**INTERPRETATION STATEMENT: IS 12/03**

# INCOME TAX – DEDUCTIBILITY OF REPAIRS AND MAINTENANCE EXPENDITURE – GENERAL PRINCIPLES

All legislative references are to the Income Tax Act 2007 (the "ITA 2007") unless otherwise stated. Relevant legislative provisions are reproduced in the Appendix to this statement.

**Reader's guide:** This Interpretation Statement contains comprehensive analysis of the common law relating to the deductibility of repairs and maintenance expenditure. It is recognised that not all readers require this level of detail. To assist, the statement has been broken into parts with summaries and examples. In particular, the following may be helpful:

- The summary of general principles at paragraphs 1 to 27.
- The flowchart at paragraph 35, setting out how to approach resolving issues of deductibility of repairs and maintenance expenditure.
- "Key points" summaries at paragraphs 97 (identifying the asset being worked on), 175 (identifying the nature and extent of the work done) and 232 (other considerations from the repairs and maintenance cases).
- Examples illustrating the practical application of the principles discussed in each part. The examples immediately follow paragraph 49 (nexus) and each of the "key points" summaries at paragraphs 97, 175 and 232.

## Contents

## Summary

1. This Interpretation Statement considers the deductibility of costs incurred by a taxpayer to repair or maintain their property. The focus of this statement is on tangible property including real property. Expenditure incurred to make repairs or alterations or to maintain assets is commonly referred to as "repairs and maintenance expenditure". For ease of reference, this Interpretation Statement also uses this expression. However, in any individual situation within this statement the expression's use should not be taken as an indication that the Commissioner considers the costs to be of a revenue nature and deductible.

2. This Interpretation Statement restates the Commissioner's view of the general principles relating to the deductibility of repairs and maintenance expenditure. It updates and replaces the Commissioner's earlier statement on repairs and maintenance expenditure published in *Tax Information Bulletin* Vol 5, No 9 (February 1994). It also updates and replaces the following items that were published in *Tax Information Bulletin* Vol 7, No 6 (December 1995): "Rental property – deducting maintenance expenses while property vacant"; "Rental property – deductibility of renovation costs"; and "Rental property – deductibility of interior redecorations".

3. The Commissioner's view on the deductibility of repairs and maintenance expenditure has not changed in any substantial way since the 1994 statement.

4. A deduction for repairs and maintenance expenditure is allowed if the expenditure is deductible under the general permission in s DA 1(1), and if that expenditure is not excluded from deductibility by any of the general limitations in s DA 2. This Interpretation Statement is concerned with the capital limitation in s DA 2(1). The other general limitations (eg, the private limitation) are beyond the scope of this statement. This statement also does not consider any specific deduction provisions in Part D that override the application of the capital limitation for certain types of expenditure.

5. To qualify for a deduction under the general permission in s DA 1(1), the repairs and maintenance expenditure must be incurred in deriving assessable income and/or excluded income, or be incurred in the course of carrying on a business for the purpose of deriving assessable income and/or excluded income.

6. The capital limitation in s DA 2(1) denies a deduction for repairs and maintenance expenditure that satisfies the general permission but is capital in nature.

7. Capital expenditure is not deductible but will be subject to the normal depreciation rules in subpart EE. If those rules are satisfied, a depreciation loss will be available. Since the 2011-2012 income year, certain buildings and any improvements to those buildings have a 0% depreciation rate. The availability or otherwise of a depreciation loss is outside the scope of this Interpretation Statement.

8. The courts have developed a two-stage approach for determining whether repairs and maintenance expenditure is of a capital or revenue nature:

    - The first stage is to identify the relevant asset that is being repaired or worked on.

- The second stage is to consider the nature and extent of the work done to that asset (*Auckland Gas Co Ltd v CIR* (2000) 19 NZTC 15,702 (PC)).

9. However in adopting this two-stage approach, the courts are clear that in any particular situation determining whether repairs and maintenance expenditure is capital or revenue in nature depends on the specific facts. The courts favour the approach of Lord Pearce in *BP Australia Ltd v FCT* [1966] AC 224 at page 264. That is care must be used in applying the capital/revenue tests, and also in applying case authorities to different circumstances (*Auckland Gas* (PC)).

**First stage – identifying the relevant asset**

10. As a matter of common sense, in deciding whether the capital limitation applies to any repairs and maintenance expenditure, the asset being worked on must be identified. This is important so an assessment can be made as to whether the work undertaken is of a capital or revenue nature in the context of the asset identified. Identifying the relevant asset is always a question of fact, degree and impression. This is not about finding a profit-earning structure or entity but rather focuses on what the courts have coined the "entirety test" – "a physical thing which satisfies a particular notion" (*Lindsay v FCT* (1961) 106 CLR 377, *CIR v Auckland Gas Co Ltd* (1999) 19 NZTC 15,011 (CA)). When considering whether something is an entirety, guidance may be taken from whether it is an entirety by itself and not a subsidiary part of anything else, and whether the thing is separately identifiable as a principal item of capital equipment. Identifying whether something is itself a separate physical thing or simply a component of a wider asset includes considering whether it is physically and functionally distinct. However, a single asset may be made up of interdependent parts. There is a danger of distortion if too large or too small a subject matter is identified (*Poverty Bay Electric v CIR* (1999) 19 NZTC 15,001 (CA)*).*

11. When considering whether something is a distinct asset it may be helpful to determine whether the thing can be separately identified by physical factors, for example, its location or size (*Lindsay v FCT* (1961) 106 CLR 392 (Full Ct HCA), *Hawkes Bay Power Distribution Ltd v CIR* (1998) 18 NZTC 13,685 (HC), *O'Grady (HM Inspector of Taxes) v Bullcroft Main Collieries Ltd* (1932) 17 TC 93 (KB), *Samuel Jones & Co (Devondale) Ltd v CIR* (1951) 32 TC 513 (IH (1 Div)), *Margrett (HM Inspector of Taxes) v Lowestoft Water and Gas Co* (1935) 19 TC 481 (KB)). Something that is physically divisible and distinct from other things might suggest that it is a single asset (*Case F67* (1983) 6 NZTC 59,897, *O'Grady*, *Samuel Jones*, *Margrett*). Also, a physical connection between component parts will often be relevant to finding a single asset (*Auckland Gas* (CA)). Subsidiary parts of an integrated system should be considered part of that system rather than assets in their own right (*Poverty Bay Electric*, *Hawkes Bay Power*).

12. Similarly, determining something's function may also be helpful when identifying the relevant asset being worked on (*Auckland Gas* (CA), *Poverty Bay Electric*, *Hawkes Bay Power*, *Case N8* (1991) 13 NZTC 3,052). A smaller thing that is integral to a larger asset's ability to physically function is not likely to be the relevant asset (*Hawkes Bay Power*), while something that is physically capable of separate operation by itself is more likely to be the relevant asset in a repairs and maintenance context (*Poverty Bay Electric*, *Hawkes Bay Power*).

## Relationship with the depreciation rules

13. The principles that the courts have developed to identify the relevant asset for repairs and maintenance purposes are the same principles that apply when identifying an item of tangible property for depreciation purposes. This being the case, when it comes to repairs and maintenance expenditure relating to an item of tangible property that is depreciable, the asset for repairs and maintenance purposes will be generally the same item.

14. In the Commissioner's view, the analysis on how to identify an item of depreciable property in a residential rental property context in IS 10/01: "*Residential rental properties – Depreciation of items of depreciable property" Tax Information Bulletin* Vol 22, No 4 (May 2010) is consistent with the analysis in this Interpretation Statement on identifying the relevant asset being repaired or worked on. IS 10/01 provides a three-step test for identifying the item of depreciable property in a residential rental property context. Any asset in a residential rental property identified for depreciation purposes by applying the three-step test in IS 10/01 will be treated by the Commissioner as the relevant asset for repairs and maintenance purposes.

15. As was noted in IS 10/01, similar principles apply when identifying the asset being worked on in a commercial property context. However, the depreciation rules for commercial buildings were amended in 2010 (after IS 10/01 was released) with the intention that items of commercial fit-out be treated as separate items of depreciable property, distinct from the buildings themselves (see the definitions of "building", "commercial building" and "commercial fit-out" in s YA 1). This means that in the context of commercial fit-out the asset used for depreciation purposes may in some cases be different from the asset identified for repairs and maintenance purposes. It is anticipated that a legislation change will be made to ensure that in the context of commercial fit-out the relevant asset that is used for depreciation purposes will be similarly treated as the asset for repairs and maintenance purposes. It is anticipated that this change will apply retrospectively from the 2011-12 income year.

## Second stage – nature and extent of work done

16. The second stage, when determining whether repairs and maintenance expenditure is deductible, is to consider whether the expenditure is capital or revenue in nature in the context of the asset identified as the entirety (*Auckland Gas* (PC), *Lindsay*). This is achieved by considering the nature and extent of the work done to the asset.

17. Repairs and maintenance problems affecting assets can be resolved in different ways. For example, an asset may be repaired and restored to an "as new" condition, or substantial parts of an asset may be replaced or an asset may be reconstructed using new and sometimes different materials. For income tax purposes, the deductibility of the expenditure incurred on repairs and maintenance depends on a consideration of the nature and extent of the work done to the asset.

18. If the work done to the asset results in the reconstruction, replacement or renewal of the asset, or substantially the whole of the asset, the cost of that work will be capital expenditure (*Auckland Gas* (PC), *Auckland Trotting Club v CIR* [1968] NZLR 193 (SC), *Lurcott v Wakely and Wheeler* [1911] 1 KB 905). Whether there has been such a substantial reconstruction, replacement or renewal will always be a matter of fact and degree.

19. Expenditure incurred to repair or maintain the asset, over and above making good wear and tear, that has the effect of changing the character of the

asset will also be capital expenditure. Expenditure incurred to repair or maintain the asset without replacing, reconstructing or renewing the asset, or substantially the whole of the asset, or without changing its character is on revenue account, and is (subject to any other limitations applying) deductible (*Auckland Gas* (PC)).

20. When determining whether the work done is capital in nature, relevant factors to consider are the nature and the scale of the work done to the asset (*Auckland Gas* (PC)). Changes to an asset's value, its earning capacity, its useful life, function or operating capacity, whether or not a goal of the work done, cannot be relied on in isolation to establish the nature of the work done to the asset (*Poverty Bay Electric*, *Highland Railway Co v Balderston (Surveyor of Taxes)* (1889) 2 TC 485 (IH (1 Div)), *Auckland Gas* (PC and CA)). Determining the scale of the work done includes a consideration of the extent of the work done, the importance of the work done to the asset and the business, as well as the cost of the work done (*Auckland Gas* (PC), *Case L68* (1989) 11 NZTC 1,398, *Western Suburbs Cinemas Ltd* (1952) 86 CLR 102, *Case N8*, *Hawkes Bay Power*).

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

22. Repairs and maintenance work that forms part of one overall project to reconstruct, replace or renew an asset, or substantially the whole of an asset, or to change that asset's character will likely take its nature from that project. This is regardless of whether that project concerns work done on a single asset or a group of assets (*Colonial Motor Co Ltd v CIR* (1994) 16 NZTC 11,361 (CA), *Hawkes Bay Power*, *Case X26* (2006) 22 NZTC 12,315).

23. Where repairs and maintenance expenditure is incurred on an ad hoc basis and not as part of one overall plan, the expenditure should take its character from the effect that the work done has on the asset (*Sherlaw v CIR* (1994) 16 NZTC 11,290 (HC)).

24. It is appropriate and possible in some situations to apportion expenditure between deductible repair costs and non-deductible capital works (*Poverty Bay Electric*).

25. There is no deduction for a notional amount that might have been spent on repairs had the work been carried out differently (*Poverty Bay Electric*).

26. No deduction is allowed for expenditure incurred to bring a newly acquired asset up to the condition necessary for it to be used in the taxpayer's business. Such expenditure forms part of the capital cost of acquiring the asset (*Law Shipping Co Ltd v IR Commrs* (1930) 12 TC 621 (IH (1 Div))). A deduction may still be allowed for expenditure on repairs to a newly acquired asset if the purchase price of the asset was not affected by the fact that the asset was in a state of disrepair, and when the asset was acquired it could be used as intended despite its state of disrepair (*Odeon Associated Theatres Ltd v Jones* [1973] Ch 288 (CA)).

27. The nature of the expenditure does not change if the repairs are carried out as a result of a significant event, for example fire, flood or earthquake. The same principles must be applied to repairs arising as a result of a significant event as are applied to repairs arising for other reasons (*Case F67*). The focus is on the work done.

## Introduction

28. Since the Commissioner's 1994 statement on repairs and maintenance expenditure the courts have heard some significant cases (eg, *Auckland Gas*), significant events have occurred (eg, the Christchurch 2010 and 2011 earthquakes) and there has been legislative changes to the depreciation rules. In the Commissioner's view, all these developments warrant a review of the general principles relating to repairs and maintenance expenditure in New Zealand and the publication of this updated Interpretation Statement.

### Approach to deductibility of repairs and maintenance expenditure

29. This Interpretation Statement sets out the Commissioner's views on the deductibility of repairs and maintenance expenditure. Usually this type of expenditure will arise when some work is done to an item of tangible property which may be depreciable property. The structure of the analysis in this Interpretation Statement is based on the general provisions, the traditional capital/revenue cases and the repairs and maintenance case law.

30. The Interpretation Statement begins by establishing that first, for a deduction for repairs and maintenance expenditure to be allowed, the expenditure must be deductible under the general permission. The statement then considers how to determine whether a deduction will be denied by the application of the capital limitation.

31. The statement explains how to identify the asset that is being worked on. Then, once the asset is identified, the statement looks at the principles developed by case law for deciding whether the cost of the work done to that particular asset is capital or revenue in nature.

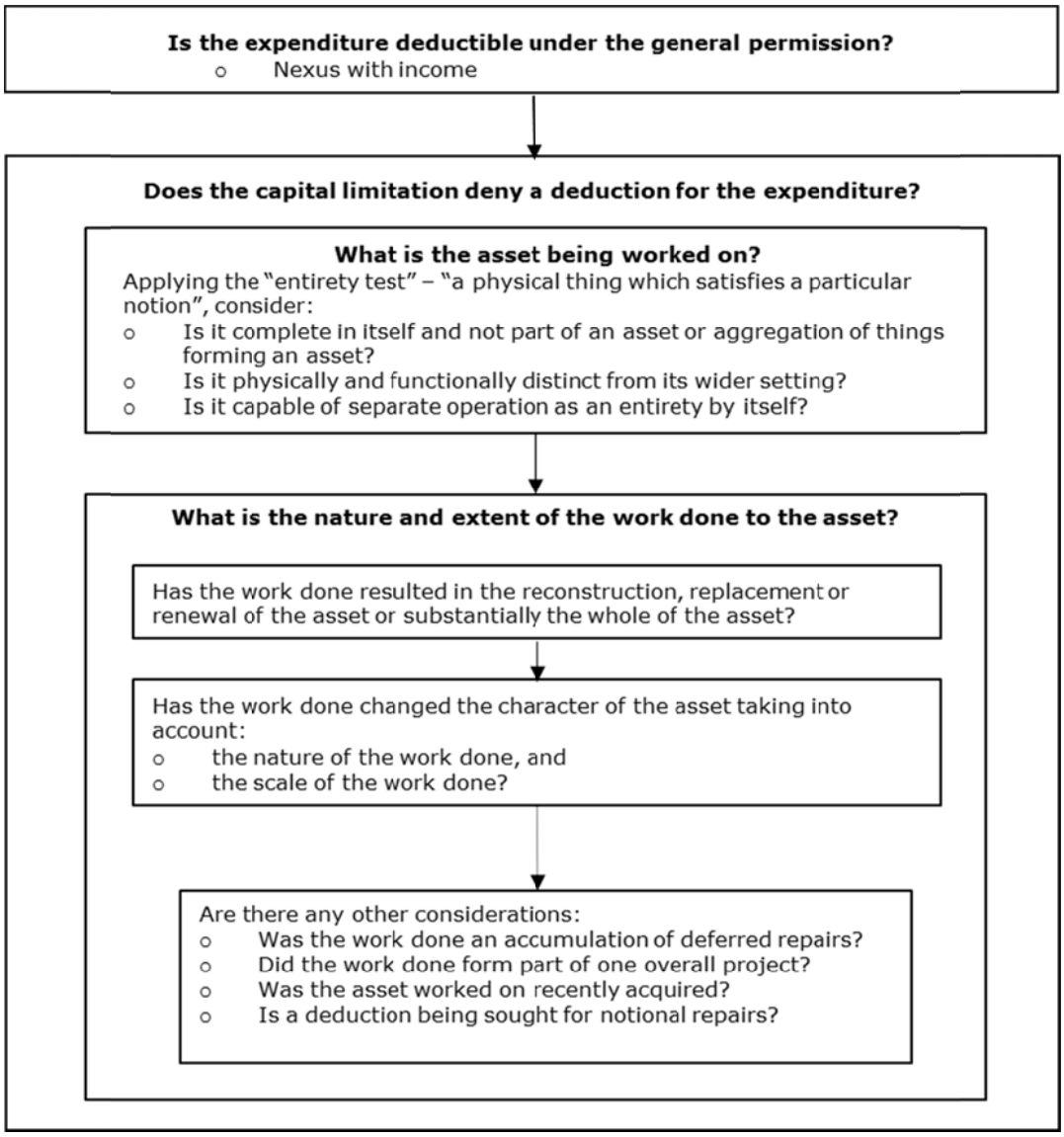
32. If the work done to the asset has resulted in the reconstruction, replacement or renewal of the asset, or substantially the whole of the asset, it will be capital expenditure. If the work done to the asset falls short of being a reconstruction, replacement or renewal of the asset, or substantially the whole of the asset, then depending on the nature of the work done the expenditure will be either capital or revenue in nature. Generally, work done that goes beyond repairs and changes the character of the asset will be capital, and work done that does not change the character of the asset (and is not a reconstruction, replacement or renewal of the asset, or substantially the whole of the asset) will be revenue.

33. There are some exceptions, for example where the work forms part of one overall project that is capital in nature or the work done relates to the pre-acquisition condition of the asset.

34. If the expenditure is found to be capital in nature a deduction for that expenditure will be denied (assuming no other specific provisions allow for a deduction). If the expenditure is found to be revenue in nature, a deduction for the expenditure will be allowed subject to satisfying any other legislative requirements.

**Flowchart - approach to analysis**

35. The following flowchart shows the approach the analysis in this Interpretation Statement takes:




36. As noted earlier, other limitations to the general permission might deny a deduction for repairs and maintenance expenditure (eg, the private limitation in s DA 2(2)). However, this Interpretation Statement is concerned only with the application of the capital limitation to expenditure on repairs and maintenance.

37. Capital expenditure is not deductible but will be subject to the normal depreciation rules in subpart EE. If those rules are satisfied, a depreciation loss will be available. Since the 2011-2012 income year, certain buildings and any improvements to those buildings have a 0% depreciation rate. The availability or otherwise of a depreciation loss is outside the scope of this Interpretation Statement.

38. It is also important to remember when considering the capital/revenue distinction that the answer will always be a matter of fact and degree (*BP Australia*). Care must be used in applying the capital/revenue tests and also in applying case authorities to different circumstances (*Auckland Gas* (PC)).

### Relevance of case law decided under previous legislation

39. Until the 1993/94 income year, s 108 of the Income Tax Act 1976 governed the deductibility of repairs and maintenance expenditure. Section 108 specifically provided for the deduction of amounts spent on repairs and alterations. An extensive body of case law addresses the deductibility (or otherwise) of repairs and maintenance expenditure under this legislation.

40. Since the repeal of s 108 of the Income Tax Act 1976, the deductibility of expenditure on repairs and maintenance has been tested under the general deductibility provisions. The general permission in s DA 1 and the general limitations in s DA 2 apply. However, as said in the Commissioner's 1994 statement, the body of repairs and maintenance case law that existed before the repeal of s 108 is still relevant.

41. In the Commissioner's view, in practice what was deductible under the old s 108 and what will be deductible under the general provisions of the ITA 2007 is essentially the same. (The most important difference is that under s 108 expenditure on work done to repair or alter an asset that did not increase the value of that asset was deductible (see the second proviso in s 108). Whereas now under the general provisions expenditure on work done to repair or alter an asset will be deductible only to the extent that the expenditure is not capital in nature.) In the Commissioner's view, the cases continue to be relevant to the extent they provide guidance on identifying the particular asset being worked on. This is because identifying the asset continues to be the starting point when approaching the deductibility of any repairs and maintenance expenditure.

42. In addition, many of the well-known repairs and maintenance cases apply the general capital/revenue tests in one form or another. For this reason, in the Commissioner's view, the principles established in these cases over the years remain useful in establishing the deductibility of such expenditure, particularly for the analogies they offer and for the distinctions they make between capital and revenue expenditure in repairs and maintenance circumstances.

43. Therefore, in summary, the Commissioner considers that both the general capital/revenue cases (ie, the cases not about repairs and maintenance) and the cases that specifically address repairs and maintenance expenditure, even if decided under repealed legislation, are relevant when determining whether a deduction for repairs and maintenance expenditure is prohibited by the capital limitation in s DA 2(1).

## Analysis

### Is the expenditure deductible under the general permission?

44. The first issue to be considered when determining whether expenditure incurred on repairs and maintenance is an allowable deduction is whether the expenditure satisfies the general permission for deductions in s DA 1(1).

45. Under the general permission, a deduction is allowed for an amount of expenditure or loss to the extent to which the expenditure or loss is incurred by the taxpayer:

- in deriving their assessable income or excluded income or a combination of both (s DA 1(1)(a)); or

- in the course of carrying on a business for the purpose of deriving their assessable income or excluded income or a combination of both (s DA 1(1)(b)).

### *Nexus with income*

46. The essential feature of s DA 1(1) is the requirement of a nexus between the expenditure and the deriving of assessable income or the carrying on of a business by the taxpayer for the purpose of deriving assessable income. This is referred to as the statutory nexus.

47. The leading cases on deductibility under earlier income tax legislation are *CIR v Banks* (1978) 3 NZTC 61,236 (CA) and *Buckley & Young Ltd v CIR* (1978) 3 NZTC 61,271 (CA). In both cases, the Court of Appeal highlighted the requirement for a statutory nexus to exist between the expenditure incurred and the assessable income or carrying on of a business of the taxpayer in order for the expenditure to be deductible. The Commissioner considers these decisions remain relevant to the interpretation of s DA 1(1). Earlier statutory provisions that correspond to s DA 1(1)(b) referred to "expenditure necessarily incurred in carrying on a business". Section DA 1 preserves that requirement for nexus, notwithstanding that the word "necessarily" is no longer included. It is the Commissioner's view that the word "necessarily" did no more than indicate a requirement that there be a sufficient degree of connection between the expenditure and the business.

48. To determine whether the required nexus exists, the true character of the expenditure and its relevance to the taxpayer's income-earning process must be considered. The factual situation must be considered at the time the expenditure is incurred. The expenditure must be connected to a continuous income-earning process. The continuance of an income-earning process will always be a matter of fact and degree. This means that the longer an asset is not used in an income-producing activity the more difficult it is to demonstrate that there is a sufficient nexus between expenditure on that asset and income from the activity or business (*Vallambrosa Rubber Co Ltd v Farmer (Surveyor of Taxes)* (1910) 5 TC 529, *Rhodesia Railways*, *Case X26*).

49. Paragraph (b) of s DA 1, which applies only to taxpayers who are carrying on a business, permits a wider approach than para (a). In contrast to the requirement under para (a), expenditure under para (b) may still be deductible even where that expenditure "… cannot be directly linked to the derivation of assessable income in some positive way, but [is] … made to … keep the enterprise on foot or reduce expenditure" (*Cox v CIR* (1992) 14 NZTC 9,164 (HC) at 9,168). That is, para (b) permits a deduction for expenditure incurred to protect or advance a business or to avoid or reduce expenditure. Paragraph (b) also permits longer-term objectives to be considered (see also *Thornton Estates Limited v CIR* (1995) 17 NZTC 12,230 (HC)).

### Examples – nexus with income

#### *Example 1 – temporary break in rental activity (sufficient nexus established)*

Jack owns a rental property. Jack's tenant has just moved out. Although Jack advertised the property he is experiencing difficulty finding a new tenant. He concludes that the reason he cannot find a new tenant is that the property is too run down. Jack decides to tidy up the property to make it more attractive to potential tenants. The property is temporarily unavailable for rental while Jack arranges to have the property repaired, cleaned, and painted. Once this work has been done

Jack will look for a new tenant. The expenditure that Jack incurs will have a sufficient nexus to Jack deriving assessable income from his rental activity.

***Example 2 – repairs made after rental activity ceased (sufficient nexus not established)***

Tina owned a residential rental property for several years. Two years ago she decided to move into the house and use it as her home. This year she has undertaken repairs on the property and had it fully repainted. Tina seeks to claim a deduction for the cost of the repairs to her house on the basis they related to damage sustained when the house was tenanted. However, the repair costs are not deductible because the rental activity has ceased and the house is no longer being used to derive assessable income. At the time the expenditure was incurred it did not have the necessary nexus to Tina's assessable income.

### Does the capital limitation deny a deduction for the expenditure?

50. Having concluded a deduction is available for repairs and maintenance expenditure under the general permission, the next step is to determine whether the capital limitation in s DA 2(1) applies to deny a deduction for the expenditure to the extent to which the expenditure is of a capital nature. If an amount of expenditure is found to be capital in nature, it will not be deductible.

51. The courts have formulated various tests for determining whether expenditure is capital or revenue in nature. However, before applying those tests, it is important to consider the approach to be taken when applying those capital/revenue tests in the context of repairs and maintenance expenditure.

52. The courts have used a two-stage approach when determining whether repairs and maintenance expenditure is capital or revenue in nature:

- The first stage is to identify the asset that has been worked on.
- The second stage is to consider the nature and extent of the work done to that asset.

53. If the work done to the asset indicates that the expenditure is capital in nature, the capital limitation in s DA 2(1) will deny a deduction for that expenditure.

54. This Interpretation Statement now looks in more detail at these two stages.

### What is the asset being worked on?

55. To establish whether expenditure on repairs or maintenance work is of a capital or revenue nature the first step, as Lord Nicholls stated in *Auckland Gas* (PC) at 15,706, "is to identify the object to which the test of repair or replacement is being applied". This is important because then an assessment can be made as to whether the work undertaken is of a capital or revenue nature in the context of the asset identified.

56. Frequently, as Lord Nicholls explains at 15,706, "this is a straightforward exercise and the answer is obvious". This is demonstrated in cases such as *Colonial Motor*, *Sherlaw* and *Case X26*. In *Colonial Motor* significant repair work was carried out to an eight-storey warehouse, including earthquake-strengthening and the addition of a storey. The relevant asset in that case was the warehouse. In *Sherlaw* the taxpayers re-piled and carried out other repair work on a boat-shed. The relevant asset was the boat-shed. Similarly in *Case X26*, where the taxpayers earthquake-strengthened a heritage building, the relevant asset was the building. However, there will

be situations where the answer is not so obvious. In this regard there are several cases where the courts have provided guidance on how to identify what the asset is that is being worked on in a repairs and maintenance context.

57. In *Auckland Gas* (PC) the taxpayer had major problems with its low-pressure gas-distribution system. The cast iron and steel pipes had leaking joints, corrosion and fracture issues causing significant gas leakage and water entry. By the 1980s, the taxpayer's system was in a poor state of repair, unreliable and expensive to maintain using a "find and fix" system of repairs as each problem was identified. To rectify these issues the taxpayer introduced a programme of inserting polyethylene piping into its existing cast iron and steel gas pipes. The polyethylene pipes allowed the gas to be transmitted at a higher pressure and were less likely to leak. The only remaining function of the old cast iron and steel pipes was to act as a support conduit for the polyethylene pipes.

58. The issue before the court was whether the expenditure on the insertion of the polyethylene pipes was deductible as repairs. The Privy Council, in identifying the object to which the test of repair or replacement was being applied, found the relevant asset to be the "assemblage of linked pipes whose function was to carry gas from one place to another" that made up Auckland's gas-distribution system. The asset was not an abstract concept of the gas-distribution system as a functional entity separate from its physical components. The Privy Council went on to hold that, by inserting new pipes, the character of the existing system was changed as the old pipes no longer discharged their original function of carrying gas, and a significant portion of the system was upgraded. As the character of the identified asset (Auckland's gas-distribution system) had changed substantially, it was found to be capital expenditure.

59. The Privy Council's reference to "an assemblage of linked pipes" suggests that having a degree of physical connection between component parts is relevant to finding a single asset. Consideration also needs to be given to what the asset's function is and what items or components are necessary to carry out that function.

***The "entirety test" – "a physical thing which satisfies a particular notion"***

60. In the Court of Appeal decision in *Auckland Gas* (which the Privy Council upheld), Blanchard J rejected the "profit-earning entity test" used to identify the asset being worked on by Williams J in the High Court decision (*Auckland Gas Company Ltd v CIR* (1997) 18 NZTC 13,408). Blanchard J noted that this test which concentrated on the relationship of the work to the taxpayer's income earning activity had been rejected in *Auckland Trotting* (CA). Instead, the Court of Appeal in *Auckland Trotting* favoured Kitto J's approach in the Australian High Court case *Lindsay v FCT* (1961) 106 CLR 377 of looking for "a physical thing which satisfies a particular notion". Blanchard J, adopting the words used by the Court of Appeal in the *Poverty Bay Electric* case (when applying Kitto J's approach in *Lindsay*), stated that the correct way to identify the asset being worked on was by inquiry into the totality or entirety of the physical asset in question, pointing out the distortion that can result from misidentification.

61. In *Lindsay*, Kitto J considered that a slipway ought to be considered an entirety by itself and not a subsidiary part of anything else – the slipway being a physical thing that satisfies a "particular notion" – namely a physical thing that is used for landing (and subsequent launching) of boats and ships

for the purpose of repairing them. In reaching his conclusion, Kitto J stated at 384:

> But where the question is whether expenditure has been for repairs, and for the purpose of deciding that question 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**. [Emphasis added]

62. Kitto J also noted it was necessary to consider whether the asset or property is an "entirety by itself" or whether it is a "subsidiary part of anything else" and concluded at 385:

> I am of opinion that the No. 1 slipway ought to be considered, **for the purposes of the question I have to decide, as an entirety by itself, and not as a subsidiary part of anything else. It is separately identifiable as a principal, and indeed the principal, item of capital equipment**, so that in a discussion as to whether work done in relation to it constitutes a repair or a renewal in the opposed senses abovementioned, the subject matter in relation to which the choice of description is to be made is the slipway itself, and **not any larger thing or aggregation of things** of which it may be suggested to form part. [Emphasis added]

63. Kitto J considered it was relevant when concluding that the slipway was "a physical thing which satisfies a particular notion" that the slipway was:

- an "entirety by itself" and not a "subsidiary part of something else";
- separately identifiable as a principal item of capital equipment.

64. The first factor, that the slipway was an "entirety by itself", suggests the slipway was whole or complete in itself rather than being a component part of a larger asset or aggregation of things forming an asset.

65. The second factor is a little less clear. The fact the slipway was "separately identifiable" as a principal item of capital equipment suggests it was important enough to be considered as an asset in its own right and could be distinguished in some way from other items. It is not clear from the judgment what characteristics led the court to its conclusion. A principal item of capital equipment is presumably an asset that is important or fundamental to the taxpayer's business (that being the ordinary meaning of "principal"). However, several possible characteristics could make such an item "separately identifiable". For example, an item of equipment could be separately identifiable because it is a functioning unit in its own right. Alternatively, it could be separately identifiable because of physical characteristics, such as not being physically attached to other items or having physical characteristics that differ from those of other items. It may be that all of these are relevant aspects to be taken into account. Later cases discuss this factor (or similar factors) in more detail.

66. *Lindsay* was appealed to the Full High Court ((1961) 106 CLR 392) who agreed with the decision of Kitto J, stating at 393:

> The entirety, it is said, consisted, either, of the whole of the partnership's premises on which its business was conducted and in connexion with which the slipway was used or, alternatively, of a number of what were called components and which together were said to constitute the slipway. These components are identified as the slip, the cradle employed upon it, the hauling machine by which the cradle is moved and the dolphins and warping winches by means of which vessels are manoeuvred onto the cradle. **This method of approach to the problem was rejected by the learned judge of first instance and we have no doubt that he was right.** It would be artificial in the extreme to approach the problem in either of the suggested ways for the slipway was, in itself, **a very substantial erection** and the real question for decision was whether the work which was done was done in the execution of repairs to it. **As**

> **we see the problem the answer to this question could not be affected by the fact that there were other buildings or erections on the appellant's premises or by the fact that, on the premises, there were appurtenances, such as those described, for use in connexion with the slipway.** [Emphasis added]

67. The above quotation suggests the High Court was influenced in its decision by the fact the slipway was a substantial structure in its own right.

### *Applying the "entirety test"*

68. The taxpayer in *Auckland Trotting* (CA) claimed expenditure on the demolition of a trotting track and the construction of a replacement track on the same site as repairs or alterations to the "premises" of the club under s 113(1) of the Land and Income Tax Act 1954. The taxpayer contended that the "premises" of the club subject to the repairs and alterations was the whole of the club's complex of buildings and improvements and not just the trotting track. The Court of Appeal disagreed and, applying the "entirety test" from *Lindsay,* found that the "premises" of the club on which the repair work was to be evaluated was just the track.

69. It is noted that the court in *Auckland Trotting* (CA) considered how the repairs and alterations undertaken by the club applied to "premises". However, in doing so, the court still had to work out a means of determining what the "entirety" was before it could evaluate whether the work carried out on that "entirety" was repair work to premises. Therefore, in that regard, the finding of the court in *Auckland Trotting* (CA) is considered still relevant in a repairs and maintenance context under the current legislation.

70. The Court of Appeal in *Poverty Bay Electric* considered whether expenditure incurred in replacing overhead electricity lines with underground cables was expenditure on "repairs or alterations". The court discussed the importance of correctly identifying the subject matter of the expenditure and noted the implications of incorrectly identifying the asset (in the context of repairs and maintenance). The court then discussed the relevant asset in the case at hand. In doing so the court warned of the danger of distortion if too large or too small a subject matter was identified, stating at 15,006:

> 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. That could lead to an absurd result, for example, treating the replacement of a car tyre or a spark plug as a capital improvement when, if the subject matter is correctly seen as the whole of the motor vehicle, the work is obviously a repair involving a replacement of a mere component, even a vital component and even if an improved or modified version of that component is substituted.

71. The Court of Appeal agreed with the High Court's finding that the relevant asset was the Gisborne urban reticulation system (rather than the wider Poverty Bay reticulation system) (*Poverty Bay Electric Power Board v CIR* (1998) 18 NZTC 13,779 (HC)). However, the Court of Appeal disagreed with the High Court's suggestion that each separate section of the line could also be viewed as a separate asset. This was because each separate section of line was part of an integrated system and incapable of separate operation. This strongly suggests it is relevant to the entirety test whether an asset can function by itself (ie, it includes all the parts that are necessary for it to function). Similarly, it is relevant whether subsidiary parts of an "integrated system" should be considered part of that system rather than assets in their own right.

72. However, the Court of Appeal also warned against taking this inquiry too far where a "substantial capital work by an individual electricity supply authority might be made to appear so relatively minor as to be thought a matter of repair only" (at 15,007). In other words, if the subject matter is seen as being too broad, then substantial capital work that forms part of the total subject matter could be seen as merely a repair to the whole. Conversely, 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. That could lead to an absurd result. A replacement of a mere component, even a vital component, may still be correctly classified as a repair.

73. In concluding that the relevant asset was the Gisborne urban reticulation system, the Court of Appeal considered it relevant that the system was clearly distinguishable in engineering terms from the rest of the Poverty Bay network, in that "[i]t could be switched (or isolated by electrical means) from the rest of the Poverty Bay network" (at 15,007).

74. In Hawkes Bay *Power* the court considered the issue of whether expenditure incurred in replacing overhead electricity lines with underground cables was expenditure on "repairs or alterations". Goddard J, noting that the starting point is identifying the "nature of the relevant asset", applied the "entirety test" from *Lindsay* (at 13,700–13,701).

75. Goddard J, in applying the analysis from *Lindsay*, determined that the urban residential distribution system constituted the relevant asset by finding it was:

- a physical thing that satisfied a particular notion,
- an entirety by itself and not a subsidiary part of anything else, and
- a separately identified principal item of capital equipment.

76. The "physical thing which satisfies a particular notion" was the network of transformers and distributors that supplied electricity to domestic consumers in a certain area. This suggests that the inquiry is focused on a physical thing (ie, the electricity network) that carries out a particular function (ie, the supply of electricity). Further, a particular part of the network (the urban residential distribution system) was found to be the relevant asset because it was "physically capable of being separately and independently installed underground without recourse to or effect upon the other areas which the distribution system satisfies" (at 13,701). Consequently, it was found to be an entirety by itself and not merely a subsidiary part of a larger distribution system.

77. Goddard J found this to be the case even though the urban residential distribution system "could not operate as an independent entity" (if disconnected from the national grid) and was "not an entire profit-earning structure" (at 13,701). It is clear from this that in defining an asset, it is not necessary that everything required to earn a profit from it is included.

78. Regarding the "separately identifiable as a principal item" inquiry, Goddard J noted that the urban residential distribution system was separately identified by customer type and area and that its separateness was further identified by the fact most of it was underground. In this regard, customer area and type distinguished "urban residential" from "urban industrial" and "rural" customers. It appears Goddard J was primarily concerned with physical factors, such as location, when determining whether two items were separately identifiable.

79. With regard to whether the "distribution system" was a principal item of capital equipment in itself, Goddard J noted that the sheer scale of the cost involved in putting the network underground, the comparative cost with overhead lines, and the extent of the system that had been put underground led "to the irrefutable conclusion" that the system was "a principal item of capital equipment" (at 13,701).

80. Goddard J also found that the distribution transformers that were replaced during the course of the conversion to underground lines were a part of the distribution system (the relevant asset in the case). This was because they were an integral part of the distribution system as a whole. The transformers were necessary for the network to reticulate. This suggests items that are integral to an asset's ability to fulfil its physical function (in this case the supply of electricity) tend to be a subsidiary part of the asset.

81. In *Case F67* the taxpayers carried on business as hotel proprietors. Part of the hotel's business was a two-storeyed rental building adjoining the hotel. The lower floor of the building was divided into two shops and the upper floor into two flats. The building was on one title and the taxpayers insured and administered the property as one building. The shops were leased out as a pizza parlour and a knick-knack shop. The upstairs flats were leased as residential flats to the respective shop lessees.

82. The taxpayers carried out significant repair work after a fire extensively damaged the building. The taxpayers claimed a deduction against their income for the portion of the repairs that insurance did not cover. Judge Barber disallowed the deduction on the basis that it was capital expenditure.

83. In reaching his decision, Judge Barber identified that the building was the relevant asset rather than the individual shops and flats within the building. This was because the taxpayers jointly owned the land and building on one title and insured and administered the property as one building. The fact the building was internally partitioned did not change Judge Barber's finding that the building as a whole was the relevant asset.

84. *Case N8* is an example of a situation where the court had to consider whether an aggregation of things made up a single asset. The taxpayer was a substantial manufacturer and supplier of ready-mixed concrete. The case concerned quite substantial works undertaken in relation to a ready-mixed concrete "batching plant". The taxpayer contended that the whole entity was the batching plant (which comprised the ground storage bins; the conveyor and a square-shaped tower; the associated water and electrical equipment and supply; and the dispatch office, control room and dispatch facilities) and that each item of expenditure was for repairs or maintenance in relation to that whole. (The plant was situated on premises that consisted of several acres of land, an office and administrative building, a laboratory, a control and supervisor's office, yards, a truck parking and washing area, and used equipment and storage yards, in addition to the batching plant.) The Commissioner argued the plant should not be seen as one entity, but rather that each individual element should be addressed to consider whether there had been a repair, renewal or replacement. It was further contended that if the plant was a single entity, then the work was of such an extent, size and amount that the expenditure was of a capital nature.

85. Having comprehensively reviewed the nature of the taxpayer's business and the various items of expenditure, Judge Bathgate turned to consider what was the relevant asset or entity against which to consider the nature of the expenditure, noting at 3,070:

> I find there were two entities involved in the work. The first and obvious is that which stores, conveys, mixes and produces the materials making up and contained in the final ready mixed concrete as supplied by the objector. **That entity is physically attached or joined**, or so far as the materials are concerned, **it is continuously involved in the one process** of manufacturing ready mixed concrete. To identify any one part and single it out for separate treatment as an individual item would be unrealistic in this context. **It is a composite whole**. If a motor car has a new spark plug installed in the place of an existing spark plug, so far as the motorist is concerned that is work undertaken in the course of repair or maintenance of the motor car, and is not a renewal of the spark plug as a capital item. **It is a question of fact, degree and impression as to what is included or excluded in an entity for present purposes.** The entity in the example given is the motor car. If the gearbox was replaced, that may be a repair, but if the engine were replaced, that would seem more like a capital item.
>
> **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]

86. Judge Bathgate identified two separate entities as being the relevant assets. The first entity being the things attached to each other that stored, conveyed, mixed and produced the materials making up and contained in the ready-mixed concrete. The other entity being the separately housed control room and the dispatch and supervisor's offices. Even though the two entities were connected, Judge Bathgate placed importance on the fact they were physically and functionally distinct from each other. Judge Bathgate continued at 3,071:

> Different functions, although associated functions, were carried out in the two entities. The first was the entity handling the raw materials that were manufactured into ready mixed concrete. The second was more in the nature of an administrative office which controlled and supervised the functions of the first entity.

### *Overseas authorities*

87. The New Zealand courts have taken guidance from overseas authorities when identifying the asset being worked on in a repair and maintenance context. Three cases often referred to are *O'Grady, Samuel Jones* and *Margrett*.

88. In *O'Grady* the taxpayer built a replacement chimney stack. The chimney was constructed to do the work of the old chimney, which was to carry away smoke and fumes from the furnaces that raise steam and power for colliery purposes. Rowlatt J found the chimney stack to be the relevant asset. Consequently, the expenditure on building the chimney stack was found to be capital. Rowlatt J (referring to *Lurcott*) said at 101:

> As regards the chimney, I think it is really very clear. Of course every repair is a replacement. You repair a roof by putting on new slates instead of old ones, which you throw away. There is no doubt about that. But the critical matter is … **what is the entirety**? The slate is not the entirety in the roof. You are repairing the roof by putting in new slates. What is the entirety? If you replace in entirety, it is having a new one and it is not repairing an old one. **I think it is very largely a question of degree.** … This was a factory chimney to which the gases and fumes, and so on, were led by flues and then went up the chimney. It was unsafe and would not do any more. What they did was simply this**: They built a new chimney at a little distance away in another place; they put flues to that chimney and then, when it was finished, they switched the gases from the old flues into the new flues and so up**

> **the new chimney**. **I do not think it is possible to regard that as repairing a subsidiary part of the factory.** I think it is simply having a new one. And they had them both. Perhaps they pulled down the old one; perhaps they kept it, because they thought it was an artistic thing to look at. There is no accounting for tastes in manufacturing circles. Anyhow, they simply built a new chimney and started to use that one instead of the old one. I think the chimney is the entirety here and they simply renewed it. [Emphasis added]

89. Rowlatt J found as a matter of fact that the chimney was not a subsidiary part of the colliery. That Rowlatt J noted the chimney was built a little distance away at another place could suggest that the new chimney was physically separate from the rest of the factory and that this influenced his decision.

90. The later decision *Samuel Jones,* also concerned the building of a replacement chimney stack. In this case, the taxpayer processed paper using a large group of buildings with the power being supplied by a steam plant that discharged into a chimney. The chimney was in a dangerous state of repair and was replaced by a new chimney. The new chimney was erected close to the existing chimney, which was demolished once the new chimney could take over the old chimney's function. Both the old and new chimneys were part of the structure of the main factory block. The Court of Session found the chimney to be an inseparable and necessary part of a larger entity, the factory. This meant the factory rather than the chimney stack was the relevant asset to which the test of repair or replacement could be applied. The court found the expenditure on the chimney to be of a revenue nature. The court also noted it was influenced in its decision by the fact the expense incurred in taking down the old chimney and building the substitute was only 2% of the value of the factory. Lord President Cooper stated at 518):

> …but so far as this case is concerned the facts seem to me to demonstrate beyond a doubt that the chimney with which we are concerned is **physically, commercially and functionally an inseparable part of an "entirety"**, which is the factory. It is quite impossible to describe this chimney as being in the words of Rowlatt, J, the "entirety" with which we are concerned. It is doubtless an indispensable part of the factory, doubtless an integral part; but none the less a subsidiary part, and one of many subsidiary parts, of a single industrial profit-earning undertaking. [Emphasis added]

91. It is considered that his Lordship's reference to the chimney being "commercially … inseparable" does not suggest his Lordship considered that an item must be an entire profit-making structure to be the relevant asset. Rather his Lordship's reference to "commercially … inseparable" was intended to refer to what a person in business would regard as necessary for the factory to be considered as complete. Even if his Lordship was suggesting this, the New Zealand courts (as seen in *Auckland Trotting* (SC and CA) and *Hawkes Bay Power*) have clearly rejected a profit-earning structure test as a means of identifying the asset in a repairs and maintenance context.

92. The decision of the court in *Samuel Jones* contrasts with that in *O'Grady* where the chimney was found to be the relevant asset. The Commissioners of Inland Revenue in *Samuel Jones* argued they were unable to distinguish the facts in that case from those in *O'Grady*. In considering this point, Lord President Cooper referred to the comment made by Rowlatt J in *O'Grady* that "the critical matter is … what is the entirety? … I think it is very largely a question of degree" (see above at paragraph [88] of this statement). His Lordship found at 518 that "it [was not] part of our duty to review the decision of Rowlatt J, as applied to the facts in the *O'Grady* case, but so far as this case is concerned the facts seem to demonstrate … the chimney … is

... part of an entirety". In this regard, his Lordship demonstrates that identifying the relevant asset in any given case will always involve consideration of the specific facts of that case at hand. Although not clearly stated by his Lordship, the distinguishing fact between the cases seems to be that in *Samuel Jones* the chimney was physically connected to the main factory building, while in *O'Grady* the chimney built was larger, situated a little distance away at another place and was not physically connected to any other structure.

93. Whether assets were separately identifiable because of physical characteristics also appears to have been a deciding factor in *Margrett*. In *Margrett*, the taxpayer company owned an old reservoir that was built in 1856 and had deteriorated to such an extent that it was not worth repairing. A new reservoir (which was twice the capacity of and a significant improvement on the old reservoir) was constructed in 1931 on a site away from the old reservoir.

94. The court had to decide whether the expenditure on building the new reservoir was capital expenditure or money "expended for repairs of premises occupied". The court examined the physical nature and physical distinctiveness of the reservoir to decide whether it was a separate asset or part of a larger asset (the water tower).

95. Finlay J stated at 488:

> Now here the subject matter under discussion seems to me to be the reservoir, and I cannot think that it is material, though it is undoubtedly the fact, that the reservoir is part only of the Respondents' whole physical undertaking. **It is a part perfectly clearly divisible from the rest**, and it is the part with which we are dealing here. If authority were needed for that I should find it in the decision of Mr. Justice Rowlatt, to which I referred a moment ago, of *O'Grady v. Bullcroft Main Collieries, Ltd*, because the reservoir here is more clearly a separate and distinct thing than was the chimney in *O'Grady v. Bullcroft Main Collieries, Ltd*. [Emphasis added]

96. Therefore, when determining whether assets are physically distinct, a practical and visual inquiry can be an appropriate consideration.

**Key points on identifying the asset being worked on**

97. The Commissioner takes the following key points from the cases on identifying the asset being worked on:

- The "first step is to identify the object to which the test of repair or replacement is being applied". In other words, what is the asset that it is relevant to consider? (*Auckland Gas* (PC))
- Identifying the asset is not about identifying the profit-earning structure or entity; rather it is about identifying a "physical thing which satisfies a particular notion". The fact 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. (*Lindsay* (HCA), *Hawkes Bay Power*, *Auckland Gas* (CA))
- A single asset may be made up of interdependent parts. There is a danger of distortion if too large or too small a subject matter is identified. For example, 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. If the subject matter is too broad then every replacement of a single unit

that forms part of the total subject matter could be seen as merely a repair to the whole. (*Poverty Bay Electric*)

- It is always a question of fact, degree and impression as to what is included or excluded in an entity or asset. However, the focus remains on the "entirety test" – "a physical thing which satisfies a particular notion" *(Lindsay* (HCA), *Auckland Trotting* (CA), *Hawkes Bay Power*, *Case N8*). When considering whether something is "a physical thing which satisfies a particular notion" the courts are guided by whether the thing would be:
  - an entirety by itself and not a part of an asset or aggregation of things forming an asset;
  - separately identifiable as a principal item of capital equipment.
- Identifying whether a part of a wider asset is itself a separate physical thing or simply a component of a wider asset includes considering whether the item is physically and functionally distinct (*Case N8*). It may be helpful to see whether something can be separately identified by physical factors, for example its location or size (*Lindsay* (Full Ct HCA)*, Hawkes Bay Power, O'Grady, Samuel Jones, Margrett*). Something that is physically divisible and distinct from other things may suggest that it is a single asset (*Case F67, O'Grady, Samuel Jones, Margrett*). A physical connection between component parts will often be relevant to finding a single asset (*Auckland Gas* (CA)). Subsidiary parts of an integrated system should be considered as part of that system rather than assets in their own right (*Poverty Bay Electric, Hawkes Bay Power*).
- Looking to see what the asset's function is and what parts or components are necessary for the asset to carry out that function may be helpful when identifying the relevant asset (*Auckland Gas* (CA), *Poverty Bay Electric*, *Hawkes Bay Power*, *Case N8*). Something that is integral to a larger asset's ability to physically function is not likely to be the relevant asset (*Hawkes Bay Power*). Alternatively something that is physically capable of separate operation by itself is more likely to be the relevant asset in a repairs and maintenance context (*Poverty Bay Electric, Hawkes Bay Power*).

**Examples – identifying the asset being worked on**

***Example 3 – reconditioned car engine (subsidiary part of a larger asset)***

Frank is an owner-operator taxi driver. He has driven the same taxi for the past 5 years. Until recently the taxi has been reliable and overall is in good condition. Frank has had his taxi serviced regularly but his mechanic has advised him that the engine is now seriously worn. The mechanic recommends that the worn engine be replaced with a reconditioned engine. The asset in this case is the taxi. The engine is a subsidiary part of that asset, and is physically and functionally connected to that larger asset. The engine is integral to the taxi.

***Example 4 – loan trailer (asset as entirety)***

Hedgy Landscape Supplies owns trailers that it makes available for its customers to use. Sometimes the company also uses the trailers for making deliveries. The deck of one trailer needs repairing. The trailer is the asset being repaired. It is the entirety and not a subsidiary part of something else. The trailer has all the necessary parts to function and is a composite whole.

### Relationship with depreciation rules

98. The principles that the courts have developed to identify the relevant asset for repairs and maintenance purposes are the same principles that apply when identifying an item of tangible property for depreciation purposes. This being the case, when it comes to repairs and maintenance expenditure relating to an item of tangible property that is depreciable, the asset for repairs and maintenance purposes will be generally the same item.

99. In 2010 the Commissioner published an Interpretation Statement IS 10/01 "Residential rental properties – Depreciation of items of depreciable property". IS 10/01 sets out how to determine whether an item in a residential rental property is a separate item of depreciable property or is part of the residential building. In the Commissioner's view, the analysis in IS 10/01 on how to identify an item of depreciable property in a residential rental property context is consistent with the analysis in this statement on identifying the relevant asset being worked on or repaired.

100. IS 10/01 concluded that if an item in a residential rental property is distinct from the building and it meets the definition of "depreciable property", it may be separately depreciated. If an item is found to be part of the building, it cannot be separately depreciated. In its analysis, IS 10/01 relied on the same repairs and maintenance cases as those relied on by this statement. IS 10/01 also provides specific guidance in the form of a three-step test on how to determine whether a particular thing is a separate item of depreciable property or is part of the residential rental property. The Commissioner considers that any outcomes reached by applying the three-step test in IS 10/01 will be consistent with the outcomes reached by applying this Interpretation Statement. Any asset in a residential rental property identified for depreciation purposes by applying the three-step test in IS 10/01 will be accepted by the Commissioner as the relevant asset when considering the deductibility of repairs and maintenance expenditure.

101. As was noted in IS 10/01, similar principles apply when identifying the asset being worked on in a commercial property context. However, the depreciation rules for commercial buildings were amended in 2010 (after IS 10/01 was released) with the intention that commercial fit-outs be treated as separate items of depreciable property, distinct from the buildings themselves (see the definitions of "building", "commercial building" and "commercial fit-out" in s YA 1). This means that in the context of commercial fit-out the asset used for depreciation purposes may in some cases be different from the asset identified for repairs and maintenance purposes. It is anticipated that a legislation change will be made to ensure that in the context of commercial fit-out the relevant asset that is used for depreciation purposes will be similarly treated as the asset for repairs and maintenance purposes. It is anticipated that this change will apply retrospectively from the 2011-12 income year.

### What is the nature and extent of the work done to the asset?

102. Once the relevant asset being worked on has been identified, the second stage in the enquiry as to whether repairs and maintenance expenditure is deductible is to consider the nature and extent of the work done to the particular asset. If the nature and extent of the work done to the asset indicates the expenditure is capital in nature the capital limitation in s DA 2(1) will deny a deduction for that expenditure.

103. The general capital/revenue cases and the more specific repairs and maintenance cases provide guidance in this second stage of the enquiry.

***General capital / revenue cases***

104. The accepted approach for determining whether any outgoing is of a capital or revenue nature is outlined in *BP Australia Ltd v FCT*. The *BP Australia* approach was confirmed as being the preferred approach in New Zealand in the leading decision of *CIR v McKenzies New Zealand Ltd* (1988) 10 NZTC 5,233 (CA). While not addressing the deductibility of repairs and maintenance expenditure, *McKenzies* provides guidance on the factors the courts take into account when deciding whether expenditure is capital or revenue in nature.

105. In *McKenzies* the Court of Appeal said at 5,236:

> 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 pp 264-265:
>
> > "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 a 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.

106. The Court of Appeal in *McKenzies* noted the Privy Council decision in *BP Australia* had been recognised in New Zealand in *CIR v LD Nathan and Co Ltd* [1972] NZLR 209 (CA) and in *Buckley & Young*. Gallen J in *Christchurch Press Co Ltd v CIR* (1993) 15 NZTC 10,206 (HC) adopted the principles from *BP Australia,* which Richardson J summarised in *McKenzies*.

107. From these leading New Zealand cases seven tests have been identified to assist in determining whether expenditure is capital or revenue in nature. The courts have considered some of these tests to be more relevant than others. In addition, the tests may point in different directions when applied. As Lord Nicholls of Birkenhead in *Auckland Gas* (PC) comments at 15,707, the tests need to be applied so as to enable the dominant features which guide to a reasoned conclusion to be identified. The tests are:

- The **need or occasion** that calls for the expenditure: This test focuses on the principal reason or need for incurring the expenditure. In the context of this test the object of the expenditure is determined by looking not at the actual thing achieved, but at the reason or need for making the expenditure. Clear and accurate application of this test is important because it will often form the basis for applying the other capital/revenue tests. The Commissioner considers this test to be important in the context of repairs and maintenance expenditure; the focus is on why this work was done in this way at this time.
- Whether the expenditure is **recurrent** in nature: This test involves a consideration of whether the expenditure is recurrent or a once and for all payment. If the expenditure is recurrent and made to meet a continuous demand, this suggests the payment is part of the cost of ordinary business operations and will be a revenue outlay; capital expenditure is more likely to be spent once and for all. To some extent this test holds true for repairs and maintenance purposes. However, the Commissioner considers the usefulness of the once and for all test is limited as a capital indicator in some repair circumstances. This is because frequently repair work, by its nature, might be unplanned or the result of unexpected damage. Repairs and maintenance work that is undertaken regularly on a recurring basis is likely to be revenue expenditure.
- Whether the source of the payment is from **fixed or circulating capital**: This test focuses on whether the source of the payment is from fixed or circulating capital, rather than whether the payment affects the fixed or circulating capital of the business in question. This test is not as useful as other tests in determining whether expenditure is capital or revenue in nature because of the ease with which a taxpayer can choose between financing an asset from circulating capital or financing it from fixed capital, irrespective of the nature of the asset financed. This test has been questioned judicially (*Milburn NZ Ltd v CIR* (2001) 20 NZTC 17,017 (HC), *CIR v Fullers Bay of Islands Ltd* (2004) 21 NZTC 18,834 (HC)). In the context of repairs and maintenance expenditure, the test has less relevance because how work is funded is not a reliable indicator of its nature.
- Whether the expenditure creates an **identifiable asset**: This test indicates that expenditure will be on capital account where an asset of a capital nature has been acquired by the expenditure, or where money is spent on improving an asset or making it more advantageous. Work done to an asset will sometimes result in a new identifiable asset, for example where the work done results in the reconstruction, replacement or renewal of the asset or substantially the whole of the asset. Similarly, where the work done involves the alteration or extension of an asset the identifiable asset test may be satisfied.
- Whether the expenditure is a once and for all payment producing assets or advantages that are of an **enduring benefit**: Under this test, expenditure will be regarded as capital where it brings into existence an asset or advantage for the enduring benefit of the business. This test is one of the more relevant and persuasive tests for deciding whether expenditure is on capital or revenue account. However, in the context of repairs and maintenance expenditure, it is often a difficult test to apply, as nearly every repair done to an asset will result in some form of enduring benefit. The Commissioner considers that the more relevant enquiry is the one developed in the

repairs and maintenance line of cases as to whether the work done has resulted in a change in the character of the asset being worked on. If a change of character has occurred, then in most situations that will also result in an advantage of an enduring benefit being produced. This "change of character" test is discussed in more detail later.

- Whether the expenditure is on the **business structure** or **business process**: This test focuses on the distinction between expenditure on the business structure set up for the earning of profit, and expenditure on the process by which such a business operates to obtain regular returns by means of regular outlay. This test is also one of the more relevant and persuasive tests used to determine whether expenditure is on capital or revenue account. In a repairs and maintenance expenditure context, the deductibility enquiry usually focuses more on the asset being worked on than the business overall. However, in the Commissioner's view the business structure test may still be a relevant indicator of capital expenditure, particularly in circumstances where the asset being worked on is an integral part of the business and the loss or enhancement of that asset would affect the business structure.
- What the treatment of the expenditure is according to the **ordinary principles of commercial accounting**: The test of applying ordinary principles of commercial accounting to the expenditure, although of some assistance, is not usually determinative. It needs to be remembered that tax and accounting have different aims, and the treatment for one may differ from the treatment for the other. While this test is often used to support an approach that the other tests have come to, it is not a sufficiently conclusive test by itself to determine the issue of whether the expenditure is on capital or revenue account. The Commissioner acknowledges that for some businesses the accounting treatment required for repairs and maintenance expenditure can be quite different from the tax treatment required for that same expenditure. This makes it even more difficult to rely on accounting treatment as an indicator of the appropriate tax treatment of repairs and maintenance expenditure.

108. Therefore, in the context of repairs and maintenance expenditure, some of these general capital/revenue tests will usually be of greater relevance than others. For example, when considering the deductibility of costs to earthquake-strengthen a building, Judge Barber in *Case X26* relied on the identifiable asset test, the enduring benefit test and the business structure test to decide whether the costs were capital or revenue in nature. At [16] Judge Barber stated:

> I agree … that the disputant's expenditure is clearly on capital account and was to bring into existence advantages of a lasting character which improved an identifiable asset, ie the property, as part of the disputant's partnership's income earning structure (as distinct from income earning process).

109. Case *X26*, which was decided in 2006 in the small claims jurisdiction of the Taxation Review Authority, is the first and only reported decision to address the deductibility of repairs and maintenance expenditure since the relevant legislative changes in 1994. Although of limited precedential value given the level of jurisdiction, the Commissioner considers the correct approach to the application of the capital/revenue tests was adopted in this decision.

### *Repairs and maintenance cases*

110. While the deductibility of repairs and maintenance expenditure is solely a question of whether the costs are capital or revenue in nature, the

Commissioner considers it remains appropriate to supplement the general capital/revenue tests with the body of cases that specifically address the deductibility of repairs and maintenance expenditure. The repairs and maintenance cases can help taxpayers decide whether expenditure incurred on work done to an asset is capital or revenue in nature. This is despite most of the repairs and maintenance cases being decided under different legislation or in different jurisdictions. It is also despite it sometimes being difficult to extract precise principles from the repairs and maintenance cases where the courts have applied a combination of the traditional capital/revenue tests together with repairs and maintenance concepts to individual fact situations. Nonetheless, when considering the deductibility of repairs and maintenance expenditure, the Commissioner considers that, when applied carefully, the specific repairs and maintenance cases frequently offer the best guidance on the boundaries between deductible repairs and maintenance expenditure and repairs and maintenance expenditure of a capital nature.

### *Analysis of case law*

*Has the work done resulted in the reconstruction, replacement or renewal of the asset, or substantially the whole of the asset?*

111. As a starting point when deciding whether the cost of work done to an identified asset is deductible as revenue expenditure, the first consideration is whether the work done has resulted in the reconstruction, replacement or renewal of the asset, or substantially the whole of the asset. If it has, then the work done will be capital in nature.

112. This is consistent with the "identifiable asset test" in *BP Australia* - where the work done results in the creation of a new identifiable asset the expenditure incurred is capital expenditure.

113. One of the earliest authorities used to support this repairs and maintenance principle is *Lurcott*. While this case was not an income tax case, and therefore it does not address the capital or revenue nature of work done, it does support the principle that the reconstruction, replacement or renewal of an asset, or substantially the whole of an asset is capital expenditure. The case considered the recovery of the cost of replacing a wall that formed part of a building. The whole building was identified as the asset, and the work done to that building by replacing a wall was considered only to be a repair and not a renewal of the building. As a result, under the lessee's covenant to repair, the cost of the work done to the building was found to be recoverable from the tenant. Lord Buckley commented on the difference between a repair and a renewal at 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]

114. This principle from *Lurcott* has been applied by the New Zealand courts in deciding whether expenditure has been incurred on the replacement or repair of an asset, and therefore whether the expenditure was capital or

revenue. The Court of Appeal in *Auckland Trotting* upheld Moller J's decision in the Supreme Court that the construction of a new track in place of an old track was not a repair and therefore the cost of the work done was capital expenditure. Moller J in *Auckland Trotting Club v Commissioner of Inland Revenue* [1968] NZLR 193 (SC) at 205 held:

> Having reached this decision [that the track was the asset] I revert back to the work done in respect of it, and find, on all the evidence available, that the amount sought to be deducted by the club was incurred not by way of "repair" or "alteration", but by the construction of what was substantially a new track in place of what was, substantially, the whole of the 1960 track.

115. In the Court of Appeal Richmond J supported Moller J's finding and held at 980 that:

> In the result, the appellant has failed in my opinion to show that the work of replacing the original shell track by a new track of greater depth and constructed substantially of new materials is either a repair or alteration of premises.

116. In *Hawkes Bay Power* Goddard J was satisfied the work Hawkes Bay Power did to its urban residential distribution system, although carried out on a job by job basis over many years, was a total reconstruction project that resulted in the creation of a new asset. At 13,707, she concluded as point seven in her summary that:

> The result in the present case is that substantially the whole of the urban residential distribution system has been placed underground. It follows therefore that the urban residential system is a new and different distribution system; not a repaired system. Thus, Hawkes Bay Power has acquired by its expenditure a "new" underground urban residential distribution system.

117. As noted in *Auckland Trotting* (SC) and *Hawkes Bay Power,* capital expenditure does not only arise when an asset is completely reconstructed, replaced or renewed. Capital expenditure may also arise when substantially the whole of the asset is reconstructed, replaced or renewed.

118. This point is further illustrated by the decision in *Case J92* (1987) 9 NZTC 1,518. This case concerned repairs and maintenance work done to a farm homestead. Some structural parts of the house were retained but there was substantial replacement of framework, linings, interior joinery, plumbing and wiring as well as re-piling and extensive exterior cladding. The taxpayer argued there had not been a complete replacement of the original homestead and that much of the original structure remained. This distinguished it from the new track in *Auckland Trotting* (SC and CA). However, Judge Barber found the building work done was so extensive it could not be regarded as repairs. The work involved the complete reconstruction of the homestead.

119. At 1,522 Barber J stated:

> After a careful analysis and consideration of the evidence I find the building work undertaken by the objector on the homestead was so extensive that it cannot be regarded as "repairs or alterations". The work involved the complete reconstruction of the homestead and, in my view, the expenditure was of a capital nature and was incurred in the improvement of the premises from a capital point of view.

120. The work done to the asset must be looked at in its totality to decide whether the work done is so substantial that the whole, or substantially the whole of the asset is reconstructed, replaced or renewed. This can include looking at the work done over more than one income year as was the case in *Auckland Gas, Poverty Bay Electric and Hawkes Bay Power.* Blanchard J noted at 15,024 of *Auckland Gas* (CA):

> The work done in a particular year is properly to be seen in its overall context, which was of an ongoing programme to replace all the low-pressure system as a conveyor of gas. The question is: what was being achieved? A taxpayer cannot by artificially treating as separate works portions of an overall programme done in separate income years deny the reality or minimise the extent of what is being effected.

121. A decision as to whether the work done to the asset is so substantial that the whole, or substantially the whole, of the asset is reconstructed, replaced or renewed may not always be easy. However, it is a judgement that needs to be made, especially when components of an asset are renewed instead of simply being kept in a serviceable condition. Some of the factors the courts have taken into account when making such judgements are set out later in this Interpretation Statement at paragraph [160] under the heading "*Scale of the work done*". These factors include indicators such as the extent of the work done to the asset, the size and importance of the replacement parts to the asset and the cost of the work done. This enquiry will always be a matter of fact and degree.

122. However, when determining whether expenditure for work done to an asset is capital or revenue in nature, it is not enough only to determine whether the work done to an asset has reconstructed, replaced or renewed the asset, or substantially the whole of the asset. The cost of the work done will still be capital expenditure if it has the effect of changing the character of the asset. This issue is discussed next.

*Has the work done changed the character of the asset?*

123. Where repair work done to an asset falls short of being a reconstruction, replacement or renewal of the identified asset, or substantially the whole of the asset, then further analysis on the effect of the work done on the character of the asset is required to determine whether the costs are capital or revenue in nature. By character of the asset, what is being referred to is the asset's distinct nature.

124. In *Auckland Gas* (PC) Lord Nicholls clarified that it is not right to presume that the cost of work done to an asset is deductible as "repairs" where that work falls short of resulting in a reconstruction, renewal or replacement of the asset, or substantially the whole of the asset. Simply put, Lord Nicholls acknowledged that sometimes the work done may well be repairs or maintenance and deductible, but that will not necessarily be the case in every situation. He considered that sometimes repair work can be capital in nature. Lord Nicholls noted that authority on the distinction between "repair" and "replacement" is only of limited assistance and that some objects do not lend themselves easily to this "exercise in characterisation". He commented at 15,706:

> Authority on the question of repair or replacement is of limited assistance. The physical objects to which the test of repair has to be applied vary widely. So does the nature of the work done. Judicial dicta applicable to one set of circumstances may be unhelpful or misleading when applied in different circumstances. This is true even of the celebrated observation of Buckley LJ in *Lurcott v Wakely & Wheeler* [1911] 1 KB 905 at p 294 ….

125. His Lordship considered that in cases where the work done to an asset falls short of being a reconstruction, replacement or renewal of the asset, or substantially the whole of the asset, the important consideration for determining the nature of the expenditure is "the effect of the work on the character of the object". Lord Nicholls stated at 15,706:

> … sometimes repair may not be the appropriate description of work even though it falls far short of being a replacement of substantially the whole of the relevant

> subject-matter. The effect of the work on the character of the object is also an important consideration.

126. If the work done to an asset has the effect of changing its character it will be capital expenditure. If the work done to the asset does not have the effect of changing the character of the asset the cost of the work done will be revenue in nature and deductible.

127. Lord Nicholls went on to identify two factors as being relevant when deciding whether the work done to an asset has the effect of changing the character of the asset: the nature and the scale of the work done. His Lordship stated at 15,707:

> If a significant portion of this series of linked pipes is effectively abandoned and replaced wholesale with new pipes, the work may readily go beyond what would normally be regarded as repair of the existing system. This is especially so if the new pipes are made from materials which perform differently from the old ones. **The work may be of such a nature and scale as to change the character of the existing system. This is to be contrasted with replacing or making good specific leaking pipes or joints. The latter would be repair, the former would do more than repair what was damaged.** [Emphasis added]

128. In *Auckland Gas* (PC) it was found that as a result of the scale of the work done and the materials used by the gas company the character of the existing gas network had been changed. A significant portion of the network had effectively been abandoned and replaced. It was also found that the function of the old pipes had changed so that they no longer carried gas, but instead had become housing for the polyethylene pipes that now carried the gas. Lord Nicholls stated at 15,708:

> Far from restoring the gas distribution system to its original state, the work changed the character of the existing gas distribution system: a significant portion of it had been upgraded. Substantial portions of the cast-iron mains and steel services were superseded by polyethylene pipes having the differences and advantages mentioned above.

129. This Interpretation Statement now considers the two factors for determining the effect of the work done on the character of an asset:

- the nature of the work done, and
- the scale of the work done.

*Nature of the work done*

130. Lord Nicholls in *Auckland Gas* (PC) referred to several decisions that formed the basis for his finding that the nature of the work done to the asset, including the choice of materials used, might change the character of the asset. Lord Nicholls stated at 15,706-15,707:

> … sometimes repair may not be the appropriate description of work even though it falls far short of being a replacement of substantially the whole of the relevant subject-matter. **The effect of the work on the character of the object is also an important consideration**.
>
> This is explicit, or implicit, in several decided cases. In *W Thomas & Co Pty Ltd v Commissioner of Taxation of the Commonwealth of Australia* (1965) 115 CLR 58 at p 72, *Windeyer* J observed that **repair "involves a restoration of a thing to a condition it formerly had *without changing its character*"** (emphasis added). In *Highland Railway Co v Balderston (Surveyor of Taxes)* (1889) 2 TC 485 parts of the main railway track were re-laid, not after their existing fashion, but with steel rails and heavier chairs. The Court of Session held this **substitution was a material alteration and great improvement, and contrasted this with taking away any worn rails and renewing them along the line: that "would not alter the character of the line"** (see the

> Lord President, Lord Inglis, at p488). The Judicial Committee applied this dictum in *Rhodesia Railways Ltd v Collector of Income Tax, Bechuanaland Protectorate* [1933] AC 368 where **the cost of relaying a railway line so as to restore it to its former condition was held to be a legitimate charge against income**. Consistently with this, in *Mitchell v BW Noble Ltd* [1927] 1 KB 719 at p 729, Rowlatt J observed that **replacement of a railing which perpetually falls down or needs painting with a brick wall would be capital expenditure**. In *FC of T v Western Suburbs Cinemas Ltd* (1952) 86 CLR 102 **a dangerous ceiling in a cinema was replaced with a new and better ceiling. Kitto J regarded the work as different in degree and kind from the type of repairs properly allowed for in the working expenses of a theatre business**. [Emphasis added]

131. If the nature and scale of the work done to an asset indicates that the work has gone beyond repairs, and has changed the character of the asset, the cost of that work is capital expenditure.

132. Usually the character of an asset will be changed when the work done improves or enhances the asset in some way or makes it more advantageous. However, an improvement to the asset will not always be determinative of capital expenditure. This is because almost any repair work to an asset will result in some degree of improvement to that asset. To be capital in nature the work done must go beyond ordinary restoration and change the character of the asset.

133. One decision that Lord Nicholls relied on was the well-known Scottish decision of *Highland Railway*, which the Privy Council also applied in *Rhodesia Railways*. These two railway cases are often compared to demonstrate the effect the work done can have on the character of an asset.

134. In *Highland Railway* the court decided that alterations made to the company's main railway line changed its character so that the expenditure incurred was capital in nature. The court held at 488:

> Then when we come to the question of the alteration of the main line itself, it must be kept in view that this is not a mere relaying of the line after the old fashion; it is not taking away rails that are worn out or partially worn out, and renewing them in whole or in part along with the whole line. That would not alter the character of the line; it would not affect the nature of the heritable property possessed by the Company. **But what has been done is to substitute one kind of rail for another, steel rails for iron rails.** Now that is a material alteration and a very great improvement on the corpus of the heritable estate belonging to the Company, and so stated is surely a charge against capital. [Emphasis added]

135. In contrast, the Privy Council in *Rhodesia Railways* distinguished *Highland Railway* and held that expenditure on repairs to the railway line did not have the effect of changing the character of the line. Instead, the expenditure was found to be an ordinary incident of railway administration. Lord Macmillan stated at 374:

> The periodical renewal by sections of the rails and sleepers of a railway line as they wear out by use is in no sense a reconstruction of the whole railway and is an ordinary incident of railway administration. The fact that the wear although continuous is not and cannot be made good annually does not render the work of renewal when it comes to be effected necessarily a capital charge. The expenditure here in question was incurred in consequence of the rails having been worn out in earning the income of previous years on which tax had been paid without deduction in respect of such wear, and represented the cost of restoring them to a state in which they could continue to earn income. It did not result in the creation of any new asset; it was incurred to maintain the appellants' existing line in a state to earn revenue.

136. Lord Macmillan commented on the differences between the situations in *Highland Railway* and *Rhodesia Railways* at 376:

> The contrast between the cost of relaying the line so as to restore it to its original condition and the cost of relaying the line so as to improve it is well brought out in the passage just quoted [ie, the passage quoted at paragraph [134] of this statement], and while the former is recognised as a legitimate charge against income the extra cost incurred in the latter case in the improvement of the line is equally recognized as a proper charge against capital. In the present instance the renewals effected constituted no improvement; they merely made good the line so as to restore it to its original state.

137. Lord Nicholls in *Auckland Gas* (PC) also referred to *FCT v Western Suburbs Cinemas*. That case is often considered with *Conn (HM Inspector of Taxes) v Robins Bros Ltd* (1966) 43 TC 266 (Ch). Both cases involved significant work done to repair buildings, but the court in each case reached a different outcome. Looked at together, the two cases illustrate the effect the nature of the work done can have on the character of an asset. They also demonstrate how the particular materials used can affect the nature of the work done. The assessment of the work done will always be a question of fact.

138. In *Western Suburbs Cinemas* a damaged ceiling was replaced because an architect considered it was impractical to repair. The court decided the cost of replacing the ceiling was expenditure on capital account. The ceiling was *replaced* with a new ceiling constructed from more suitable modern materials than those materials previously used, even though equivalent materials were available. The court held that the work done did much more than meet a need for restoration. The resulting ceiling was new and better and had considerable advantages. It was held that the repair work done was different, in degree and in kind, from the usual allowable working expenses of a theatre business. Kitto J stated at page 105:

> To decide whether a particular item of expenditure on business premises ought to be charged to capital or revenue account is apt to be a matter of difficulty, though the difference between the two accounts is clear enough as a matter of general statement (*Sun Newspapers Ltd. v. Federal Commissioner of Taxation*). **In this case the work done consisted of the replacement of the entire ceiling, a major and important part of the structure of the theatre, with a new and better ceiling**. The operation seems to me different, not only in degree, but in kind, from the type of repairs which are properly allowed for in the working expenses of a theatre business. It did much more than meet a need for restoration; **it provided a ceiling having considerable advantages over the old one**, including the advantage that it reduced the likelihood of repair bills in the future. The case resembles one of the illustrations given by Rowlatt J. in *Mitchell v. B. W. Noble Ltd* [1927] 1 KB 719, at p 729. As his Lordship there observed, if you say, "I will not have a railing which perpetually falls down or wants repainting; I will abolish it and I will build a brick wall which will not fall down or will not want painting", that is a capital expenditure. **The truth is, I think, that the new ceiling was an improvement to a fixed capital asset and that its cost was a capital charge.** [Emphasis added]

139. *Robins Bros* involved extensive repairs to leased retail premises. The building was over 400 years old and for the most part was original, but a great part of it was rotten. The building was protected and any work done to it could be for preservation purposes only. The work done included renewing some of the roof timbers and replacing the slate roof with corrugated asbestos. Some walls on the lower floor were removed, so steel girders had to be inserted to support the upper storeys. The rotten timber ground floor was re-formed in concrete. In contrast to the decision in *Western Suburbs Cinema*, the court in *Robins Bros* held that although there

was extensive replacement of the existing asset, the expenditure was on revenue account. Buckley J's reasoning at 274 was 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 Commissioners' 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]

140. While the decisions in *Western Suburbs Cinemas* and *Robins Bros* might seem contradictory, the Commissioner considers the two cases demonstrate the subtle factual differences that make decisions in this area so difficult. It is not wise simply to view the cases as irreconcilable or that the approach in one case is to be preferred over the other. What is clear from these two cases is that when major components of an asset are replaced instead of simply being repaired to a serviceable condition, a judgement has to be made as to the nature of the work done to the asset.

141. In *Western Suburbs Cinemas* the court focused on the improvement the taxpayer made by choosing to replace the damaged ceiling with a new ceiling constructed from a superior modern product when other equivalent products were available. The inference is that if the ceiling had been repaired using the equivalent materials then the work would have been more likely to be a deductible repair. In *Robins Bros*, the company took a different approach to maintaining the building (much of which was 400 years old and protected), and viewed the replacement of major components as a natural part of the repair process, using materials that were appropriate for construction at the time the work was done. Arguably, in *Robins Bros* the company did not seek to improve the building but only to maintain the building's inherent utility. The building remained the same size and in the same location. The building was not completely reconstructed, replaced or renewed, nor was substantially the whole of the building reconstructed, replaced or renewed. The court found in *Robins Bros* that, based on its particular facts, while the building was improved as a result of being repaired, the work done to the building did not go beyond repairs. In contrast, the work done to the ceiling in *Western Suburbs Cinemas*, while necessary, went beyond restoration and changed the character of the building.

142. It is also interesting to consider the decision in *Robins Bros* in the light of Lord Nicholl's observations in *Auckland Gas* (PC) regarding *Lurcott*. Lord Nicholls makes it clear that work done to an asset will be capital expenditure where that work results in the asset, or substantially the whole of the asset, being reconstructed, replaced or renewed. As seen, Lord Nicholls also makes it clear that work done to an asset will be capital expenditure where that work changes the character of the asset. Buckley J appeared to be influenced by the lower court finding of fact that the work done was repairs. It could be suggested that if similar facts as in *Robins Bros* arose under the ITA 2007, the expenditure would be found to be capital in nature on the

basis that the character of the building had changed, or the work amounted to a reconstruction, replacement or renewal of substantially the whole of the asset, or both.

*Use of more modern materials*

143. The decision in *Western Suburbs Cinemas* illustrates how the materials used to make repairs can have an important bearing on the nature of the work done.

144. In *Western Suburbs Cinemas* the ceiling of the theatre was predominantly made from sheets of an imported product called "Ten Test". Over time the Ten Test material had become dry, buckled and brittle. Many of the pins affixing the sheets to the ceiling joists had drawn through. An architect concluded that it was practically impossible to repair the ceiling. The product Ten Test was not available, although two equivalent products were available - celotex and caneite. However, the architect would not use any product of this type as he considered them to be unsatisfactory for this purpose. Instead he replaced the ceiling with fibrous plaster, attached to new battens that were attached to new ceiling joists. The plaster had a longer life, was harder, better suited to decorative treatment and could be moulded. Even though the architect had advised against repair, the cinema company still got a price for repairs to the ceiling using equivalent materials. The company considered both options (ie, repair or replacement of the ceiling) and chose not to repair but to replace the whole ceiling. Kitto J concluded at 106 that the result of the work done was a "new and better" ceiling that provided considerable advantages over the old one. He found that "the new ceiling was an improvement to a fixed capital asset" and therefore capital expenditure.

145. These same principles were applied by Judge Barber in the Taxation Review Authority decision, *Case F78* (1984) 6 NZTC 59,951. Judge Barber decided the replacement of a cracked fibrolite roof of a rental property with a new type of tiled roof did not restore the asset to its original character but altered it. The roof could have been repaired by the replacement of the damaged sheets of fibrolite but instead the owners chose to replace the entire roof with a "better" type of tiled roof. This meant the work was capital in nature.

146. In *Auckland Gas* (PC) Lord Nicholls also discussed the use of new materials in repairs and maintenance work. He noted that the use of newer and better technology may not in itself change the character of the asset. At 15,706 he states:

> It often happens that, with improvements in technology, a replacement part is better than the original and will last longer or function better. That does not, of itself, change the character of the larger object or, hence, the appropriate description of the work.

147. However, while the use of new materials may not in itself change the character of an asset, Lord Nicholls went on and found in *Auckland Gas* (PC) that when new materials were used extensively and performed differently, then their use did result in a change of character of the asset. He held that the fact that a significant portion of the gas network had been replaced with new polyethylene pipes, together with the fact that the new pipes were made of materials which performed differently from the old pipes, meant that the nature and scale of the work was such that the character of the existing gas system was changed (at 15,708).

148. With regard to the nature of the work done, the use of new materials in completing the work does not necessarily mean that the asset is improved. However, where different materials are used and as a result the asset is more advantageous or performs or functions better or differently than it did previously, that may indicate a change in the character of the asset. Where a decision is made to use better materials instead of the same or equivalent materials a change in the character of the asset will result and the cost of the work done will be capital expenditure.

149. However, regardless of the choice of materials, as seen above, where new materials are used extensively so that the asset, or substantially the whole of the asset, is reconstructed, replaced or renewed, the expenditure will be capital in nature.

*Other factors potentially affecting the nature of the work done*

150. From time to time the courts have been asked to take into account other factors when deciding whether the work done to an asset is capital or revenue in nature. The types of factors that the courts sometimes consider include the effect of the work done on:

- the value of the asset;
- the income-earning capacity of the asset;
- the useful life of the asset;
- the function of the asset;
- the operating capacity of the asset.

151. The cases show that these factors are rarely determinative of the nature of the work done. The courts instead consider the overall effect of the work done on the asset when determining whether the character of the asset has changed.

152. For example, an increase in value by itself has not been considered a reliable indicator of work being of a capital nature. In *Poverty Bay Electric* Blanchard J commented at 15,008:

> It is worth observing also that it is hard to see the adding of value as an essential element in capital expenditure when restoration or repair work usually adds value to the object which is restored or repaired.

153. Similarly, the income-earning capacity of an asset does not need to increase for the work done to the asset to be capital in nature. The changes made to the railway line in *Highland Railway* were found to be a "permanent improvement" even though the company "derived no additional revenue from the outlay". Therefore, a comparison of the income-earning capacity of the asset alone cannot always accurately determine whether the work done has changed the character of the asset. This conclusion was also reached by Judge Barber in *Case X26* in response to an argument that the work done to the building did not result in any increase in the rental income the building was capable of generating, and therefore the cost could not be capital expenditure.

154. It is sometimes suggested that the extension of an asset's useful life may indicate the work done to an asset is of a capital nature. Correspondingly, if there is no increase in an asset's useful life that may indicate revenue expenditure. However, the Court of Appeal in *Auckland Gas* noted at 15,022 that if the old gas network had been repaired by merely replacing the joints and corroded sections of pipe the network would have been capable of giving more service and the benefits would have been long lasting. Further,

the Court of Appeal observed that where the work done creates a new asset it is not essential that the life of the original asset be extended for the work done to be capital in nature. This means that the effect of the work done on an asset's useful life is not always a reliable indicator of the capital or revenue nature of work done to an asset. Every fact situation is different.

155. In *Auckland Gas* (PC), Lord Nicholls also noted that a comparison of the functional position of an asset before and after the work is done is not a reliable guide by itself as to whether the work done is capital or revenue in nature. He explained at 15,708 that this was because a maintenance problem can be solved in more than one way:

> The Court of Appeal held, and their Lordships agree, that Williams J [in the High Court] reached a conclusion which did not reflect the reality of the work done. In particular, his comparison of the functional position before and after was made at a level of abstraction which paid insufficient regard to the nature and extent of the operation carried out by Auckland Gas. A maintenance problem such as existed here may be capable of being solved in more than one way. It may be solved by work which would be regarded as a repair of the existing structure. Or it may be solved by scrapping all or much of the existing structure and providing a new one. **In overall functional terms the result may be much the same in the two cases, but that is not by itself a reliable guide.** If the latter alternative is chosen, the expenditure may well be of a capital nature. [Emphasis added]

156. Lord Nicholls then said at 15,709 that:

> … the desire to solve a maintenance problem is not inconsistent with carrying out work of a capital nature. **The nature and extent of the work carried out to the physical asset are what is determinative of the character of the work**. [Emphasis added]

157. A further point to note is that sometimes work done to an asset may result in unsought benefits. For example, in *Auckland Gas* the insertion of the replacement pipes meant that the new pipes, although smaller in diameter, would be able to carry gas at a higher pressure than the old pipes. This meant the overall capacity of the network was increased. While this outcome was not a goal in itself, as the existing system already had enough additional capacity for future growth, it was found to be an improvement brought about by the work done, and as such indicated a change in the character of the network.

158. This suggests that where the work done to an asset results in an unsought benefit, the fact that obtaining the advantage was not a goal of the work done does not prevent a finding that the character of the asset has been changed.

159. In summary, factors such as changes to an asset's value, earning capacity, useful life, function or operating capacity, whether or not a goal of the work done, cannot be relied on in isolation to establish the nature of the work done to the asset. However, in some cases the courts have tended to use such factors to support an overall assessment of whether the character of an asset has changed.

*Scale of the work done*

160. Another important consideration when determining whether the work done to an asset has changed the character of the asset is the scale of the work done. This is also an important consideration when determining whether the work done has resulted in the asset or substantially the whole of the asset being reconstructed, replaced or renewed.

161. When considering the scale of the work done the courts may take into account the extent of the work done, the importance of the work done to the asset and the business, and the cost of work done in the context of the asset.

162. As seen in *Auckland Gas* (PC) Lord Nicholls confirmed that repairs and maintenance expenditure is on capital account when the work done to the asset is so substantial that it is a reconstruction, replacement or renewal of the identified asset or substantially the whole of the asset. Under general capital/revenue principles, one-off expenditure that results in the creation of a new asset, or the production of an advantage of an enduring benefit, may indicate that expenditure is of a capital nature. The courts have also indicated that even where the work done to an asset falls short of being the renewal of substantially the whole of the asset, the more substantial the work is in relation to the asset, the more likely it is that the work will have had the effect of changing the character of the asset and will be of a capital nature. For example, in *Auckland Gas* polyethylene pipes were inserted into 380 km of the network's cast-iron mains and into 150 km of the network's steel services, amounting to 23% of the entire network and 32% of the steel services respectively. The courts found that these were substantial portions of the gas distribution system.

163. In *Case L68* (which concerned work done to two fishing boats – the first had its motor replaced and the second was refitted), Judge Keane considered the scale of work done to refit the second boat indicated the expenditure was capital in nature. He held at 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.**
>
> ...
>
> The refitting of the "S" seems much more to me than an accumulation of repairs. **The sheer scale of what was done tells against the possibility that it was routine.** It was an extraordinary event in the life of the vessel. There was nothing piecemeal about what was done. The whole capital entity was affected. Entire aspects of the fabric were replaced. The vessel was restored in the fullest sense, in some respects with more modern materials, to a new and much extended life. The expenditure seems to me to have been capital in nature. [Emphasis added]

164. It also follows that the bigger, more significant or more integral the part of the asset being worked on or replaced is, relative to the asset as a whole, the more likely the expenditure will be of a capital nature. For example, in *Western Suburbs Cinemas* Kitto J referred to the fact the ceiling was a "major and important part of the structure of the theatre" when reaching his conclusion that the expenditure was capital.

165. In *Case N8* (which concerned the deductibility of repair costs to a cement manufacturing plant), Judge Bathgate found it significant in his analysis of the work done to the plant that the mixer was replaced. The mixer was central to the operation of the plant and was housed in the tower of the central working core of the batching plant. The contents of the tower were replaced to a significant degree.

166. At 3,074 his Honour commented:

> Altogether, item by item by item there was a significant replacement and renewal of the central core parts in the concrete making process. There were also significant replacements by renewal of many stationary parts. When they

> are together considered with the renewal, replacements and improvements to the structural parts housing or supporting the plant and equipment, the entire entity, as a composite whole had such a quantity and value of work that I think, fairly obviously, it was capital and not revenue in character.

167. Therefore, when the scale of the work done is being considered, the importance of the parts being worked on to the asset and to the business as a whole forms part of that consideration.

168. Judge Bathgate also considered that the cost of the work done relative to the value of the asset can be an indicator as to the nature of the expenditure. In keeping with general capital/revenue principles he suggested an amount incurred regularly and that is small, relative to the whole value of the asset, is more likely to be revenue in nature. On the other hand, one-off expenditure that is substantial in relation to the value of the asset before the work is done is more likely to be capital in nature. He stated at 3,073:

> 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 under sec 108(1). [Emphasis added]

169. Judge Bathgate's decision provides one example of how cost can be taken into account in the assessment of the nature and scale of the work done – in that case comparing the cost of the work with the value of the asset. However, in the Commissioner's view, the courts do not provide any consistent authority as to how best to make such cost comparisons, nor the importance of them. The courts tend to focus more widely on the scale of the work done to the asset, of which cost is only one factor.

170. In *Hawkes Bay Power*, when considering the effect of the work done Goddard J said at 13,706:

> The evidence from the valuation experts … was extremely interesting, although varied. In the end, however, it did not assist in determining the key issues. …the fact of the matter is that the degree of expenditure invested by Hawkes Bay Power in its underground conversion programme can only be regarded as capital in nature.

171. In summary Goddard J noted at 13,707 that "the scale and degree of the work involved in the total project and the money expended on it leads to only one conclusion; that is, that the expenditure in question is capital in nature".

172. In the Commissioner's view, cost on its own is not always a reliable indicator of the nature of expenditure. Sometimes the cost of repair work can be very high, for example, if the replacement parts are expensive or the repair work is difficult. This does not mean the nature of the work done has changed from being revenue to capital. Similarly, in some circumstances it may be less expensive to replace an asset than to repair it – but that saving does not change the character of the work done from being capital. That said, the Commissioner considers that as a general proposition the more significant the costs incurred, the more likely the expenditure will be capital in nature.

173. Overall, the courts consider the scale of the work done, including the extent and cost of work done, when deciding whether work done is of a capital or

revenue nature. The more important the asset is to the business, or the more integral the replacement parts are to the asset then arguably the scale of work done increases and the more likely the expenditure will be capital in nature.

174. When both the nature and the scale of the work done are considered, a decision can be made as to the character of the work done – that is, whether it is capital or revenue in nature.

**Key points on the nature and extent of the work done to the asset**

175. The Commissioner takes the following key points from the analysis of the cases on the nature and extent of the work done:

- If the work done results in the reconstruction, replacement or renewal of the asset or substantially the whole of the asset the cost of that work will be capital expenditure. (*Auckland Gas* (PC), *Auckland Trotting* (SC and CA), *Lurcott*)
- Expenditure incurred to repair or maintain the asset, over and above making good wear and tear, that has the effect of changing the character of the asset will also be capital expenditure. Expenditure incurred to repair or maintain the asset without changing its character will be on revenue account. (*Auckland Gas* (PC))
- When determining whether the work done is capital in nature, relevant factors to consider are the nature and the scale of the work done to the asset (*Auckland Gas* (PC)).
- With regard to the nature of the work done, the use of new materials in completing the work does not necessarily mean that the asset is improved. However, where different materials are used and as a result the asset is more advantageous or performs or functions better or differently than it did previously, that may indicate a change in the character of the asset. Where a decision is made to use better materials instead of the same or equivalent materials a change in the character of the asset will result and the cost of the work done will be capital expenditure. Where new materials are used extensively so that the asset, or substantially the whole of the asset, is reconstructed, replaced or renewed, the cost of the work done will be capital expenditure regardless of the choice of materials. (*Auckland Gas* (PC), *Western Suburbs Cinemas*, *Case F78*)
- Changes to an asset's value, its earning capacity, its useful life, function or operating capacity, whether or not a goal of the work done, cannot be relied on in isolation to establish the nature of the work done to the asset. Instead in some cases the courts have tended to use such factors to support an overall assessment of whether the character of an asset has changed. (*Poverty Bay Electric, Highland Railway, Auckland Gas* (PC and CA))
- Determining the scale of the work done includes a consideration of the extent of the work done, the importance of the work done to the asset and the business, as well as the cost of the work done. The greater the extent of the work done, the greater the importance of the work done to the asset and the business, and the more significant the costs incurred, the more likely the expenditure will be capital. (*Auckland Gas* (PC), *Case L68, Western Suburbs Cinemas*, *Case N8, Hawkes Bay Power)*

## Examples – nature and extent of the work done to the asset

### *Example 5– taxi driver replaces engine (no change in character or substantial renewal)*

Frank is an owner-operator taxi driver. He has driven the same taxi for the past 5 years. Until recently the taxi has been reliable and overall is in good condition. Frank has had his taxi serviced regularly but his mechanic has advised him that the engine is now seriously worn. Frank arranges for his mechanic to replace his taxi's worn engine with a reconditioned engine that is comparable to the worn one. The cost of the replacement engine and its installation is revenue in nature. This is because the work done does not go beyond repairs to change the character of the taxi. The work done also does not result in a renewal of substantially the whole of the asset (ie, the taxi).

### *Example 6 – taxi driver upgrades engine (change in character)*

Frank decides that if he needs to install a reconditioned engine in his taxi, rather than replacing the worn engine with a comparable engine he would prefer to upgrade to a more powerful one so that he can tow a luggage trailer. The ability to carry additional luggage will expand his business. Therefore, he asks his mechanic about sourcing and installing a compatible but more powerful engine. In this case the cost of the replacement engine and its installation will be capital expenditure. This is because the work done goes beyond repairs and has changed the character of the taxi.

### *Example 7 – refurbishment of item of industrial plant (substantial replacement and renewal)*

Best Processors Limited owns a large item of specialised industrial plant that is central to its business. Due to wear and tear on the plant, and despite regular maintenance, the company is concerned that the quality of its products is declining. To ensure the company preserves its quality standards the company resolves to refurbish the item of plant. Extensive work is undertaken. The plant casing is repaired. The core processor unit is replaced, along with the drive mechanisms, motors and conveyors. Repairs on related parts are also undertaken. As a result of the work done to the plant, improved production quality is achieved. There have been negligible gains in the operating capacity of the plant. The cost of the work done was significant.

The costs incurred by Best Processors Limited will be capital expenditure. Although the plant may not be functionally different after the work, overall, a replacement and renewal of substantially the whole of the plant has occurred. The nature and scale of the work done supports this conclusion.

### *Example 8 – replacement of rotary platform in a dairy shed (substantial replacement and renewal)*

Loamsdown Farms needs to replace the rotary platform in its rotary dairy shed. The existing platform drive mechanism and motor will be retained. The new platform will have no greater capacity than the old platform. The rotary platform, together with its associated drive mechanism and motor, makes up the rotary platform asset. The replacement of the platform will involve the replacement and renewal of substantially the whole of the rotary platform asset. The platform is a significant and distinct part of the entire rotary system in terms of both its size and value. The cost of replacing the rotary platform will be capital expenditure. An increase in the capacity of the platform is not necessary to establish capital expenditure, if the replacement is so significant that it amounts to the replacement or renewal of substantially the whole of the asset.

(This example is based on findings made in the Commissioner's Interpretation Statement IS0025 "Dairy Farming – Deductibility of certain expenditure" *Tax Information Bulletin* Vol 12, No 2 (February 2000).)

***Example 9 – insulation top-up (no change in character or substantial replacement or renewal)***

Peter and Alice own a residential rental property in Wellington that was built 30 years ago. After a cold snap, their tenants complain that the insulation in the house has deteriorated and is no longer effective. Peter and Alice arrange for new insulation to be inserted into the house. The cost of the insulation is revenue in nature on the basis that it is a repair to the property and does not change the character of the asset. Nor does it result in a replacement or renewal of substantially the whole of the house. The work done only restores the property to its former condition.

***Example 10 – new insulation (improvement that changes character)***

Ralph and Bridget own a residential rental property that has never been insulated. Their tenants have been asking for years for the walls and floors to be insulated. Finally, Ralph and Bridget agree and insulation is installed. The cost of this new insulation is capital expenditure. It is not a repair to the rental property. The addition of insulation to the house improves the house and changes its character.

***Example 11 – replacement of garage roof using equivalent materials (no change in character or substantial reconstruction, replacement or renewal)***

Natalie and Albert own a residential rental property. The rental property has a lean-to garage attached to it which has an asbestos roof. The roof has recently cracked and started leaking. It is no longer appropriate to use asbestos as a roofing material, so the roof of the lean-to is replaced with a comparable pre-painted steel roofing product. The cost of replacing the garage roof is revenue in nature. In this case the work done does not change the character of the asset. This is even though a newer, more modern material was used. The roofing material selected reflects current building practices, was an equivalent product and did not improve the lean-to beyond restoring it to its original condition. Nor did the work result in a reconstruction, replacement or renewal of substantially the whole of the house.

***Example 12 – leaky home repairs (no change in character or substantial reconstruction, replacement or renewal)***

Cath and Simon own a residential rental property. A few years ago they added a two room extension to the property. The extension has been leaking. The timber framing within the extension is rotten and needs replacing. To make the repairs the cladding and windows need to be removed from the extension and refitted. The cost of the repairs is revenue in nature. The work done to the house does not amount to a reconstruction, replacement or renewal of substantially the whole of the house. Nor do the repairs change the character of the house.

***Example 13 – leaky home improvements (change in character)***

Cath and Simon are unlucky and have discovered that another of the rental properties they own is a “leaky home”. In this case the solution is not as straightforward as in Example 12 above and the remedial work required is extensive. Cath and Simon decide to re-clad all the house’s exterior walls using a superior concrete block construction system rather than the equivalent substitute cladding system. While the concrete block construction system is more expensive, it should be more durable, and require less maintenance. The cost of repairs will be capital expenditure. The work done goes beyond repairing the house and the character of the house is changed. This is the outcome in this case regardless of whether the work done results in the reconstruction, replacement or renewal of the house or substantially the whole of the house.

***Example 14 – major repairs to leaky building (substantial reconstruction)***

Stuart owns a stand-alone single-storey commercial building in Onehunga that he leases to a small manufacturing business. The building has been leaking badly and the walls and timber framing are extensively damaged. To rectify the damage and prevent it recurring, extensive work is undertaken. All the exterior wall cladding is removed and replaced with an equivalent recommended product. Large sections of

the building's framing are replaced with treated timber. Also, damaged sections of the floor are replaced. New flashings are installed around the windows, and portions of the interior walls are relined. The cost of the work done to the building is significant. The cost is capital expenditure. This is because the remedial work done is so extensive it has resulted in the reconstruction of substantially the whole of the building.

***Example 15 – repair to land improvement (no change of character or substantial reconstruction, replacement or renewal)***

Andrea owns a rental property. The house is built on a steep slope, and rests on a terrace that has been cut into the hillside. The hillside is supported by a large retaining wall. The retaining wall is deteriorating in some places and needs to be repaired. The asset in this case is the retaining wall (a land improvement). The expenditure on the work done to repair the retaining wall is revenue in nature. The work done is not extensive enough to amount to a reconstruction of substantially the whole of the retaining wall. The work done also does not change the character of the wall.

### *Other considerations from the repairs and maintenance cases*

176. Over the years the courts have considered many different situations relating to the deductibility of repairs and maintenance expenditure. To deal with some of these situations the courts have developed a number of principles that can provide assistance when deciding whether repairs and maintenance expenditure in these types of situations is deductible. This Interpretation Statement will now consider some of these situations along with the principles that have been developed by the courts:

- What if repairs are deferred and then completed all at once?
- What happens when the repair work forms part of one overall project?
- What are notional repairs?
- Is a deduction available for expenditure incurred to repair a newly acquired but dilapidated asset?
- Does the nature of the expenditure change if damage is repaired as a result of a significant event?

*What if repairs are deferred and then completed all at once?*

177. Where the work done is the result of accumulated repairs the expenditure may be deductible. The timing of repairs can vary. Some businesses undertake repairs and maintenance of their business assets on a regular basis. Other businesses may undertake repairs as and when they become necessary. Some businesses may choose to defer their repairs and maintenance work and carry them out infrequently at a time that is convenient to the business. Other businesses may undertake regular maintenance but from time to time they may also be required to perform a major overhaul of an asset.

178. Where repairs are deferred, then accumulated and completed all at once, the resulting scale of work done can be substantial. Similarly, where significant overhaul costs are incurred occasionally in addition to regular repairs costs, the issue can arise as to whether the work done, through its scale and because it occurs irregularly, is capital expenditure.

179. The courts have considered issues relating to the timing of repairs and whether the deferral of repairs can result in the cost of those repairs being capital expenditure.

180. *Ounsworth* considered the deductibility of costs incurred by a ship-building company to regain access to the sea. The previous shipping channel available to the company had silted up through neglect. A local railway company was responsible for keeping the channel clear but it had not carried out dredging for several years. Rowlatt J commented that the cost of dredging the existing shipping channel would have been revenue expenditure to the railway company if the channel had been dredged year by year, or even if it had only been dredged as and when seriously required. However, in this case he held that the cost incurred by the ship-building company in regaining access to the sea by dredging some of the channel itself and constructing a deep-water berth was capital expenditure. The company had effectively abandoned its old means of access and constructed a new means of access to the sea.

181. However, the obiter comments Rowlatt J made in *Ounsworth* demonstrate that deductibility of expenditure on repairs and maintenance is not limited to expenditure incurred regularly year by year. Expenditure incurred on repairs and maintenance as and when required can also be deductible. Rowlatt J said at 273 that "the real test is between expenditure which is made to meet a continuous demand, as opposed to an expenditure which is made once [and] for all".

182. The Privy Council's decision in *Rhodesia Railways* supports the view that the deferral of repairs should not change the character of those repairs from being revenue expenditure to capital expenditure. Lord Macmillan stated at 374:

> The periodical renewal by sections of the rails and sleepers of a railway line as they wear out by use is in no sense a reconstruction of the whole railway and is an ordinary incident of railway administration. **The fact that the wear although continuous is not and cannot be made good annually does not render the work of renewal when it comes to be effected necessarily a capital charge.** [Emphasis added]

183. Sometimes repairs can take a lengthy period to complete. Again, the courts have held that this does not determine whether the expenditure incurred is revenue or capital in nature. Lord Nicholls commented at 15,708 of the Privy Council's decision in *Auckland Gas* that "the speed or slowness with which the work was carried out cannot affect its nature or, hence, its proper characterisation".

184. The Commissioner notes however, that if the repairs become so extensive that they amount to the reconstruction, replacement or renewal of the asset or substantially the whole of the asset, the cost of that work will be capital expenditure. Similarly, if the deferred repairs form part of one overall project that is capital in nature, then those repairs will take their character from the project. The cases show that different taxation outcomes can result depending on what the particular taxpayer did and when. This will always be a question of fact and degree in the particular circumstances.

*What happens when the repair work forms part of one overall project?*

185. When repair work forms part of one overall project the courts have suggested that it is not appropriate to separate out the different costs of the project for tax purposes where that project is of a capital nature. This is the case whether the project concerns work done on a single asset or work done on a group of assets.

186. In *Colonial Motor* the Court of Appeal considered whether the work done to convert a building from a warehouse to an office building, including seismic

strengthening, was one project or whether the work done on the seismic strengthening could be considered separately from other work done on the building. The local city council considered the building to be an earthquake risk and without the strengthening work the building would have been demolished. The work done involved the construction of new concrete walls, the removal of a mezzanine floor, the addition of a penthouse, and general refurbishment and seismic strengthening. The taxpayer divided the expenditure incurred into three categories: revenue, seismic strengthening and capital. The Commissioner and the taxpayer agreed on the deductibility status of the expenditure, with the exception of the expenditure on seismic strengthening. The taxpayer argued it was deductible being repairs and alterations that did not increase the capital value of the building in terms of the proviso to s 108 of the Income Tax Act 1976.

187. The Court of Appeal suggested that if the work undertaken is all part of one overall project then the work must be evaluated holistically to determine whether the work did no more than repair or alter the asset in question. This was despite the fact that the dispute only concerned the expenditure on the seismic strengthening and not the expenditure that the Commissioner and the taxpayer had already agreed was either revenue and deductible or capital and non-deductible. Richardson J stated that the mere accounting allocation of the total expenditure did not change the character of the work done. Looking at the total work carried out and the magnitude of the work involved, Richardson J found that the work was not the subject of two independent unrelated projects. It was a single project that converted the eight storey warehouse destined for demolition into a nine storey office block. His Honour stated at 11,366:

> **That statutory inquiry relates to the work that was actually done. If there was one overall construction project, it is the total work involved in relation to the particular premises which has to constitute "repairs or alterations of any such asset" so as to come within the proviso**. In such a case it begs the question to say that the taxpayer could have confined itself to certain specific parts of the work done in which case that limited work would have constituted alterations. **The allocation of the total expenditure to different categories of work does not change the character of the work that was done.**
>
> **On the facts of this case it is essential to consider the total work carried out.** It was not and could not sensibly have been the subject of two independent unrelated contractual projects, one for strengthening the building and the other for new and repair work. **It was a single project** which converted the eight storey warehouse-type structure otherwise destined for demolition into a nine storey office block with a 50 year revenue earning life. …The magnitude of the work involved is reflected in the total expenditure of $5.7 million of which the great bulk was in new work ($3.47 million) and the major part of the strengthening ($1.28m) was the construction of two new concrete walls. That was an entirely new structural addition.
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> …While strengthening alone or capital and repairs alone might have added little if anything to the value, it was their combined effect that was so significant. [Emphasis added]

188. The Commissioner recognises that the decision in *Colonial Motor* was addressing whether the work done was "repairs or alterations" for the purposes of s 108 of the Income Tax Act 1976. However, in the Commissioner's view, the principle Richardson J put forward in *Colonial Motor* continues to be relevant when considering whether expenditure incurred on work carried out as part of a larger project is capital or revenue in nature. Where repair work is done as part of one overall project to reconstruct, renew or replace an asset, or substantially the whole of an asset, or to change its character, the nature of the expenditure on the repair

work is taken from the character of the overall project, and the repair work is not looked at in isolation.

189. *Colonial Motor* is often compared with *Sherlaw.* In *Sherlaw* a boat-shed needed re-piling. However, the re-piling work caused the roof and floor of the boat-shed to be substantially damaged. As a result the taxpayer was required to replace a substantial part of the damaged roof that was unable to be repaired. Also, because of the changes in the roof, the floor was relocated to a slightly higher level. In carrying out the repairs the taxpayer used materials that were second-hand or salvaged from the original boat-shed. The building was the same dimensions before and after the work.

190. The Commissioner, relying on *Auckland Trotting* (SC and CA) and *Colonial Motor*, contended that the work done on the boat-shed in *Sherlaw* was a reconstruction of substantially the whole of the boat-shed. Therefore, all the work done was non-deductible being capital in nature. Doogue J disagreed. His Honour found that the taxpayer carried out nothing more than necessary maintenance of the piles. The course adopted (of doing, wherever possible, work by himself and with friends with second-hand and salvaged materials) indicated this was not an endeavour to improve the structure of the building but simply to ensure that necessary maintenance was carried out to it.

191. Doogue J distinguished *Colonial Motor* on the grounds that the building in *Colonial Motor* was transformed and strengthened with a completely new layout and refurbishment. In *Sherlaw* the boat-shed layout and size were not altered, and substantial parts of the boat-shed remained unchanged. No overall construction project to change the character of the boat-shed existed, and neither did a project to reconstruct, renew, or replace the boat-shed or substantially the whole of the boat-shed. While the scale of the work done was extensive, Doogue J attributed that to the amount of maintenance that had been deferred rather than to any decision by the taxpayer to reconstruct most of the premises. Doogue J stated at [22]:

> In this case the taxpayer sought to repair the piles to the building. That was his objective. That was what he tried to do. The consequences of those necessary repairs resulted in other work being required to be done. Unlike the cases to which the Commissioner referred me, this is not one overall construction project in the manner submitted for the Commissioner. In this case once the essential work was commenced other work became necessary. Upon the evidence it may indeed be doubtful whether the taxpayer would necessarily have incurred all the work and expense that he ultimately was involved in if he had known of the extent of it at the beginning. It is true that he undertook it all once he was committed, because that was the practical way for him to deal with the problems which faced him after he had been committed. **This is not a case, however, of the kind referred to me where there was one overall construction project resulting in the complete reconstruction of the boat-shed or of a project for the deliberate improvement of the boat-shed. Here the taxpayer chose to repair the boat-shed and, as a result of that decision, he was faced with consequential repair work and upgrading becoming necessary.** [Emphasis added]

192. In the Commissioner's view, *Sherlaw* highlights a situation where repairs are undertaken and those repairs have a flow-on effect, causing further repairs to be required. The repairs when looked at in totality, might be extensive. However, they were not undertaken as one overall plan to reconstruct, replace or renew an asset, or substantially the whole of an asset or to change its character.

193. Doogue J noted the Commissioner had not sought to categorise separately any of the work additional to the original re-piling and floor work as capital work. Doogue J then went on to say that if the Commissioner had submitted

that certain aspects of the works carried out were of a capital nature there may have been a point to the submission. This suggests that as the work done on the boat-shed was not part of one overall project to substantially reconstruct or renew, or to change its character, different aspects of the work could be identified as being either capital or revenue in nature depending on the effect that the work had on the boat-shed.

194. Both *Colonial Motor* and *Sherlaw* were considered by Goddard J in *Hawkes Bay Power*. In *Hawkes Bay Power* the taxpayer contended that it did not have one overall objective to replace the overhead system in its urban residential areas with an underground system. Hawkes Bay Power contended that each conversion job was simply carried out on an ad hoc basis according to the particular reason for the job.

195. Goddard J, basing her reasons on the documentary evidence before her and Hawkes Bay Power's own acknowledgement of its long standing policy to convert those areas to an underground system, disagreed. On that evidence Goddard J found the work done by Hawkes Bay Power to replace its overhead wires with underground cables was done with an overall objective to replace the entire overhead system in its urban residential areas with an underground system. Goddard J concluded that given the scale and degree of the work involved in the total project and the money expended on it, the expenditure in question was capital in nature.

196. Hawkes Bay Power, relying on *Sherlaw*, had separately classified expenditure on work done to replace the overhead wires with an underground cable system into capital and non-capital items. For example the expenditure on the replacement of the worn out overhead wires with underground replacements was treated as revenue while the expenditure on the distribution transformers was capitalised. On this point Goddard J held at 13,707:

> In the context **of the total project** and the extent to which it has been achieved to date, **it is artificial to dissect the work into capital and revenue categories, or to further dissect the "purported" revenue category into capital and non-capital items.**
>
> As Kitto J said in *FC of T v Western Suburbs Cinemas Ltd* (1952) 86 CLR 102 at p 108:
>
> > "...the capital or income character of expenditure actually incurred depends upon the nature of the purpose for which it was incurred. **If a total expenditure is of a capital nature, so is every part of it**; you cannot take a portion of the work done such as the erection of a scaffolding and, closing your eyes to the purpose for which it was in fact erected, attribute to the cost of that portion an income nature for no better reason than that the same scaffolding, would have been erected in order to serve a purpose which, if it had existed, would have made the total expenditure an income charge. "
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> And as Richardson J said in *Colonial Motor Co Ltd v CIR* (1994) 16 NZTC 11,361 at p 11,366:
>
> > "That statutory enquiry relates to the work that was actually done. **If there was one overall construction project, it is the total work involved in relation to the particular premises which has to constitute 'repairs or alterations of any such asset' so as to come within the proviso.** In such a case it begs the question to say that the taxpayer could have confined itself to certain specific parts of the work done in which case that limited work would have constituted alterations. The allocation of the total expenditure to different categories of work does not change the character of the work that was done.
> >
> > On the facts of this case it is essential to consider the total work carried out. It was not and could not sensibly have been the subject of two

> independent unrelated contractual projects, one for strengthening the building and the other for new and repair work. It was a single project which converted the eight storey warehouse-type structure otherwise destined for demolition into a nine storey office block with a 50 year revenue earning life. "
>
> The case of *Sherlaw v CIR* (1994) 16 NZTC 11,290 on which Hawkes Bay Power sought to rely as authority for separate classification of expenditure into capital and non-capital items falls into a different category to the present case on the issues of both scale and degree. **On the facts in *Sherlaw* Doogue J found there was not one overall construction project resulting in a complete reconstruction or that the expenditure was so disproportionate as to indicate that it was of a capital nature.** [Emphasis added]

197. *Hawkes Bay Power* makes it clear that where work forms part of one overall project of capital work, then that work will take its character from the character of that overall project. In such a case, it is artificial to dissect the work forming part of that project into capital or revenue categories. This is because work done in every part of that project is calculated to achieve the same objective from both a practical and business point of view.

198. Goddard J in *Hawkes Bay Power* also observed that the taxpayer had treated all expenditure on repairing or replacing existing overhead lines with new overhead lines as being revenue in nature. Goddard J accepted that this expenditure was not part of the overall plan to put in underground cables. Goddard J found that the nature of this expenditure had to be determined on its own facts as to the extent and scale of the work done.

199. Goddard J noted that even if the overall plan was not viewed as a total project in terms of the conversion of the entire urban residential distribution system but rather in terms of the individual conversion of individual streets serviced by a distribution transformer, her finding would not have changed. Her Honour observed at 13,700:

> Alternatively, even if the "final objective" were not to be viewed as a 'total project' but in terms of the individual conversion jobs undertaken on a year by year basis in respect of individual streets containing groups of consumers serviced by a distribution transformer, that would not alter the picture. All of those jobs were undertaken pursuant to the one "firm policy" instituted by the old Board in 1969 and continued by Hawkes Bay Power after incorporation in 1987. On this basis all have resulted in the creation of a new asset. Each individual conversion project completed and each individual distributor installed underground would constitute a new asset, whatever the particular reason that motivated Hawkes Bay Power to effect each conversion project and each underground installation.

200. This suggests that where there is one overall capital project involving a group of assets, the nature of the expenditure on any repair work done on those assets is taken from the character of that one overall project, and the repair work is not looked at in isolation.

201. *Case X26* considered the deductibility of earthquake-strengthening costs incurred as part of one overall project. It followed the decision in *Colonial Motor,* and Judge Barber found that costs incurred to earthquake-strengthen a building were capital costs. In reaching that decision Judge Barber applied the general capital/revenue principles, together with the *Colonial Motor* decision, and found at [39] that:

> In *Colonial Motor Co Ltd v C of IR*, as in the present case, from a practical and business point of view, the total work undertaken was to transform an unsound building with a potentially very limited or, possibly, non-existent revenue-earning capacity into a sound building capable of being used to earn income.

202. Judge Barber found at [43] that the earthquake-strengthening work was done as a consequence of a single plan, rather than as an ad hoc response to issues arising when undertaking other work. On this basis, he distinguished the decision in *Sherlaw.*

203. Judge Barber noted that, while the work done in *Case X26* was less extensive than that done in *Colonial Motor,* it was of the same character. At [43]:

> Of course, in the present case the work undertaken was not as extensive as that in *Colonial Motor Co Ltd v CIR*, but the same result must follow. There was work undertaken to improve the building's earning-capacity by making it earthquake code compliant and thus avoiding the sterilisation of the asset. While the work in this case was to make the building earthquake-code compliant, it ensured the continued availability of the asset as part of the income-earning structure of the taxpayer's partnership. That structure is a concept of capital. The process of earning income is revenue in concept. [Emphasis in original]

204. In the Commissioner's view, expenditure on repairs forming part of one overall project should take its character from that project.

205. However, the Commissioner agrees that in some situations apportionment may be appropriate. For example, as was the case in *Hawkes Bay Power,* a taxpayer may do work on an asset while at the same time undertaking an overall project. If it can be demonstrated that the work done is not part of that project the nature of the work must be determined on its own facts. Consequently, if that work does not reconstruct, renew or replace an asset or substantially the whole of an asset or change its character the expenditure on that work is likely to be revenue in nature and deductible.

206. To determine if apportionment is appropriate in any particular situation, it is necessary to consider the work done from a practical and business point of view. For example, in the Commissioner's view, apportionment of expenditure between capital and revenue will be appropriate where the work done is a repair, but at the same time some upgrading of a capital nature can be identified (*Sherlaw*). In contrast, where repairs and maintenance work forms part of one overall project, where the objective of that project is to reconstruct, replace or renew the asset or substantially the whole of the asset or to change the asset's character, then apportionment will not be appropriate and all the expenditure incurred as part of that project will take its nature from the overall project (*Colonial Motor, Hawkes Bay Power* and *Case X26*).

207. In the Court of Appeal's decision in *Poverty Bay Electric* Blanchard J also acknowledged that an apportionment of costs between deductible repair costs and non-deductible capital costs is possible and appropriate in some situations, but that apportionment was not appropriate in every case. Blanchard J made this acknowledgement in response to the taxpayer's alternative submission that having capitalised a portion of the expenditure to recognise the improvements in the work done it was then entitled to claim a deduction for the balance of the expenditure. Blanchard J commented at 15,008:

> In particular situations an apportionment of an amount of expenditure is possible and appropriate — where a part of the money spent has been applied to work which is truly a repair and at the same time some upgrading of a capital nature has been done. It is often possible to distinguish which is which. But this is not such a case.

208. Blanchard J, relying on *Auckland Trotting* (CA) and *Western Suburbs Cinema*, found on the facts of the case that, as a new asset had been created, no repair work had in fact been carried out by the taxpayer. His Honour concluded that the taxpayer was not entitled to a deduction on the basis that none of the work done by the taxpayer consisted of repairs.

*What are notional repairs?*

209. Where capital expenditure is incurred the courts have held that no deduction can be claimed for an amount that might have been spent on repairs had the work been carried out differently.

210. As stated above Blanchard J made this clear in *Poverty Bay Electric* where he discussed the decision of the Court of Appeal in *Auckland Trotting*. At 15,008:

> In *Auckland Trotting Club (Inc) v C of IR* [1968] NZLR 967 at p 980 *Richmond* J said that **no part of the money spent on constructing the new trotting track was, in fact, spent on repairs and it was not possible to treat part of it as notionally spent on repairs when that is not what happened**. *North* P and *Turner* J expressed their agreement (p 977). The Court adopted the reasons of *Finlay* J in *Margrett (HM Inspector of Taxes) v Lowestoft Water and Gas Co* (1935) 19 TC 481 at pp 488–489 and of *Kitto* J in *FC of T v Western Suburbs Cinemas Ltd* (1952) 86 CLR 102 at pp 107–109. At p 107 *Kitto* J said:
>
> > ... when a taxpayer has two courses open to him, one involving an expenditure which will be an allowable deduction for income tax and the other involving an expenditure which will not be an allowable deduction, and for his own reasons he chooses the second course, he cannot have his income tax assessed as if he had exercised his choice in the opposite way. Section 53 is concerned with expenditure which was in fact incurred, not with expenditure which could have been incurred but was not.
>
> ...
>
> To similar effect is the judgment of this Court in *Colonial Motor Co Ltd v C of IR* (1994) 16 NZTC 11,361.
>
> **We agree that it is not possible to claim as expenditure on a repair a payment which has not actually been expended for that purpose. There cannot be a dissection of what is spent upon a capital work because part of it might otherwise have been laid out on repairs, but was not.** [Emphasis added]

211. Where a taxpayer could have done the work differently but chose not to, a deduction cannot be claimed for a notional amount of expenditure on repairs. A taxpayer cannot deduct expenditure for work they have not done.

*Is a deduction available for expenditure incurred to repair a newly acquired but dilapidated asset?*

212. Where expenditure is incurred on repairs and maintenance soon after an asset has been acquired, that expenditure is likely to be considered part of the capital cost of acquiring the asset.

213. *Law Shipping* addressed the special situation of deductions for repairs to a recently acquired asset. *Law Shipping* concerned a company that purchased a ship in a poor state of repair for £97,000. The company used the vessel while in the poor state of repair for one voyage and then carried out repairs to the value of £51,558. The court held that the cost of the repairs was not deductible but was part of the capital cost of acquiring the ship. That decision was followed in *Collector of Inland Revenue, Cook Islands v AB*

*Donald Ltd* [1965] NZLR 679 (SC), which also addressed the deductibility of repairs to a recently acquired ship.

214. The court in *W Thomas & Co Pty Ltd v Commissioner of Taxation of the Commonwealth of Australia* (1965) 115 CLR 58 endorsed *AB Donald Ltd*. In *W Thomas* the taxpayer company acquired a building that required work to be done to it, some of which was necessary to make the building suitable for use in the company's business. Windeyer J held that the repairs done to the building to make it suitable for use were not deductible. The cost of getting the building ready to be used by the taxpayer company formed part of the acquisition cost of that asset, so was a capital cost.

215. *Windeyer* J observed at 72:

> Expenditure upon repairs is properly attributed to revenue account when the repairs are for the maintenance of an income-producing capital asset. Maintenance involves the periodic repair of defects that are the result of normal wear and tear in operation. It is an expense of a revenue nature when it is to repair defects arising from the operations of the person who incurs it. **But if when a thing is bought for use as a capital asset in the buyer's business it is not in good order and suitable for use in the way intended, the cost of putting it in order suitable for use is part of the cost of its acquisition, not a cost of its maintenance**. [Emphasis added]

216. It is well settled by the courts that expenditure incurred to repair a newly acquired asset so that it is in good order and suitable for use in the way intended by a taxpayer is a capital cost and forms part of the acquisition cost of that asset.

217. The limits of the principle in *Law Shipping* are demonstrated in *Odeon Associated Theatres*. The English Court of Appeal found that expenditure on deferred repairs to a movie theatre acquired in a dilapidated condition was deductible. In that case the taxpayer acquired a fully operational but run down movie theatre in 1945. The theatre had not been repaired for a number of years. The taxpayer repaired the theatre gradually over seven years. Salmon LJ distinguished *Law Shipping* on the following grounds at 296:

> There seem to me to be many important distinctions between that case [*Law Shipping*] and the present case.
>
> (1) In the *Law Shipping Co. Ltd. v. Inland Revenue Commissioners, 12 T.C. 621* the purchase price was substantially less than it would have been had the vessel been in a fit state of repair … and that they made good this defect at the first opportunity. … .
>
> In the present case, the purchase price paid by the taxpayers was in no way affected by the fact that the cinema was in disrepair at the date of its acquisition. The sellers could not lawfully have executed the repairs prior to the acquisition since no licence to execute such work was then obtainable.
>
> (2) In the *Law Shipping* case the vessel was not in a state to pass survey at the time of purchase…. In the present case, the cinema was a profit-earning asset at the date of its acquisition in spite of its state of disrepair. It remained so, although no money was spent on deferred repairs for a number of years after its acquisition.
>
> (3) In the *Law Shipping* case there was no evidence that on established principles of sound commercial accounting the £39,558 could properly be charged by the taxpayer as revenue expenditure. …. In the present case, however, the commissioners held, on ample evidence, that it was in accordance with the established principles of sound commercial accounting to charge the disputed items to revenue expenditure, and these principles in no way conflict with any statute.

218. Even though the expenditure was to repair an asset acquired in a dilapidated state, the expenditure was still found to be deductible. Significantly, the purchase price paid by the taxpayer had not been discounted to take account of the condition of the theatre, as all theatres at that time were in a similar condition due to restrictions imposed by the war. Further, the theatre was immediately profitable, despite its run-down condition.

*Does the nature of the expenditure change if damage is repaired as a result of a significant event?*

219. The Commissioner considers that the nature of the expenditure does not change if the damage to be repaired occurs as a result of a significant event such as an earthquake, a fire or a storm. Consequently, the same issues as considered in this statement need to be addressed to determine whether any expenditure incurred on repairs and maintenance is capital or revenue expenditure. If the repair work is on revenue account, the expenditure will be deductible; if it is on capital account, it will not be deductible. This is because the deductibility of the repair costs is determined more by the effect that the work has on the asset, rather than when the work was done or what caused the damage to the asset.

220. This is demonstrated in *Case F67* where the taxpayers' building was extensively damaged by fire. The taxpayers leased the lower floor of the building as two shops (a pizza parlour and a knick-knack shop). The taxpayers leased the upstairs part of the building to the respective shop lessees as residential flats.

221. The fire significantly damaged the wall linings of the knick-knack shop. The pizza parlour also suffered considerable water and smoke damage. To bring the shops back into working condition the lining of the knick-knack shop was replaced, while in the pizza parlour some of the lining was cleaned and re-plastered. Both shops were redecorated. The electrical wiring was replaced and substantial plumbing repairs were undertaken. The upstairs portion of the building was gutted. The roof structure was replaced and the parts of the iron roofing destroyed by fire were also replaced. However, the upstairs flats were left gutted.

222. The builder who undertook the work stated that at the conclusion of the repairs the overall structure was probably in a far worse condition than it was before the fire. This was mainly because the upstairs flats, the larger of which had recently been refurbished before the fire, had been left gutted. The downstairs shops were restored to their pre-fire condition with no improvement. The taxpayers claimed a deduction for the portion of the repairs that the insurance payment did not cover. The Commissioner disallowed the deduction on the basis it was capital expenditure.

223. Judge Barber identified the building as the asset that was the subject of the work rather than the individual shops. He found the building work undertaken was so extensive in relation to the building that it amounted to the replacement, reconstruction or renewal of a substantial part of a capital asset that went beyond the normal concept of repair. Judge Barber did accept the building was not totally destroyed and a major portion of the basic building structure remained intact after the fire. However, he concluded that as the expenditure by the taxpayers was not to repair the building but to rebuild it, it was capital and not deductible.

224. The Federal Court of Appeal of Canada has also considered the deductibility of repairs and maintenance expenditure after a significant event (*Bowland v R* 2001 FCA 160, [2001] 3 CTC 109). In *Bowland* the taxpayer's rental

property was damaged by fire. Before the fire the building was valued at $80,000 of which $5,000 was attributable to the land. The taxpayer claimed that after the fire he spent $66,472 on repairing the property. The court concluded the renovations were so extensive in nature that the house was virtually rebuilt and resulted in a new capital asset. Consequently, the court concluded the cost of the work was not deductible because it was capital in nature.

225. In both *Case F67* and *Bowland* the courts looked at the nature and scale of the work undertaken and the effect that work had on the asset when determining whether the expenditure was on capital or revenue account. In making its decision neither court focused on when the work was done or what caused the damage to the asset.

226. In the Commissioner's view, where the work done is to repair damage caused by a significant event, and the work done results in the reconstruction, replacement or renewal of the asset, or substantially the whole of the asset, or the character of the asset is changed, the expenditure will be capital in nature. However, where some necessary repair work must be done to an asset as a result of a significant event and further repair work comes about as a consequence of the necessary repairs, then the repair costs, while extensive, may be deductible *(Sherlaw)*. This will always be a question of fact and degree.

Significant events and dilapidated assets

227. As found in *Case F67* and *Bowland,* the deductibility of repair costs is determined by the nature and scale of the work undertaken and the effect it has on the asset. The deferral of repairs, before a significant event, should not in itself change the character of whether expenditure on repairs is deductible.

228. The Canadian Tax Court demonstrated this in *Martinello v R* 2010 TCC 432, 2010 DTC 1300. In *Martinello* the taxpayer owned a house that she rented out. In October 2004 a substantial hurricane-strength storm significantly damaged the property, making it uninhabitable for a time. The winds had lifted the house off its foundation causing the main wooden beam to give way. Dampness over the years had weakened the sills and joists, which caused much of the rest of the floor to fall in. In addition, the storm waters rushed underneath the house leaving much of the floor and parts of the sidewalls sitting in mud. The storm also blew down an old chimney that was no longer used. The property had also suffered some tenant wear and tear and damage. Eight years before the storm, the taxpayer had replaced the house's windows and doors and updated the plumbing and wiring. Other than this, and painting and cleaning between tenants, the taxpayer had not undertaken other work on the house.

229. The taxpayer paid to have the house repaired. Much of the expenditure related to the floor that was damaged when the house was lifted up off its foundations. The work included straightening the footings and reinforcing them with more cement, removing silt and debris, and putting in new sills, joists and, where necessary, new floor boards. The footing of the walls was also replaced. Once the house was back on its foundations the existing plumbing and electrical supply had to be reconnected. The house's wiring was replaced. The fallen chimney was removed, the roof and walls were patched, and half the roof was re-shingled. The old aluminium siding was reused in the gable ends of the house and a new vinyl siding was used to clad the bottom of the house. The inside of the house was repainted where

needed. A small, attached wooden mud room (for removal of outdoor footwear) at the back entrance and modest wooden deck had to be replaced.

230. The house was repaired to its original rentable condition. The court found that all the damage that had occurred was the result of tenant damage, normal wear or tear, depreciation over the time it was rented out, or storm damage while it was rented out. The repairs did not improve the house beyond its original condition in any manner. Therefore, the costs of the repairs and maintenance, although all done at once, were properly deductible as current expenses and were not required to be capitalised.

231. The Commissioner considers that the court reached this conclusion because, while the work the taxpayer undertook was extensive, the storm damage was largely as a result of deferred repairs – from tenant damage, normal wear and tear, and depreciation (eg, the weakened floor joists and sills). Therefore, while the significant event (the storm) did create damage that required repairing, the nature of the work undertaken after the storm was repairs that had accumulated over the period that the house was tenanted. Implicit in this is that the court in *Martinello* considered the work done by the taxpayer did not reconstruct, replace or renew the house, or substantially the whole of the house or, change its character.

**Key points relating to other considerations from the repairs and maintenance cases**

232. The Commissioner takes the following key points from the analysis relating to other considerations from the repairs and maintenance cases:

- The timing of repairs is not a critical factor when deciding whether the expenditure incurred is deductible – repairs can be deferred and completed as and when required without necessarily giving rise to capital expenditure (*Ounsworth*).
- The deductibility of repair costs is determined more by the nature of the work carried out and the effect that it has on the asset, rather than on when the work is carried out (*Rhodesia Railways*).
- The speed or slowness with which the work is done is not usually relevant to deciding whether the expenditure is capital or revenue in nature (*Auckland Gas* (PC)).
- Where deferred repairs become so extensive that they amount to the reconstruction, replacement or renewal of the asset or substantially the whole of the asset or where deferred repairs form part of one overall project that is capital in nature then those repairs will be capital in nature. This will always be a question of fact and degree in the particular circumstances (*Auckland Gas* (PC)).
- Repairs and maintenance work that forms part of one overall project to reconstruct, replace or renew an asset or substantially the whole of an asset or to change that asset's character will take its nature from that project. This is regardless of whether that project concerns work done on a single asset or work on a group of assets (*Colonial Motor Co Ltd v CIR* (CA), *Hawkes Bay Power*, *Case X26*).
- Where repairs and maintenance expenditure is incurred on an ad hoc basis and not as part of one overall plan, the expenditure should take its character from the effect that the work done has on the asset (*Sherlaw*).

- It is appropriate and possible in some situations to apportion an amount of expenditure between deductible repair costs and non-deductible capital works (*Poverty Bay Electric*).
- No deductions are available for a notional amount of expenditure for repairs. A taxpayer cannot deduct expenditure for work they have not done (*Western Suburbs*, *Auckland Trotting* (CA), *Poverty Bay Electric*).
- Expenditure incurred to repair a newly acquired asset so that it is in good order and suitable for use in the way intended by the taxpayer is a capital cost and forms part of the acquisition cost of that asset (*Law Shipping*, *W Thomas*).
- Depending on the circumstances, a deduction may still be allowed for expenditure on repairs to a newly acquired asset if the purchase price was not affected by the asset's state of disrepair and, when the asset was acquired, it could be used as intended despite its state of disrepair (*Odeon Associated Theatres*).
- Where an asset is damaged as a result of a significant event, the deductibility of expenditure to repair the asset depends on the nature and scale of the work undertaken and the effect that work has on the asset and not on the occasion that caused the work to be done (*Case F67*, *Bowland*).
- If an asset damaged as a result of a significant event was dilapidated before the event, the deductibility of repairs and maintenance expenditure continues to depend on the nature and scale of the work undertaken and the effect that work has on the asset. This may mean that, although extensive work is undertaken all at once, the cost of that work could still be considered to be revenue in nature (*Martinello*).

## Examples – other considerations from the repairs and maintenance cases

### *Example 16 – repairs to rental property (deferred repairs done all at once)*

Phil owns a rental property. A long period has passed since repairs were last made to the property but the tenants have recently vacated and Phil is taking the opportunity to restore the property to a good condition before letting it again. He has to incur significant expenditure on the property. The work done includes extensive cleaning, repainting, easing windows (ie, repairing windows to enable them to open and shut smoothly) and replacing cracked panes, sanding and re-varnishing the floors, replacing the kitchen bench top, fitting a new hand basin to replace a cracked one, and having a plumber check and repair all the taps. Phil does not replace, reconstruct or renew the property or substantially the whole of the property. The work done also does not change the character of the property. Although the costs incurred by Phil are significant, they arose from repairs that had been allowed to accumulate and are revenue in nature.

### *Example 17 – project to refurbish and strengthen building (one overall project to change character)*

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

***Example 18 – repair to building that led to more repairs (repair; no overall project of substantial reconstruction, replacement or renewal or change in character)***

As a result of ground subsidence, Northern Roasters Limited set about repairing the uneven floor of the small factory premises that it owns. This involved minor foundation work. As a result of the foundation work, several windows and walls cracked. These had to be repaired, and the walls then had to be re-plastered and painted. Although the work done to the factory was costly, the repairs were completed on an ad hoc basis. The work done was not done as part of one overall plan to reconstruct, replace or renew the premises, or substantially the whole of the premises, or to change the character of the premises. Further, the actual scale and nature of the work done did not have this effect. Therefore, the repair costs are revenue in nature.

***Example 19 – double glazing (one overall project to change character with no apportionment available)***

Erica has a restaurant in an old villa that she owns. The villa is used exclusively for the restaurant. The villa is located near a very busy thoroughfare. To keep noise levels down inside the restaurant Erica has decided to install double glazing. While installing the double glazing the builder discovers that two window frames on the south side of the villa are rotten. The windows are repaired to enable the installation of the double glazing. Erica's objective in this case was to install double glazing in her villa. The work done has changed the character of the villa. The work done to repair the windows formed part of Erica's objective to double glaze the villa and therefore is part of one overall project to change its character. Consequently, all the expenditure incurred by Erica is capital in nature.

***Example 20 – house painting and extension (one overall project to change character along with maintenance work where apportionment is available)***

George owns a rental property. George decides that by adding on two new bedrooms and another bathroom to the property he will be able to get a much higher rental. George employs a builder to build the new extension. George also thinks the property is looking tired and needs a new coat of paint so he employs a painter to paint the property. The painter also paints the new extension. George's objective in this case was to add on the two bedroom extension. The work done to extend the house changed the character of the property and so is of a capital nature. The painting of the new extension is part of George's project to change the character of his rental property and is also capital in nature. However, George can establish from a practical and business point of view that re-painting the remainder of the house was not part of his project to change the character of his property. Re-painting the remainder of the house is maintenance work. Therefore, George can treat the portion of the painting expenditure that relates to painting the house but not the extension as being revenue in nature.

***Example 21 – newly acquired but damaged rental property (part of capital cost)***

Anne and Jane bought a property at a discounted rate because of earthquake damage. The roof of the property has partially collapsed and a corner of the house has been damaged. Anne and Jane want to rent the property out, so spend money fixing the roof and the damaged part of the house to put it in a tenantable state. The expenditure on the repairs is capital in nature. Anne and Jane's costs in getting the property to a tenantable state are treated as part of the property's acquisition cost.

***Example 22 – damaged and dilapidated commercial building (repairs; not substantial reconstruction, replacement or renewal or change in character)***

David and Angus own a commercial building that was superficially damaged in an earthquake. David and Angus have owned the property for a long time. When David and Angus purchased the property it was in excellent condition. Over time it has become dilapidated, so when the earthquake occurred the poor state of the roof led

to more repairs then being necessary. The tenants are unhappy and request that the building be fixed. David and Angus spend money on the building: inside the building the interior walls are re-plastered and repainted and the stairwells are repaired; outside the building the roof is repaired, cracked and broken windows are replaced, and the exterior walls are repainted. The work done brings the building back to the standard it was when David and Angus bought it. The work done does not reconstruct, replace or renew the building or substantially the whole of the building. The work also does not change the building's character. The expenditure undertaken by David and Angus is for accumulated repairs and is revenue in nature.

***Example 23 –reconstruction of damaged rental property (substantial reconstruction, replacement and renewal)***

Jennifer and Peter own a residential rental property that was significantly damaged in an earthquake. Before the earthquake the property was in a good state of repair. After the earthquake, to get the property in a tenantable state, Jennifer and Peter replace the property's severely damaged foundations, reconstruct the floors, rebuild three of the property's collapsed external walls and replace the badly damaged roof. Jennifer and Peter also demolish the property's partially collapsed chimney, which is a hazard. In this case, the cost of the work Jennifer and Peter have done is capital expenditure and not deductible. Where work is so extensive that it results in the reconstruction, replacement or renewal of the asset, or substantially the whole of the asset, the cost of that work will be capital expenditure.

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Capital/revenue
Deductions
Income tax
Repairs and maintenance

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## Appendix: Legislation

### Income Tax Act 2007

1. Section DA 1(1) and (2) provides:

> **DA 1 General permission**
>
> *Nexus with income*
>
> (1) A person is allowed a deduction for an amount of expenditure or loss, including an amount of depreciation loss, to the extent to which the expenditure or loss is—
>
> (a) incurred by them in deriving—
>
> (i) their assessable income; or
>
> (ii) their excluded income; or
>
> (iii) a combination of their assessable income and excluded income; or
>
> (b) incurred by them in the course of carrying on a business for the purpose of deriving—
>
> (i) their assessable income; or
>
> (ii) their excluded income; or
>
> (iii) a combination of their assessable income and excluded income.
>
> *General permission*
>
> (2) Subsection (1) is called **the general permission**.

2. Section DA 2(1) provides:

> **DA 2 General limitations**
>
> *Capital limitation*
>
> (1) A person is denied a deduction for an amount of expenditure or loss to the extent to which it is of a capital nature. This rule is called the **capital limitation**.