing paddocks, whether divided paddocks must be put to different uses, or whether replacing an existing fence with a new one will satisfy the provision.** It is considered that the problem can best be addressed by amending paragraph (f) to-

"(f) The construction on the land of fences". (*Emphasis added*)

The report went on to recommend:

(b) that all construction on the land of fences should be deductible as the current proposal of only fences subdividing the use of land is unworkable

During the Bill's second reading, the Minister of Revenue discussed the issues raised by the submissions:

The proposed amended section 127 in clause 13 implements a National Party policy commitment to allow immediate deductibility for certain development expenditure on farms….There is a problem in that it is hard to make a distinction between capital and revenue. **When a farmer puts up a fence it could be a new fence, the replacement of an existing fence, or, it could be a considerable improvement on what was there before, in which case part of it could be regarded as capital. But that distinction is completely impractical to make in the real world and for that reason we have decided to allow it to be completely deductible.** (*Emphasis* added)

In the third reading the Minister of Revenue clarified that "genuinely capital" expenditure would continue to be treated as such:

Changes were made to the categories of development expenditure. In practice those are causing considerable problems, which result from the difficulty in so many cases of making a distinction between capital expense and revenue expense. That was not clear under the old rules, and this rule should clarify the matter once and for all. Items that are genuinely capital expenditure, **such as sheep-yards and covers**, frames for crops, and so on, will continue to be treated as they were under the old Act. (*Emphasis added*)

Section 127 as enacted read:

(A1) Any taxpayer engaged in any farming or agricultural business on any land in New Zealand shall, in calculating the assessable income derived from that business in the income year commencing on the 1st day of April 1991 or in any subsequent year, be entitled to a deduction of the amount of any expenditure incurred by the taxpayer in that year, being expenditure that is not deductible otherwise than under this section or under section 128A of this Act, in -
…
(g) The construction on the land of fences for agricultural purposes, including the purchase of wire or wire netting for the purpose of making new or existing fences rabbit-proof.

Notwithstanding these amendments to section 127, section 128A (now section DO 4) continued to provide depreciable rates for certain types of land improvements, including fencing. This was to ensure that taxpayers who had moved to treating certain land improvements under that provision, rather than under section 127, could continue to do so. It was also because section 127 was narrower than section 128A – the former only referring to fencing for agricultural purposes.
The wording of section 127 as regards fencing was not altered with the enactment of the Income Tax Act 1994.

From this background it is considered that the original intention behind the precursors to section DO 3 and DO 4 was to promote the development of unutilised and/or unproductive ("second-class") farming land. The flavour of the *Hansard* and Budget statement comments from 1950 is that of opening up pastoral land, e.g. clearing scrub, weeds, cultivating and seeding, draining, access tracks, earthen dams, repairing flood or erosion damage, and constructing landing strips for top dressing aircraft, so as to develop newly acquired or unbroken land. This culminated in legislation that referred to "the construction on the land of fences, including the purchase of wire or wire netting for the purpose of making new or existing fences rabbit proof". Arguably, the reference to "on the land" tends to confirm this focus on opening up and developing grazing land, rather than simply any development of farming land. The reference to rabbit-proofing new or existing fences also indicates a focus on fences used for dividing open land. Arguably, the 1963 Budget Statement comments also focus on "development" of land with references to breaking in marginal hill country.

However, by 1991 it appears that the legislation had broadened to permit deductions for certain capital costs involved in farming, with the emphasis not necessarily being on the development of new or difficult land. The government of the day's aim seems to have been on limiting deductions for fencing to those relating to subdividing land, but this proved to be too difficult a task and wording almost identical to that used in the past was enacted. However, it does not appear that the problem was seen as being a choice between giving deductions for a broad range of barriers that farmers had treated as being fences, and conventional fences, but rather the types of conventional fencing to include, i.e. only those which divided paddocks versus other fences such as boundary and

holding paddock fences. Again, although far from conclusive, the focus seems to have been on fences used to surround open land. Arguably, this is borne out to some degree by the comments made about "sheep yards", apparently thought of as a distinct matter, and the fact that Schedule 13 at the time separately referred to "feeding platforms" and "feeding yards".

As discussed, "fences" is not defined and has a common meaning potentially wide enough to encompass the pipe work. However, on balance the better view is that it does not apply here for the following reasons:

- The reference to "construction on the land" tends to suggest that Parliament had conventional fencing in mind, i.e. free-standing fences made of wood and wire used principally as paddock boundaries. This is supported by the legislative history of the provision, and particularly the early focus on open land development. It is also supported by the reference to rabbit-proofing – something which would be generally unnecessary in the context of a concrete based yard such as a milking shed yard – involving wire and wire netting.

- This view is supported to some extent by exactly the same wording being used in section DZ 2 in the context of forestry, where it might be reasonable to expect that fencing would be of the conventional type, and not involve yards of any description.

- That Parliament did not have yards as such in mind, i.e. that it did not view them in some way as being a collection of fences, is also apparent from the 1991 *Hansard* references to sheep yards, and the fact that Schedule 7 and its precursors all refer separately to feeding yards.

- There is also the practical difficulty of isolating expenditure on the pipe work from the general costs of constructing a milking shed. It seems unreasonable to assume that Parliament meant for farmers to separate the cost of the pipe work from the total (depreciable) cost of the dairy shed complex, especially where, as seen, such pipe work may run inside the shed and/or form a part of the infra-structure by supporting the milking machinery.

The yard will also comprise any gates (including the backing gate) forming part of the pipe work structure. The motorised drive unit for the backing gate is also part of the yard. The cost of replacing the motor unit with one of the same capacity will be on revenue account. This is because the motor unit is only a minor part of the total dairy shed complex.

Conclusion

The dairy shed complex (building and yard) is the asset. The concrete base of the yard and supporting pipe work including bails and rails and any gates, are part of and are integral to the overall complex. The cost of their construction should be capitalised to the cost of the shed.
The dairy shed complex is distinct from the stock races. The race generally abuts the dairy shed yard, but serves a distinct function: to provide a hardened track along which the cows walk to and from the dairy shed.

It is not accepted that the concrete base of the dairy shed yard is hardstanding, and thereby separately depreciable. The better view is that the reference to hardstanding in Schedule 16 is to free-standing concreted or other hardened areas used for standing animals or vehicles. In this situation the concrete base of the yard forms an integral part of that yard: itself part of the dairy shed complex. This is consistent with the treatment of concrete-based feeding platforms and yards, which are classed as complete assets rather than in-part consisting of hardstanding.

Separate expensing for the pipe work, bails and rails, in terms of section DO 3, is not available. Although it is accepted that the word "fence" has a wide ordinary meaning, it is necessary to take into account the context in which the word is used in the legislation, the nature of a dairy shed, views expressed in cases regarding the integrated nature or entirety of assets, and the legislative background. Given these considerations, on balance, the pipe work forms part of the dairy shed asset itself and is not a "fence" under section DO 3 or section DO 4.

Undergrounding electricity reticulation to dairy sheds

In the late 1980s as part of the electricity supply industry reforms, ownership of most electricity supply lines running from the pole on farmers' and other landowners' road boundaries to farm buildings, passed to the landowners at no cost. Since that time farmers have generally been responsible for all costs of: maintaining the lines on their property, installing any new lines or extending existing lines, and/or placing the lines underground.

This category of expenditure therefore relates to the electricity reticulation system running from the edge of a farmer's property to, among other buildings, the dairy shed. The issue is whether this system can be seen as being a separately identifiable asset or entirety in its own right, or if in this context it forms part of the dairy shed or other farm buildings.

As discussed, in identifying an asset it is important to identify "a physical thing which satisfies a particular notion." The focus is on a "physical thing", rather than the operational significance or the economic value of the subject matter. The fact that a particular physical thing realises its economic value only when used in conjunction with other "things" or business systems, does not mean it is not to be regarded as a separate asset the replacement of which is on capital account. It will always be a question of fact, degree, and impression as to what is included or excluded in an entity or asset. The focus is, however, on finding a significant physical asset that will either function by itself or is clearly divisible in size or function from other assets that make up the premises or business of the taxpayer.

An electricity reticulation system situated on a farmer's land is a distinct physical thing satisfying a particular notion, i.e. the supply of electricity to the farm. Although the lines, whether underground or overground, will be joined to the dairy shed (and other buildings), they do not form an integral part of those buildings in the way that the yard or pipe work does. The lines are both physically distinct from the building and perform a distinct function, i.e. the supply of electricity. The authorities show that the fact that the reticulation system only realises its economic value when used in

conjunction with other assets, does not mean that it is not a separate asset in its own right. For example, Goddard J in *Hawkes Bay Power* rejected (at page 13,701) the taxpayer's argument that its total reticulation system constituted the relevant asset, rather than just the urban residential distribution system, because none of the constituent components of those systems could function alone. Part A of Schedule 7 also tends to confirm this approach, in that it lists the cost of erecting electric power lines or telephone lines as a separate item.

The fact that, until the electricity industry reforms, electricity lines from farm boundaries to farm buildings were the property of the local electrical supply authority is also indicative of the lines being a separate asset, not forming part of the dairy shed or any other building asset.

In *Case N8* the wiring between the batching plant and the administration sections of the premises were referred to: Bathgate J concluding that this "link" did not make the two assets one entirety. His Honour did not however comment on the status of the wiring itself, i.e. whether it stood alone or formed part of the two entities he had identified (at page 3,070):

> I consider the supervisor's office, the dispatch office and the control room, which were all housed in a separate and detached building from the ground bins, elevators and tower, to be a separate and distinct entity from the ground bins, elevators and tower plus its contents. The only connection between the two were **the electrical wiring connections** and the less tangible connections of electrical controls, administration and supervision from one to the other. (*Emphasis added*)

It is acknowledged that, depending on the particular configuration of a dairy farm's power reticulation system, it could be argued that the supply running from the edge of the farmer's property to the dairy shed is an asset distinguishable from the rest of the farm power supply system. This argument might be especially sustainable if in a particular case the supplies are independently metered or distinct in some other way, e.g. the land on which the dairy shed is situated is physically apart from land on which other buildings to which power is supplied are sited, or the needs of the dairy operation are so great as to demand a different system from that supplying the rest of the farm. However, usually the farm power reticulation system is one integrated "network".

Conclusion

The entire dairy farm electricity reticulation system is the asset to which expenditure on repairs or alterations is measured. The asset may possibly be the power supply to the dairy shed alone if this is distinct from the supply to the rest of the farm.

Summary of conclusions on identification of asset

It is considered that:

- The milk extraction and cleansing unit together form a single asset, i.e. the milking plant.

- The milking plant is capable of being considered an "entirety by itself" and not merely a "subsidiary part" of the entire collection of plant found in a dairy shed.

Other items of plant typically located in the dairy shed, e.g. the water heaters, storage vats and wash down units, are separate plant performing distinct, albeit related, functions.

- The rotary milking platform of a rotary milking system is a separate asset from the dairy shed building itself which is the "premises" or "setting" where the milking operation is conducted, and is also distinct from other pieces of equipment used in the milking process, e.g. the milking plant. The drive mechanism and motor form a subsidiary and integral part of the platform and should be treated as part of the entire asset, rather than as separate items.

- The dairy shed yard and the dairy shed itself, together constitute a single asset making up the dairy shed complex. The dairy shed complex is the "premises" or "setting" where the dairy farmer's milking operation is conducted, as distinct from the plant or equipment housed within it.

- The concrete base of the dairy shed yard should not be treated as separately depreciable. It forms an integral part of the dairy shed complex, in terms of function and physical proximity, and is not hardstanding for the purposes of Schedule 16.

- The pipe work railings surrounding the dairy shed yard (and any other barriers making up the dairy shed complex) are also an integral part of the dairy shed complex, i.e. the shed and/or the yard. They form the sides of the yard and/or the barriers within the shed for containing the cows while they are being milked. The pipe work, i.e. bails and rails, are not fences for the purposes of section DO 3.

- The stock race leading to the dairy shed complex does not form part of this asset, but is a separate asset, both physically and also in terms of the function it performs. The race generally abuts the dairy shed yard, but serves a distinct function: to provide a hardened track along which the cows walk to and from the dairy shed.

- A dairy farm electricity reticulation system is a separate asset as distinct from the milking shed or other farm buildings.

The capital/revenue distinction – specific assets

This part of the statement covers the treatment of expenditure on "repairs", maintenance, and renewals (adopting the same categories of assets as used in the previous "identification of the asset" section). Having identified the relevant asset, the aim is to ascertain the nature, extent, and cost of the work undertaken in relation to a particular asset and then determine whether the work has remedied fair wear and tear (deductible repairs), or whether that asset has been improved, altered, or so substantially changed that it amounts to a new asset (capital).

The assets so far identified usually consist of a number of individual items or parts, capable of experiencing differing levels of repairs and maintenance alone or in combination. Consequently, determining whether certain expenditure is deductible will always be a question of fact and degree, given the particular circumstances. The

borderline between a repair and an improvement of a capital nature may be difficult to determine. The test is essentially whether the act to be done is one that in substance is the renewal or replacement of defective parts, or the renewal or replacement of substantially the whole (*Wakely & Wheeler*).

Milking and other associated plant

It was concluded above that the "milking plant" includes all those items of plant commencing with the cups attached to the cow and ending with the pipe from which the milk flows into the storage vat, including the cleansing unit. It is possible to identify numerous items of expenditure arising in relation to the operation of milking plant. The following is a typical selection, addressing whether those items are deductible.

Minor items forming part of the milking plant

The milking plant consists of many integrated parts. A number of those parts are relatively small when compared with the entire plant, and are used in the overall operation in such a way that their repair or replacement is fairly frequent when compared with the repair or replacement of larger items. These parts include all the rubberware, the pvc/plastic pipe work used in the plant, the wash or mixing bath, and the jetter washers. Also included are minor fittings forming part of some of the larger items, e.g. the replacement of "O" rings in a pulsator, gaskets and other fittings forming part of the milk filter unit.

The replacement cost of these items will be on revenue account. The regular recurrence of the expenditure on such replacements, and the fact that it does not produce assets or advantages that are of an enduring benefit, point to the expenditure being revenue in nature.

Pulsators

These units operate a cyclical time delay in the vacuum fed to the milking cups that gives rise to the milking action. The cups are held in place on the cow's teats by a constant vacuum, but the vacuum itself will not extract the milk and a "squeezing" or pulsating action is necessary. Each pulsator unit generally services two sets of cups. Pulsators are either analogue (old technology) or electronic (new technology) and are largely maintenance-free. The most common repair involves replacing "O" rings, i.e. small circular gaskets.

The cost of replacing a full set of pulsators with a new set of the same type and capacity would be on revenue account and deductible. This is because a set, or all the sets of pulsators together, forms only a subsidiary part of the milking plant. The pulsators do not constitute a sufficiently significant part of the milking plant that their replacement could be regarded as a renewal, reconstruction, or replacement of the whole, or substantially the whole, of the plant. In that situation there has been no overall improvement to the milking plant or an increase in its capacity, i.e. no additional cows can be milked within a given time. The plant has simply been restored to its original function. The renewal of the pulsation unit by replacing the

pulsators with new ones has not necessarily extended the life of the milking plant as a whole.

Although expenditure on replacing all the pulsators would presumably be fairly infrequent (as they have a relatively long useful life), this could still not be described as being of a "once-and-for-all nature" producing assets or advantages of an enduring benefit. They are enduring to the extent that there will be a reduction in repairs and maintenance required in relation to the pulsators in succeeding years, but the same can be said of many repairs and maintenance expenditure items. This does not necessarily lead to the conclusion that the expenditure is on capital account. It cannot be said that the replacement of the pulsators with new ones of the same capacity whether of the same type or different models using the same technology, has done more than at most restore that part of the milking plant to its "as new" condition.

Conclusion

It is considered that the replacement of the pulsation units would be in substance the renewal or replacement of defective parts, rather than a renewal or replacement of substantially the whole (per *Wakely and Wheeler*). It is expenditure that does no more than restore an asset to an "as new" condition, rather than create a new asset. It is not considered that the replacement of all the pulsators at one time would involve significant reconstruction resulting in an operationally superior asset. Nor would it necessarily significantly increase the overall value of the milking plant.

However, the situation might be different if the replacement of the pulsation units formed part of a wider programme of replacement and/or upgrade (c.f. *Case N8* and *Sherlaw*). It would then be relevant to ascertain the taxpayer's underlying intention in undertaking the replacement (*Auckland Gas*; *Hawkes Bay Power*). However, a programme of replacement and/or upgrade will usually be distinct from a programme designed simply to maintain an asset in good working order over its useful life, e.g. a periodic replacement of worn and wearing rubberware to ensure that untimely and costly breakdowns do not occur).

Replacement of analogue pulsators with electronic pulsators

An issue arises as to whether the same conclusion holds if a farmer changes all the pulsation units with new technology, e.g. moving from an analogue system to electronic vacuum pulsators. The question then is whether the "upgrading" of the pulsator units is an extensive enough renewal of the milking plant asset when considered as a whole, to fall on capital account. It is worth noting here the following comments from *Wakely and Wheeler*:

The question of repair is in every case one of degree, and the test is whether the act to be done is one which in substance is the renewal or replacement of defective parts, or the renewal or replacement of substantially the whole.

In that case, the judge in discussing the difference between a repair and a renewal said (at page 923):

"Repair" and "renew" are not words expressive of a clear contrast. Repair always involves renewal; renewal of a part; of a subordinate part. A skylight leaks; repair is effected by hacking out the putties,

putting in new ones, and renewing the paint. A roof falls out of repair; the necessary work is to replace the decayed timbers by sound wood; to substitute sound tiles or slates for those which are cracked, broken, or missing; to make good the flashings, and the like. Part of a garden wall tumbles down; repair is effected by building it up again with new mortar, and, so far as necessary, new bricks or stone. **Repair is restoration by renewal or replacement of subsidiary parts of a whole. Renewal, as distinguished from repair, is reconstruction of the entirety, meaning by the entirety not necessarily the whole but substantially the whole subject-matter under discussion**. (*Emphasis added*)

In *Case N8* Bathgate J drew the distinction in these terms (page 3,073):

If a repair does not significantly improve the asset or make it different in kind by changing its character, and thus increase its value or extend its useful life, and does no more than restore it to its original condition, then that is more likely to be a deductible item of repair and maintenance. The expenditure would generally be deductible also if the expense is for an amount that is regularly incurred by reason of ordinary wear and tear, or the expense is small and subordinate in nature in relation to the whole value of the asset involved. On the other hand work resulting in a significant increase in value of the asset, a change in its character or kind, of an amount not regularly incurred, or substantial in amount in relation to the value of the asset prior to the work, may be more likely to be capital expenditure of the nature not allowed as a deduction…

The ready mixed concrete plant in *Case N8* provides some analogies with a milking plant, although on a much larger scale. Both are assets or *entireties* made up of a number of subsidiary units, each performing a function that is one step in an overall process. In *Case N8*, very few working parts of the concrete mixing process were untouched and not renewed or replaced to some extent. However, in the situation being considered here only the pulsators are being replaced, albeit with modern technology. The replacement is therefore not on the same scale in relation to the total entity, i.e. the milking plant.

Using the language in *Lurcott v Wakely and Wheeler*, the replacement of the pulsators in the milking plant seems to be the "renewal or replacement of subsidiary parts of a whole". It does not amount to "reconstruction of the entirety, meaning by the entirety not necessarily the whole, but substantially the whole subject-matter under discussion", i.e. the milking plant. However, against this is the change in the character of the milking plant brought about by the change from the old mechanical pulsation units to the new electronic units. In a number of R&M cases where individual parts of the larger asset have been replaced using more modern materials or technology, the expenditure has been held to be on revenue account and not an improvement of the asset. As Willy J said in *Case T43* (at page 8,292):

If the only way to effect a repair is to renew that part of the building – even extensive renewal as in *Conn v Robins Bros*, then the work remains a repair and not an improvement … The fact that the repair will continue the life of the building does not convert the expenditure into capital. Indeed that is the whole purpose of effecting the repairs.

In *Case T43* the TRA held that reasonably extensive "repairs" to a recently purchased commercial building were not an improvement. The repairs included replacing a leaking fibrolite roof with corrugated iron, replacing rotten sections of floor joists, and covering the partly rotten floorboards with a new covering of particle board. A dilapidated wall was re-clad and re-framed, and stormwater drains re-routed and renewed. The TRA decided the evidence established that as the work carried out was a repair to existing works and not the creation of a new work, it could then be

properly said that the building had been maintained in its original form by the repair work.

The *Robins Bros* decision, cited in *Case T43*, is one often referred to where the distinction between repairs and improvements is being considered. In that case, the company carried out extensive repairs to premises it leased (as the lessee). These included replacing the slate roof with an asbestos roof, replacing some roofing timbers, inserting steel girders to support the upper storey, replacing rotten floor boards with a concrete floor, and replacing shop windows with windows of a different type. The Court held the expenditure to be on revenue account, Buckley J commenting (at page 274):

> In the light of that circumstance it seems to me that this was expenditure incurred by the company with a view to enabling it to continue to earn profits from its business, not by acquiring some asset for that purpose but by putting the company's existing asset into a state of repair which would enable it to continue to use that asset. **No doubt in the course of carrying out these works certain structural alterations were made**, as one would expect with any extensive repair of a building over 400 years old, **when repairs were being carried out at a time when building techniques have completely altered**. But the fact that there were alterations in the structural details of the building does not seem to me to be a good ground for proceeding upon the basis that the work produced something new. On the contrary, I think it is implicit in the Commissioner's finding that the result of this work was not to produce something new but to repair something which had previously existed. Upon that basis it seems to me that there is no ground for regarding this expenditure as a capital expenditure. It was expenditure incurred for the purpose of enabling the company to continue to earn its profits, and was therefore in my judgment expenditure which would properly be chargeable to income. (*Emphasis added*)

These cases indicate that if the work undertaken affects only some parts of the entire asset and brings that asset back up to a fully functioning capacity, the work is more likely to be found to be of a revenue nature. It has also been accepted that replacement of a part with a more modern version, which may be more effective, does not necessarily mean the cost of the part is on capital account. The replacement of the pulsators has similarities with the position in *Robins Bros* in that the alterations to the milking plant are being made using new technology that was not available when the plant was first constructed. Although the change to an electronic system reflects an enhancement in terms of the advantages brought by new technology, it has not resulted in a change in capacity, i.e. throughput. In this regard the authorities show that an improvement in the level of anticipated future repairs does not equate to an upgrade of a capital nature, but merely reflects improved technology and the advantages that come from having a newer part.

Revenue treatment of the costs of replacing old parts with new using modern material is also supported by the decisions of *Morcom v Campbell-Johnson* [1956] 1 QB 106, 115 and *W Thomas & Co Pty Limited v FCT* (1965) 115 CLR 58. In *W Thomas & Co Pty* it was held by the Australian High Court that (at page 72):

> It may sometimes be convenient for some purposes to contrast a "repair" with a "replacement" or "renewal". But repairs to a whole are often made by the replacement of worn-out parts by new parts. Repair involves the restoration of a thing to a condition it formerly had without changing its character. But in the case of a thing considered from the point of view of its use as distinct from its appearance, it is restoration of efficiency in function rather than exact repetition of form or material that is significant.

Blanchard J expressed similar sentiments in *Auckland Gas Co* where he said in his conclusions on the capital/revenue question (at page 15,022):

If work of a maintenance character had been done on the joints and corroded sections of pipe had been replaced, the cost involved would certainly have been deductible, even if it was done according to a programme intended eventually to restore the whole of the low pressure part of the network to an "as new" condition, with the benefit being long lasting. …. (**We include in this the cost of replacement** of corroded sections **with** piping or **new jointing with greater resistance to corrosion and leak free because of new technology**. As Mr Farmer said, **the fact that the use of new technology will reduce future maintenance bills does not mean that the cost of the work must be charged to capital**.) (*Emphasis added*)

In the present situation the repair of the whole, the milking plant, is occurring by "replacement of worn-out parts by new parts" as discussed in *W Thomas & Co Pty*. Therefore, this involves "the restoration of a thing to a condition it formerly had without changing its character" because the milking plant still incorporates a pulsation unit with the same capacity. That is, in looking at the milking plant "from the point of view of its use as distinct from its appearance, it is restoration of efficiency in function rather than exact repetition of form or material that is significant".

It is understood that in some cases there may be some additional operational advantages with the new electronic units, e.g. the ability to record each cow's milk production. Where this occurs there may be a stronger argument that the new system is an improved one as compared to the old system. This will depend on the facts of the individual case.

Conclusion

Where analogue pulsation units are replaced by electronic pulsation units this will generally be on revenue account given that:

- such a replacement relates only to a subsidiary part of the entire asset, being the milking plant
- the electronic system does not increase capacity, i.e. throughput
- the reason for the change in the type of system is likely to be more of a reflection of changes in the relevant technology, than a desire to enhance the plant.

However, this may not be so if the replacement coincided with the replacement of other parts of the plant or some kind of general "upgrade". Seen together, the expenditure might be considered to be on capital account; as was the case in *Case N8*. It would not matter that the programme of upgrading occurred at one time, or over a period of years as in *Auckland Gas* (see Blanchard J's comments on p.15,024).

Stainless steel milk pipes

The steel milk pipes carry milk from the cup units through a releaser milk pump, filter, and cooler to the vat. Stainless steel pipes have an extremely long life and require little maintenance beyond the replacement of minor items such as rubber joints and joining hoses, (already considered above).

Given their long life, it is considered that the replacement of these pipes will only arise as part of a dairy shed complex being upgraded and therefore would be on capital account. The replacement of a damaged section of stainless steel pipe, in the

rare instances where that would be necessary, e.g. damage caused by a cow, is the same as that relating to the replacement of rubber hoses (considered above). Such expenditure on the pipes is probably not of a regular or recurring nature given its infrequency (although, arguably, the risk of such damage is a constant one directly related to daily operations). However, the part replaced would be so small in relation to the entire milking plant asset (or even the milk pipes themselves) as to be unlikely to give rise to an enduring benefit of any kind. Therefore, such expenditure will be on revenue account and be deductible as an ordinary business expense.

Milk filters

The milk filter consists of a stainless steel unit containing disposable gauze filters replaced at each milking. The stainless steel unit has an extremely long life and repairs are minimal.

The replacement of gauze filters is a revenue cost as an ordinary, on-going business expense. Some, generally larger sheds, may have two milk filters. The inclusion of an additional filter would seem to occur only for the reason of increasing the capacity of the milking plant and is likely to be accompanied by upgrading of other parts of the plant. Accordingly, the cost of introducing a further filter or filters is capital in nature.

Milk cooler

The milk cooler is made up of a series of thin metal plates with a honeycomb network through them, encased by heavy metal plates at each end bolted together. The cooler operates in a similar way to the cooling system of a car radiator with pressure-fed cold water passing through the veins of the unit to cool the milk as it passes through. Such units have a long life with little maintenance required, although servicing may be necessary from time to time. It is understood that servicing occurs fairly infrequently (approximately every five years) and is generally carried out by specialists who replace small fittings, e.g. gaskets, and resealing.

The cost of servicing a milk cooler, although infrequent, is a revenue expense, and that even if a new or reconditioned cooler of the same capacity were purchased, this would still be on revenue account. Although physically quite large, the cooler performs a relatively small part of the milking plant process, and its replacement would be no more than "renewal or replacement of subsidiary parts of a whole" (*Wakely and Wheeler*). However, in practice, as is the case with the milk filter unit, replacement is more likely to occur only as part of a general upgrade of some kind. In these circumstances the cost is likely to be on capital account (*Case N8*).

Milk receiver/Air intercepter

Both types of can are made of stainless steel and vary in size depending on the size of the milking operation. The milk receiver is the first collection point of milk taken from the herd. It fills to a certain level, before probes inside it (operating similar to a float system in a trough) trigger the releaser milk pump to pump the milk through the pipes to the milk filter and cooler. These cans are constructed for a long life, generally lasting the life of the shed. The see-through bolted on solid plastic covers at

one or both ends may deteriorate through exposure to UV rays. The cost of replacing these covers is low.

The replacement of the plastic covers is a revenue expense. Although, such expenditure may be infrequent, the part replaced would be so small in relation to the milking plant asset (or even the receiving cans themselves) that it would involve only "renewal or replacement of a subsidiary part" of the asset and would not amount to "reconstruction of the entirety" (*Wakely and Wheeler*).

Any replacement of the receiving cans as a whole would seem to be required only when there is a need to increase the capacity of the milking plant. For example, where the capacity of the shed itself has been increased because of the increased size of the herd. As such, replacement of the receiving cans is part of an expansion to the entirety of the milking plant and would generally be on capital account.

Pumps/electric motors

Milking plant usually includes at least three different types of pump, each with an associated electric motor. The three types of pump are:

- *Releaser milk pump*

The releaser milk pump is situated adjacent to the milk receiver and pumps milk from that reservoir through the pipes to the milk filter. It might generally be expected to have a useful life in excess of 10 years.

- *Vacuum pump*

This pump is usually situated in the milk receiving area of the shed. It provides the vacuum or suction through a series of air pipes/lines to the milking cups to remove the milk from the cow, and then draws the milk through pipes to the milk receiver. It would also be expected to have a useful life in excess of 10 years.

- *Plant wash water pump*

This pump forms part of the cleansing unit and is connected to the pipes from the wash bath. It is used for pumping the succession of cold water, hot water and detergents through the milking unit to cleanse it. Such pumps require little maintenance.

Replacement of a single pump

The replacement of a single pump will be on revenue account because:

- The expenditure restores the asset (the milking plant), both in function and form, to its original standard without improvement. Indicatively, this places the expenditure on revenue account. (If the pump had been replaced with one of an increased capacity, this could be said to result in a permanent improvement to the milking plant (*Rhodesia Railways* and *Highland Railway*) or an "upgrading" of the plant (*Auckland Gas Co*) and thus be on capital account.)

- No "new" asset has been acquired. The pump, although relatively expensive to replace, does not form a substantial enough portion of the milking plant for it to be said that its replacement "renews" the milking plant. Neither can it be said that the milking plant has been improved. The old pump has been replaced with a pump of exactly the same capacity. The "new" asset is to be assessed from the base of the "old" asset in good repair (per *Hodgins v Plunder & Pollak (Ireland) Ltd* [1957] IR 58).

Because it is rare for this type of component to require replacement, it might be argued that the payment has been made "once and for all for the enduring benefit of the taxpayer's trade" *(British Insulated and Helsby Cables Ltd v Atherton* [1926] AC 213; 10 TC 155, *BP Australia* et al), and the expenditure is therefore on capital account. However, because the pump is not a substantial enough component of the overall milking plant, it is considered that its replacement will not alone extend the life of the milking plant asset to any marked degree so as to give rise to an enduring benefit. However, the cost may be capital expenditure where, for example, replacement of a single pump:

- involves a new pump that is more powerful or offers some other superior performance level or feature; or

- occurs as part of a programme of more widespread renewal, upgrading, and/or extension of the milking plant (whether or not occurring at the same time).

Repairs/replacement of several items of milking plant

It was concluded above that the milking plant is one asset. However, that does not mean that replacing a component part of the milking plant will always be a repair and therefore revenue expenditure. The position becomes less clear when more than one component is replaced at, or near, the same time.

It is acknowledged that there are an infinite number of types and combinations of repairs and replacements that may occur to milking plant, and it is not possible to deal with them all. The only workable approach is to provide some examples and outline the principles to be applied and likely outcomes, so these can be used in considering other situations. Two examples are provided by way of illustration.

Example 1

Releaser milk pump replaced and vacuum pump repaired

The replacement of a single vacuum pump with a new pump was considered above. The following considers a case where two pumps fail within a short period.

The releaser milk pump is replaced with a new pump at a cost of approximately $7,000. The performance of the pump has gradually deteriorated throughout the previous season, but it has been possible to manage with lower milk volumes at that time. With an increase in milk volumes due in the new season, the farmer decides to replace the pump, although it could be repaired. Though the new releaser milk pump

is of the latest design, it offers no increase in capacity over that of the old pump when it was new. A month into the new season the vacuum pump fails. It would cost the farmer several thousand dollars to replace it with a new one. The farmer has a serviceman remove the vacuum pump and install a loan pump while the failed pump is repaired. The repairs will extend the pump's life by several years.

In applying the case law tests outlined earlier, the following comments can be made.

- As with the replacement of a single pump, although two pumps are involved the expenditure can be said to do no more than restore the asset (the milking plant), both in function and form, to, at most, its original standard without improvement. Indicatively, therefore, this places the expenditure on revenue account. The expenditure on the pumps has not resulted in any increased capacity that could be said to result in a permanent improvement to the milking plant.

- Arguably, no "new" asset has been acquired. Although expenditure on two pumps has been outlaid, the character of the milking plant has not changed (c.f. *Case N8* or *Highland Railway*). Although costly to replace, the releaser milk pump does not by itself form a substantial enough portion of the milking plant for it to be said that its replacement "renews" the milking plant. This remains so, even when that replacement is considered along with the repairs to the vacuum pump. There is no programme of systematic renewal or upgrading. The events were unconnected.

- It cannot be said that the milking plant has been improved beyond its original condition. The old releaser milk pump has been replaced with a pump of exactly the same capacity. The repairs to the vacuum pump have simply restored it to its usual condition, rather than extended its useful life. Indicatively, this places the expenditure on revenue account.

- As with the single pump scenario, because it is rare for both these components to require replacement or major repair, it is possible to argue that the payments have been made once and for all for the enduring benefit of the taxpayer's trade *(British Insulated and Helsby Cables Ltd*, *BP Australia*). It could be said that the expenditure should therefore be on capital account. However, the counter to this argument is the fact that the replacement of one pump and repair of the other are not substantial enough for it to be said that they will, by themselves, extend the life of the milking plant asset to any marked degree.

For these reasons, the cost of the replacement of one pump and the repair of the other would, in the particular circumstances outlined, be on revenue account.

Example 2

Replacement of vacuum and releaser milk pumps and pulsators

As in Example 1, a dairy farmer is in the position of having to replace a vacuum pump. However, the farmer would also like to replace a number of other items at the same time ie, the pulsators and uplift pump, although they are not causing major problems. As the dry season is approaching, the decision is made to replace all three

components while the plant is not being used. All are to be replaced with components of the same capacity.

As with the first example, the asset, against which the expenditure is to be measured, is the milking plant. Having decided that these components are part of a larger asset, it is then necessary to apply the case law tests against the expenditure incurred:

- Expenditure that does no more than restore an asset to an "as new" condition, rather than create a new asset, will be deductible whether this is done within one income year, or over a number of years. However, if expenditure is on renewal, replacement, or reconstruction of substantially the whole of an asset, this is more than a repair and is non-deductible. This applies even if the asset gives no greater performance and/or has no greater life span than that of the replaced asset. Here the vacuum pump, the uplift pump, and the pulsation units are being replaced. Together these items are largely responsible for the milk extraction process – suggesting that something more than repair is being undertaken – and together their replacement has the flavour of "reconstruction of substantially the whole" (*Wakely and Wheeler*).

- The renewal of major components, as opposed to their maintenance in a serviceable condition, can be indicative of the expenditure falling on capital account. An assessment has to be made of whether the work is of sufficient substance to place the expenditure on capital account. This will always be a question of fact and degree, and more difficult to determine in situations where the asset has not been improved in any way.

- In determining whether certain work comprising repairs and or replacements of a large number of component parts is capital or revenue in nature, it is important to ascertain the taxpayer's overall intention, i.e. to repair or to totally improve or reconstruct. Here the farmer chose to replace all of the items: the vacuum pump because it could not continue to be used; and the uplift pump and pulsation units because it was convenient to do so. It might be said that the farmer's intention was simply to keep the milking plant going by replacing items that had worn out or would require significant repairs, i.e. there was no concerted decision to "improve" or remodel the plant. However, conversely the replacements constitute such a significant part of the total plant that the decision to replace them at the same time suggests something more than an intention simply to repair (*Case N8*).

- Work resulting in a significant increase in value of the asset, a change in its character or kind, or involving an amount not regularly incurred, or substantial in relation to the value of the asset prior to the work, is more likely to be capital expenditure. In this case the new items will not give rise to a change in character or kind. However, it appears that the cost overall will be reasonably significant in relation to the whole. It might also be argued that the replacement of three items of equipment at the same time in this way is not in the nature of a recurrent expense.

- Authorities such as *Case N8* suggest that it may in the context of a total project be artificial to dissect the work into capital and revenue categories, or to further dissect a purported revenue category into capital and non-capital items. It is

necessary to look at the entire asset and see what existed before and after. In this example, before the expenditure the milking plant included one major item that was essentially unusable. After the replacements, the milking plant has largely been renewed through the replacement of three major items: the overall effect is one of renewal. Although part of the old milking plant asset remains, for all practical purposes the replacement of these critical components means that a largely "new" asset has been created.

- The farmer chose to replace the pulsators and uplift pump at the same time as the vacuum pump. Case law (*Colonial Motors*) makes it clear that there is no deduction available for notional repairs – the cost of replacement will be on capital account, although repairs on the existing part would have been revenue in nature.

The replacement of such a substantial portion of the milking plant would tend to, on the particular facts of this example, be on capital account. However, the result in this example would be different if the milk pump and pulsators were also in a poor state of repair and the farmer simply chose to wait until the dry season to effect repairs and/or replacement of these parts. The cases tend to indicate that where the taxpayer's intention is simply to maintain or replace defective items, even where this is carried out in one income year (or at the same time) this will not amount to a substantial change to the whole. The correct treatment will always be a question of fact and degree.

Upgrading the milking plant

A dairy operation may be upgraded, usually to increase production. For example, a 16 a-side herringbone shed is converted into a 20 a-side herringbone operation. This would usually involve extending the herringbone pit and shed roof, plus the addition of new sets of droppers and clusters. An upgrade would also occur if a herringbone operation were converted to a rotary system.

The extent of the cost of an upgrade appears to be a function of how compatible the old layout and equipment is to the new equipment, and the extent to which some of the existing plant may be incorporated into the new system, e.g. milk pipes and coolers having sufficient capacity to deal with increased volumes.

In all these situations the milking plant would be improved beyond its original state or condition. As such, and on the basis of the authorities (e.g. *Highland Railway*, *Case N8*) the cost would clearly fall on capital account. The payments would be made "once and for all for the enduring benefit of the taxpayer's trade" *(*e.g. *British Insulated and Helsby Cables Ltd* and *BP Australia*).

Other equipment situated in the dairy shed

It was concluded above that the milking plant is distinct from a number of other items of equipment possibly found in the dairy shed, e.g: the wash down unit; water heaters; milk storage vats; refrigeration unit; drenching system; plant wash down unit; yard wash down unit; and vat washing unit.

The repair and/or replacement of these items must be considered separately from the milking plant and the dairy shed. It is accepted that the cost of repairs to, or replacements of, subsidiary parts making up these assets will be revenue in nature (e.g. repairs to or replacement of sections of the water hose or pipes that form part of the wash-down unit). However, the complete replacement of such an asset (e.g. the water heater) with a new one would amount to the replacement of the entirety, i.e. a new asset, and the cost will be on capital account (*Wakely and Wheeler*).

Rotary platforms

It was earlier concluded that in a rotary dairy shed it is the rotary milking platform together with its associated drive mechanism and motor that is the asset satisfying the "entirety" test.

Repairs

The cost of any repairs to the rotary platform, drive mechanism or motor will be on revenue account, including the replacement of minor items, e.g. the hard rubber wheel that turns the platform, or the steel rollers on which a conventional steel platform rests.

Replacement of the platform

It is understood that replacement of the entire rotary platform is rare. It is most likely to occur only if a rotary cowshed is being expanded in size because of a significant increase in the size of the milking herd and the need to increase the milking plant capacity. The platform itself is by far the largest part of the rotary milking platform asset. Based on the authorities it is clear that its replacement would be on capital account, given that it would involve the reconstruction or renewal of substantially the whole of the rotary platform asset (*Wakely and Wheeler*, *Auckland Trotting Club, Lindsay* and *Case N8*). The platform is a significant and distinct part of the entire rotary system in terms of both sheer size and value.

This would apply whether or not the new replacement platform holds more cows than the old one. As held in a number of cases (e.g. *Case N8)* it is not necessary that there be an increase in the capacity of the asset over that which existed previously, if the replacement is so significant that it amounts to a substantial change to the entire asset. Seemingly, the position would also be unaffected by use of part or all of the old drive machinery to rotate the new platform (*Case N8*).

Replacement of the drive mechanism or motor

As seen, whether the expense of replacing a component part will be on capital or revenue account is always one of fact and degree. The test is whether the act to be done is one that in substance is the renewal or replacement of defective parts, or the renewal or replacement of substantially the whole (*Wakely & Wheeler*).

Case L68 concerned, *inter alia*, the deductibility of the cost of replacing a fishing vessel's engine. Deane J concluded that this cost was capital in nature. Although his Honour appears to have taken into account the terms of section 115 of the Income Tax

Act 1976, which expressly provided for depreciation of "expenditure of a capital nature" incurred in acquiring, installing, or extending any equipment or machinery that was to be used in a fishing boat, he also concluded that the cost of acquiring the engine was, according to ordinary principles, on capital account. His Honour noted (at page 1,401):

Whether expenditure is for "repairs or alterations", or is more substantial and capital in nature, appears to depend on the scale and significance of the work done, when related to the asset to which it occurs. The larger and more significant the work, relative to the whole, the more probable it is that capital expenditure is involved. Much then depends on the scale and significance of the totality against which the comparison is to be made. It may be an entire capital enterprise, or it may be some lesser part. Various measures have been adopted in the cases to decide whether it is one or the other. In *Samuel Jones and Co (Devondale) Limited v IR Commrs* (1951) 32 TC 513 the Scottish Court of Session made a physical, commercial, and functional analysis of the asset being repaired relative to the totality of assets. In the *Auckland Trotting Club* case the Court of Appeal did not accept that approach (at p 976), and deliberately took a more restricted perspective. The court adopted, at p 975, the method stated by Kitto J in *Lindsay v FC of T* (1961) 106 CLR 377 at p 384:

> "where the question is whether expenditure has been for repairs, and ... one asks what is the entirety which it is relevant to consider, one is looking not for a profit-earning structure or entity, as such, but for a physical thing which satisfies a particular notion."

The Court thought, at p 976, that one indicator might be whether the entity repaired or replaced was "a part perfectly clearly divisible from the rest"; and that the answer in each case must be one "essentially of fact and of degree" (adopting dicta of Findlay J in *Margrett v Lowestoft Water and Gas Co* (1935) 19 TC 481 at p 488).

Deane J went on to apply those principles to the deductibility of the cost of replacing the fishing boat engine:

When the work done on the two vessels in the present case is viewed from the perspective of that cumulative test, and that derived earlier from sec 115(1), the nature of the expenditure seems to be tolerably clear.

The motor of the "M", in my view, was, and is, capital plant. As the source of the vessel's motive power it was, and is, an essential, and relatively very substantial, aspect of the whole. Yet it was not, and is not, part of the fabric of the vessel. It could be detached from the vessel, independently traded as a commodity, and replaced, as indeed happened. The replacement also seems to me to have been capital in nature. It was an entire substitution, an order of magnitude greater than a repair, or maintenance. There may have been no improvement in function. Indeed the replacement motor was less powerful than the first. What seems more significant to me is that the life of the new motor was expected to be, and will be, much longer than could have been achieved by repair of the old motor.

Deane J concluded that the asset in question was the vessel, i.e. the engine was a part of that larger asset. He then appears to have taken three factors into account in determining whether the replacement of the engine was a capital or revenue expense, i.e. the importance of the part replaced to the operation of the whole; the size of the part as compared with the whole asset; and whether the part could be removed from the whole asset and independently traded.

Applying those factors in this case:

- The motor is clearly fundamentally important to the operation of the platform because it provides the power to turn the platform during milking. In this respect it seems directly analogous to an engine of a fishing vessel. However, conversely

it would be correct in the case of most parts of a wider asset that they are necessary to the overall functionality of the asset in question.

- The rotary platform itself is by far the largest part of the rotary system asset, i.e. the motor is a relatively small part of that asset. Deane J concluded that the engine of the vessel was "relatively substantial" as regards the whole boat. Apparently he did not require that the part under consideration should make up more than 50% of the total asset, or any other particular proportion, but that the asset must be of some reasonable size when compared to the overall size of the asset. A rotary motor is generally no bigger than one metre square, whereas a platform is at a minimum twenty metres in circumference. Therefore, in terms of sheer size, it is difficult to say that the motor makes up a relatively substantial part of the whole. In addition, the cost of replacing a rotary motor is small in comparison to the overall value of the rotary platform unit. Although, cost is not determinative of the issue, relative cost can be relevant.

- The third point considered by Deane J was whether the part could be removed and independently traded. The electric motor is detachable, and would be tradeable in its own right as it could be used for various purposes.

For these reasons it is considered that the replacement of the motor will generally be a revenue cost.

However, the installation of a more powerful electric motor in the drive machinery to replace the old motor would constitute an improvement in the rotary platform asset, and would clearly be on capital account (*Western Suburbs Cinemas* and *Highland Railways)*.

In practice, the replacement of the entire drive mechanism would be less likely to occur than replacement of the motor. It is more likely that the drive mechanism would be repaired over time with replacements of subsidiary parts. The cost of such repairs and replacement parts would be deductible. However, in the event that an entire drive mechanism was replaced, the cost would be capital in nature for the same reasons referred to above in respect of the platform. Furthermore, the drive mechanism forms a larger part of the entire rotary system asset than the motor, and is a more integrated part of the rest of the system, given that the drive mechanism is connected to the platform, whereas the motor essentially stands alone.

Dairy shed and yard

It has been concluded that the yard and dairy shed together constitute a single asset making up the dairy shed complex. The dairy shed complex is the "premises" or "setting" where the dairy farmer's milking operation is conducted and satisfies the "entirety test". Repairs and/or alterations relating to the dairy shed complex asset fall into three different broad situations:

Repairs to the complex resulting from fair wear and tear

The cost of such repairs will be on revenue account, e.g. repairs to: replace a section of wire or pipe work; straighten a bent pipe, or to fix the weld or bolts which may

have broken. The need or occasion calling for the expenditure will be the events arising from the daily operation of the dairy milking system. The payments do not give rise to an enduring benefit when compared to the entire complex.

Complete replacement of a damaged pipe work gate leading to or from the yard or shed will also be on revenue account. Such a replacement would be a replacement of a component part of an asset. In terms of the dairy shed complex, it would be a minor part, and would be far from "a reconstruction of the whole, or substantially the whole of the asset" (*Wakely and Wheeler* and *Auckland Trotting Club*).

Alterations to the shed and/or yard to extend it in size

It is relatively common for dairy farmers to extend their existing dairy shed, rather than to build a completely new one when they increase the size of their herd. In a herringbone system this can be done without major reconstruction of the existing shed by simply expanding the shed to hold an increased number of cows. Generally, this involves extending the existing base of the shed at one end including the central pit, extending the existing roof to cover it, adding additional bails, and adding to the milking plant according to the number of additional cows accommodated at each cycle by the extension.

As in relation to milking plant, this constitutes an improvement to the asset beyond its original state or condition. As such, and on the basis of cases such as *Highland Railway,* the cost would fall on capital account. It would give rise to an enduring benefit in terms of increased capacity, and would relate to the structure of the operation rather than the income earning process.

Alterations to the shed and/or yard to modify the herd flow

The deductibility of such costs will depend on the scale of the alterations, and will always be a question of fact and degree. If the changes made and costs involved are minimal, on the basis of the capital/revenue tests identified in *BP Australia*, such costs would be revenue in nature. The focus is on improving the daily efficiencies of the milking process, rather than changing the overall structure to give rise to an enduring benefit.

However, if changes are more substantial, e.g. the pipe work is completely dismantled and rearranged requiring relaying concrete to secure the new system, the cost involved would be capital in nature. In such a case the emphasis would have moved from simply improving the efficiency of the daily operation of the milking process (i.e. the income-earning process), to changing a part of the fixed assets which form the structure of the business. Whereas with minor alterations, perhaps made a number of times to reflect the changing needs of the daily operation, changes involving more substantial work are unlikely to be made on a recurring basis. Again, this is more suggestive of a capital expense, which should be added to the cost of the dairy shed structure and depreciated over time.

Undergrounding the electricity supply to cowsheds

Earlier it was concluded that the electricity supply lines leading to a dairy shed (and other farm buildings) are the asset against which expenditure on repairs or alterations is to be measured.

Ordinary "repairs" to overhead lines

This expenditure will commonly involve repairs to parts of the overhead line or lines that run from the road boundary to the dairy shed and other farm buildings, rather than renewal or replacement of the entire line. It will include, for example, mending or replacing individual power poles, cross-arms, stays, insulators, or wires where they have been damaged by storm or accident or have rotted or otherwise deteriorated over time.

These costs, which have come about through ordinary "wear and tear", will be on revenue account as they clearly satisfy the tests for deduction as an ordinary business expense. They are likely to be recurrent, and will give rise to no greater benefit than the continued efficient operation of the power reticulation system.

New, renewed, or extended overhead lines

Generally, cost will be on capital account if:

- an entirely new overhead line is run from the farm boundary to a new dairy shed, or an old line to an existing shed is replaced (and the old line is then pulled down); or
- an existing line is extended, e.g. from the site of an old to a new dairy shed.

In the first situation a "new" asset has been constructed. The cost of the new line should be capitalised (and "amortised" at 10% DV in line with clause 14 of Part A to the Seventh Schedule). If the asset (the old line) has been completely replaced or "renewed" and not "repaired", the cost should also be on capital account. This is consistent with the observations of Buckley LJ in *Wakely & Wheeler*:

"Repair" and "renew" are not words expressive of a clear contrast. Repair always involves renewal; renewal of a part; of a subordinate part. …. Repair is restoration by renewal or replacement of subsidiary parts of a whole. Renewal, as distinguished from repair, is reconstruction of the entirety, meaning by the entirety not necessarily the whole but substantially the whole subject matter under discussion.

(These words were quoted with approval in the decision of the Court of Appeal in *Auckland Trotting Club* among other cases.) This situation can be distinguished from cases such as *Sherlaw*, and similarly from *Conn v Robins Bros* where significant repairs were held to be on revenue account. In that case, although the repairs were extensive, sizeable parts of the old asset remained.

The extended power lines in the second situation constitute a "permanent improvement" in, or addition to, the asset. On the basis of principles established in cases such as *Lindsay* and *Highland Railways*, the cost of such an addition is not a repair and would fall on capital account. This is the position irrespective of whether the extended line results in the taxpayer deriving an increase in income (*Highland Railways*).

It is of relevance to note that Goddard J in *Hawkes Bay Power* warned (at page 13,705) against any suggestion that the replacement of old overhead lines with new overhead lines simply to restore the asset to its original condition would necessarily be on revenue account. In her view this was "too one-dimensional an approach" - the issue must always be one of scale and degree.

Replacing overhead lines with underground cables

Usually, overhead electricity lines are replaced with an underground cable in one of two situations:

- The overhead line is in a poor state of repair, e.g. partially rotted poles, and instead of replacing the poles or repairing a section of overhead line the farmer elects, or is required, to install underground cable.

- The existing overhead line is susceptible to storm or other damage, and the farmer replaces it with underground cable.

Where, for whatever reason, a farmer decides to replace the overhead line with an underground cable, on the basis of recent authority the cost will be on capital account. The "undergrounding" will involve the "reconstruction of the entirety" of the asset in question (the electricity supply line the farmer owns) and its replacement with a new and improved asset.

In *Poverty Bay Electric Power Board* the Court of Appeal confirmed the earlier High Court decision of Ellis J that the cost of undergrounding power lines was on capital account. Blanchard J noted at page 15,007:

…. we are satisfied that the work …. was intended to produce such a different and operationally superior asset for the Board that it is impossible to regard it as anything but a capital improvement. Nor is it possible to divide the work into capital and non-capital portions, for what was substituted underground was entirely new.

Reference has already been made to the characteristics of the underground cabling which make it different from and superior to overhead lines and led to the Judge's conclusion that the work was not repairs and maintenance.

In that case the overhead lines were replaced by new and significantly different underground cables. The replacements were physically larger, of greater capacity, and otherwise operationally more efficient. The Court of Appeal found that what was achieved went well beyond restoring the old lines to an "as new" state.

A similar result was reached in the earlier High Court decision in *Hawkes Bay Power*. Again, the court considered that the replacement of one asset with an entirely new asset would be on capital account.

It is considered that the principles applied in these cases apply equally to the situation of dairy farmers who, for whatever reason, place their electricity supply underground. On the findings of the cases, it would seem irrelevant to the capital/revenue issue whether farmers have chosen freely to convert from overhead to underground

systems, or have been in some way compelled to do so due to the attitude or actions of local authorities. In both cases, a new and different asset of enduring benefit to the farmer results, indicating that the expenditure is capital in nature.

Summary of conclusions reached on the application of capital/revenue principles to specific assets:

Milking plant

- The replacement of minor items forming part of the milking plant, e.g. rubberware, pvc piping, the wash or mixing bath, and the jetter washers will be on revenue account. The same applies to the replacement of minor fittings forming part of some of the larger items, e.g. the replacement of "O" rings in a pulsator, gaskets, and other fittings forming part of the milk filter unit.

- The replacement of one or all of the pulsator units will be on revenue account. The same situation arises when analogue pulsators are replaced with more modern technology in the form of an electronic system.

- Given the long life of the stainless steel pipe work which forms part of a milking plant, its total replacement is unlikely to occur other than as part of an upgrade of the plant and would therefore be on capital account. The cost of repairs to parts of the piping, including the replacement of sections of pipe due to wear and tear, will be on revenue account.

- The same approach applies to the milk filter, milk coolers, and the milk receiver/air intercepter, i.e. total replacement is unlikely to occur other than as part of an upgrade the cost of which would be on capital account. If an entire cooler should need replacing, other than as part of a general upgrade, the cost will be on revenue account. On-going servicing costs will also be deductible, as will the cost of replacing the gauze filters forming part of the milk filter unit. The same applies to the plastic covers used to cover the milk receiver and air intercepter.

- The replacement of a single pump (vacuum, milklift, or water pump) forming part of the milking plant will generally be on revenue account. This result would change if the replacement involves a more powerful pump or is made as part of a programme of widespread renewal, upgrading, and/or extension of the milking plant (whether or not occurring at the same time). These factors are all indicative of the expenses being on capital account.

- The situation is not as straightforward when a number of items forming part of the milking plant are replaced or repaired at, or about, the same time. By way of example, the cost of the replacement of one pump and the repair of the another will generally be on revenue account. However, the replacement of vacuum and milk pumps and the pulsator units would constitute a change to a substantial part of the milking plant and would be on capital account.

- Consistent with decisions such as *Case N8*, costs incurred for a general upgrade of a dairy shed complex, e.g. to increase capacity, will be on capital account.

- The replacement of other items of equipment situated in the dairy shed, e.g. the wash down unit; water heaters; milk storage vats; refrigeration unit; drenching system; plant wash down unit; yard wash down unit; and vat washing unit will be on capital account. The cost of repairs to these items will be deductible.

Rotary platform system

- The cost of repairs, not involving a replacement of the entire platform or motor/drive mechanism, will be on revenue account. Such repairs will mainly involve servicing the motor and drive mechanism. It is possible that the pipe work forming part of the platform may require minor repair work from time to time. In both cases the nature of the work reflects on-going maintenance requirements rather than a capital improvement.

- The cost of replacing the entire platform will be on capital account. Such a replacement would amount to a substantial change to the asset when viewed as a whole. The likelihood of replacing the platform, other than as part of a wider upgrade of the dairy operation, is minimal as platforms are anticipated to have a long, useful life.

- However, the electric motor that powers the platform may well need to be replaced over the life of the rotary system. It is considered that the cost of replacing the entire motor will be on revenue account. The replacement of the motor does not amount to a change to a substantial part of the whole. However, a replacement of the drive mechanism in its entirety will be on capital account, although it is presumed that this would be a less frequent event as the mechanism is comprised of a number of working parts that are more likely to be repaired and replaced individually over time. The on-going servicing costs of these items will be deductible.

Dairy shed and yards

- The cost of replacing or repairing a section of wire or pipe work will be deductible. The complete replacement of a damaged pipe work gate leading to or from the yard or shed will also be on revenue account, as will repairs to the concrete surface of the dairy shed yard.

- The cost of extending the size of an existing dairy shed constitutes an improvement and will be capital in nature.

- The ability to deduct the cost of alterations to the dairy shed complex to improve herd flow will be a matter of degree, i.e. minor changes will be deductible but more major alterations will be capital, e.g. if the pipe work is completely dismantled and rearranged, involving relaying concrete to secure the new system.

Undergrounding the electricity supply to cowsheds

- The cost of ordinary, on-going repairs to existing overhead power lines supplying power to the dairy complex will be deductible, e.g. replacing an individual pole,

whereas the cost of replacing an entire overhead system with new poles and wires or extending an existing line will generally not be deductible.

- Based on the decisions in *Poverty Bay Electric* and *Hawkes Bay Power*, the cost of replacing an overhead system with an underground system will be a capital expense.

Recently acquired plant

If a farmer has recently acquired a dairy farm, or secondhand milking plant or other equipment to incorporate into a dairy shed, deductibility may be affected as repairs to recently acquired assets are a special case. Repairs that may otherwise be deductible may be held to be on capital account when an asset has been acquired at a lower cost because of deferred maintenance.

The Law Shipping Co Ltd v IRC (1924) 22 TC 621 (Court of Session, Scotland) concerned the purchase of a ship in need of repair. At the time the vessel was acquired it was about to sail on a freight voyage and was due for a periodical survey to ascertain its seaworthiness. Following the survey the taxpayer upgraded the ship. It was considered that most of the repairs related to the condition of the ship at the time it was purchased. The Court held that the expenditure related to the defects in the vessel at the time it was acquired and was therefore capital in nature and non-deductible. The Court also concluded that had the repair work not been required, the purchase price would have been higher. The repairs were necessary to remedy an "inherited legacy of disrepair".

Law Shipping Co was considered by the New Zealand Supreme Court in a case on appeal from the High Court of the Cook Islands: *Collector of Inland Revenue, Cook Islands v AB Donald Limited* [1965] NZLR 679. The taxpayer had purchased an ocean-going vessel, and after a short period of trading carried out substantial repairs. The issue was whether the cost of those repairs was deductible.

Woodhouse J reversed the earlier decision. In his view the issue did not turn on whether the vessel could be operated immediately on purchase, but rather as to the cause of the need to repair – in this case this arose out of the operation of the vessel *prior* to acquisition by the taxpayer. Therefore, to the extent that the work remedied an inherited legacy of disrepair, or went beyond the restoration of wear and tear arising out of the taxpayer's own use of the vessel, the result was an improvement, and was just as much a part of the ship's establishment as a capital asset as the purchase price (at page 684).

Another decision on this issue is *Odeon Associated Theatres Limited v LJ Jones* [1972] 1 All ER 681. That case concerned the purchase of a chain of cinemas in a relatively poor state of repair after the Second World War. The Court found that the need for repair did not affect the price paid, as the cinemas were still a fully effective profit-earning asset. *Law Shipping* was distinguished on the basis that here the repairs were carried out over a ten-year period. Although it was true that a portion of the expenditure had been incurred shortly after the cinemas were acquired, the repair work did not affect the use of the cinemas. The cost of the repairs was held to be deductible.

These cases highlight the fact that the need for the repair work should arise out of the purchaser's, and not the vendor's, use of the relevant asset. If the purchase price paid for an asset is lower so as to take into account the need for immediate repair work, the cost of such repairs will be on capital account. If this were shown to be the case in the acquisition of a dairy farm, or secondhand milking plant or other equipment, the same principles would apply.

Comments on technical submissions received

Submissions were received on a number of the key issues addressed by this statement. These were fully considered, but not necessarily agreed with. Submissions received as regards the deductibility of the cost of replacing a rotary platform motor were taken into account resulting in the conclusion set out above that such an expense will be deductible.

A number of submissions were received in relation to Example 2. These submissions were given careful consideration and resulted in the example being modified to indicate a distinction between the situation where the taxpayer chooses to replace a significant portion of the entire asset where only some of the items are in need of repair, and one where a number of individual parts are in a poor state of repair necessitating repair or replacement and the taxpayer chooses to effect such work at one time because it is convenient to do so.

It will however, always be a question of fact and degree in a particular taxpayer's case, as to whether the facts show that the expenditure is more in the nature of on-going repairs, rather than a renewal of substantially the whole.