

## QUESTION WE'VE BEEN ASKED

QB 20/01

Can owners of existing residential rental properties claim deductions for costs incurred to meet Healthy Homes standards?

*Owners of existing residential rental properties may incur expenditure to meet the Healthy Homes standards.*

*This Question we've been asked (QWBA) discusses the tax treatment of such expenditure under the Income Tax Act 2007.*

### Key terms

**Healthy Homes standards:**

Minimum requirements for residential rental homes for smoke alarms, heating, insulation, ventilation, draught-stopping, drainage and moisture ingress set by regulation under the Residential Tenancies Act 1986.

The regulations were introduced in two stages in 2016 (the **2016 regulations** that applied from 1 July 2019) and 2019 (the **2019 regulations** that will be universally applicable from 1 July 2024).

**Low-value asset:** An item of property that meets the requirements of s EE 38(1) (generally, one with a cost of not more than \$500, \$1,000 or \$5,000, depending when the asset was purchased (see footnote to [33]).

## Question

Can owners of existing residential rental properties claim income tax deductions for costs incurred to meet Healthy Homes standards?

## Answer

Costs of a revenue nature are generally deductible in the income year they are incurred and these may include the costs of:

- **repairing items that would otherwise meet the standards if operational or in a reasonable condition;**
- **minor additions or alterations not involving repairs that do not change the character of the building, such as:**
  - **some costs of meeting the draught-stopping standards, such as blocking unused chimneys or fireplaces (if sufficiently attached to the building);**
  - **making mechanical ventilation systems compliant; and**
  - **some costs of meeting the moisture ingress and drainage standard in respect of ground moisture barriers;**
- **replacing items on a like-for-like basis in the future where they have previously been treated as part of the building; and**
- **recordkeeping and providing information in tenancy agreements.**

Capital costs will generally result in a deduction for a depreciation loss unless they are for something that is part of the residential rental building. The cost of items that are part of the building are added to the building's cost and depreciated at the same rate as the building. Generally, this is zero percent.

**Items that are likely to be part of the building include:**

- smoke alarms;
- insulation;
- ducted or multi-unit heat pumps;
- flued fires (wood or gas);
- new or replacement openable windows;
- new exterior doors;
- most extractor fans or rangehoods;
- ground moisture barriers; and
- drainage systems for storm, surface and ground water and drainage of water from roofs.

**Capital costs for some items acquired that are not part of the building will be either:**

- depreciated over multiple income years using a rate set out in Depreciation Determination DEP80: *Residential rental property chattels* for assets of that type; or
- depreciated at a rate of 100% in the income year the expenditure is incurred if the item is a “low-value asset”.

**Items able to be depreciated include:**

- electric panel heaters (67% DV or SL);<sup>1</sup>
- some heat pumps (eg, single-split type) (20% DV or 13.5% SL); and
- through-window extractor fans, window stays, door openers and stops, external door draught excluders and some devices for blocking fireplaces or chimneys (if the devices are not sufficiently attached to the building) (40% DV or 30% SL).

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## Background

1. Owners of residential rental properties are required to make sure their properties meet certain minimum standards. Since 1 July 2019, residential rental properties must have met underfloor and ceiling insulation and smoke alarm standards (see the Residential Tenancies (Smoke Alarms and Insulation) Regulations 2016) (the 2016 regulations). From 1 July 2021, the 2016 regulations will be added to by the Residential Tenancies (Healthy Homes Standards) Regulations 2019 (the 2019 regulations).
2. The 2019 regulations apply progressively when there are changes in tenancies after 1 July 2021 with universal application from 1 July 2024.
3. In this QWBA, references to the “Healthy Homes standards” or the “standards” means the standards made under both the 2016 and 2019 regulations — unless indicated otherwise. This item considers the tax treatment under the Income Tax Act 2007 that may apply to expenditure owners of existing residential rental properties may incur to comply with the Healthy Homes standards.
4. Existing rental properties in this context include the situation where the property is temporarily vacant when the work to meet the standards is undertaken. See example 1

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<sup>1</sup> Diminishing value (DV) and straight line (SL) are two methods for calculating depreciation.

of "IS 12/03: Income tax – deductibility of repairs and maintenance expenditure – general principles", *Tax Information Bulletin* Vol 24, No 7 (August 2012): 68.

## Tax treatment

### Introduction

5. Whether expenditure is revenue in nature and deductible in the year incurred or capital in nature and depreciable, depends on the specific facts. Expenditure to meet the standards will be capital in nature if the work:
  - results in the reconstruction, replacement or renewal of the whole asset or substantially the whole asset; or
  - goes over and above making good wear and tear (ie, is not a repair) and changes the character of the asset.
6. Conversely, expenditure incurred on work to repair or maintain an asset without reconstructing, replacing or renewing the whole asset, or substantially the whole asset, or without changing its character, will be revenue in nature.
7. Deciding whether expenditure is of a capital or revenue nature requires identifying what the relevant asset is against which the character of the expenditure is then gauged.

### Identifying the relevant asset

8. In this context, the Commissioner applies a three-step test to identify whether expenditure has been incurred for an item that is a separate asset or part of a larger asset, in this case, a residential rental building. The test is set out in "IS 10/01: Residential rental properties – depreciation of items of depreciable property", *Tax Information Bulletin* Vol 22, No 4 (May 2010): 16 (at [166]):
  - **Step 1:** Determine whether the item is in some way attached or connected to the building. If so, go to step 2. If not, the item will be a separate asset.
  - **Step 2:** Determine whether the item is an integral part of the residential rental property such that a residential rental property would be considered incomplete or unable to function without the item. If so, the item will be part of the residential rental building. If not, go to step 3.
  - **Step 3:** Determine whether the item is built-in or attached or connected to the building in such a way that it is part of the "fabric" of the building. If so, the item will be part of the residential rental building. If not, the item will be a separate asset.

### ***Applying the three-step test in the context of Healthy Homes expenditure***

*Step 1 is almost always met*

9. The work required to meet the standards almost always involves something that is attached or connected in some way to the residential rental building. While the degree of attachment may seem minimal in some instances (such as with ground moisture barriers or some insulation in ceiling cavities) there is, in most cases, sufficient connection to the building to satisfy step 1 of the test. Accordingly, in the Commissioner's view, it will almost always be the case that step 1 of the three-step test is met.

*Step 2 will be met in most cases*

10. Step 2, in the context of a residential rental property looks at what:
  - "makes up the residence as a lettable entity";

- is “part of the complete entity which must be provided by a landlord, at the very minimum, to a tenant”;
  - “is a basic requirement of a leased residential dwelling”; or
  - is “a de facto precondition of the residential leasehold agreement”.<sup>2</sup>
11. The Commissioner’s view is that applying step 2 requires assessing what features or items comprise the relevant asset. In the context of expenditure incurred to meet the Healthy Homes standards, the Commissioner considers the relevant asset is, in this case, a “residential rental building”. This involves considering what would ordinarily meet the concept of a particular type of building, that is, a residential rental building. The ordinary concept of a particular asset can evolve over time under the influence of many factors, one of which may be regulatory change.
12. The Commissioner considers that the requirements currently imposed by the 2016 regulations for smoke alarms and insulation mean these items are now an integral part of the property under step 2 and the residential rental property would be considered incomplete without them.
13. However, this is not the case with the 2019 regulations that are not yet fully in force. Despite this, some of the requirements under the 2019 regulations cover things that are already within the ordinary concept of a residential rental building and, as a result, are integral to the building under step 2. In particular, the ventilation standard’s requirements for external opening windows and doors and the moisture ingress and drainage standard’s requirements for drainage.<sup>3</sup> The Commissioner considers items such as these would be integral to a residential rental property under step 2, regardless of not yet being required under the 2019 regulations.
14. This means that, in the Commissioner’s view, step 2 of the three-step test will be met for much of the work required to meet the Healthy Homes standards. Where step 2 is met, the relevant asset is the residential rental building and step 3 is not applicable.

*Step 3 is sometimes applicable*

15. Where step 2 is not met, it is necessary to consider step 3. Applying step 3 requires determining whether the item is built-in or attached or connected to the building in such a way that it is part of the “fabric” of the building. Factors such as the nature and degree of attachment, the difficulty involved in the item’s removal, and whether there would be any significant damage to the item or the building if the item were removed, are relevant. Step 3 also includes considering whether, once installed, an item has lost its physical distinctness or separateness from the building.
16. This factor is particularly relevant to insulation (whether required under the 2016 or 2019 regulations) and moisture ingress and drainage standard requirements under the 2019 regulations for ground moisture barriers (but not for drainage, gutters, and downpipes that are already considered part of the building under step 2, as mentioned above).
17. If the item is part of the fabric of the residential rental building, the relevant asset to gauge the nature of the costs incurred in meeting the Healthy Homes standards is the building — not the item that the expenditure may involve (for example, a heat pump). However, if the item is not part of the residential rental building the relevant asset against which the nature of the costs is gauged will be the item.

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<sup>2</sup> See: *Case 11/97 97 ATC 173 (AAT)* cited in IS 10/01 at [146]–[155].

<sup>3</sup> Some of the 2019 regulation’s standards reinforce existing regulations, for instance, regulations 9(1), 11(3), 14 and 15 of the Housing Improvement Regulations 1947.

## Nature and extent of the work carried out

18. IS 12/03 explains that after identifying the relevant asset the next step is to consider the nature and extent of the work done to the asset.
19. The nature of the work undertaken to meet the Healthy Homes standards may involve repairing or maintaining existing parts of the building. If so, the expenditure may be revenue in nature on account of being “repairs”.
20. However, in the Commissioner’s view, the nature of the work is more likely to involve making additions or alterations to the building, rather than repairs.
21. The extent of the addition or alteration work required to meet the standards will not typically extend to the reconstruction, replacement or renewal of the whole residential rental building or substantially the whole building. However, the extent of the work may improve or enhance the building or in some way make it better or different and, hence, alter its character.
22. As mentioned at [5], whether expenditure is revenue or capital in nature depends on the specific facts. Some matters that may help with assessing the nature and extent of the work carried out include:
  - expenditure on some minor additions or alterations that do not involve repairs is likely to be revenue in nature;
  - replacements using modern materials are not necessarily capital in nature; and
  - expenditure that is part of an overall project may be capital in nature.

### *Expenditure on some minor additions or alterations not involving repairs may be revenue in nature*

23. In some cases, expenditure incurred in meeting the Healthy Homes standards will involve some additions or alterations that do not involve repairs to the building that are minor in their extent in terms of the work carried out, its importance and its cost. If so, there is a presumption the work is insufficient to alter the character of the building.
24. This is provided the work is not in relation to something that is considered an integral part of the building under step 2 of the three-step test. Items that are part of the building under step 2 are necessary to complete the building or make it fully functional and therefore alter the character of the building. Thus, the ability to deduct the costs of minor additions or alterations to the residential rental building that do not involve repairs will be limited to where the expenditure relates to something that is only considered part of the building under step 3 of the three-step test.

### *Repairs using modern materials are not necessarily capital in nature*

25. In some situations, work needed to be done to meet the Healthy Homes standards may require replacing one item with another that is made of more modern materials and that is superior in some way.
26. If so, the use of modern materials alone does not necessarily mean the repairs are of a capital nature. This is provided the extent of the use of the new materials is such that the whole asset or substantially the whole asset, is not reconstructed, replaced or renewed or the character of the building changed.

### *Expenditure that is part of an overall project may be capital in nature*

27. Expenditure that may otherwise be revenue in nature can take on a capital nature in some circumstances. This may occur if the work is part of an overall project to reconstruct, replace or renew a whole asset or substantially the whole asset or that changes the asset’s character (see IS 12/03 at [185] to [208] and examples 17, 19 and 20).

## Depreciation losses for capital expenditure may be deductible

28. Where costs incurred to meet a Healthy Homes standard are capital in nature, the expenditure is treated as either:
- adding to the capital value of the building and subject to the depreciation treatment applicable to that building; or
  - the cost of an asset that is separate from the building.

### ***Depreciation losses for buildings***

29. The depreciation rate for buildings with an estimated useful life of 50 years or more is zero percent, which effectively means no depreciation loss is allowed. Most residential rental properties subject to the standards will be buildings of this type. This means any expenditure incurred to meet the Healthy Homes standards that is treated as adding to the capital value of the building is depreciated at the rate applicable to such buildings (generally, zero percent).
30. Note, this outcome applies even though the costs may involve an item that is listed in a general depreciation rate determination for the residential rental property chattels industry code (see "Depreciation Determination DEP80: Residential rental property chattels", *Tax Information Bulletin* Vol 23, No 10 (December 2011): 6). The fact that an item is listed in a depreciation determination does not make the item separately depreciable.

### ***Depreciation losses for separate assets***

31. Capital expenditure incurred on separate assets may give rise to a deduction for a depreciation loss:
- at a rate of 100% in the income year the expenditure is incurred if the item is a "low-value asset" under s EE 38; or
  - over multiple income years using a rate set out in Depreciation Determination DEP80 for assets of that nature.
32. A "separate asset" in this context means that once the three-step test has been applied, the relevant asset is something other than the residential rental building.

### ***Low-value assets may be depreciated in full***

33. Section EE 38 states that the entire cost of a low-value asset may be allowed as a depreciation loss in the year the asset is acquired (ie, depreciation is allowed at the rate of 100%). Generally, a low-value asset is one where the cost is not more than a certain amount.<sup>4</sup> The low-value asset cannot be or become part of any other depreciable property, such as the residential rental building.
34. The deduction allowed under s EE 38 is subject to a number of other conditions, including if the property is one of a group of items acquired at the same time from the same supplier, the total cost of the group does not exceed the relevant amount and:
- the items would be subject to the same depreciation rate if all were treated as items of depreciable property; or
  - if the items generally are trading stock, the cost of those items not treated solely as trading stock does not exceed the relevant amount.

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<sup>4</sup> The applicable amount depends on when the property was purchased. For purchases prior to 17 March 2020, the amount is not more than \$500. For purchases on or after 17 March 2020 and prior to 17 March 2021, the amount is not more than \$5,000. For purchases on or after 17 March 2021, the amount is not more than \$1,000.

*Separate assets that are not low-value assets are depreciated at rate set by Commissioner*

35. For separate assets that are not low-value assets, the relevant annual depreciation rate to be used is found in the Commissioner's determination DEP80.

### **Future replacement costs may be treated differently than current costs**

36. Where the tax treatment in this QWBA has been applied, and as a result, an item has been treated as capital in nature and added to the cost of the residential rental building, any future replacement of that item on a like-for-like basis may then involve a repair of the building. This is because the nature and extent of any future replacement expenditure will be assessed against the building as the relevant asset. Unlike the original expenditure on the item, the replacement expenditure may then be revenue in nature.
37. Conversely, if under the tax treatment in this QWBA, expenditure is treated as being for a separate asset from the building and further expenditure is incurred in the future to replace that asset (on a like-for-like basis or otherwise), the replacement expenditure is more likely to be capital in nature. This is because the nature and extent of the future expenditure is assessed against the item replaced (as the relevant asset) and not the building. However, a deduction for a depreciation loss may be allowed for any remaining undepreciated part of the cost of the original item being replaced (subject to any depreciation recovery income on disposal).

## **Healthy Homes standards**

38. The tax treatment of expenditure incurred to meet specific standards is considered below. In each case, any conclusion that expenditure may be revenue in nature is subject to the proviso that the costs are not incurred as part of an overall capital project.

### **Smoke alarm standard**

39. Smoke alarms required under the 2016 regulations are integral to the building under step 2 of the three-step test, so the relevant asset is the building. Installing new smoke alarms in a residential rental building that did not previously have alarms installed is an addition that changes the character of the building, so is capital in nature.
40. Where smoke alarms that have been treated as part of the building reach the end of their useful lives and are replaced, a repair of the building is involved, so the costs will generally be treated as revenue in nature.

### **Insulation standard**

41. As mentioned at [12] and [16], insulation will form part of the building under step 2 of the three-step test due to the 2016 regulations or under step 3 due to the insulation losing its physical distinctness from the building, or both. Some insulation may also be sufficiently built-in, attached or connected to the building to be part of the building under step 3 of the test.
42. In the Commissioner's view, this means that the relevant asset is the building. Further, the costs of installing or replacing insulation to meet the standards (whether under the 2016 or 2019 regulations) will alter the character of the building. The costs are capital in nature, added to the capital value of the building and depreciated, in most cases, at the rate of zero percent.
43. In some cases, the insulation installed may be replacing, topping-up or patching existing insulation to restore the insulation to its original state where its original state

was enough to meet the insulation standard. If so, the work undertaken is in the nature of a repair, so the expenditure will be revenue in nature and deductible in the income year incurred.

44. The costs of patch replacement of foil insulation may also be revenue in nature and deductible in the income year incurred. The repair or installation of foil insulation in residential buildings is banned under the Building Act 2004 due to the electrocution dangers it poses. Foil insulation can only be replaced with non-electrically conductive insulation, and this may be considered an improvement over the original insulation. However, the use of more modern materials does not necessarily mean the relevant expenditure is capital in nature. In these cases, the expenditure is considered deductible expenditure on repairs and maintenance, provided there is not such extensive use of the alternative material that it is likely to change the character of the building.

### Heating standard

45. The Commissioner considers that heat pumps and the other forms of heating sufficient to meet the 2019 regulations are not yet a required feature of all residential rental buildings. Accordingly, at present, a building may be considered complete without these particular heating systems. As such, they are not integral to the building under step 2.
46. In terms of step 3, the type of heating systems required to meet the 2019 regulations appear to vary in their likely degree of attachment or connection to the building. For instance, fixed electric panel heaters may not be attached or connected to the building to such a degree that they form part of the fabric of the building. This means the heaters may be treated as a separate asset from the building for repairs and maintenance and depreciation purposes.
47. The most common residential heat pumps are air source, split-single type, with an external unit and single internal unit that is installed through a wall or window. Again, they may also, in most cases, be considered a separate asset from the building. However, with systems such as ducted or multi-unit heat pumps and flued fires (gas or wood) it may be more likely that these form part of the fabric of the building.
48. Where the expenditure can be treated as the cost of acquiring a separate asset, the expenditure will be capital in nature and may be deducted in full in the year incurred depending on its cost and whether the other terms of s EE 38 are met. Otherwise, the expenditure may result in a depreciation deduction over multiple years that is calculated using the appropriate rate in DEP80. Under DEP80 the depreciation rates that may be relevant are:
- “Air conditioners and heat pumps (through wall or window type)” – 20% (DV) 13.5% (SL);
  - “Heaters (electric)” – 67% (DV and SL); or
  - “Chattel (default class)” – 40% (DV) 30% (SL).
49. Where the heating system is considered part of the building, the relevant asset will be the building. The expenditure will alter the character of the building and be capital in nature. The costs of the heating system are added to the cost of the building and depreciated at the rate applicable to the building (generally, zero percent).
50. Repairs of any existing heating systems that would otherwise meet the heating standard if operational or in a reasonable condition will be deductible as repairs and maintenance expenditure in the income year incurred.



## Ventilation standard

51. The costs most likely to be incurred to meet the ventilation standard (other than repairs to existing items) involve acquiring and installing new items to the building, such as openable external doors and windows or rangehoods and extractor fans that vent to the outdoors. The ventilation requirements in the 2019 regulations are not yet a required feature of all residential rental buildings but, as mentioned at [13], the ventilation standard's requirements for opening doors and windows are considered integral to the building under step 2, regardless of not yet being required under the 2019 regulations.
52. In terms of step 3, the type of additions to the building required to meet the ventilation standards (such as, most externally-venting extractor fans) will usually be attached or connected to the building to such a degree that they are considered part of the fabric of the building.
53. An exception may be where a single extractor fan is installed through a window and removal of the fan involves little more than the replacement of the windowpane. In that case, the relevant asset is the fan and its purchase and installation costs may be depreciated at a rate set by the Commissioner (the default chattel rate of 40% DV or 30% SL) unless claimed under the low-value asset option provided by s EE 38.
54. Where the ventilation item is considered part of the fabric of the building under step 2 or step 3, the relevant asset will be the building, the expenditure will, generally, alter the character of the building and be capital in nature. The costs of the item are added to the cost of the building and depreciated at the rate applicable to the building (generally, zero percent).
55. Repairs of existing ventilation items that would otherwise meet the ventilation standard if operational or in a reasonable condition will be deductible as repairs and maintenance expenditure in the income year incurred. However, replacing fixed windows that are otherwise not in need of replacement with opening windows to meet the ventilation standard would not involve a repair. Repairs or minor alterations or additions may also be needed for extractor fans to make sure they are vented correctly according to the 2019 regulations.
56. Under the ventilation standard, existing windows or doors must be able to remain fixed in an open position during normal occupation of the building. This may require work being undertaken to add or alter doors or windows to fit door openers or stops or window stays. These are required under the 2019 regulations and would not at present be considered integral to the building, nor are they likely to have lost their separate identity or have become part of the fabric of the building under step 3. This means the relevant asset currently is likely to be the window stay, door opener or stop, rather than the building and the costs capital in nature. If so, the costs may be able to be deducted under the low-value asset provision of s EE 38, should it apply in the particular circumstances.

## Moisture ingress and drainage standards

57. Other than repairs, the costs likely to fall into this category are costs to install new:
  - ground moisture barriers;
  - drainage to efficiently drain storm water, surface water and ground water to an appropriate outfall; or
  - gutters, downpipes and drains for the removal of water from roofs.
58. As mentioned at [13] and [16] most items required for the moisture ingress and drainage standards will be either integral to the building under step 2 (for the drainage requirements) or part of the fabric of the building under step 3 (for ground moisture barriers).

59. Accordingly, the relevant asset for most expenditure incurred to meet the moisture ingress or drainage standards will be the residential rental building. Unless the work undertaken is a minor addition or alteration that is not a repair and specifically relates to ground moisture barriers, any other costs of meeting this standard will alter the character of the building, are added to the capital cost of the building and depreciated, in most cases, at the rate of zero percent.
60. Where expenditure is incurred repairing existing parts of the building that would otherwise meet the standards if these parts were operable or in good condition, the costs are likely to be revenue in nature and deductible in the income year incurred. For example, repairs to existing roofs, gutters, ground moisture barriers or drainage systems.

### **Draught stopping standard**

61. Where the expenditure is for the caulking or sealing of gaps or holes, the relevant asset will be the residential rental building. In most cases, this expenditure will be revenue in nature as repairs or maintenance of the building. The expenditure will be able to be deducted in the income year it is incurred.
62. Where the expenditure is for the fitting of draught excluders to external doors or for blocking an unused fireplace or chimney the relevant asset is likely to be the item itself and not the building. However, there may be some cases where the way in which the blocking device is attached to the building and the extent to which it is attached to the building means the device loses its separate visual identity and cannot be removed without significant damage. If so, the relevant asset is the building under step 3 of the three-step test.
63. Where the relevant asset is the item and not the building the costs are likely to be considered capital in nature and, if not able to be depreciated in full under s EE 38, can be depreciated over multiple years at the default chattel rate (40% DV or 30% SL).
64. Where the relevant asset is the building and the costs are not a minor addition or alteration as discussed above they will be capital in nature and added to the capital value of the building and depreciated in most cases at zero percent. Where the relevant asset is the building but the costs are minor they may be deducted in the year incurred as minor additions or alterations not involving repairs that do not change the character of the building.

### **Recordkeeping and provision of compliance information in tenancy agreements requirements**

65. Costs incurred to meet the requirements to provide compliance information and keep records will be deductible expenditure in the income year incurred. An example would be property management fees charged for providing Healthy Homes compliance services.

## Examples

66. The following examples illustrate the income tax treatment of costs incurred to meet the Healthy Homes standards. Unless stated otherwise, the examples assume:
- the work undertaken and the expenses incurred are necessary to meet the Healthy Homes standards; and
  - the work carried out is not part of any other work carried out on the property at the same time.

### **Example 1: Installation of new heat pump – not deductible but depreciable**

In June 2021, Ari installs a single split-single type heat pump in the main living area of his residential rental building at a total cost of \$2,000.

Ari's heat pump is not built into the building to a significant degree and could be removed without great difficulty without damaging the unit or the building. The expenditure is treated as the capital cost of acquiring an asset separate from the building. As the cost is over \$1,000 the low-value asset option under s EE 38 is not available. Ari can claim an annual depreciation loss based on the \$2,000 cost price of the heat pump at the rate of 20% (DV) or 13.5% (SL). If the heat pump had been acquired between 17 March 2020 and 17 March 2021, then s EE 38 may have applied to allow a depreciation loss calculated at 100% because the cost is below \$5,000.

See also, example 16 (heating/air-conditioning systems) in "IS 10/01: Residential rental properties – depreciation of items of depreciable property", *Tax Information Bulletin* Vol 22, No 4 (May 2010): 16.

### **Example 2: Installation of new insulation – not deductible**

Brenda installs new insulation in the ceiling and floors of her previously uninsulated residential rental building. The relevant asset is the residential rental building under step 2 of the three-step test. The expenditure involves additions to the building that changes its character.

The expenditure is not deductible and is added to the capital value of the residential rental building and depreciated at the rate of zero percent.

This example is based on, and consistent with example 10 (new insulation – improvement that changes character) in "IS 12/03: Income tax – deductibility of repairs and maintenance expenditure – general principles", *Tax Information Bulletin* Vol 24, No 7 (August 2012): 68.

### **Example 3: Topping up insulation to restore its original condition – deductible**

Carlos owns a rental flat with existing ceiling insulation. The tenant has just moved out, but Carlos is actively seeking a new tenant. Carlos obtains advice from a professional installer of insulation who confirms the ceiling insulation has settled over the years since it was installed and, but for this, would have met the insulation standards.

The most efficient solution is to top up the insulation to restore it to its original condition, which is enough to meet the standard. Carlos arranges for the ceiling insulation to be topped up before the flat is let to a new tenant.

The relevant asset is the flat and the work restores the efficiency of the insulation to its former condition. Therefore, the work undertaken is in the nature of a repair. The costs are revenue in nature and can be deducted in the year incurred.

This example is consistent with example 9 (insulation top-up – no change in character or substantial replacement or renewal) in "IS 12/03: Income tax – deductibility of repairs and maintenance expenditure – general principles", *Tax Information Bulletin* Vol 24, No 7 (August 2012): 68.

**Example 4: Topping up insulation beyond its original condition – not deductible**

Dara owns a rental flat with existing ceiling insulation. Dara obtains advice from a professional installer of insulation who confirms the ceiling insulation is in reasonable condition but does not meet the 2016 or 2019 regulations' insulation standards. The installer's advice is that the most efficient solution is to top up the existing insulation with significantly more insulation.

The relevant asset is the flat under step 2 of the three-step test. The work undertaken adds significantly to the amount of insulation in the ceilings. The nature and extent of the work changes the character of the flat.

The expenditure is not deductible and is added to the capital value of the residential rental building and depreciated at the rate of zero percent.

**Example 5: Minor additions and alterations not involving repairs – deductible**

Wiremu installs a small area of additional ground moisture barrier to extend the existing moisture barrier ensuring it covers all the underfloor areas of his residential rental property and meets the moisture ingress and drainage standard of the 2019 regulations. The cost is \$90.

The relevant asset is the residential rental building under step 3 of the three-step test. The expenditure does not involve repairs, and the moisture barrier is an addition to the property. However, the work undertaken and expenditure is minor so the nature and extent of the expenditure does not change the character of the building.

The expenditure is revenue in nature, so can be deducted in the year incurred.

**Example 6: Repairs to insulation using different materials – deductible**

Aroha's residential rental building has foil-based underfloor insulation. The insulation under one bedroom is ripped and has deteriorated to the point it is no longer in a reasonable condition. It does not meet the standard set for insulation in the 2016 regulations. The underfloor insulation in other areas of the building is in reasonable condition and meets the standard.

Aroha discovers that it is not possible to repair or replace the foil insulation. This is because the repair or installation of foil insulation in residential buildings poses electrocution dangers and has been banned under the Building Act 2004.

Aroha replaces the damaged insulation with a non-electrically conductive but comparatively performing insulation that meets the insulation standard.

The relevant asset is the residential rental building. The work undertaken is in the nature of a repair that does not change the character of the property.

Using a different insulation material that may be considered better in some respects (for example, safer) does not mean the building is relevantly changed or improved. The new type of insulation does not essentially function differently from the original insulation and has not been used to such an extent that it is likely to change the character of the building.

The costs are revenue in nature, so can be deducted in the year incurred.

## References

### Subject references

Capital expenditure  
Depreciation  
Healthy Homes standards  
Income tax  
Repairs and maintenance  
Residential rental chattels

### Legislative references

Building Act 2004  
Income Tax Act 2007, s EE 38(1)  
Housing Improvement Regulations 1947:  
regs 9(1), 11(3), 14 and 15  
Residential Tenancies Act 1986  
Residential Tenancies (Healthy Homes  
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