

QUESTION WE'VE BEEN ASKED

QB 18/01

Can a fit-out of an existing building be “improvements” for the purposes of s CB 11?

Unexpected tax consequences may result from the sale of an investment property for people who complete a fit-out of their property where they are in the business of erecting buildings, or are associated with someone in that business.

Key provision

Section CB 11 of the Income Tax Act 2007

Key terms in this item

“**Improvements**”, for the purposes of s CB 11, is defined as being **improvements to land** that are **not minor** and are **made by a person, or an associated person, erecting a building or otherwise**.

Question

Can a fit-out of an existing building be “improvements” for the purposes of s CB 11?

Answer

Yes. A person in the business of erecting buildings (or associated with such a person) who does a fit-out of an existing building, and later sells that building, may be required to pay tax on the net proceeds of the sale under s CB 11.

Explanation

- Under s CB 11, a person in the business of erecting buildings who makes “improvements” to land and then sells that land within 10 years of completing the “improvements”, is liable for income tax on the net sale proceeds. It is irrelevant whether the land was acquired for the purpose of the person’s business of erecting buildings.
- Section CB 11 also applies in the same way to a person who is not in the business of erecting buildings themselves, but is associated with someone in the business of erecting buildings. Further information on the “associated persons” rules can be found in “New Definitions of ‘Associated Persons’”, *Tax Information Bulletin* Vol. 21, No 8, Pt II (October/November 2009): 75–93.
- Section CB 11 provides:

CB 11 Disposal within 10 years of improvement: building business

Income

- (1) An amount that a person derives from disposing of land is income of the person if—
 - (a) they dispose of the land within 10 years of completing improvements to it; and
 - (b) at the time they began the improvements, they carried on a business of erecting buildings, whether or not the land was acquired for the purpose of the business.

Income: associated person in business of erecting buildings

- (2) An amount that a person (person A) derives from disposing of land within 10 years of completing improvements on it is income of person A if another person (person B) associated with person A at the time the improvements were begun carried on a business of erecting buildings, whether or not—
- (a) person A carried on a business of erecting buildings; or
 - (b) the land was acquired for the purpose of person B's business.

Exclusions

- (3) Subsection (2) is overridden by the exclusion for bodies controlled by a local authority in section CB 15C and subsections (1) and (2) are overridden by the exclusions for residential land in section CB 16 and for business premises in section CB 19.

4. Subsection (1) applies to persons in the business of erecting buildings and subs (2) applies to landowners who are associated with a person in the business of erecting buildings. While there are some exclusions in s CB 11(3) for council-controlled organisations and for residential land and business premises, these are not covered in this item. The key requirement for triggering the section is that the landowner made "improvements".

The definition of "improvements"

5. For the purposes of s CB 11, the term "improvements" is defined under s YA 1 as:

improvements, in ... CB 11 (Disposal within 10 years of improvement: building business), means **improvements to land** that—

- (a) are **not minor**; and
- (b) are **made—**
 - (i) **by a person erecting a building or otherwise**; or
 - (ii) by an associated person erecting a building or otherwise

[Emphasis added]

6. There are three main criteria that need to be satisfied in the definition of "improvements": **improvements to land** that are **not minor** and are **made by a person erecting a building or otherwise**.
7. The term "improvements" used in the context of s CB 11 should not be confused with the term "improvement" defined under s EE 67 for the purposes of the depreciation rules.

Improvements to land

8. "Improvements" under s YA 1 must be improvements to land. Based on case law, improvements to land include any work or operations done to land that enhance the value of that land (*Case L43* (1989) 11 NZTC 1,262; *Morrison v Federal Commissioner of Land Tax* (1914) 17 CLR 498).
9. Improvements to land will often involve work or operations that add something to land, for example, the construction of a house. However, improvements to land can also involve the removal of something previously attached to land, for example, the removal of an unsafe building from land enhancing the value of that land (*Morrison v Federal Commissioner of Land Tax*; *McGeoch v Federal Commissioner of Land Tax* (1929) 43 CLR 277).
10. Work done to a building may be improvements to land to the extent that it involves adding fixtures or making structural changes to the building. This is because legally, a building and its fixtures are considered part of the land to which they are attached. This long-standing principle of land law is summarised in *Hinde, McMorland & Sim Land Law in New Zealand* (online looseleaf ed, LexisNexis, accessed 8 September 2017) at [6.036]:

... whatever is affixed to the soil, belongs to the soil. Thus buildings erected on land and items permanently attached to the buildings become fixtures and a part of the land itself.

11. In most instances, building fixtures will be those items permanently attached to a building. In the context of a fit-out of an existing building, it is unlikely that items not permanently attached to the building would be classified as fixtures. Therefore, to the extent that a fit-out of an existing building involves the addition and/or removal of fixtures enhancing the value of the building, the fit-out will be improvements to the land on which the building is built.
12. However, where the work done to a building is repairs and maintenance, it is not considered to be improvements to land for the purposes of s CB 11. Interpretation Statement IS 12/03: **"Income Tax – Deductibility of Repairs and Maintenance: Expenditure – General Principles"** (*Tax Information Bulletin* Vol 24 No 7 (August 2012): 68-105) sets out the approach for determining whether work is repairs and maintenance or a capital improvement.

"Erecting a building or otherwise"

13. Under s YA 1, **"improvements"** means **"improvements to land ... made by a person [or an associated person] erecting a building or otherwise"**. The words **"improvements to land ... made by a person erecting a building"** provide an example of the most common type of improvements to land, the erecting of a building. However, the words **"or otherwise"** make it clear that the erecting of a building is not the only improvements to land that can meet the **definition of "improvements"**, and that any other improvements to land can also be included. This wide interpretation is consistent with the common law and the legislative history of s CB 11.
14. **Before being rewritten in its current form, the definition of "improvements", most recently contained in s CD 1(2)(d) of the Income Tax Act 1994, was worded as "any improvements ... to that land (whether by way of erecting a building or otherwise)".** This earlier wording highlights that **any improvements to land can be "improvements"**. The current definition of **"improvements" under s YA 1 (and s OB 1 of the Income Tax Act 2004 before it)** was intended to have the same effect as the wording of the definition in s CD 1(2)(d) of the Income Tax Act 1994.

"Not minor"

15. Even where improvements to land have been made by a person (or an associated person) erecting a building or otherwise, they will only **be "improvements"** for the purposes of s CB 11 if **they are "not minor"**.
16. **The meaning of "not minor" has previously been considered** in Interpretation Guideline IG0010 **"Work of a Minor Nature"**, *Tax Information Bulletin* Vol 17, No 1 (February 2005): 5–23 (IG0010). IG0010 confirms that **"not ... of a minor nature"** and **"not minor"** have the same meaning and effect. Although IG0010 discusses when **development or division work** is **"not minor" in the context of s CB 12**, the common legislative history of ss CB 11 and CB 12 suggests that similar principles will apply when determining whether **improvements to land** are **"not minor" for the purposes of s CB 11**.
17. **When considering whether improvements to land are "not minor" for the purposes of s CB 11, an overall assessment of what was done in the particular circumstances should be made.** The following factors set out in IG0010 for the purposes of s CB 12 are considered useful and **relevant when deciding whether improvements to land are "not minor" for the purposes of s CB 11**:
 - the importance of the improvements in relation to the physical nature and character of the land;
 - the total cost of the improvements made in both absolute and relative terms;
 - the nature of the professional services required; and
 - the nature of the work required for the improvements.

Examples

The following examples are included to assist in explaining the application of the law.

Example 1 - A fit-out that triggers s CB 11

Valyrian Villas Ltd is a construction company that builds homes for customers based on pre-drawn plans. It is in the business of erecting buildings. Seven years ago, Valyrian Villas Ltd purchased a two-storey office building as a rental investment separate from its building business. Valyrian Villas Ltd leased the whole office building to a law firm.

Last year, the law firm moved to larger premises and Valyrian Villas Ltd decided to do a new fit-out of the office building. The cost of the fit-out was considerable. Both floors of the building were converted from individually partitioned offices into an open plan layout. All the internal walls around each of the 20 offices were removed. The large kitchen and staff room on the ground floor were replaced by six smaller kitchenettes located around the building. The two large boardrooms were divided into smaller, soundproofed meeting rooms. The entire building also had new LED lighting and cabling for state-of-the-art information and communications technology installed. Recently, almost a year after the fit-out was completed, Valyrian Villas Ltd sold the office building. Under s CB 11, Valyrian Villas Ltd is liable for income tax on the sale of the building because:

- Valyrian Villas Ltd is in the business of erecting buildings.
- The fit-out involved the addition and removal of fixtures, enhancing the value of the office building. Therefore, the fit-out is improvements to the office building and as a consequence, to the underlying land.
- Although a question of fact and degree, **Valyrian Villas Ltd's fit-out of the office building is considered to be "not minor". The completed fit-out** was important in relation to the physical nature and character of the building (and therefore the land), with a marked change to the floor plan and amenities across the building **as a whole. The cost of Valyrian Villas Ltd's fit-out was considerable.** The nature of both the professional services and physical work required to complete the fit-out was likely to have been significant, given the extent of the changes made.
- Although the fit-out did not involve the erecting of a building, s CB 11 applies to **any class of "improvements". Therefore, the fit-out comes within the "or otherwise" class of "improvements" provided for by the words "made by a person erecting a building or otherwise".**
- The building was sold within ten years of the fit-out being completed.
- While there are some statutory exclusions to s CB 11, none of these are relevant **to Valyrian Villas Ltd's situation (see ss CB 11(3), CB 15C, CB 16 and CB 19 for the exclusions to s CB 11).**

Example 2 – A fit-out that is only a minor improvement to land

Dornish Dwellings Ltd is in the business of erecting buildings. It also owns a small retail shop that it leases to a florist. **The florist's lease ends, and Dornish Dwellings Ltd** looks for new long-term tenants. Sandy, a young clothing designer, approaches Dornish Dwellings Ltd and asks if he could set up a pop-up store in the shop for one month so he can sell his line of designer clothing. Dornish Dwellings Ltd agrees to lease the shop to Sandy. Dornish Dwellings Ltd fits out the now empty shop with some old shelving and clothes racks, a couple of bamboo screens for customers to change behind, and other shop furniture.

Because nothing done in the fit-out is permanently attached to the building, Dornish Dwellings Ltd has not made improvements to land. Accordingly, s CB 11 would not be triggered by Dornish Dwellings Ltd providing Sandy with the temporary fittings.

Example 3 – A fit-out that is only a minor improvement to land

North Of The Wall Limited is in the business of erecting buildings. The company decides to invest profits in an investment property and purchases a 16 floor office building for \$82,000,000. Six months after North Of The Wall Limited purchased the building, the tenant that leased the fourth floor moves out. In order to attract a new tenant, North Of The Wall Limited does a fit-out of the fourth floor. The fit-out takes three months to complete and includes both the addition of fixtures at a cost of \$200,000, and fittings at a cost of \$50,000. The fit-out does not significantly change the overall character of the office building. Although the fit-out involves improvements (the fixtures) to land, these are considered to be minor. While the cost of the improvements in absolute terms is not insignificant, it is small relative to the overall value of the office building. The fit-out is not considered to be important in relation to the nature and character of the building (and, therefore, the land). No architectural or other professional services are used and only minimal physical work is required.

Therefore, although North Of The Wall Ltd has made improvements to land, these are **considered to be minor and therefore do not meet the definition of "improvements"** for the purposes of s CB 11.

Example 4 – A person associated with someone in the business of erecting buildings

Tyroshi Tenements Ltd is a property-holding company owned by Braavosi Building Ltd, a construction company. Tyroshi Tenements Ltd is not in the business of erecting buildings, but Braavosi Building Ltd is. Tyroshi Tenements Ltd has been associated with Braavosi Building Ltd for over 20 years. This year, Tyroshi Tenements Ltd sells one of its commercial properties (office block A). Importantly, eight years earlier, Tyroshi Tenements Ltd carried out a significant and costly fit-out of every floor in office block A. Although Tyroshi Tenements Ltd is not in the business of erecting buildings itself, it is still subject to s CB 11 because it was associated with Braavosi Building Ltd at the time the fit-out was begun. Therefore, assuming the fit-out of office block A was **"improvements" for the purposes of s CB 11**, by selling office block A this year, eight years after completing the fit-out, Tyroshi Tenements Ltd must pay tax on the sale.

References

Subject references

Business of erecting buildings
Fit-out
Improvements

Legislative references

Income Tax Act 1994: s CD 1(2)(d)
Income Tax Act 2004: ss CB 10 and OB 1
("improvements")
Income Tax Act 2007: ss CB 11, CB 12 and
YA 1 ("improvements")

Case references

Case L43 (1989) 11 NZTC 1,262
Morrison v Federal Commissioner of Land Tax
(1914) 17 CLR 498
McGeoch v Federal Commissioner of Land Tax
(1929) 43 CLR 277

Other references

Hinde, McMorland & Sim Land Law in New Zealand (online looseleaf ed, LexisNexis, accessed 8 September 2017) at [6.036]
"New Definitions of 'Associated Persons'", Tax Information Bulletin Vol 21, No 8, Pt II (October/November 2009): 75–93
"Work of a Minor Nature" Tax Information Bulletin Vol 17, No 1 (February 2005): 5–23