

Whether expenditure to resolve weathertightness issues is deductible

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TDS 23/07

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Subjects | Kaupapa

Income tax: capital limitation; repairs and maintenance; weathertightness repairs.

Abbreviations | Whakapotonga

The abbreviations used in this document include:

CCS	Customer & Compliance Services, Inland Revenue
Commissioner or CIR	Commissioner of Inland Revenue
ITA	Income Tax Act 2007
TCO	Tax Counsel Office, Inland Revenue

Taxation laws | Ture tāke

All legislative references are to the Income Tax Act 2007 (**ITA**) unless otherwise stated.

Facts | Meka

1. The Taxpayer is an individual who owns a rental property.
2. The rental property is a unit (the Unit), which is part of a block of 6 units (the Block). The Block is part of a complex (the Complex) consisting of other similar blocks and other dwellings. The Block operates as a free-standing building within the Complex. The units within the Block are connected by inter-tenancy walls.
3. The Block was largely clad with monolithic cladding. The Block (along with the other blocks in the Complex) required remediation work to resolve weathertightness issues. This remediation work (Remediation) was carried out by the body corporate (the Body Corporate) and paid for by special levies payable by each unit holder calculated by reference to their expected portion of the total expenditure.
4. The Unit was untenanted while the Remediation was carried out. The Taxpayer independently organised for internal painting to be done to the Unit (Painting) while the property was untenanted.

Issues | Take

5. The main issues considered in this dispute were whether the capital limitation in s DA 2(1) applied to deny a deduction for expenditure claimed by the Taxpayer for the special levies and the Painting in the disputed periods
6. There was also a preliminary issue on the onus and standard of proof.

Decisions | Whakatau

7. The Tax Counsel Office (TCO) decided that the capital limitation applied to deny a deduction for the special levies claimed for the Taxpayer's share of the cost of the Remediation. However, the capital limitation did not apply to deny a deduction for the cost of the Painting.

Reasons for decisions | Pūnga o ngā whakatau

Preliminary issue | Take tōmua: Onus and standard of proof

8. The onus of proof in civil proceedings¹ is on the taxpayer, except for shortfall penalties for evasion or similar act, or obstruction.² The taxpayer must prove that an assessment is wrong, why it is wrong, and by how much it is wrong.³
9. The standard of proof in civil proceedings is the balance of probabilities.⁴ This standard is met if it is proved that a matter is "more likely than not".⁵ Whether the Taxpayer has discharged the onus of proof is considered in the other issues.

Issue 1 | Take tuatahi: Whether the capital limitation applies

10. The issue is whether expenditure claimed by the Taxpayer for Remediation incurred as special levies paid to the Body Corporate, and for the cost of painting incurred directly

¹ Challenge proceedings (ie, the proceedings that would follow if this dispute proceeds to the Taxation Review Authority or a court) are civil proceedings.

² Section 149A(2) of the Tax Administration Act 1994.

³ *Buckley & Young Ltd v CIR* (1978) 3 NZTC 61,271 (CA); *Beckham v CIR* (2008) 23 NZTC 22,066 (CA).

⁴ Section 149A(1) of the TAA; *Yew v CIR* (1984) 6 NZTC 61,710 (CA); *Birkdale Service Station Ltd v CIR* (1999) 19 NZTC 15,493 (HC); *Case X16* (2005) 22 NZTC 12,216; *Case Y3* (2007) 23 NZTC 13,028.

⁵ *Miller v Minister of Pensions* [1947] 2 All ER 372, 374.

by the Taxpayer, is capital and therefore not deductible by virtue of the capital limitation in s DA 2(1).

11. Customer & Compliance Services, Inland Revenue (**CCS**) considered that all of the expenditure claimed, including that for the Painting, was capital, as the scope of the Remediation involved the reconstruction of the whole asset, or at the very least, changed the character of the asset. CCS argued that the Painting was part of the overall Remediation project and is therefore capital expenditure.
12. The Taxpayer considered that the expenditure was on revenue account and therefore deductible or, alternatively, it was appropriate to apportion the expenditure. The Remediation was primarily limited to certain portions of the inter-tenancy walls and decks, and the rest of the units were intact and weathertight. The Taxpayer stated the Painting was carried out independently by the Taxpayer and did not form part of the Remediation. The Taxpayer argued the Painting was therefore ordinary repairs and maintenance expenditure.
13. The parties did not dispute that the expenditure met the requirements of the general permission in s DA 1.

Capital limitation

14. The general permission is overridden by the general limitations in s DA 2 (s DA 2(7)). The relevant general limitation in the present dispute is the capital limitation in s DA 2(1).
15. In applying the capital limitation, it is necessary to distinguish between revenue expenditure (potentially deductible) and capital expenditure (not deductible because of the capital limitation). One of the seminal cases on how to distinguish between the two types of expenditure is *BP Australia*.⁶ The Privy Council in *BP Australia* set out the factors to determine the nature of an expense.⁷
16. TCO considered there are three elements from the general application of the *BP Australia* principles to remediation expenditure that are most relevant to determining if an expenditure is of a revenue or capital nature. These are:⁸

⁶ *BP Australia Ltd v CT* [1965] UKPCHCA 2, (1965) 112 CLR 386.

⁷ See *CIR v McKenzies New Zealand Limited* (1988) 10 NZTC 5,233 (CA) at 5,236 for a summary of these factors.

⁸ These elements will be discussed further below.

- Whether the work done resulted in the reconstruction, replacement or renewal of the asset, or substantially the whole of the asset.
 - Whether the work done had the effect of changing the character of the asset.
 - Whether the work was part of one overall project or was a series of projects that merely happened to be undertaken at the same time.
17. TCO considered that the following analysis was consistent with the Commissioner's position in IS 12/03 *Income tax- deductibility of repairs and maintenance expenditure – general principles*.

Repairs and maintenance expenditure

18. The crux of the issue is whether the expenditure is caught by the capital limitation in the context of repairs and maintenance expenditure.
19. The Privy Council case of *Auckland Gas*⁹, the leading New Zealand decision on the tax treatment of repairs and maintenance expenditure, adopted a two-stage process when determining whether the expenditure is of a revenue or capital nature:
- First, the asset being repaired or worked on is identified.
 - Second, the nature and extent of the work done to that asset is analysed.

Stage one: identify the asset

20. TCO considered the cases that addressed how to identify the asset being repaired or worked on¹⁰, and inferred the following principles from these cases:
- It is a question of fact and degree as to what constitutes a single asset. However, the focus is on identifying what constitutes the entirety of the asset. This involves identifying the "physical thing which satisfies a particular notion".
 - Identifying the asset is not about identifying the profit-earning structure or entity. The fact that a particular physical thing realises its economic value only when used in conjunction with other things or a business operation does not mean it cannot be the relevant asset on which the work is undertaken.

⁹ *CIR v Auckland Gas Co Ltd* (1999) 19 NZTC 15,011 (CA) at 15,702.

¹⁰ *Auckland Gas* at 15,707; *Lindsay v FCT* (1961) 106 CLR 377 (HCA); *Poverty Bay Electric Power Board v CIR* (1999) 19 NZTC 15,001 (CA); *Auckland Trotting Club (Incorporated) v CIR* [1968] NZLR 967 (CA); *Hawkes Bay Power Distribution Ltd v CIR* (1998) 18 NZTC 13,685 (HC); *Case N8* (1991) 13 NZTC 3,052; *Case F67* (1983) 6 NZTC 59,897.

- A single asset may be made up of interdependent parts. There is a potential danger of distortion if too large or too small an asset is identified. The entirety of the asset must be identified by itself. It will not be an aggregation of things.
- Identifying whether a part of a wider asset is itself a separate physical thing, or merely a component of the wider asset, includes considering whether the item is physically and functionally distinct from the wider asset. That is, it is relevant to consider:
 - whether there is a degree of physical connection between the component parts, and
 - whether the components are necessary to carry out the asset's function.
- Subsidiary parts of an integrated system form part of that system rather than being assets in their own right. Something that is integral to a larger asset's ability to function is unlikely to be the relevant asset that is worked upon.

Stage two: nature and extent of the work done

21. The second step is to consider the nature and extent of the work done on the asset. The three elements to determining if an expenditure is of a revenue or capital nature, mentioned in [16] above, are discussed here.

Whether the work done resulted in the reconstruction, replacement or renewal of the asset, or substantially the whole of the asset.

22. If the work done resulted in the reconstruction, replacement or renewal of an asset, the expenditure is likely to be of a capital nature. This is contrasted with renewal or replacement of subsidiary parts of a whole.¹¹ In applying this test, the work done to the asset must be looked at in its totality to decide whether the work done is so substantial that the whole, or substantially the whole of the asset is reconstructed, replaced or renewed. This may include work done over more than one income year.¹²

Whether the work done had the effect of changing the character of the asset.

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

¹¹ *Lurcott v Wakely & Wheeler* [1911] 1 KB 905. See *Auckland Trotting Club* at 205; *Hawkes Bay Power* at 13,707; *Case J92* (1987) 9 NZTC 1,518 at 1,522.

¹² See *Auckland Gas*, *Poverty Bay Electric Power* and *Hawkes Bay Power*.

capital expenditure.¹³ In contrast, work that merely restores an asset to its original condition will be of a revenue nature. Key factors to consider include:

- The use of new materials in completing the work does not necessarily mean that the asset is improved.¹⁴ However, where different materials are used, and as a result the asset is more advantageous or performs or functions better or differently than it did previously, this may indicate a change in the character of the asset.¹⁵ Where a decision is made to use better materials instead of the same or equivalent materials, a change in the character of the asset will result and the expenditure will be of a capital nature.¹⁶
- Changes to an asset's value, earning capacity, useful life, or function or operating capacity, whether or not a goal of the work done, cannot be relied on in isolation to establish the nature of the work done to the asset. But in some cases, the courts have used such factors to support an overall assessment of whether the character of an asset has changed.¹⁷
- Determining the scale of the work done includes a consideration of the extent of the work done, the importance of the work done to the asset and the business, as well as the cost of the work done. The greater the extent of the work done, the greater the importance of the work done to the asset and the business, and the more significant the costs incurred, the more likely the expenditure will be of a capital nature.¹⁸

Whether the work was part of one overall project or was a series of projects that merely happened to be undertaken at the same time.

24. Where remediation forms part of one overall capital project, it is not appropriate to separate the different costs for tax purposes. Rather, all of the expenditure should take its nature from that of the overall project.¹⁹ However, there may be some situations where apportionment is appropriate. For example, a taxpayer may do work on an asset while at the same undertaking an overall project. If it can be demonstrated that the work done is not part of that project, the nature of the work must be determined on its own facts. Consequently, if that work does not reconstruct, renew or replace an asset

¹³ *Auckland Gas* at 15,706–15,707

¹⁴ *Conn (HMIT) v Robins Bros Ltd* (1966) 43 TC 266 (Ch).

¹⁵ *FCT v Western Suburbs Cinemas Ltd* (1952) 86 CLR 102 (HCA).

¹⁶ *Auckland Gas* at 15,708

¹⁷ *Case X26* (2006) 22 NZTC 12,315; *Colonial Motor Company Ltd v CIR* (1994) 16 NZTC 11,361 (CA).

¹⁸ *Auckland Gas* at 15,706; *Case L68* (1989) 11 NZTC 1,398; *Hawkes Bay Power* at 13,706–13,707.

¹⁹ *Colonial Motor; Sherlaw v CIR* (1994) 16 NZTC 11,290

or substantially the whole of an asset or change its character the expenditure on that work is likely to be revenue in nature and deductible.²⁰

Was the Painting part of the Remediation?

25. TCO first considered the nature of the Painting and whether it was part of the Remediation project. This is because if the Painting was part of the overall Remediation project, as CCS alleged, then whether the Painting was on its own deductible would not be relevant.
26. TCO considered the Painting was not part of the overall Remediation project as it was separate maintenance work that was, from the information provided, contracted, invoiced and paid for by the Taxpayer completely separately from the special levies for the Remediation.
27. Accordingly, from a practical and business point of view, the Painting was not part of the Remediation project. The only connection with the Remediation is that both were carried out at the same time.
28. Therefore, the deductibility of the Painting was considered separately from the deductibility of the special levies.

The Remediation

29. The parties' arguments focused on whether the Remediation expenditure incurred by the Body Corporate was of a revenue or capital nature. As the special levies were calculated by reference to the Taxpayer's share of the Remediation expenditure, TCO considered that the levies would take the character of that expenditure.
30. Regarding the first stage of the two-stage approach in *Auckland Gas*, the parties disagreed as to whether the relevant asset was the Unit, the Block, or the entire Complex. TCO considered that the relevant asset subject to the Remediation work was the Block. The Unit was not the asset because at issue is the nature of the expenditure incurred by the Body Corporate, which concerned work on the blocks within the Complex on a block-by-block basis. The work was not carried out solely within the boundaries of the Unit. The Complex was also not the asset due to the lack of physical and functional connection between the blocks and the fact that the project only concerned particular parts of the entire Complex. The Complex was not a physical thing which satisfied a particular notion.

²⁰ *Hawkes Bay Power*

31. The Remediation included, among other things, repair and replacement of damaged timber framing in the exterior portions of the inter-tenancy walls, re-cladding of the exterior portions of the inter-tenancy walls to make them less prone to weathertightness issues (including the installation of new connections, junctions and flashings for those walls), rebuilding of decks with moisture and structural issues (including the installation of new balustrades, connections and flashings), replacement of membrane roofs over certain windows, and providing additional clearance between the cladding and the ground.
32. Regarding the nature and scope of the Remediation done to the Block, TCO concluded the following:
 - The Remediation did not result in the reconstruction, replacement, or renewal of the Block or substantially the whole of the Block. While the work done to some affected parts of the Block was arguably extensive, those areas are not so significant a part of the Block that the work done could constitute a reconstruction, renewal, or replacement of the whole, or substantially the whole, of the asset. However, the expenditure would still be capital if the nature and scale of the remedial work had the effect of changing the character of the asset.
 - After weighing up the various factors, the nature and scale of the work done was such that it changed the character of the Block because the cost of the Remediation was high (around 20% of the value of the units in the Complex), and there were clear, significant improvements to the affected areas, some of which were structurally significant and important to the operation of the asset. In addition, the remediation of the Block was necessary to prevent water ingress and protect the overall structural integrity and income-earning capacity of the Unit and the rest of the Block.

The Painting

33. As the Painting was not part of the Remediation project, its tax treatment was considered on its own facts.
34. TCO considered the Painting did not result in the reconstruction, replacement or renewal of the whole of or substantially the whole of the Unit, the Block or the Complex, and it did not change the character of any of them. The purpose of the Painting was to restore the internal walls to the state they were in when the Unit had originally been freshly painted. The Painting was maintenance work that must be done regularly to keep a rental property in good condition. This was indicative of the Painting being a revenue expense.

Overall conclusion

35. The capital limitation applied to deny a deduction for the special levies claimed by the Taxpayer for their share of the cost of the Remediation. However, the Painting was a revenue expense and was, therefore, deductible in accordance with s DA 1.