

Interpretation Statement IS 10/01

Residential Rental Properties—Depreciation of Items of Depreciable Property

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All legislative references are to the Income Tax Act 2007 unless otherwise stated.

Summary

1. This interpretation statement sets out the Commissioner's view on determining whether an item in a residential rental property is a separate item of depreciable property, or is part of the building. It concludes 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 part of the building, it cannot be separately depreciated, but can be depreciated with the building.
2. A residential rental property is comprised of several different items. It is important that the correct approach is applied to determine whether these items are regarded as distinct from or part of the building, because this affects the depreciation rate to be applied and the tax treatment of expenditure on repairs.
3. Sometimes different approaches have been taken in respect of the depreciation treatment of some items within a residential rental property. For example, questions have arisen as to whether items relating to the residential property (eg plumbing and piping, electrical wiring, internal walls, and doors) are to be treated as part of the building or as items separate from the building. The Commissioner considers that it is not correct to break down a residential rental property into such separate items for depreciation purposes. While this statement applies only in respect of residential rental properties, many of the principles are also likely to apply in the context of commercial properties and other assets.
4. The Commissioner concludes that the approach to determine whether a particular item is part of or separate from the building, is to apply the following three-step test:

Step 1: Determine whether the item is in some way attached or connected to the building. If the item is completely unattached, then it will not form a part of the building. An item will not be considered attached for these purposes, if its only means of attachment is being plugged or wired into an electrical outlet (such as a freestanding oven), or attached to a water or gas outlet. If the item is attached to the building, go to step 2.

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 the item is an integral part of the residential rental property, then the item will be a part of the building. If the item is not an integral part of the residential rental property, 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. Consider 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. If the item is part of the fabric of the building, then it is part of the building for depreciation purposes.
5. In summary, the legal reasons for applying this approach to determine whether an item should be treated as a separate item or as part of the building are as follows.
6. The history of depreciation supports this approach:

- While section 108 of the Income Tax Act 1976 did not state how to determine whether an asset was a separate item or part of the building, it was implicit that the approach taken under section 108 was to determine whether the item could be broken down into separate items in order to apply the provision.

(Under section 108 of the Income Tax Act 1976 depreciation was combined with the repairs and maintenance provisions. Section 108 allowed for deductions in respect of repairs and the maintenance of an "asset", as well as providing for depreciation allowances in respect of any such "asset" that met the other requirements of the section.)

- The case law relating to section 108 of the Income Tax Act 1976 confirmed that the approach was to determine whether an item was a separate item or part of the building. While these cases dealt with repairs and maintenance rather than depreciation, the linkages between repairs and maintenance and depreciation under section 108, indicated that the same approach would have been applied if a case had arisen in the depreciation context.
- Analogous case law from other jurisdictions also supports the approach. While none of the cases definitively explains how to determine the relevant asset for depreciation purposes, factors taken from the case law support the above test.

7. The enactment of the Income Tax Act 1994, Income Tax Act 2004, and Income Tax Act 2007 were not intended to depart from the approach of determining whether an item was a separate item or part of the building:

- Nothing in section EG 1 of the Income Tax Act 1994 or the legislative background to section EG 1 indicated an intention to depart from the need to establish whether an item was a separate item or part of the building in the context of depreciation.
- The word "asset" was replaced with the word "property" in section EG 1 of the Income Tax Act 1994, but the ordinary meanings of these two words are sufficiently similar that they can be used interchangeably. This change in wording did not reflect an intention to depart from the approach taken under section 108 of the Income Tax Act 1976. Also, several sections concerning depreciation continued to use the word "asset".
- While the 1991 Valabh Committee report recommended that the repairs and maintenance and depreciation provisions be separated, it did not suggest that the approach of determining whether an item could be broken into separate items or not should be altered (Consultative Committee on the Taxation of Income from Capital, *Tax Accounting Issues* (Consultative Committee, Wellington, 1991)).
- In addition, nothing in Determination DEP 1: Tax Depreciation Rates General Determination Number 1 (DEP 1), the relevant depreciation determination, suggests it was intended to depart from the need to determine whether an item was separate to, or part of, the building or that the breaking down of an item into separate items was the preferred approach.

- The words used under the current depreciation provisions do not suggest a meaning that is different to that in section EG 1 of the Income Tax Act 1994. In particular, there were no relevant intended policy changes included in schedule 22A of the Income Tax Act 2004 or schedule 51 of the Income Tax Act 2007.
8. It is also concluded that the approach taken in the statement is not altered by the operation of section EE 37. Under this section, when a taxpayer makes a capital improvement to an item of depreciable property that improvement is depreciated at the same applicable rate as that applied to the item improved, although it is possible for a taxpayer to choose to treat the improvement as a separate item. Such an election permits a taxpayer to take advantage of any favourable change to the depreciation rate applicable to that item. However, the depreciation treatment of the improvement does not alter the approach outlined in this statement, which determines whether an item is a separate item or part of the building. The depreciation rate of an improvement can be determined only once the item of depreciable property that is subject to the improvement has been properly identified using the approach outlined in this statement.
9. The appendix to this statement contains examples illustrating how the Commissioner considers the test would apply to some specific assets. The examples do not cover every possible item, but they give a practical application of the test to some items. The assets covered are:
- plumbing and piping
 - electrical wiring
 - internal walls
 - internal and external doors
 - garage doors (when the garage is part of the residential rental building)
 - fitted furniture (wardrobes and cupboards built into the wall)
 - kitchen cupboards
 - bathroom fittings and furniture
 - wardrobes and cupboards not built into the wall
 - carpets
 - linoleum
 - tiles (wall and floor)
 - curtains
 - blinds
 - water heaters and hot-water cylinders.
10. The plumbing and piping, electrical wiring, internal walls, internal and external doors, garage doors (when the garage is part of the residential rental building), fitted furniture (wardrobes and cupboards built into the wall), kitchen cupboards, bathroom fittings and furniture, linoleum, and tiles (wall and floor) are not separate assets, but are part of the building. Wardrobes and cupboards not built into the wall, carpets, curtains, blinds and water heaters and hot-water cylinders can be regarded as separate from the building, so can be depreciated at a different rate.

Application

11. On 29 May 2006, IRD released a media statement setting out the Commissioner's view that residential rental property owners breaking up their properties into smaller components in order to get higher

depreciation rates for tax purposes was not allowed under the law. The media statement listed a number of components and stated whether they were considered to be separately depreciable or part of the building. A copy of the media statement can be obtained from the IRD website (<http://www.ird.govt.nz/aboutir/media-centre/media-releases/2006/media-release-2006-05-29a.html>).

12. The media statement also contained a transitional approach to assist taxpayers who had been claiming too much depreciation to amend their positions going forward. IRD has been applying the position set out in the media statement since it was issued and will continue to do so.
13. This statement does not consider the deductibility of expenditure on repairs and maintenance. However, it is noted that some expenditure upon an item that may have been regarded as a separate asset under the "smallest asset" approach might be deductible as repairs and maintenance under the approach taken in this statement. This is because, whereas expenditure on a separate item of property may have to be treated as capital, if the item is more correctly characterised as a small part of a larger item, the expenditure may qualify as repairs and maintenance. However, this does not mean that all expenditure on objects that are part of the building under the approach taken in this statement will necessarily be deductible as repairs and maintenance. The Commissioner's view is that the conclusions in this statement do not affect the capital / revenue distinction established by case law.

Background

14. Depreciation is an allowance for tax purposes to take account of the fact assets used in deriving income wear out or become obsolete, even though they are maintained and repaired. This reducing value is recognised for tax purposes by allowing a deduction against income for depreciation for the time the assets are used in earning income.
15. To claim a depreciation deduction for an asset the:
 - property must be depreciable property;
 - taxpayer must own the property;
 - property has to be used, or be available to be used, by the taxpayer in deriving income; and
 - depreciation loss has to be calculated under sections EE 9 to EE 11.
16. Before depreciation can be claimed, the relevant item needs to be identified. This statement sets out the correct approach to use, in the context of a residential rental property, when identifying whether an item is a separate item of depreciable property that can be depreciated separately or whether it forms part of a building and must be depreciated with the building.

Legislation:

Income Tax Act 2007

17. Section EE 1(1) is as follows:

EE 1 What this subpart does

Quantifying amounts of depreciation loss and depreciation recovery income

- (1) This subpart—
- (a) quantifies the amount of depreciation loss for which a person is allowed a deduction if the provisions of Part D (Deductions) are met; and
 - (b) quantifies the amount of depreciation recovery income that is income under Part C (Income).

18. Section EE 6(1) is as follows:

EE 6 What is depreciable property?

Description

- (1) **Depreciable property** is property that, in normal circumstances, might reasonably be expected to decline in value while it is used or available for use—
- (a) in deriving assessable income; or
 - (b) in carrying on a business for the purpose of deriving assessable income.

Subsections (2) to (4) expand on this subsection.

19. Section EE 7 is as follows:

EE 7 What is not depreciable property?

The following property is not **depreciable property**:

- (a) land, although buildings, fixtures, and the improvements listed in schedule 13 (Depreciable land improvements) are depreciable property if they are described by section EE 6(1);
- (b) trading stock;
- (c) livestock to which subpart EB (Valuation of trading stock (including dealer's livestock)) applies;
- (d) financial arrangements;
- (e) excepted financial arrangements;

- (f) property that will not decline in value, as far as its owner is concerned, because, when they dispose of it, they have a right to be compensated for any decline in its value:
- (g) property that its owner chooses, under section EE 8, to treat as not depreciable:
- (h) property that its owner chooses, under section EE 38, to deal with under that section:
- (i) property for whose cost a person other than the property's owner is allowed a deduction:
- (j) property for whose cost a person is allowed a deduction under a provision of this Act outside this subpart or under a provision of an earlier Act, except for an asset to which section DU 6(4) (Depreciation) applies.

20. Section EE 9(1) and (2) is as follows:

EE 9 Description of elements of calculation

Depreciation methods

- (1) Sections EE 12 to EE 24 deal with the methods of calculating an amount of depreciation loss. The methods are—
 - (a) the straight-line method, which is dealt with in sections EE 13 to EE 19; and
 - (b) the diminishing value method, which is also dealt with in sections EE 13 to EE 19; and
 - (c) the pool method, which is dealt with in sections EE 20 to EE 24.

Depreciation rates

- (2) Sections EE 26 to EE 36 deal with the rates of depreciation. The rates are—
 - (a) the economic rate, which is dealt with in section EE 26; and
 - (b) the annual rate, which is dealt with in sections EE 31, EE 33, and EE 34; and
 - (c) a special rate or a provisional rate, both of which are dealt with in sections EE 35 and EE 36.

21. Section EE 37(1) to (5) is as follows:

EE 37 Improvements

When this section applies

- (1) This section applies when a person makes an improvement to an item of depreciable property.

Income year in which improvement made

- (2) In the income year in which the person makes the improvement, the provisions of this subpart apply to the improvement, as if it were a separate item of depreciable property, in the period that—
 - (a) starts at the start of the month in which the person first uses the improvement or has it available for use; and
 - (b) ends at the end of the income year.

Following income years

- (3) For income years following the income year in which the person makes the improvement,—
 - (a) a person who uses the diminishing value method or the straight-line method for the item that was improved may choose to apply subsection (4) or (5):
 - (b) a person who uses the pool method for the item that was improved must apply subsections (6) and (7).

Improvement treated as separate item

- (4) For the purposes of subsection (3)(a), a person may choose to treat the improvement as a separate item of depreciable property.

Improvement treated as part of item

- (5) For the purposes of subsection (3)(a), a person may choose to treat the improvement as part of the item of depreciable property that was improved. They must do 1 of the following for the first income year, after the income year in which they made the improvement, in which they use the improvement or have it available for use:
 - (a) if they use the diminishing value method for the item, add the improvement's adjusted tax value at the start of the income year to the item's adjusted tax value at the start of the income year:
 - (b) if they use the straight-line method for the item,—
 - (i) add the improvement's adjusted tax value at the start of the income year to the item's adjusted tax value at the start of the income year; and
 - (ii) add the improvement's cost to the item's cost.

- 22. Section EE 67 (other definitions) defines "improvement" when used in the Act as follows:

improvement means an alteration, extension, or repair of an item of depreciable property that increases its capital value.

- 23. Determinations are subordinate or delegated legislation, so it is also appropriate to refer to the relevant parts of the Commissioner's Table of Depreciation Rates.

24. The introduction to DEP 1 is as follows:

1. Application

This determination shall apply to every item of depreciable property acquired on or after 1 April 1993.

2. Determination

Pursuant to section 108C of the Income Tax Act 1976 I have determined the basic economic depreciation rates for all depreciable property other than fixed life intangible property or excluded depreciable property to be the rates specified in the schedule to this determination.

3. Interpretation

In this determination, unless the context otherwise required, expressions have the same meaning as in the Income Tax Act 1976.

25. The "Building Fit-out (when in books separately from building cost)" asset category currently contains the following items:

Asset Class	Estimated Useful Life (years)	Diminishing Value Banded Depreciation Rate (%)	Straight-line Equivalent Banded Depreciation Rate (%)
<i>Building Fit-out (when in books separately from building cost)</i>			
Building fit-out (not specified)	20	9.5	6.5
Aerials (for televisions)	15.5	12	8
Air conditioners (split system)	10	18	12.5
Air conditioners (through-window type)	10	18	12.5
Air conditioning systems	20	9.5	6.5
Air conditioning systems (in use 24 hours per day)	12.5	15	10
Alarm systems (fire)	20	9.5	6.5
Alarms (burglar)	8	22	15.5
Appliances (domestic type)	8	22	15.5
Awnings	10	18	12.5
Blinds	8	22	15.5
Canopies	20	9.5	6.5
Carpets (modular nylon tile construction)	15.5	12	8
Carpets (other than modular nylon tile construction)	5	33	24
Ceilings (suspended)	20	9.5	6.5
Cleaners cradles	15.5	12	8
Clotheslines	8	22	15.5
Cranes (overhead travellings)	25	7.5	5.5
Curtains	8	22	15.5
Delivery systems (for messages, other than tube)	12.5	15	10
Delivery systems (for messages, tube type)	20	9.5	6.5
Delivery systems (for packages, other than tube)	12.5	15	10
Delivery systems (for packages, tube type)	20	9.5	6.5
Dock levellers	20	9.5	6.5
Door closers	15.5	12	8
Doors (for strongrooms)	25	7.5	5.5
Doors (roller and the like)	12.5	15	10

Asset Class	Estimated Useful Life (years)	Diminishing Value Banded Depreciation Rate (%)	Straight-line Equivalent Banded Depreciation Rate (%)
Drapes	8	22	15.5
Dry risers	25	7.5	5.5
Electrical reticulation	25	7.5	5.5
Escalators	20	9.5	6.5
Fences	20	9.5	6.5
Flagpoles	25	7.5	5.5
Flooring (parquet)	15.5	12	8
Floors (for computer rooms)	20	9.5	6.5
Fume extraction systems (ducted)	15.5	12	8
Fume extraction systems (roof mounted)	15.5	12	8
Furniture (fitted)	15.5	12	8
Gas dowsing systems	20	9.5	6.5
Generators (standby)	25	7.5	5.5
Grills (roller and the like)	15.5	12	8
Hand driers (air type)	3	50	40
Hand soap dispensers	2	63.5	63.5
Handrails	25	7.5	5.5
Heat detectors	20	9.5	6.5
Heaters (electric)	3	50	40
Heating systems	20	9.5	6.5
Hose reels (fire)	25	7.5	5.5
Incinerators	8	22	15.5
Incinerators (rubbish)	20	9.5	6.5
Lifts	25	7.5	5.5
LED screens (fixed, in use 24 hours per day)	8	25	17.5
LED screens (fixed)	15.5	13	8.5
Light fittings	10	18	12.5
Lighting controllers (emergency)	12.5	15	10
Mailboxes	25	7.5	5.5
Maintenance units (for buildings)	20	9.5	6.5
Meters (gas)	15.5	12	8
Meters (water)	15.5	12	8
Monitoring systems	10	18	12.5
Motors (for roller doors)	10	18	12.5
Paper towel dispensers	2	63.5	63.5
Partitions (dismountable)	15.5	12	8
Partitions (non-load bearing)	20	9.5	6.5
Plumbing	25	7.5	5.5
Plumbing fixtures	25	7.5	5.5
Pumps (heat)	10	18	12.5
Railings	25	7.5	5.5
Runway beams	25	7.5	5.5
Sanitary appliances	8	22	15.5
Saunas	15.5	12	8
Security systems	10	18	12.5
Signs (electric)	10	18	12.5
Signs (other than electric)	20	9.5	6.5
Smoke detectors	20	9.5	6.5
Spa pools	12.5	15	10
Speed humps (metal)	5	40	30
Speed humps (plastic)	5	40	30
Speed humps (rubber)	10	20	13.5
Sprinkler systems	25	7.5	5.5

Asset Class	Estimated Useful Life (years)	Diminishing Value Banded Depreciation Rate (%)	Straight-line Equivalent Banded Depreciation Rate (%)
Strong boxes	25	7.5	5.5
Toilet roll dispensers	2	63.5	63.5
Ventilating fans	10	18	12.5
Ventilating fans (ducted)	15.5	12	8
Ventilating fans (roof mounted)	15.5	12	8
Vinyl flooring	10	18	12.5
Walkways	25	7.5	5.5
Walkways (moving)	20	9.5	6.5
Water heaters (not over-sink type)	12.5	15	10
Water heaters (over-sink)	10	18	12.5
Water savers	3	50	40
Watering systems	3	50	40

26. In January 1994, Determination DEP4: Tax Depreciation Rates General Determination Number 4 (DEP 4) introduced the "Residential Rental Property Chattels" industry category (part of the Commissioner's Table of Depreciation Rates). The "Residential Rental Property Chattels" industry category currently contains the following items:

Asset Class	Estimated Useful Life (years)	Diminishing Value Banded Depreciation Rate (%)	Straight-line Equivalent Banded Depreciation Rate (%)
<i>Residential Rental Property chattels</i>			
Chattels (not elsewhere specified)		5	33 24
Appliances (small)	4	40	30
Bedding	3	50	40
Blinds	8	22	15.5
Carpets (modular nylon tile construction)	15.5	12	8
Carpets (other than modular nylon tile construction)	5	33	24
Compact disc players	5	33	24
Compact discs	1	100	100
Crockery	3	50	40
Curtains	8	22	15.5
Cutlery	3	50	40
Digital versatile disc (DVD) players	5	33	24
Digital versatile disc (DVDs)	2	63.5	63.5
Dishwashers	6.66	26	18
Drapes	8	22	15.5
Dryers (clothes, domestic type)	6.66	26	18
Freezers (domestic type)	8	22	15.5
Furniture (fitted)	15.5	12	8
Furniture (loose)	10	18	12.5
Glassware	3	50	40
Heaters (electric)	3	50	40
Heaters (gas, fitted)	8	22	15.5
Heaters (gas, portable)	5	33	24
Integrated silk flower arrangements	63.5	2	63.5

Asset Class	Estimated Useful Life (years)	Diminishing Value Banded Depreciation Rate (%)	Straight-line Equivalent Banded Depreciation Rate (%)
Lawn mowers	4	40	30
Light fittings	10	18	12.5
Linen	3	50	40
Microwave Ovens (domestic type)	6.66	26	18
Ovens (domestic type)	8	22	15.5
Paintings and drawings, in either case being property the value of which might reasonably be expected in normal circumstances to decline in value	20	9.5	6.5
Prints (including limited edition prints)	10	18	12.5
Refrigerators (domestic type)	8	22	15.5
Stereos	5	33	24
Stoves (domestic type)	8	22	15.5
Televisions	5	33	24
Utensils (including pots and pans)	3	50	40
Vacuum cleaners (domestic type)	3	50	40
Video game discs	1	100	100
Video game players	3	50	40
Video recorders	5	33	24
Vinyl flooring	10	18	12.5
Washing machines (domestic type)	6.66	26	18
Water heaters	12.5	15	10

Analysis

What is the correct approach to be applied in the context of depreciation for residential rental properties?

27. It has been argued that all of the items that make up a residential rental property should be depreciated separately. This is effectively a "smallest asset" approach since it involves breaking down the larger item (the residential rental property) into smaller components. Alternatively, it has been argued that this is not the appropriate approach, because frequently there will be cases where it is the combination of these smaller components that is to be treated as the one depreciable item.
28. To establish the correct approach to be applied for determining the appropriate depreciation rates in a residential rental property context, the following matters need to be considered:
 - The approach required under section 108 of the Income Tax Act 1976.
 - The approach taken by the New Zealand courts.
 - The approach taken by the United Kingdom and Australian courts.
 - The approach applied under the amendments to the depreciation regime in 1993, which were incorporated into the Income Tax Act 1994.

- The approach taken under the Income Tax Act 2004.
- The approach taken under the Income Tax Act 2007.

Section 108 of the Income Tax Act 1976

29. Section 108 of the Income Tax Act 1976 stated that:

- (1) Notwithstanding anything in section 104 of this Act, in calculating the assessable income derived by any person from any source no deduction shall, except as expressly provided in this Act, be made in respect of any of the following sums or matters, namely, the repair of premises, or the repair of plant, machinery, or equipment used in the production of income, beyond the sum usually expended in any year for those purposes:

Provided that in cases where—

- (a) Depreciation of any such **asset**, not being plant, machinery, or equipment, or a temporary building, is caused by fair wear and tear:
- (b) Depreciation of any such **asset**, being plant, machinery, or equipment, or a temporary building, is caused by fair wear and tear or by the fact of the **asset** becoming obsolete or useless,—

And, in either case, the depreciation cannot be made good by repair, the Commissioner may, subject to sections 111, 111A and 117 of this Act, allow such deduction as he thinks just:

Provided also that where the Commissioner is satisfied that any repairs or alterations of any such **asset** do not increase the capital value of the **asset**, or that the repairs or alterations increase that value by an amount less than the cost of the repairs or alterations, he may allow such deduction as he thinks just:

Provided further that the Commissioner shall not allow any deduction under this section in respect of any repair, alteration, or depreciation of any asset where, and to the extent that, that **asset** is used by a private company (as defined in section 2 of the Companies Act 1955) in the providing, before the 1st day of April 1989, of a benefit (being a benefit that is, or that would, but for the provisions of paragraphs (f) to (n) of the definition of the expression “fringe benefit” in section 336N(1) of this Act, be, a fringe benefit within the meaning of that definition) to any person who, in relation to the private company, is a major shareholder.

- (2) Without limiting the discretion of the Commissioner under this section, it is hereby declared that he may refuse in whole or in part to allow any deduction under the first proviso to subsection (1) of this section in any case where he is not satisfied that complete and satisfactory accounts have been kept by or on behalf of the taxpayer.

[Emphasis added]

30. It is important to understand what is meant by “asset”, because this is what the allowable repairs and maintenance deduction or depreciation allowance was based on. The *Shorter Oxford English Dictionary* (5th ed, Oxford University Press, Oxford, 2002) defines “asset” as follows:

Asset: 1. In pl. Sufficient estate or effects for an executor to discharge a testator's debts and legacies. 2. In pl. any property or effects available to meet the debts of a testator, debtor or company, whether sufficient or not; sing. An item of property or an effect so available. 3. fig. A thing or person of use or value.

31. *Butterworths New Zealand Law Dictionary* (6th ed, LexisNexis NZ, Wellington, 2005) defines "asset" as follows:

asset: ... An asset is available for the payment of the debts of an individual or company, or of a deceased person.

32. *Black's Law Dictionary* (8th ed, West Group, St. Paul, MN, 2004) defines "asset" as follows:

Asset: 1. n item that is owned and has value. 2. pl. The entries on a balance sheet showing the items of property owned, including cash, inventory, equipment, real estate, accounts receivable, and goodwill. 3. pl. All the property of a person (esp. a bankrupt or deceased person) available for paying debts.

33. The word "asset", therefore, requires the item to be identifiable.
34. Section 108 of the Income Tax Act 1976 allowed for deductions in respect of repairs and maintenance of an "asset". It also provided for depreciation allowances in respect of any such asset (being plant, machinery, or equipment or a temporary building) where the depreciation had been caused by fair wear and tear or as a result of the asset becoming obsolete or useless. It further provided for depreciation of any such asset, not being plant, machinery, or equipment or a temporary building, where the depreciation had been caused by fair wear and tear. An allowance was available only when the depreciation could not be made good by repairs.
35. Inevitably, it became necessary when considering depreciation allowances, or deductions in respect of repairs and maintenance of an asset, to establish exactly what the item was that was to be depreciated, so an appropriate allowance or deduction could be established. This is supported by New Zealand case law in a repairs and maintenance context and cases from other jurisdictions in both repairs and maintenance and depreciation contexts.

Outline of New Zealand case law

Repairs and maintenance cases

36. One of the leading New Zealand cases on repairs and maintenance is *Auckland Trotting Club v CIR* [1968] NZLR 193, which cited the Australian case *Lindsay v FCT* (1961) 106 CLR 377 with approval. *Lindsay* concerned whether work done on a slipway could be properly categorised as repairs or renewal. In reaching a conclusion in *Lindsay* Kitto J stated (at page 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]

37. Kitto J also noted that 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”.
38. The same approach of needing to identify the relevant asset was also followed in later New Zealand cases such as *Hawkes Bay Power Distribution Ltd v CIR* (1998) 18 NZTC 13,685, *Poverty Bay Electric Power Board v CIR* (1999) 19 NZTC 15,001 (CA), and *Auckland Gas Co Ltd v CIR* [2000] 3 NZLR 6 (PC).
39. In the Privy Council case *Auckland Gas Co Ltd*, Lord Nicholls of Birkenhead stated (at pages 10 and 11) that in deciding whether work done on an item constitutes repair or replacement:

[T]he first step is to identify the object to which the test of repair or replacement is being applied. Frequently this is a straightforward exercise and the answer is obvious. To take a homely instance, replacement of a worn washer on a household tap is normally regarded as a repair of the tap even though one of its parts has been wholly replaced. The tap has been repaired by the replacement of one of its component parts. Similarly with a car: replacement of a spent battery or a corroded exhaust system will normally be regarded as a repair of the car. The car has been put into working condition again. 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.

40. Similarly, the Court of Appeal in *Poverty Bay Electric Power Board* noted (at page 445):

Where a tax deduction is claimed for expenditure on property of a taxpayer it is necessary, in order to classify it *either* as repairs or maintenance *or* an improvement of a capital nature, first to determine what can fairly be said to have been the subject matter of the work. **What is the totality or entirety of the physical asset which is the subject matter? There is always a danger of distortion if too large or too small a subject matter is identified.** 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.

[Emphasis added (in bold)]

41. These cases all involved similar approaches. *Hawkes Bay Power* stated the need to identify “the relevant asset”, *Poverty Bay Electric Power Board* determined the need to identify the subject matter, and *Auckland Gas Co Ltd* confirmed that “the first step is to identify the object”. These cases confirm that it is necessary to clearly identify “what is the asset?”. Case law, therefore, has developed the “what is the asset?” test.

Depreciation cases

42. New Zealand cases on “what is the asset?” have arisen only in a repairs and maintenance context, but the same approach would have been applied in relation to depreciation issues because both repairs and maintenance and depreciation were contained within the same section of the Act.
43. The repairs and maintenance case law continued to apply the “what is the asset?” approach under the 1993 amendments to the Income Tax Act 1976. No cases have been decided under the Income Tax Act 2004 or Income Tax Act 2007, but it is considered that the same approach would be followed. Therefore, before a deduction for expenditure on repairs is allowed, the question of “what is the asset?” has first to be determined. It is also necessary to establish the relevant asset in the depreciation context.

Approaches taken in other jurisdictions

44. Care needs to be taken when considering cases from other jurisdictions in this context because of the different legislative provisions. However, Australia and the United Kingdom have also considered that it is necessary to identify the relevant item before applying depreciation and repairs and maintenance provisions (eg, *Cooke (Inspector of the Taxes) v Beach Station Caravans Ltd* [1974] 3 All ER 159, *Cole Bros Ltd v Phillips (HMIT)* (1982) 55 TC 188, *Imperial Chemical Industries of Australia & New Zealand Ltd v FCT* (1970) 1 ATR 450, *Woodward v FCT* (2003) 51 ATR 1115, *Case 11/97 97 ATC 173*).

Conclusion on the approach applied in the context of depreciation

45. In summary, the approach applied under section 108 of the Income Tax Act 1976 was to consider “what is the asset?”. The reasons for this are as follows:
 - Section 108 was the core depreciation provision under the Income Tax Act 1976. It also dealt with deductions for repairs and maintenance. Repairs and maintenance and depreciation were linked by the words used in section 108, which provided for a depreciation allowance where “in either case, the depreciation cannot be made good by repair”. Although section 108 did not provide a test to determine what makes up an asset, it is implicit and inevitable that one must ask what is the relevant asset in the circumstances – is it part of the larger item or is it a separate asset? New Zealand case law on repairs and maintenance from this time concentrated on whether an asset was a separate item or part of another item, and it is likely that had a case arisen in the depreciation context, the same approach would have been adopted.
 - The Commissioner, therefore, concludes that a court would not regard the breaking down of a larger item (the residential rental property) into smaller components as the universally applicable approach, but would instead determine whether the item is part of the building or separate from it. If an item is a separate item, that particular **component** of the residential rental property may be depreciated

separately. If, however, the item is not separate but **combined** with the residential rental property, it will be depreciated as part of the building. This approach, to determine “what is the asset?”, as opposed to always seeking the “smallest asset”, is referred to in this statement as the “combined asset versus component assets” approach.

- Case law concentrated on “what is the asset?” by determining whether an item is connected to or separate from the larger asset, so the “combined asset versus component assets” approach reflects the case law analysis above.
- The United Kingdom and Australian courts used the “combined asset versus component assets” approach in the repairs and maintenance context, as well as in the depreciation context.

Do the changes to the depreciation legislation in the Income Tax Act 1994 mean the “combined asset versus component assets” approach is no longer applicable?

Repairs and maintenance no longer in the same section as depreciation

46. The repairs and maintenance provision was not included in the same section as the core depreciation provisions under the Income Tax Act 1994. This has continued under the Income Tax Act 2004 and Income Tax Act 2007. A deduction for repairs and maintenance is now obtained under the general deductibility provision, section DA 1 (previously section BD 2(1)(b) of the Income Tax Act 1994).
47. The repairs and maintenance provisions were not included with the depreciation provisions at the recommendation of the Valabh Committee, which considered that repairs and maintenance should be dealt with under the general deductibility provisions (Consultative Committee on the Taxation of Income from Capital *Tax Accounting Issues* (Consultative Committee, Wellington, 1991). In effect, the Committee considered that what was deductible under the previous repairs and maintenance provision in section 108 of the Income Tax Act 1976, would still be deductible under the general deductibility provisions.
48. The Valabh Committee did not suggest that the repairs and maintenance and depreciation provisions be split up to prevent the “combined asset versus component assets” approach from being used; rather, repairs and maintenance did not need a specific provision and could be easily dealt with under the general deductibility provisions. In separating repairs and maintenance and depreciation provisions, New Zealand followed the position in Australia, where sections 53 and 54 of the Income Tax Assessment Act 1936 dealt with repairs and maintenance and depreciation respectively.

Section EG 1 of the Income Tax Act 1994

49. The depreciation provision in section EG 1 of the Income Tax Act 1994 stated:

- (1) Subject to this Act, a taxpayer is allowed a deduction in an income year for an amount on account of depreciation for any **depreciable property** owned by that taxpayer at any time during that income year.
- (2) No depreciation deduction shall be allowed in respect of any **property** for the income year in which the property is sold or otherwise disposed of, except in the case of property that is—
 - (a) A building; or
 - (b) Schedule depreciable property.

[Emphasis added]

50. The Income Tax Act 1994 used the phrase “depreciable property” rather than “asset”, which was used in section 108 of the Income Tax Act 1976. “Depreciable property” was defined in section OB 1 as follows:

Depreciable property, in relation to any taxpayer,—

- (a) Means any property of that taxpayer which might reasonably be expected in normal circumstances to decline in value while used or available for use by persons—
 - (i) In deriving gross income; or
 - (ii) In carrying on a business for the purpose of deriving gross income; but
- (b) Does not include—
 - (i) Trading stock of the taxpayer:
 - (ii) Land (excluding buildings and other fixtures and such improvements as are listed in Schedule 16):
 - (iii) Financial arrangements:
 - (iv) Intangible property other than depreciable intangible property:
 - (v) Property which the taxpayer has elected to treat as low value property under section EG 16:
 - (vi) Property the cost of which is allowed as a deduction under any of sections BD 2(1)(b)(i) and (ii), DJ 6, DJ 11, DL 6, DM 1, DO 3, DO 6, DO 7, DZ 1, DZ 3, EO 5, EZ 5, and EZ 6, or by virtue of an amortisation or other similar deduction allowed under any section of this Act such as sections DJ 9, DL 2, DO 4, DO 5, and EO 2, other than sections EG 1 to EG 15 and section EG 18:
 - (vii) Property which will not, in respect of the taxpayer, decline in value as a result of any right of the taxpayer to receive compensation for any decline in value on disposition of that property:
 - (viii) Property the cost of which was or is allowed as a deduction in any income year to any other taxpayer under any of sections DO 3, DZ 2, DZ 3 and DZ 4 of this Act (or any of sections 127, 127A and 128 of the Income Tax Act 1976 or

sections 119, 119D and 119G of the Land and Income Tax Act 1954):

- (ix) Property that the taxpayer elects under section EG 16A to treat as not depreciable:

51. The definition of the words “depreciable property” initially appear very broad, as it included “any property” that declined in value and was used, or was available for use, in deriving gross income or in carrying on a business. However, the exclusions in paragraph (b) limited the scope of the definition, as did the definition of “excluded depreciable property” in section OB 1 of the Income Tax Act 1994:

Excluded depreciable property means, in respect of any taxpayer, any depreciable property—

- (a) That was used or was available to be used by the taxpayer for any purpose whatever within New Zealand, other than as trading stock, before 1 April 1993; or
- (b) For which a binding contract for its purchase or construction was entered into by the taxpayer before 16 December 1991; or
- (c) That is or has been in respect of the taxpayer a qualifying asset; or
- (d) To the extent that the property is or has been in respect of the taxpayer a qualifying improvement; or
- (e) That is an intangible asset that was used or was available for use by the taxpayer before 1 April 1993;—

but does not include any item of property in existence at the end of the 1992-93 income year that was permitted by the Commissioner to be accounted for in that income year using any of the standard value, replacement value, or annual revaluation methods:

52. The *Shorter Oxford English Dictionary* (5th ed, Oxford University Press, Oxford, 2002) gives the following definitions of “property”:

Property

1 That which one owns; a thing or things belonging to a person or persons; possessions collectively; *spec.* real estate, housing. **b** A house or piece of land owned. **c** Shares or investments in property.

...

3 The condition or fact of owning or being owned; the (exclusive) right to the possession, use, or disposal of a thing, ownership.

53. *Butterworths Law Dictionary* (6th ed, LexisNexis NZ, Wellington, 2005) gives the following definitions of “property”:

property 1. A thing owned, that over which title is exercised, whether tangible or intangible, real or personal.

2. A title to or right of ownership in goods or other property...

54. *Black's Law Dictionary* (8th ed, West Group, St Paul, MN 2004) gives the following definitions of “property”:

Property 1. The right to possess, use, and enjoy a determinate thing (either a tract of land or a chattel); the right of ownership... **2.** Any external thing over which the rights of possession, use, and enjoyment are exercised...

55. These definitions all indicate that property is a “thing”, but this does not greatly assist in the context of depreciation, as it is still necessary to ask “what is the property in question?”. Is the property made up of several parts or is each of those parts an item of “property” on its own?
56. Section EG 1 of the Income Tax Act 1994 did not contain express words providing for a test to determine what is an item of “property”, but (as was the case with the word “asset” under section 108 of the Income Tax Act 1976), the word “property” itself necessitates a further question - what comprises an item of “property”?
57. The dictionary definitions of “asset” and “property” are similar, although all of the definitions of “asset” use the word “property” as a descriptor, while the definitions of “property” do not use “asset” as a descriptor. This may suggest that “asset” is a subset of property. However, it is concluded that both terms, used in the depreciation context, require a decision about the appropriate “asset” or “item of property” to be considered.
58. “Asset” and “property” have similar meanings, so it is considered that when choosing to use “property” rather than the previous term “asset”, Parliament did not deliberately move away from the approach that had been applicable to the word “asset”.
59. In this regard, it is noteworthy that several sections of the Income Tax Act 1994 continued to use the word “asset” (eg, sections EG 2(2A), DC 1(3), ED 4(4) and (6), EG 15, EG 16, EG 19, and the section OB 1 definition of “excluded depreciable property”).

Valabh Committee Report

60. The 1991 Valabh Committee report does not discuss the change in wording in the legislation from “asset” to “depreciable property” (Consultative Committee on the Taxation of Income from Capital, *Tax Accounting Issues* (Consultative Committee, Wellington, 1991)). This suggests no substantive policy or interpretative change was intended by the change in wording. It appears the 1991 report was written after the decision had been made to change the wording in the legislation from “asset” to “depreciable property”, as the report included the draft legislation, which used the term “depreciable property” in the proposed section 108 and discussed the meaning of “depreciable property” only in terms of extending the definition that had already been proposed. The report stated (at paragraph 8.5.1):

The Committee considers the existing statutory definition of depreciable property is deficient to the extent that it:

- (a) is defined in a manner that gives little indication of the criteria used to determine whether or not an asset should be included in the class of depreciable property; and
- (b) is too narrowly defined. In particular, it excludes certain types of intangible assets that can be expected systematically to decline in value over their useful lives.

DEP 1 as a contemporaneous document

61. The development and drafting of DEP 1 could assist in ascertaining whether the intention in enacting DEP 1 was to depart from the “combined asset versus component assets” approach in respect of depreciation matters. This is because it is a contemporaneous document that may indicate what people involved in advising the Government at the time thought. In this regard, with some minor exceptions, the asset and industry categories in DEP 1 are consistent with the “component assets versus combined asset” approach. Further, considered as a whole, the categories do not support any alternative interpretation.
62. However, DEP 1 is a determination, so is not substantive legislation. The statutory right to claim depreciation is not determined by there being a rate listed in a table and, likewise, the existence of a rate does not identify the item of depreciable property – this is achieved by applying the “combined asset versus component asset” approach.

What was intended by the insertion of the “Residential Rental Property Chattels” industry category?

63. The “Residential Rental Property Chattels” industry category, (inserted into the Commissioner’s Table of Depreciation Rates by DEP 4 in January 1994), sets out the depreciation rates to be applied to items commonly located in a rental property.
64. Before the creation of the “Residential Rental Property Chattels” industry category, it appears it may have been difficult to identify the appropriate depreciation rate for some chattels commonly supplied with a rental property. At the time of the category’s introduction, several of the items in the “Residential Rental Property Chattels” industry category were also present in the “Building Fit-out (when in books separately from building cost)” asset category. This may suggest that the creation of the “Residential Rental Property Chattels” industry category was considered necessary because the “Building Fit-out (when in books separately from building cost)” asset category applied essentially in the commercial context and did not apply in the residential context.
65. The “Residential Rental Property Chattels” category appears to largely include items that are separate items of depreciable property. The word “chattel” is defined in the *Concise Oxford English Dictionary* (11th ed, revised, Oxford University Press, Oxford, 2006) as:

chattel n. (in general use) a personal possession. *Law* an item of property other than freehold land, including tangible goods (**chattels personal**) and leasehold interest (**chattels real**).

66. *Butterworths New Zealand Law Dictionary* (6th ed, LexisNexis NZ, Wellington, 2005) defines “chattels” as:

chattels ... The name given to things which in law are deemed personal property. Chattels are divided into chattels real and chattels personal. Chattels real are interests less than freehold in land which formerly devolved in the same way as personal estate, for example, leaseholds. Chattels personal are movables.

67. *Black's Law Dictionary* (8th ed, West Group, St. Paul, MN, 2004) defines "chattel" as:

chattel Moveable or transferable property; personal property; esp., a physical object capable of manual delivery and not the subject matter of real property.

68. Consequently, it would seem that most of the items of depreciable property listed in the "Residential Rental Property Chattels" industry category are items separate from the building. They can be physically removed and relocated, and do something different to the function of the building.
69. However, there are some items in the "Residential Rental Property Chattels" industry category that the Commissioner now considers are not separate items of depreciable property but are instead items that are part of the building. Two such items are "Vinyl flooring" and "Furniture (fitted)". These are discussed further in the examples in the appendix to this statement.

Income Tax Act 2004 and Income Tax Act 2007

70. The relevant depreciation provision of the Income Tax Act 2004 is section EE 1(2)–(5), which states:

When amount of depreciation loss arises

- (2) A person has an amount of depreciation loss for an item for an income year if—
- (a) the person owns an ***item of property***, as described in sections EE 2 to EE 5; and
 - (b) the item is ***depreciable property***, as described in sections EE 6 to EE 8; and
 - (c) the item is used, or is available for use, by the person in the income year; and
 - (d) the amount of depreciation loss is calculated for the person, the item, and the income year under sections EE 9 to EE 11.

When amount of depreciation recovery income arises

- (3) A person has an amount of depreciation recovery income for an item for an income year if—
- (a) the person owns an ***item of property***, as described in sections EE 2 to EE 5; and
 - (b) the item is ***depreciable property***, as described in sections EE 6 to EE 8; and
 - (c) the item is disposed of or an event of a kind described in section EE 40 occurs; and
 - (d) the amount of depreciation recovery income is calculated for the person, the item, and the income year under any of sections EE 22(5), EE 31(4), EE 41(1), EE 42(2), EE 43(3), and EE 44(3).

Amounts of loss incurred and income derived

- (4) To avoid doubt,—
- (a) an amount of depreciation loss is treated as being incurred in the income year for which it is calculated; and
 - (b) an amount of depreciation recovery income is treated as being derived in the income year for which it is calculated.

Partial income-producing use

- (5) Subpart DE (Motor vehicle expenditure) and section FB 7 (Depreciation: partial income-producing use) contain rules for calculating the amount of deduction available for depreciation loss in circumstances in which an **item of property** is only partly used or available for use in a way that satisfies the general permission.

[Emphasis added]

71. Section EE 1 of the Income Tax Act 2004 uses the term “item of property” and refers to an item that is “depreciable property”. These references are different from those used in the Income Tax Act 1994, where the term “any depreciable property” was used.
72. As the above analysis was on a different Act and wording, consideration needs to be given to whether the “combined asset versus component assets” approach is still the correct approach to apply under the current legislation.
73. The words used in section EE 1 of the Income Tax Act 2004 do not suggest a meaning that is different from that of section EG 1 of the Income Tax Act 1994. The use of the word “item” in the Income Tax Act 2004 in the place of the word “property” (which previously replaced “asset”), reinforces that depreciation is concerned with a specific item of property, rather than with property in general or as a generic term. It is arguable that the use of the word “item” does this more strongly than the wording under the previous legislation.
74. It may also be said that a need remains to have some kind of test that determines what is part of a particular item of property and what is a separate item of property under the Income Tax Act 2004.
75. Relevantly, Barber DJ briefly considered the meaning of “item” in *Case H8* (1986) 8 NZTC 156. *Case H8* involved a taxpayer who purchased a computer and a disk drive (costing \$995 each) to assist him with his work. Under the relevant legislation (clause 4 of the fourth schedule to the Income Tax Act 1976) a deduction was allowed for:
- Expenditure incurred in the purchase, maintenance, or repair of any hand-tool, equipment, or technical aid. The maximum deduction allowable under this clause shall be \$250 for any item.
76. At issue was whether the disk drive was a separate “item” from the computer. Barber DJ concluded that the computer and the disk drive were separate “items”. He noted that each piece of equipment was purchased separately under a separate description and serial number and with a separate price. In reaching his conclusion, Barber DJ considered the ability of the computer to operate without the disk drive:

The computer has important and useful functions without the disk drive. It does not need the disk drive. However, the disk drive has no function without the computer. Nevertheless, it seems to me to be limiting the meaning of the word "item" in an unrealistic manner to deny that the disk drive is an item in its own right. It seems to me that although the disk drive has no useful function unless hooked up to the computer, it is nevertheless a separate item or article or object in terms of the English language and in terms of cl 4. It is not needed by the computer but it needs the computer. I find it to be a piece of equipment separate from the computer.

77. The view that the words used in section EE 1 of the Income Tax Act 2004 have the same meaning as in section EG 1 of the Income Tax Act 1994 is further reinforced by the fact that, with limited exceptions, the 2004 Act was not intended to change the operation of the law under the earlier statute, but was rather intended to clarify the wording used. The small number of intended policy changes are listed in schedule 22A of the Income Tax Act 2004. None of the provisions considered in the 2004 Act relating to depreciation are listed in schedule 22A.
78. On the basis of this analysis, it follows that the "combined asset versus component assets" approach applied under section EG 1 of the Income Tax Act 1994 is also to be applied under section EE 1 of the Income Tax Act 2004.
79. The same approach was also applied in the Income Tax Act 2007, with intended policy changes being included in schedule 51. No depreciation provisions are included in that schedule.

Conclusion on the approach taken under the depreciation legislation

80. It is concluded that the "combined asset versus component assets" approach applied in depreciation situations under section 108 of the Income Tax Act 1976. In 1993 the depreciation regime was reviewed, and the repairs and maintenance provision, which used to be combined with the depreciation provisions in section 108, was separated. This change was more a matter of simplification and not an attempt to prevent the "combined asset versus component assets" approach, which was applied in the repairs and maintenance case law, from being applied in the context of depreciation.
81. Section EG 1 of the Income Tax Act 1994, which effectively replaced section 108 of the Income Tax Act 1976, no longer used the word "asset" to define the item that may be depreciated, but instead used the word "property". The dictionary definitions that give the ordinary meanings of "asset" and "property" are similar, and the two terms can be used virtually interchangeably. Because of the similarities between the ordinary meanings of "asset" and "property", it is concluded no change was intended in respect of the "combined asset versus component assets" approach.
82. As several sections of the Income Tax Act 1994 continued to use the word "asset" rather than "property", this supports an absence of any deliberate intention to move away from the "combined asset versus component assets" approach.

83. Despite the repairs and maintenance provisions no longer being in the same section as the depreciation provisions (which is where the “combined asset versus component assets” approach was developed in New Zealand case law), the Valabh Committee, which had recommended splitting up these provisions, gave no indication that the use of the “combined asset versus component assets” approach in respect of depreciation was to end. The reasons given for the change were simplification and that repairs and maintenance did not require a special section permitting a deduction.
84. Nothing in DEP 1 indicates that a move away from the “combined asset versus component assets” approach was intended in respect of depreciation.
85. The “combined asset versus component assets” approach remains the approach taken under the Income Tax Act 2004 and Income Tax Act 2007. This is because the depreciation provisions are not listed in schedule 22A of the 2004 Act or schedule 51 of the 2007 Act as an intended change. Therefore, there was not intended to be any change to the meaning of the words. Further, the use of the word “item” strengthens rather than weakens the “combined asset versus component assets” approach.

How is the approach applied to determine the correct depreciation value for items in a residential rental property?

86. In the repairs and maintenance context it is important to establish what the asset is. (This was discussed above in the Court of Appeal decision *Poverty Bay Electric Power Board* and Privy Council decision *Auckland Gas Co Ltd*.) This is important because the courts can then assess whether the work done constitutes a repair or a replacement in the context of the asset identified. For depreciation, it is necessary to know whether an item of property is a separate asset or whether it forms part of another asset so the appropriate depreciation rate can be applied. The application of the relevant legal tests will not be affected by how different items are treated in an agreement for sale and purchase. For example, specifying different consideration for parts of a building will not make them separate items of depreciable property. Conversely, specifying a global sum for a number of different items of depreciable property will not make them a single item.

Test/factors for determining the relevant item of depreciable property

87. In several cases in the repairs and maintenance context the courts, in the course of determining whether expenditure was on repairs or maintenance, had cause to consider how to determine the relevant asset. It is considered that this is fundamentally the same question that needs to be answered in determining the relevant asset for depreciation purposes. Each of the relevant cases is considered below.
88. In the discussion that follows, several cases use terms the meanings of which are not readily apparent. In order to assist with the analysis of these cases, it is useful to try to use consistent terminology when attempting to identify what the courts are referring to. The following terminology is used when analysing the cases:
 - “Completeness” refers to considerations of whether an item has everything it needs to function (ie, to carry out its required role). Sometimes cases refer to this as “functionality”. However, the term

“completeness” is used to distinguish this concept from other meanings of functionality.

- “Functional” refers to whether an item carries out a different or separate function to another item of which it may or may not be a part.
- “Physical” describes factors that relate to the physical characteristics of an item. These include the size of the item, whether it is physically separate, or whether and how it is attached to other items.

89. *Lindsay v FCT* (1961) 106 CLR 377 is an Australian repairs and maintenance case that has been extensively quoted in New Zealand cases. *Lindsay* concerned substantial expenditure on a slipway. In the course of his judgment, Kitto J sought to determine the relevant asset for the purposes of determining whether the expenditure was repairs and maintenance or capital (at page 384):

The only justification that was suggested for treating the whole premises, or the whole No. 1 slip, as the relevant entirety, was that the entirety to be considered is “the income-earning unit”. In order to determine whether an item of expenditure is to be held on general principles to be chargeable to income or capital account, it is of course necessary to distinguish between “the business entity, structure or organization set up or established for the earning of profit and the process by which such an organization operates to obtain regular returns by means of regular outlay”; and it is true that “the business structure or entity or organization ... may consist in a great aggregate of buildings, machinery and plant all assembled and systematized as the material means by which an organized body of men produce and distribute commodities or perform services”: *Sun Newspapers Ltd. and Associated Newspapers Ltd. v. Federal Commissioner of Taxation* [(1938) 61 CLR 337]. 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]

90. Kitto J went on to conclude (at page 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]

91. It can be seen from this that Kitto J’s test of the relevant asset was “a physical thing which satisfies a particular notion”. In determining whether the No. 1 slipway satisfied this description, Kitto J considered it was relevant that the slipway was:

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

92. The first factor, that the slipway was an “entirety by itself”, suggests the asset was whole or complete in itself rather than being a component part of a larger asset.
93. 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 factors 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 whether it is attached to other items or whether it has physical characteristics that differ from other items. It may be that all of these are relevant factors to be taken into account. Later cases discuss this factor (or similar factors) in more detail. The possible meanings of this factor, therefore, are discussed in more detail below.
94. *Lindsay* was appealed to the full High Court (Dixon CJ and McTiernan and Taylor JJ). The full High Court (agreeing with the decision of Kitto J) made the following comments on the relevant entirety for repairs and maintenance purposes:

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 machinery 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]

95. Thus, the full High Court upheld the approach taken by Kitto J. In addition, the court noted that the slipway was itself a very substantial erection and that there were a number of other buildings or erections on the taxpayer’s premises (which were not part of the slipway). It appears from this that the court was influenced by the fact the slipway was a substantial structure in its own right. The potential relevance of this is discussed in more detail below.
96. The taxpayer in *Auckland Trotting Club v CIR* [1968] NZLR 967 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. The court considered the meaning of “repairs or

alterations to the premises". The court adopted the reasoning of Kitto J in *Lindsay*. Turner J stated (at page 975):

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.**

...

Thus, if a factory window were blown out and had to be repaired, it would be obviously wrong to argue that as the entirety of the window had been restored it was not a repair to the premises. In such a case the 'premises' would be the entire factory, in relation to which the window would be a repair and nothing else. But if, for example, a retort house in a gasworks was destroyed and had to be rebuilt, one would hardly call that a repair to the gasworks. ... These examples illustrate what I think is the truth, that there is no one line of approach to the problem which is exclusively correct. In some cases it will be right to regard the premises as the entire factory, and in others as some part of the factory. Whichever alternative is the right one to adopt will depend upon the facts of the particular case.

[Emphasis added]

97. Turner J concluded that the "track" was the relevant "premises", and then went on to consider what made up the track. In particular, his Honour had to determine whether a lighting system was a part of the premises that comprised the track. In the course of determining this, Turner J (at page 976) considered the United Kingdom case *J. Lyons & Co. Ltd v Attorney General* [1994] 1 All ER 477, which considered whether certain lamps were "plant" or part of the premises:

In the present case then, the track must be the "premises" in respect of which the Club sets up that the work done is a "repair or alteration"; and what is comprised in the track? It was to this question that Mr Barker addressed his second submission, **and again we reject his contention that the lighting system must be regarded as an integral part of the track, and of the "premises" of which it is at least the principal component.** The lighting system is in our opinion plant or equipment. In so far as a resolution of the matter is a question of fact, Moller J. has decided it against the Club. In so far as it is a question of law, we find nothing in the evidence which persuades us to hold that the lighting system should be regarded not as plant or equipment, but as a part of the premises. ...

In the case before us the facts are completely different and the application of the test suggested by Uthwatt J. must result in a decision to the opposite effect. **The presence of the lighting system on this course was dictated by the nature of the particular uses to which the course is put to earn its revenue. The lighting system is not required simply to enable persons to go about their business on the course, in the absence of natural lighting; it is required for the primary function of enabling the paying spectators to view at night the spectacle for which they have paid. Moreover the lamps themselves are obviously highly specialised in construction, purpose, and position, and can well be said to form a part of a separate electric lighting plant on the hereditament. That plant is in fact specially valued in the Club's balance sheet as a separate item, on which depreciation has been claimed from year to year.** For all these reasons we are clear that the lighting plant must be regarded as plant or equipment, and not as forming an integral part of the "premises" designated in this case by the general description of "the 1962 track".

[Emphasis added]

98. It can be seen from this that Turner J concludes that the lighting system is plant or equipment, so is not part of the premises. His Honour used

United Kingdom case law on plant to help him reach this conclusion. Turner J was (by virtue of the legislation he was interpreting) focused on determining what were the “premises”, so he was interested in distinguishing between “premises” and “plant”. Thus, he found the United Kingdom cases relevant.

99. Because Turner J was focused on distinguishing between premises and plant his judgment is of limited relevance. Although he was seeking to determine what the relevant entirety was for the purpose of testing whether expenditure was on repairs and maintenance, the fact the legislative context required him to determine the entirety in the context of “premises” influenced the factors he considered relevant. In particular, considerations of the function and purpose of the lighting system and its relationship with the taxpayer’s income earning activity arise out of tests used in the United Kingdom to distinguish between premises and items of plant. In this regard, premises are where the taxpayer carries on its business (the setting), whereas plant is something that is actively used in the taxpayer’s business – hence Turner J’s interest in the fact the lighting system was dictated by the nature of the use of the premises. Consequently, it is considered that, to the extent that the judgment is concerned with these plant specific issues, it is not relevant to determining what the relevant asset for depreciation purposes is. It is possible that parts of the judgment may still be useful to the current enquiry to the extent that they consider similar factors to cases that are more on point. For example, the reference to whether the lighting system was an “integral part” of the track is arguably the flipside of the enquiry in *Lindsay* about whether an item is an entirety by itself (the “completeness” test) – that is, if an item is an integral part of a larger item, then the larger item could be considered incomplete without the smaller item.
100. Richmond J delivered a separate judgment reaching the same conclusion. He acknowledged (at page 979) that “any inquiry as to whether or not there has been a ‘repair’ or an ‘alteration’ must necessarily involve a decision as to the entirety of the asset alleged to have been repaired or altered”. His Honour then went on to reject the submission that the relevant asset was everything that was part of the income earning unit, stating (at page 979):
- I find myself unable to accept the submission that in the present case the relevant entirety is the whole of the Club’s undertaking. That undertaking is made up of **a number of capital assets which are sufficiently distinct from one another from a physical point of view, and from the point of view of their individual importance, to satisfy severally the notion of “premises”**.
- [Emphasis added]
101. The above quotation suggests it is relevant to consider whether the items are physically distinct.
102. Richmond J further appears to be suggesting it is relevant to consider whether two capital assets are sufficiently distinct from one another in terms of their individual importance. This appears to be similar to the consideration in *Lindsay* of whether an item is separately identifiable as a principal item of capital equipment. It is necessary to consider what is meant by “sufficiently distinct” in this context. As the phrase “sufficiently distinct from one another in terms of their individual importance” is being compared with “sufficiently distinct from one another from a physical point

of view", it is considered that the judge must be referring to "sufficiently distinct" for reasons other than physical reasons. These factors are discussed in terms of whether an asset is important enough by itself to satisfy the notion of premises. This tends to suggest that the item in question is sufficient to be complete premises by itself (a completeness type test).

103. Richmond J also went on to consider what other components made up the premises comprising the track (at pages 979-980):

Alternatively, Mr Barker submitted that the entirety of the "premises" comprises not only the race track itself but also the running rail and the floodlight standards. I am quite prepared to treat the running rail as **an integral part of the track**. Its inclusion would not influence the ultimate decision of this case one way or the other. As to the floodlight standards, there is not a great deal of evidence. It does appear that these floodlight standards were originally installed in 1958 at a cost of between £40,000 and £50,000. They were moved to their present positions during the year ended June 1960 at a cost of £5,000. This is virtually all the information available to the Court. **I infer that the floodlight standards are of considerable size and are erected at intervals in positions adjacent to the track itself. In these circumstances I am not satisfied that the floodlight standards should be regarded as forming a component part of "premises" which also include the track. Their cost and probable size suggest to my mind that as a matter of fact and degree they should be treated as a distinct and separate capital asset in the nature of plant or equipment. The mere fact that their purpose is to render the track usable as a night trotting track is not in itself sufficient to justify their inclusion along with the track as one entirety, for the same argument could be advanced in relation to various other buildings (such as stables) whose purpose is also ancillary to the use of the track, but which nevertheless are separate and distinct physical entities.** Moller J. has held, on the evidence before him, that the physical thing which satisfies the notion of "premises" is the race track itself and "not any larger thing or aggregation of things of which it may be suggested to form part".

[Emphasis added]

104. This quotation suggests that cost and size is relevant to determining whether an item is a separate asset. The potential relevance of these factors is considered in more detail later.
105. It is considered that much of Richmond J's reasoning in determining whether the lights were part of the track is, like Turner J's, a function of considering the difference between premises and plant. Notwithstanding this, however, his references to items being sufficiently physically distinct, separate and distinct physical entities, and "an integral part" of an asset are potentially relevant to determining what the relevant asset is. These are consistent with points noted in later cases.
106. *Hawkes Bay Power Distribution Ltd v CIR* (1998) 18 NZTC 13,685 considered whether expenditure incurred in replacing overhead electricity lines with underground cables was expenditure on "repairs or alterations". Goddard J noted that the starting point is identifying the "nature of the relevant asset". In this regard she stated (at page 13,696):

The task of identifying the relevant asset is assisted by examining the nature and make-up of Hawkes Bay Power's electricity reticulation system as a whole and by comparing the fundamental characteristics of overhead wiring systems and underground cable systems.

107. Her Honour went on to apply the “entirety” test set out in *Lindsay v FCT* (at pages 13,700 – 13,701):

Relevant asset - was the expenditure in issue on account of capital or revenue?

... It is prudent, however, to consider, whether the urban residential distribution system constitutes an “entirety” for the purposes of deciding that same issue.

Using the “entirety” test as the appropriate yardstick by which to measure the system, it is clear that the system fulfils the criterion of a “physical thing which satisfies a particular notion,” just as did the No 1 slipway in the case of *Lindsay v FCT* (1961) 106 CLR 377 (HCA).

...To summarise, the *Lindsay v FCT* case provides **a test of relevant assets in its use of the words “a physical thing which satisfies a particular notion”, “not as a subsidiary part of anything else”; and “a principal item of capital equipment.”**

Applying the *Lindsay* test, I am satisfied the urban residential distribution system is (i) “a physical thing which satisfies a particular notion”, (ii) “an entirety by itself and not ... a subsidiary part of anything else” and (iii) a “separately identified ... principal item of capital equipment”, for the following reasons:

(i) The “particular notion” is the supply of electricity to domestic consumers in designated (urban) areas. The system “satisfies” this notion via its own network of transformers and distributors

(ii) The urban residential distribution system is physically capable of being separately and independently installed underground without recourse to or effect upon the other areas which the distribution system satisfies, that is, the urban industrial and rural areas. Neither does its underground character affect or alter the performance of the subtransmission system. For those reasons it is capable of being considered an “entirety by itself” and not merely a “subsidiary part” of either the distribution system as a whole, with or without the subtransmission system. The fact that the urban residential distribution system could not operate as an independent entity does not affect that conclusion. Adopting the same analysis, Hawkes Bay Power itself could not operate as an independent entity if disconnected from the National Grid but is nevertheless an “entirety by itself.” Nor does the fact that the system is not an entire profit-earning structure affect that conclusion. The system is still capable of being administered separately and independently, in terms of satisfying its particular notion which is the supplying, metering and billing of urban residential consumers who, significantly, comprise the majority (about 88%) of the population of Hawkes Bay Power’s total district.

(iii) The urban residential distribution system is “separately identified” by customer type and area, that is, “urban residential”. The “separateness” of its identity is further highlighted by the fact that 85% of its system is now underground, thus distinguishing it in character from the other customer types and areas of supply (urban industrial and rural). Further, the sheer scale of the cost involved in putting the system underground (around \$45 million), the comparative cost with overhead lines (at least 3.25 times), the extent of the system which is now underground (920 kilometres), and the fact that urban residential consumers account for approximately 88% of the population of Hawkes Bay Power’s total district, leads to the irrefutable conclusion that the system is “a principal item of capital equipment”.

[Emphasis added]

108. It can be seen from this that Goddard J applied the analysis from *Lindsay*, determining the relevant asset by finding:
- a physical thing that satisfies a particular notion;
 - not as a subsidiary part of anything else; and
 - separately identifiable as a principal item of capital equipment.
109. 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 enquiry 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”. Thus, it was found to be an entirety by itself and not merely a subsidiary part of a larger distribution system.
110. Goddard J found this to be the case notwithstanding that the urban residential distribution system “could not operate as an independent entity” and was “not an entire profit-earning structure”. 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.
111. In terms of the “principal item of capital equipment” enquiry, Goddard J notes that the urban residential distribution system is “separately identified” by customer type and area and that its separateness is further identified by the fact that most of it is underground. This sheds some light on the factors Goddard J considers make a capital asset separately identifiable. In this regard, customer area and type distinguish “urban residential” from “urban industrial” and “rural” customers. Thus, it would appear that physical location is relevant as urban and rural customers are separated by location (especially since the taxpayer stated it did not impose urban or rural boundaries on the system from an operational point of view). Similarly, Goddard J found that the urban residential system was distinguishable from the other customer types by virtue of the fact it was mostly underground. This would also appear to be a physical distinction (especially since, earlier in her judgment, Goddard J states that the underground and overhead systems are identical in nature and function). Therefore, it appears Goddard J was primarily concerned with physical factors when determining whether two items were separately identifiable.
112. In terms of whether a distribution system is a “principal item of capital equipment”, Goddard J notes that the sheer scale of the cost involved in undergrounding the network, the comparative cost with overhead lines, and the extent of the system that had been undergrounded led “to the irrefutable conclusion that the system is “a principal item of capital equipment” (at page 13,701).
113. Goddard J appears to be suggesting that if an item is expensive, then it will be a principal item of capital equipment. Further, she also seems to be suggesting that cost can be relevant in both an absolute and a relative sense (ie, she refers to the “sheer scale of the cost”, which implies absolute, and the “comparative cost”, which implies relative).
114. Goddard J also noted that the question of entirety was “a matter of degree and of the right conclusion to be drawn from the facts” (at page 13,701).

Her Honour then went on to consider whether the entire reticulation system could be the relevant asset, in the process rejecting the “functionality” and “profit earning structure” tests:

Hawkes Bay Power attempted to argue that its total reticulation system, with or without the subtransmission system, constitutes the relevant asset. On that premise, the replacement of the urban residential distribution system would amount to no more than a repair to or alteration of a subsidiary part of the total system. In support of that argument, Hawkes Bay Power relied on a “functionality” test, based on the integrated nature of electricity reticulation systems and the fact that none of the constituent components of those systems are capable of functioning on their own.

Mr Whitfield’s evidence was that the separate components of the network could not be treated as separate assets as, unless the network is connected together, each individual piece is useless by itself. Mr Walker, the General Manager-Distribution, said that, from an operational point of view, Hawkes Bay Power regards its system as a whole and does not impose urban or rural boundaries on it.

...

With one exception, neither the “functionality” test nor its kindred “profit earning structure” test appear to have found favour with the courts. That exception is *Auckland Gas Co Ltd v CIR* (1997) 18 NZTC 13,408 [Goddard J is referring to the High Court decision, which was later appealed to the Court of Appeal and Privy Council]. In *Auckland Gas Co Ltd*, Williams J held that expenditure incurred in inserting polyethylene pipe into the steel and cast iron pipes which made up the objector’s gas network should be charged to revenue not capital. In reaching that conclusion, he considered whether the relevant asset was commercially or functionally inseparable from the taxpayers profit earning activities, and found:

“Just as with any network utilised for the conveyance of liquids or gases, the network should be regarded as an interdependent whole, seeing it not as its individual components but as all those components linked together to provide a comprehensive delivery system.”

With respect to Williams J, however, it seems that the tests he applied are contrary to the approach that has been consistently taken by the courts. Both the “functionality” and the “profit earning structure” tests were specifically rejected by the High Court of Australia in *FCT v Lindsay*, and, by application, in the *Auckland Trotting Club* case.

115. It would appear from this that Goddard J is suggesting that “functionality” and “profit-earning structure” are not relevant considerations when determining what constitutes the relevant asset. Her conclusion in relation to the “profit-earning structure” test is relatively uncontroversial because the New Zealand courts have largely rejected the test. “Functionality”, however, is more difficult. Her Honour refers to “functionality” in terms of the integrated nature of the electricity system and the inability of part of the system to function on its own. This appears to be a rejection of a “completeness” test.
116. Goddard J notes that (what she refers to as) the “functionality” test was specifically rejected by the High Court of Australia in *Lindsay*, and, by application, in *Auckland Trotting Club*. However, *Lindsay* does not mention “function” or “functionality”. Neither of the two judgments (Kitto J in the High Court decision and the judgment from the appeal to the full High Court) appears to clearly reject a completeness (or a functionality) test.

117. The case Goddard J referred to as being the only one that has applied (what she called) the functionality test (the High Court in *Auckland Gas Co Ltd v CIR* (1997) 18 NZTC 13,408)) was appealed to the Court of Appeal and the Privy Council after Goddard J gave her judgment. Consequently, it is necessary to consider later decisions to determine the relevance of the completeness test. In this regard, as is seen below, later courts considered that whether an item is complete is a relevant factor to take into account.
118. Goddard J found that a smaller group of customers (to which each conversion job was applied) could also be considered separate assets and entreties themselves. However, as is seen below, this approach was rejected by the Court of Appeal in *Poverty Bay Electric Power Board v CIR* (1999) 19 NZTC 15,001.
119. Goddard J went on to consider whether the transformers were separate assets or part of the distribution system (at page 13,704):

Transformers

I have already found that the urban residential distribution system, *including the distribution transformers*, is the relevant asset for the purposes of this case.

It is unarguable that the transformers are capital items and Hawkes Bay Power has always accepted this. Transformers replaced during the course of conversion jobs for which it claimed deductibility, were always separately identified from the cost of those conversion jobs and capitalised by it in all instances. ...

The evidence establishes that transformers are an integral part of the distribution system as a whole and an integral part of underground conversion jobs. On this topic Mr Whitfield said:

“... the transformers are an integral part or one of the asset components that make up a network and the ability to reticulate.”

120. It can be seen from this that Goddard J found the transformers were a part of the distribution system (the relevant asset in the case) because they were an integral part of the distribution system as a whole. It is further noted that the transformers were necessary for the network to reticulate. This suggests items that are integral to an asset’s ability to fulfil their function are part of the asset. This is arguably a “completeness” type test – that is, if the asset would be incomplete (ie, unable to function) without an item, then that item is a part of the asset. This seems to be at odds with Goddard J’s finding above that a completeness test is irrelevant.
121. *Poverty Bay Electric Power Board* (1998) 18 NZTC 13,779 considered similar facts to those considered in *Hawkes Bay Power*. In the High Court (1998) 18 NZTC 13,779 Ellis J found that the relevant asset was the reticulation system in Gisborne city, not the entire network including rural areas. In this regard, he noted the appellant’s long-standing undergrounding policy was applicable to that area. It was also “fiscally recognised [by the power board] as an area to be contrasted with rural distribution”(at page 13,792). In passing, Ellis J said it was possible also to look at each of the jobs in question as separate assets (as Goddard J had done in *Hawkes Bay Power*).
122. On appeal *Poverty Bay Electric Power Board v CIR* (1999) 2 NZLR 438), the Court of Appeal 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 went on to discuss the relevant asset in the case at hand. In doing so, the court rejected Ellis J's finding (and, by implication, Goddard J's finding in *Hawkes Bay Power*) that each separate section of line could also be the relevant asset. In reaching its conclusion, the court considered the fact each separate section of line was incapable of separate operation, but rather was part of an integrated system. However, the court also warned against taking this enquiry too far:

The present case contains an example of this kind of error in the suggestion that each separate section of line which was converted from overhead to underground might be the relevant subject matter of that work. If that were so, the conclusion would be almost irresistible in each case that the work was an improvement, for the whole of the subject matter would then have been entirely substituted and placed in a different physical location. **But that would ignore the fact that the section of line so dealt with was part of an integrated system and quite incapable of separate operation.** Even this last observation, however, if taken to its extreme can result in misidentification in the other direction, for the whole of the appellant's reticulation system is but a small part of the national electricity grid. If the subject matter were taken to be the grid, 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.

We reject the idea that the sections of the Board's system separately worked upon were "the physical thing which satisfies a particular notion", to use Kitto J's phrase in *Lindsay v FCT* (1961) 106 CLR 377. That leaves as the respective contentions for the appellants and the Commissioner about the entirety which it is appropriate to consider, on the one hand, the Board's reticulation system throughout Poverty Bay and the East Coast including Gisborne and, on the other hand, the Board's reticulation system in Gisborne alone. In the view we take it would not seem to make much difference, because of the great importance to the Board of the urban area in terms of numbers of consumers and revenues and the relative concentration therein of its distribution system. We would certainly not be prepared to say that on this factual issue the Judge was wrong to plump for the urban reticulation system. There was evidence from Mr Issa that **in engineering terms the Gisborne area was clearly distinguishable. It could be switched (or isolated by electrical means) from the rest of the Poverty Bay network.** The Board itself recognised it as a separate area for fiscal purposes.

[Emphasis added]

123. The Court of Appeal noted the following factors as being relevant to determining which parts of the distribution network made up the relevant asset. The relevant part of the system was:
 - clearly distinguishable (in engineering terms) and could be isolated (by electrical means) from the rest of the network; and
 - separately recognised by the taxpayer's board.
124. In addition, the court found that a smaller part of the network was not the relevant asset because it was only part of an integrated system and was incapable of separate operation. This strongly suggests it is relevant that an asset be able to function by itself (ie, it includes all the parts that are necessary for it to function) and, similarly, that subsidiary parts of an "integrated system" should be considered part of that system rather than assets in their own right.

125. It is not clear what is meant by being “distinguishable in engineering terms”. However, in the context of the judgment, the sentence following that comment (stating it could be isolated (by electrical means) from the rest of the network) appears to elaborate on the point. When the two sentences are read together it is considered that the court was noting that the relevant part of the network was distinguishable because it could be isolated from the rest of the network (and presumably retain its ability to function) – that is, it was not reliant on the rest of the network. Therefore, while not entirely free from doubt, it is considered the court was pointing to the fact that part of the network was able to function by itself (ie, a completeness test). This is consistent with earlier remarks the court made.
126. That the power board recognised the relevant part of the network separately may well have provided evidence to support the conclusion reached. However, it is considered that the taxpayer’s treatment of items cannot be determinative of the tax treatment of items.
127. The taxpayer in *CIR v Auckland Gas* [1999] 2 NZLR 418 (CA) had a programme of inserting polyethylene piping into its existing cast iron and steel gas pipes. At issue was the deductibility of the expenditure as repairs. The High Court found in favour of the taxpayer ((1997) 18 NZTC 13408). The Court of Appeal made the following observation in rejecting the approach taken by Williams J:

The subject matter of the work

The High Court judgment does not contain a direct statement of definition of the subject matter of the work done by AGC in the income years in question: what exactly it is which is said to have been repaired. Williams J appears to have concentrated on the relationship of the work to the taxpayer’s income earning activity. This has been called a profit earning entity test. The Commissioner correctly points out that such a test was rejected in *Auckland Trotting Club Inc v CIR* [1968] NZLR 967 in favour of Kitto J’s approach in *Lindsay v FCT* (1961) 106 CLR 377, 384 of looking for “a physical thing which satisfies a particular notion.” In its judgment in *Poverty Bay Electric Power Board v CIR* (1999) 19 NZTC 15,001 (CA) which is being delivered at the same time as the decision in this appeal, this Court approaches the question in what it considers to be the correct way - by inquiry into the totality or entirety of the physical asset in question.

128. Blanchard J, delivering the judgment of the majority (Richardson P, Henry and Tipping JJ) then went on to find that the relevant asset was the whole of Auckland Gas’ network:

The Commissioner submitted that the relevant asset is the low pressure distribution system, which he said was the entity on which the work was done and represented approximately 70% of the total distribution system. **Although it was conceded by the Commissioner that the low pressure and medium pressure systems were interconnected, he said they had physical and operational differences, the most obvious being the different pressures, necessitating the use of regulators.** On this basis, the Commissioner argued, a low pressure system was being replaced by a medium pressure system in accordance with a programme of works.

It seems, however, that Williams J must have proceeded on the basis that the asset was the whole of AGC’s network. Certainly he took this view when considering the second proviso. **Although he did not apply the right test in reaching that conclusion, if he had done so he would rightly have rejected the Commissioner’s argument.** AGC’s system, though operating at different pressures in its different parts, was an **integrated network for conveying gas**

from the natural gas gateway to the consumers. **The low pressure system was dependent on the medium pressure mains. It was not able to function separately and, as a result of the work programme, was being converted so as to operate at the same pressure. AGC was upgrading its network as a whole and the low pressure system was a major part of that network.** The effect of what was being done is best judged by looking at the **Auckland-wide network as a single interconnected and interdependent asset.**

[Emphasis added]

129. It can be seen from this that Blanchard J focuses on the fact that one item (the low pressure system) is dependent on another for its function – that is, it is unable to function separately. This is a “completeness” test – that is, the relevant item includes all the physical things necessary for it to carry out its function and would be incomplete if one of the items necessary for it to function was not included. As well as considering the interdependence between parts of the network, Blanchard J also notes that the network is “interconnected”. This arguably suggests some reference to the physical connection between items may be relevant to determining whether something is a single asset.

130. The Privy Council ([2000] 3 NZLR 6 (PC)) upheld the decision of the Court of Appeal. The judgment included the following discussion:

The appropriate description of the work done by Auckland Gas

[20] In the present case work was done to a gas distribution system. The Courts below treated the entirety of the system as the relevant asset. The taxpayer defended this approach, and their Lordships are content to proceed on this footing. **But one must be clear about what is meant in this context by Auckland Gas’s distribution system. That expression is not a reference to a means of distributing gas which can be considered as a functional entity separate from its physical components. In the present context Auckland Gas’s distribution system is a reference to an assemblage of linked pipes whose function was to carry gas from one place to another.**

[Emphasis added]

131. It is considered that this also supports the view that the relevant focus is on the physical asset. In this regard, the above 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.

Factors considered in the repairs and maintenance cases

132. The question being asked in the cases is “what is the entirety that it is relevant to consider?”. The cases appear to agree that it is not about finding a profit-earning structure or entity, but is about a “physical thing which satisfies a particular notion”.

133. The courts have gone about determining this in a number of different ways and have considered various factors. However, the courts have also repeatedly warned of the danger of applying previous authorities to a different set of circumstances. Notwithstanding this, common factors appear across the cases (albeit that they may have been applied differently, depending on the facts being considered). These factors can

be usefully grouped into the categories outlined in paragraph 87 as follows:

Physical

134. The physical category is about whether an item is physically distinct or separate or whether there is a degree of physical connection between the items (*Auckland Trotting*, *Auckland Gas* (CA and PC)).
135. Some of the cases have suggested that the size and/or cost of an item may be relevant factors to consider (at least in so far as whether an item is sufficiently big or expensive).
136. In terms of the relevance of size, in *Lindsay* the court noted that the slipway was a “very substantial” erection. The court also noted the existence of other erections and buildings on the taxpayer’s premises. In *Auckland Trotting* the court noted that the lamps adjacent to the track were large, and considered that this supported the view that they were not a part of the racing track (although this appears to have been relevant to their being a separate piece of plant rather than just a separate asset – the court was also concerned with their function in relation to the track). In both cases, the items under consideration were not attached to the other items of which they potentially formed a part, although it is not clear whether this was a relevant consideration.
137. It is not immediately clear whether or how similar considerations would apply in the context of residential rental properties. It would appear that this factor is suggesting that if an item is physically large enough, then it could be considered a “principal item of capital equipment”, and, thus, not part of a larger asset. It may be that it would apply to an item such as a large shed or glasshouse on a property. However, these are likely to be considered separate assets based on the application of the other factors. Most of the items being considered in this statement are substantially smaller in physical size than the building under consideration. Similarly, when looked at in absolute terms, no item in a residential rental property is likely to be equal to the size of the slipway in *Lindsay* or the lamps in *Auckland Trotting*.
138. As is seen below, size does not appear to be a relevant consideration in the depreciation context and, specifically, it was not considered in the cases on residential rental properties in that context. Consequently, it is considered that this factor should be given limited or no weight in any test.
139. Similar considerations arise in terms of the relevance of the cost of the item in question. The court in *Auckland Trotting* noted that the lamps appeared to be expensive (although it did not appear to have evidence on this point). Similarly, in *Hawkes Bay Power* the court noted the significant cost of the underground part of the electricity network (both in relative and absolute terms). Particularly, in *Hawkes Bay Power*, the court may have been influenced by the repairs and maintenance context – as the cost and scale of the undergrounding would most certainly be relevant to whether what was done constituted repairs or replacement. However, as with physical size, this factor does not appear to be a relevant consideration in the depreciation cases (considered below). Further, in the context of a residential rental property, it is difficult from a conceptual point of view, to see how the cost of an item can be relevant to whether it

is part of a building or not. This could potentially lead to cases where (for example) cheap kitchen cabinetry is part of the building, but expensive kitchen cabinetry is not. The conclusions would seem to get even more unusual if cost is relative – for example, a new bathroom vanity is part of the building if it is put in an expensive house, but the same bathroom vanity is not a part of the building if it is put in a cheap house (because in relative terms, it would be more expensive). Based on this it is considered that the cost of the item in question is not a relevant factor to look at when determining the appropriate asset for depreciation purposes.

Completeness

140. Completeness involves a consideration of whether the item is:
- an integral part of the asset (*Auckland Trotting, Hawkes Bay Power*);
 - a subsidiary part of something else or can be independently installed without recourse to other items (*Lindsay, Hawkes Bay Power*);
 - necessary for the asset to function (*Lindsay, Hawkes Bay Power, Auckland Gas (CA)*);
 - capable of separate operation or whether it is part of an integrated system (*Poverty Bay, Auckland Gas (CA)*);
 - clearly distinguishable (*Poverty Bay*).
141. It is considered that all of these factors are directed to a similar enquiry. For example, whether an item is an integral part of an asset, is the same question as whether the item is necessary for the asset to function. Whether the item is a subsidiary part of something else is asking the question another way – that is, if it is a whole standalone asset that can function by itself, it is less likely to be a subsidiary part of something else. However, where an item is an integral part of the asset in question, then it will be a subsidiary part of that asset. Similarly, whether the item is capable of separate operation or whether it is part of an integrated system is making the same enquiry.
142. Consequently, it is considered that all of the above factors can be combined into one enquiry along the lines of: is the item in question part of a larger asset that would be considered incomplete or unable to function without the item in question? In this regard, if the item is complete and capable of separate operation on its own this will point towards the smaller item not being a necessary part of a larger item.
143. Although not a repairs and maintenance case, *Case H8* (discussed above from paragraph 75) also considers similar factors. In this regard, it is noted that Barber DJ was heavily influenced by the fact that the computer could function without the disk drive (and at the time 80% of such computers were sold without disk drives). However, in that case, he did not consider it relevant that the disk drive was unable to function without being “hooked up” to the computer. This suggests that, while a potentially relevant factor to consider, the ability of a smaller item to function without a larger one is not necessary for the two items to be considered separate.

Depreciation and plant cases

144. It is noted that there are no cases on point in the New Zealand depreciation context. However, it is useful to briefly consider some depreciation cases from Australia and the United Kingdom to see how they determine the relevant depreciable asset and whether they shed any further light on how the above factors should be applied (in terms of ordering and weighting).
145. The Australian case of *Imperial Chemical Industries of Australia and New Zealand v FCT* 70 ATC 4,024 considered whether acoustic metal pan fittings and framework forming ceilings and electrical wiring, conduits and trunking were “plant” or “articles” for depreciation purposes. The ceiling consisted of metal panels with multiple perforations, backed by paper bags containing sound-absorbent material, and each was supported by a metal framework attached by metal rods to the concrete floor above. The panels could be readily removed. Relevantly, Kitto J concluded that neither the ceiling nor the wiring was “plant”, noting that the mode of affixation, although slight, was adequate. Kitto J also noted that the panels were part of the ceiling and their purpose was to make the building a complete building.
146. *Case 11/97* 97 ATC 173 concerned whether kitchen cupboards and a wardrobe in a residential rental property were depreciable. It considered the meaning of “plant”, and stated that the “functional test” was important in determining whether an item was “plant”. This was said to require that the item under consideration *be functional* in relation to the income earning activities (at page 177). While the “functional” test was not considered a complete answer, it was noted that, in the context of applying the “functional test, that which is the setting (or venue) for the taxpayer’s activities is not plant.
147. Although *Case 11/97* is also in the plant context and, as such, much of it will not be able to be readily translated into the New Zealand context, the case specifically considers what makes up a residential rental property. Further, it considers whether items are an “integral part” of the property as a residential unit, which is the same factor considered in some of the New Zealand cases. Therefore, the case is worthy of consideration.
148. The Administrative Appeals Tribunal made the following observations about the distinction between “plant” and items that are an integral part of a residential property (at page 179):
- (i) It follows that that which forms the rental property as “setting”, that which contributes to its usefulness as “setting”, gives it efficacy as “setting”, will also not be treated as “plant”. **Thus it has been held that those items which are an “integral part” of the property as a residential unit, or in other words, which form “part of the fabric” of such property are not “plant”.**
- ...
- (j) The critical question is, then, as to the circumstances in which an item will be treated as “part of the fabric” of a building, such that it will be regarded as a “part of the setting”. **It is clear that the item must in some way be attached or connected to the building. By the same token, the Tribunal does not consider that every attached item, simply by virtue of attachment, will be regarded as integral with the premises.** And nor can it be shortly concluded that once a “fixture”, in the technical legal sense, an item is ipso facto part of the

fabric of a building.

[Emphasis added]

149. The above quotation notes that an item must be in some way attached or connected to the building before it will be considered part of the building. Similarly, it is clear that the Administrative Appeals Tribunal is of the view that, while attachment is relevant to the enquiry (and a necessary attribute), it is not sufficient to answer the question. The tribunal went on to consider other case law on this issue and reached some further conclusions (at page 180):

It can be seen that two distinct elements emerge from this line of reasoning. The first looks at the role of the relevant items in the context of a property utilised for residential lease. **It examines whether the items are an essential aspect of that which makes up the residence as a lettable entity.** If, in other words, the items are part of the complete entity which must be provided by a landlord, at the very minimum, to a tenant; almost as, one might say, a de facto precondition of the residential leasehold agreement, the item will be part of the "setting". **This is the test referred to by the Tribunal for the purposes of these Reasons as the "completeness test".** The second element looks to the method of installation, that is, the nature and extent of the item's attachment to the building in a purely physical sense; **this then is the test referred to by the Tribunal for the purposes of these Reasons as the "affixation test".**

[Emphasis added]

150. It can be seen from this that the Administrative Appeals Tribunal favoured dual tests of "completeness" and "affixation". "Affixation" relates to how the items are connected in a physical sense. This is a similar enquiry to that made in *Auckland Trotting* and *Auckland Gas* and is a "physical" test.
151. Similarly, the "completeness test" is about whether certain items are necessary for a rental property to be a complete entity. This is similar to some of the factors considered in the New Zealand cases, such as whether an item is an integral part of the asset, whether the item is necessary for the asset to function, and whether the item is part of an integrated system.
152. The Administrative Appeals Tribunal reached the view that, of the two tests, "completeness" was the dominant one, with "affixation" being of lesser significance. J Block (Senior Member) summarised the relationship between the two tests (at page 183):

(t) Looking at these cases overall, therefore, the test for determining that which is part of the fabric of a residential dwelling can be distilled as follows: an item will be regarded as an integral part of the structure of the unit, as part of its "fabric", if it is an essential aspect of that which makes up the residence as a lettable entity; or put in other words, **if it is a basic requirement of a leased residential dwelling without which the dwelling cannot be used for such a purpose. Considerations of attachment; namely the mode, manner and degree of affixation; are relevant, but only insofar as they contribute to an understanding of the more probative question as to the item's role in the premises as a complete lettable entity.**

[Emphasis added]

153. The Administrative Appeals Tribunal also went on to observe that what is required for a complete entity may change over time and may differ between different types of dwelling.
154. The two specific items considered in *Case 11/97* were kitchen cupboards and a wardrobe. J Block (Senior Member) found that a flat was not a lettable entity without the attachments necessary for a proper kitchen, so the kitchen cupboards were part of the building.
155. In contrast, it was found that a wardrobe was not a basic requirement of the residence as a lettable entity. In addition, it was not “built in” and could be dismantled quickly and easily by the removal of a few screws, leaving no damage to the structure of the wardrobe or to the unit. Consequently the wardrobe was not part of the building.
156. *Woodward v FCT* 2003 ATC 2001 considered whether a number of items were depreciable items of plant in the context of a group of apartments that were let for residential rental. The Administrative Appeals Tribunal followed the judgment of J Block (senior member) in *Case 11/97*. Of interest is the tribunal’s consideration of a built-in wardrobe. *Woodward* reached the opposite view to that found in *Case 11/97*, and concluded that the wardrobe was part of the building. This was primarily because the wardrobe in question was found to be part of the walls of the property, and because dismantling it would create a space for built-in wardrobe cupboards without doors or shelves.
157. Cases from the United Kingdom on the meaning of plant have the same fundamental difficulty as Australian plant cases, in that they are asking a slightly different question to the one this statement is trying to answer. Further, the United Kingdom cases considered do not specifically relate to residential rental properties, so are arguably of even less assistance. Notwithstanding this, it is useful to briefly consider *Wimpy International Ltd v Warland* (1987) BTC 591 (which has been applied in subsequent cases in the United Kingdom) to determine whether it has anything useful to offer.
158. The court in *Wimpy* was deciding whether the taxpayers were entitled to a capital allowance for expenditure on plant. In the United Kingdom, “plant” (apparatus used for carrying on a business) is distinguished from “premises” (the place in which the business is conducted). The disputed expenditure in *Wimpy* was on the refurbishment of premises and included expenditure on items such as shop fronts, tiles, suspended ceilings, mirrors, stairs, and light fittings.
159. The court focused on whether the items in question were used to create an “ambience” for the restaurants (in which case they could potentially be items of plant), or whether they were a part of the premises. In the Chancery Division, Hoffmann J gave the following statement of the test to be applied in determining whether the expenditure was on “premises” or “plant”(at page 615):

How does one apply the premises test **to items which were not incorporated as part of the original building but have been added by way of subsequent improvement?** Lord *Lowry*, as we have seen, said that the question was whether something had ‘**become part of the premises**’, and *Templeman J.* spoke of ‘**integral parts of the building**’. The question is not, I think, the same as whether it has become part of the realty for the purposes of the law of real property or a fixture for the purposes of the law of landlord and tenant. In

Yarmouth v. France, Lindley L.J. contemplated that fixed chattels might be plant.
...

Adopting the words of Lord Lowry, the question seems to me to be whether it would be more appropriate to describe the item as having become part of the premises than as having retained a separate identity. This is a question of fact and degree, **to which some of the relevant considerations will be: whether the item appears visually to retain a separate identity, the degree of permanence with which it has been attached, the incompleteness of the structure without it and the extent to which it was intended to be permanent or whether it was likely to be replaced within a relatively short period.** Mr. Aaronson submitted in reply that, if contrary to his submission, this was the proper test, those considerations constituted a series of separate hurdles which had to be overcome before an item could be regarded as a part of the premises. It had to have been attached with the intention of being a permanent fixture, it must have been actually and irremovably fixed and it must not be a mere ornament or embellishment. I do not agree. In my judgment these matters are factors to be taken into account in answering the question posed by Lord Lowry.

[Emphasis added (in bold)]

160. It can be seen from the quotation above that the court was specifically considering items that had been added to the original building by way of subsequent improvements. Hoffmann J considered that the factors relevant to determining whether these items had become part of the building were:
- whether the item appears visually to retain a separate identity;
 - the degree of permanence with which the item has been attached;
 - the incompleteness of the structure without the item; and
 - the extent to which the item was intended to be permanent or whether the item was likely to be replaced within a relatively short period.
161. The degree of attachment and the incompleteness factors are similar to those considered in other cases. Whether the item appears visually to retain a separate identity is arguably also the same type of factor the New Zealand cases were taking into account when they looked at whether an item was physically distinct (although Hoffmann J does not offer any further explanation as to what he intended this factor to mean).
162. On the other hand, the extent to which the item was intended to be permanent appears to be specifically relevant to determining whether an item is décor or whether it has become part of the premises (ie, replacing an item regularly may suggest its function is more decorative than a substantive part of the building). Consequently, it is considered that this factor is not relevant to determining the appropriate asset for depreciation purposes.

Summary

163. It can be seen from the above discussion that none of the cases considered gives a definitive answer to how to determine the relevant asset for depreciation purposes (specifically in the residential rental property context). None of the cases is directly on point, and each case considers different factors depending on the circumstances.

Notwithstanding this, however, it is necessary to come up with a test that can be applied to determine whether an item is part of a building for the purposes of calculating depreciation on residential rental properties.

164. The following paragraphs draw from the factors discussed in the cases and combine them into a practical test. Although the particular test adopted below is not drawn from (and is not found in) any specific case, it is considered that it is consistent with the factors discussed in the cases and reflects a workable position that the Commissioner and taxpayers can apply.
165. The depreciation cases (to the extent that they are relevant) are largely consistent with the repairs and maintenance cases. *Case 11/97* is the most useful of the cases considered as it specifically looks at the factors in a residential rental property context. It also gives some order and weighting to the factors, which is largely absent from the repairs and maintenance cases (although the greater references to completeness considerations suggest they are more important than the physical attachment factor).
166. Because the tests taken from the repairs and maintenance cases are substantially the same as the two tests outlined in *Case 11/97* and that *Case 11/97* specifically considers a residential rental property, the weightings this case gives to the factors should be taken into consideration (especially as they are not inconsistent with anything in the New Zealand cases). Taking into account all of the cases considered above, the Commissioner will apply the following approach to determine whether an item is a separate asset, or a part of a larger asset:

Step 1: Determine whether the item is in some way attached or connected to the building. If the item is completely unattached, then it will not form a part of the building. An item will not be considered attached for these purposes, if its only means of attachment is being plugged or wired into an electrical outlet (such as a freestanding oven), or attached to a water or gas outlet. If the item is attached to the building, go to step 2.

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 the item is an integral part of the residential rental property, then the item will be a part of the building. If the item is not an integral part of the residential rental property, 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. Consider 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. If the item is part of the fabric of the building, then it is part of the building for depreciation purposes.

Capital improvements from the 2005/06 tax year: depreciation treatment

167. Section EE 37 applies when a person makes an improvement to an item of depreciable property. This section applies to improvements made in the 2005/06 tax year and following tax years.
168. An "improvement" is defined in section EE 67 as an "alteration, extension, or repair of an item of depreciable property that increases its capital value". The Act does not define the words "alteration", "extension" and

“repair”, but their meanings are limited to those alterations, extensions and repairs that increase the capital value of the item of depreciable property identified. The ordinary meaning of an alteration, an extension, or a repair will provide guidance in determining whether the work results in an improvement. This demonstrates that an improvement can result from a wide variety of work of a capital nature, but does not include work that results in the creation of a new item of depreciable property.

169. In applying section EE 37 there must first be an existing item of depreciable property. Then it must be determined whether the work carried out has resulted in an improvement or in a new item of depreciable property. The “combined asset versus component assets” approach set out in this statement will be useful in making this determination for residential rental properties. When the work has resulted in an improvement, the improvement forms part of, and has the same characteristics as, the existing item.
170. Having determined that there is an improvement under the section EE 67 definition, section EE 37 sets out how to calculate the depreciation loss deduction for the improvement. To calculate the part-year depreciation loss for the income year in which the improvement is made, the improvement is treated as if it were a separate item of depreciable property. Even though the improvement is treated as if it were a separate item, the same depreciation treatment as the item it improved is applied, subject to any change in the rate.
171. In the following income years, a person using the diminishing value depreciation method or straight-line depreciation method may choose to continue to treat the improvement as if it were a separate item of depreciable property or as part of the item of depreciable property that was improved.
172. Taxpayers may take into consideration changes to the depreciation rate when deciding whether to continue to treat the improvement as if it were a separate item or incorporate the cost of the improvement into the existing item’s adjusted tax value in the income years following the year the improvement was made so as to take advantage of any favourable change to the depreciation rate applicable to that item.
173. By way of example, where a building was acquired before 19 May 2005, and an improvement to the building was carried out after the changes introduced by the Taxation (Depreciation, Payment Dates Alignment, FBT, and Miscellaneous Provisions) Act 2006, it will generally be more beneficial for the taxpayer to treat the improvement as part of the building and continue to depreciate at the pre 2005 rates. Conversely, for an item of depreciable property acquired before 1 April 2005 that is not a building, it will generally be more beneficial for the taxpayer for an improvement made after the changes introduced by the Taxation (Depreciation, Payment Dates Alignment, FBT, and Miscellaneous Provisions) Act 2006 to be treated as if it were a separate item of depreciable property so as to be eligible for the higher depreciation rates.
174. The Commissioner considers that section EE 37 does not allow a taxpayer to break down items that form part of the residential rental property after carrying out an improvement. The section does not disturb the “combined asset versus components asset” approach because it does not establish an alternative test for identifying separate items of depreciable property.

Section EE 37 does not allow for an improvement to be depreciated as a different item of depreciable property to that of the item improved.

175. The Commissioner's conclusion on the application of section EE 37 is further supported by the section's history. Section EE 37 is a codification of a practice published in *Tax Information Bulletin* Vol 4, No 9 (May 1993) as part of the introduction of the statutory depreciation regime, including the introduction of loading to depreciation rates. The *Tax Information Bulletin* item stated that improvement expenditure could be added to the cost of the depreciable property and depreciated as part of that property **or** it could be separately capitalised and treated as a separate asset. This practice ensured taxpayers were not disadvantaged by carrying out improvements to items of depreciable property acquired before the depreciation regime's introduction. Section EE 37 codifies this practice.
176. In summary, an improvement under section EE 37 does not change the nature of the item improved. Applying section EE 37 does not create a new item of depreciable property. The definition of improvement in section EE 67 means an improvement forms an integral part of the item it improved and is treated as if it were a separate item of depreciable property only for the purposes of calculating a part-year depreciation loss amount. It also allows the taxpayer the benefit of any change to the depreciation rate applying to that kind of item. Therefore, the item improved is the same item of depreciable property identified using the approach outlined in this statement.
177. Section EE 37 provides the statutory mechanism by which to calculate the part-year depreciation loss amount for the improvement during the year the improvement was made and for the period in which the improvement is used or available for use. The section ensures the depreciation loss for the improvement is calculated accurately and on a consistent basis with the existing item. It also removes any possible disadvantage resulting from any changes to depreciation rates faced by taxpayers when carrying out capital improvements to existing items of depreciable property.

Conclusions

178. The Commissioner will apply the following approach to determine whether an item is part of a residential rental property or a separate item of property.

Step 1: Determine whether the item is in some way attached or connected to the building. If the item is completely unattached, then it will not form a part of the building. An item will not be considered attached for these purposes, if its only means of attachment is being plugged or wired into an electrical outlet (such as a freestanding oven), or attached to a water or gas outlet. If the item is attached to the building, go to step 2.

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 the item is an integral part of the residential rental property, then the item will be a part of the building. If the item is not an integral part of the residential rental property, 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. Consider 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. If the item is part of the fabric of the building, then it is part of the building for depreciation purposes.

Submissions Received

179. Submissions received on the exposure draft raised several issues, which are briefly commented on below to the extent that they have not otherwise been dealt with in the statement.
180. Some submissions queried whether the fact that different parts of a building have different economic lives should mean that those parts should be treated as separate items of depreciable property. It is noted that many assets that are made up of a number of components will have parts that wear out more quickly than others. This does not mean that those parts are necessarily separate assets. It is the Commissioner's view that the depreciation rate set takes into account that different parts of an asset have different economic lives. Consequently the fact that different parts of a building have shorter economic lives does not mean that they are separately depreciable. The question is "what is the item of depreciable property?".
181. Some submissions queried why the discussion on the meaning of the "building fit-out (when in books separately from building cost)" assets category was removed from the previous draft. It is the Commissioner's view that the discussion on how the words "building fit-out (when in books separately from building cost)" went beyond the scope of the statement, which is about how to determine what the appropriate asset for depreciation purposes is. It is not about determining whether such an asset would come within the building fit-out category (by analysing factors such as whether the fit-out was done subsequent to acquisition, or how the consideration was allocated between different items). It is the Commissioner's view that including this analysis potentially obscured the issue considered by the Statement (ie whether an item is separately depreciable property) and may confuse taxpayers. In addition, it is considered that the analysis was not necessary to support the conclusions reached in the Statement.
182. Some submissions queried why hot water cylinders were considered part of the building when they were generally only attached to a power source and a water source. As a result of the submissions received, the Commissioner has reconsidered his position in respect of hot water cylinders and water heaters and has reached the view that they can be separately depreciated.

Appendix: Examples

Example 1: Plumbing and piping

183. Plumbing and piping within a residential rental building are not separate assets but are a part of the building in which they are installed. They meet the preliminary threshold test (step 1 of the three-step test) because they are attached to the building (being contained within, and held in place by, the walls and roof of a building, as well as being secured to the walls and roof).
184. Under step 2 of the three-step test, a residential rental building would be considered incomplete without plumbing. Running water and sewerage systems are ordinary features of residential rental buildings in New Zealand and it is extremely unlikely a building would be let without plumbing.

Example 2: Electrical wiring

185. Electrical wiring is part of a residential rental building, so should not be treated as a separate asset. Electrical wiring is attached to the building because it is threaded through holes drilled into beams inside the walls and held in place within the roof of the building.
186. Without electrical wiring to provide electricity, a residential rental building would not be considered complete. It is another basic feature that is expected in residential rental buildings in New Zealand, without which it would be unlikely that such a building could be let. Consequently, electrical wiring satisfies step 2 of the three-step test, so is a part of the building in which it is installed. This is consistent with *Woodward v FCT* (2003) 51 ATR 1115 where it was held that electrical distribution gear (wiring, cabling and switchboards) was part of the rental apartment and not a separate asset.

Example 3: Internal walls

187. The internal walls of a building are part of the building and should not be treated as a separate asset. They are attached to the ceiling and floor and to other internal walls of the building and form part of its structure.
188. Internal walls are an ordinary and expected feature of a residential rental building. Such a building would be considered incomplete without internal walls to divide the building into rooms. Consequently, internal walls are part of the building to which they are attached and should not be treated as separate assets.

Example 4: Doors (Internal and external doors)

189. Doors are a part of the building to which they are attached. Although the level of attachment is not strong (doors generally being affixed to walls by hinges that are screwed into the side of the door and the door frame), it is sufficient to meet the threshold test in step 1 of the three-step test.

190. The outcome under step 2 of the three-step test is not as clear. It is noted that not every access way in a wall requires a door in order to be complete. However, a building could not be said to be complete without at least an external door to prevent people from entering the residential rental building without permission. It is further considered that a residential rental building would also not be complete without some internal doors to allow privacy in certain areas of the building, such as bathrooms and toilets. Therefore, a residential rental property would be considered incomplete if it had no doors. As all doors in a residential rental property should generally be treated in the same manner (as they are materially similar), on balance, it is concluded that doors are a part of the building, so should not be treated as separate assets.

Example 5: Garage doors (when the garage is part of the residential rental building)

191. When a garage is part of a residential rental building, the garage door forms part of that building, so should not be treated as a separate asset. A garage door is attached to the building, usually by some kind of runners or hinges that are attached to the door frame (step 1 of the three-step test).
192. While, it is arguably possible to have a garage without a door, where a garage has been built to have a door, it would be considered incomplete without that door, which is designed to prevent people who should not have access from entering the building (step 2 of the three-step test).

Example 6: Fitted furniture (wardrobes and cupboards built into the wall)

193. Fitted furniture (ie, furniture, such as wardrobes and cupboards, that are built into a wall) is part of the building and not a separate asset. Fitted furniture meets the threshold test (step 1 of the three-step test) because it is attached to the walls of the building (by virtue of being built in).
194. A residential rental property would not generally be considered incomplete without fitted furniture such as wardrobes and cupboards and residential rental properties are routinely let without wardrobes (step 2 of the three-step test). Therefore, it is necessary to consider step 3.
195. Under step 3 of the test, fitted furniture is built into the wall and, so is attached to the ceiling and the floor of a building, as well as forming part of the wall. Therefore, the level of attachment is significant. If wardrobes and cupboards that are built into the wall were removed from a residential rental building, significant damage would likely be caused to the surrounding walls and ceiling of the building, as well as to the wardrobe or cupboard itself. Based on this, it is considered that the degree of attachment of such fitted furniture is such that it forms a part of the fabric of the building, so is part of the building rather than a separate asset.

Example 7: Kitchen cupboards

196. Kitchen cupboards are part of a residential rental building, so should not be treated as separate assets. Kitchen cupboards are attached to the wall and/or floor of the residential rental building. Some cupboards are more

strongly attached than others – for example, many modern kitchen cupboards are attached to the wall with little more than a few screws. However, this level of attachment is sufficient to meet the threshold test in step 1.

197. Under step 2, a residential rental property would generally be considered incomplete without kitchen cupboards, because a kitchen (with cupboards) is essential for tenants to be able to carry out their daily activities. As step 2 is satisfied, it is considered that kitchen cupboards are a part of the building to which they are attached. This is consistent with *Case 11/97*.

Example 8: Bathroom fittings and furniture

198. Bathroom fittings (toilets, baths, showers, and basin and vanity units) are part of a residential rental building, so should not be treated as separate assets. Such fittings easily meet the threshold attachment requirement (step 1). Further, a residential rental building would generally be considered incomplete without a toilet, a bath or a shower, and a basin and vanity unit. If a residential rental property has a bath and a separate shower, it could be argued that it would still be complete without one or the other. However, under step 3, it is considered that both baths and showers would be attached to such a degree that they are a part of the building (because they are plumbed in and generally also affixed by other means). It is, however, possible that a rental property could have a freestanding bath that could be easily removed from the bathroom without damage. In such a case, if the property also had a separate shower, then it could be argued that the bath was a separate asset.
199. On the other hand, much like wardrobes, bathroom cupboards are not considered necessary for a residential rental property to be complete. There are many rental properties without separate bathroom cupboards. Consequently, whether such cupboards are a part of the building will be determined by applying step 3 and considering whether they are “built in” or attached to such a degree that they are really a part of the fabric of the building. In this regard, a cupboard that is, for example, attached to the wall by a few screws and can be easily removed without significant damage to the wall or the cupboard, is considered a separate asset.

Example 9: Wardrobes and cupboards not built into the wall

200. Wardrobes and cupboards that are not built into the wall are separate assets. Freestanding wardrobes and cupboards may not be attached to the building at all. In such a case, it is unnecessary to go on to consider steps 2 and 3.
201. Freestanding wardrobes and cupboards may be attached to a wall or the ceiling to prevent them from tipping over. In these cases, the threshold attachment requirement is satisfied and it is necessary to consider step 2 of the test. Under step 2, a residential rental property would not be considered incomplete without free standing wardrobes and cupboards. Therefore, it is necessary to consider step 3.
202. Unlike with built in cupboards and wardrobes, freestanding cupboards and wardrobes do not have a sufficient degree of attachment to make them part of the fabric of the building. Generally, they can be relatively easily

detached with little or no damage to the wall or the wardrobe or cupboard. Similarly, such items are easily relocated within a residential rental building or even to another building. Consequently, free standing cupboards and wardrobes will be separate assets. This is consistent with *Case 11/97*.

Example 10: Carpet

203. Carpet is a separate asset and can be separately depreciated. Carpet satisfies the threshold attachment requirement (in step 1 of the three-step test) because it is generally attached at the edges to keep it in place.
204. Under step 2, a residential rental building would not be considered incomplete without carpet because many residential rental buildings have, for instance, wooden floors rather than carpets.
205. Under step 3, carpet is not attached to such a degree that it could be said to form a part of the fabric of the building. Rather, carpet is generally only attached at its edges and can be relatively easily removed without damage to the floor or the carpet.

Example 11: Linoleum

206. Linoleum is part of the building in which it is installed and should not be treated as a separate asset. Linoleum is attached to the floor by an adhesive, so satisfies the necessary threshold attachment (in step 1 of the three-step test).
207. A residential rental building can be let without linoleum (eg, with bare floorboards), so a building can be considered complete without linoleum.
208. Under step 3, linoleum is considered to be attached to such a degree that it forms part of the fabric of the building. Unlike carpet, linoleum is strongly affixed to the building. Adhesive is spread over the floor and the linoleum is placed on top. Because of the way linoleum is attached to a residential rental building, it is very difficult for it to be removed without damage to the linoleum and, albeit to a lesser extent, the floor. Although it is possible for linoleum to be removed from the floor of a residential rental building, it is unlikely that it could be removed in one piece, so it is almost impossible for it to be reused in another room or building.

Example 12: Tiles (wall and floor)

209. Tiles can be placed on the wall and floor of a residential rental building. Irrespective of where they are placed, tiles are a part of the residential rental building to which they are attached, so should not be treated as separate assets.
210. Tiles are attached to the floor or walls with an adhesive, so satisfy the necessary threshold attachment (in step 1 of the three-step test).
211. Tiles are not required for a residential rental building to be considered complete. A residential rental building can be let without wall or floor tiles. Therefore, the step 2 of the test is not satisfied and it is necessary to consider step 3.

212. Under step 3 of the test, tiles are part of a residential rental building because they are attached to such a degree that they are a part of the fabric of the building. Tiles are generally strongly attached to the floor or walls by an adhesive. Because of the adhesive's strength, it is generally difficult to remove tiles without breaking them or damaging the underlying surface. Because of the damage that would likely be caused to the tiles on their removal, they would not be able to be relocated within the building or to another building.

Example 13: Curtains

213. Curtains are not a part of the building in which they are installed and can be treated as separate assets for depreciation purposes.
214. Curtains satisfy the required threshold attachment (in step 1 of the three-step test) because they are attached to the building. However, a residential rental property would be considered complete without curtains and could be let. In this regard, it would not be unusual to find a residential rental property without window coverings. Kitchen and bathroom windows are commonly found without window coverings. Similarly, where a lounge or bedroom, for example, has particular views, an owner may decide to leave the windows uncovered.
215. Under step 3, curtains are not considered to be attached to such a degree that they form a part of the fabric of the building. They have a limited extent of affixation as they are generally attached with small clips to curtain rails, so are easily removed without damage to either the curtains or the building. Curtains are also easily relocated to another room within a building or another building.

Example 14: Blinds

216. Blinds are not a part of the building and can be treated as separate assets. Blinds are attached sufficiently to satisfy the required threshold attachment (in step 1 of the three-step test). However, they are not necessary for a residential rental property to be considered complete. Further, they are not attached to such a degree that they form a part of the fabric of the building as they are merely screwed to the top of window frames and can be easily removed without damage to either the blind or the building.

Example 15: Water heaters and hot-water cylinders

217. Water heaters and hot water cylinders (both gas and electric) are not generally a part of the building and can be treated as separate assets.
218. Water heaters and hot water cylinders will not satisfy the required threshold attachment (in step 1 of the three-step test). Generally hot water cylinders and water heaters are attached to a power supply (electricity or gas) and to a water supply. In these circumstances, step 1 of the three-step test will not be satisfied and hot water cylinders and water heaters will be treated as separately depreciable items.

Example 16: Heating / Air conditioning systems

219. Whether or not heating and air conditioning systems are part of the building will depend on exactly how they are attached to the building.
220. The majority of heating and air conditioning systems (other than those that are merely plugged into an electricity supply) will satisfy the threshold test (step 1 of the three-step test).
221. A residential rental property would not generally be considered incomplete without a heating or air conditioning system and residential rental properties are routinely let without such systems (step 2 of the three-step test). Therefore, it is necessary to consider step 3.
222. Under step 3 of the test, home ventilation systems that are built into the structure of the building will be a part of the building as the degree of attachment is such that the systems form a part of the fabric of the building. Whether other heating systems, such as heat pumps, are a part of the building will depend on the degree to which they are attached. Where the degree of attachment is not significant and the unit can be removed with minimal damage to the building and the unit, then such a system will not be part of the building and will be separately depreciable. Conversely, where such a system is built-in to a significant degree and cannot be removed without considerable damage, then it will generally be a part of the building and not separately depreciable.