Inland Revenue
Te Tari Taake

TECHNICAL DECISION SUMMARY > ADJUDICATION

WHAKARĀPOPOTO WHAKATAU HANGARAU > WHAKAWĀ

Renovation work on recently acquired properties and the capital limitation

Decision date | Rā o te Whakatau: 28 July 2023

Issue date | Rā Tuku: 31 January 2024

TDS 24/02

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Subjects | Kaupapa

Income tax; general permission; capital limitation; neglected acquisition.

Taxation laws | Ture tāke

All legislative references are to the Income Tax Act 2007.

Facts | Meka

1. The Taxpayer is a trust that purchased several rental properties. At the time of purchase all but one of the properties were tenanted. After the purchase, the Taxpayer undertook work on the properties.
2. The work on the properties included:
   - replacing kitchen units
   - adding dishwashers and heat pumps
   - replacing bathroom fittings
   - replacing carpets and vinyl
   - repairing and repainting exterior and interior walls
   - cleaning and repairing roofs.
3. The Taxpayer said that at the time of purchase the properties were fit for purpose, the work done was to bring them back to their original condition and no improvements were made.
4. The Taxpayer claimed the full amount of costs in its income tax return, but later made a voluntary disclosure to treat some amounts as capital expenditure. With the voluntary disclosure and subsequent agreed adjustments, the amount claimed was reduced.
5. Subsequently, Customer and Compliance Services (CCS) argued that the amount paid for the work on each property was capital on two grounds:
   - The expenditure was part of the cost of acquisition of the properties.
   - The work went beyond ordinary repairs and maintenance.

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Issues | Take

6. The issue considered in this dispute was whether the capital limitation under s DA 2(1) applied to deny a deduction.

7. There was also a preliminary issue on the onus and standard of proof.

Decisions | Whakatau

8. In accordance with the capital limitation in s DA 2, the Tax Counsel Office (TCO) decided that the expenditure relating to the work undertaken by the Taxpayer was not deductible as the expenditure was part of the cost of acquisition and, therefore, capital.

Reasons for decisions | Pūnga o ngā whakatau

Preliminary issue | Take tōmua: Onus and standard of proof

9. The onus of proof in civil proceedings[1] 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]

10. The standard of proof in civil proceedings is in 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.

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[1] Challenge proceedings (ie, the proceedings that would follow if this dispute proceeds to the TRA or a court) are civil proceedings.

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

[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.

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Issue 1 | Take tuatahi: Whether the expenditure is subject to the capital limitation

11. The issue was whether the capital limitation in s DA 2(1) applied. TCO noted that both parties to the dispute agreed that the general permission under s DA 1 was met with a sufficient connection between the expenditure and the rental activity of the Taxpayer.

Whether s DA 2(1) applies

12. Section DA 1 is subject to the general limitations in s DA 2. Under s DA 2(1), a person is denied a deduction for an amount of expenditure to the extent to which the expenditure is of a capital nature.

13. 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). In this context, as the properties were recently acquired when work began, the parties focused on whether the various expenses incurred by the Taxpayer were part of the cost of acquisition of the properties. If so, the expenditure would be capital in nature.

14. The Taxpayer and CCS disagreed about whether the works were part of the cost of acquisition on three grounds:

    - The condition of the properties when purchased.
    - Whether a discount on the purchase price was given to account for the condition of the properties.
    - The cause of the need for the work.

15. TCO summarised the relevant law as follows:

    - If the capital asset was not in good working order at the time of acquisition, the cost of putting it in order suitable for use was more likely to be part of the cost of its acquisition, not a cost of maintenance. This did not require the asset to be incapable of being used in the taxpayer's business on acquisition and turned on the asset's suitability for the taxpayer's intended purpose. That is, whether the taxpayer at the time of acquisition recognised further expenditure would be needed to bring the asset to the condition desired by the taxpayer for its long-term use.[6] However, following *Odeon*, if the issues with the asset did not require immediate remedy, and there was no question of danger or of the asset

[6] *W Thomas & Co Pty Limited v FCT* (1965) 14 ATD 78 (HCA); *Case W7* 89 ATC 161.

not being able to be used to derive income for the foreseeable future, the expenditure was more likely to be revenue.[7]

- If the purchase price was discounted to account for the disrepair of the asset, this would indicate the expenditure was part of the cost of acquisition. If the purchase price was not affected by the condition of the asset, then it was more likely to be deductible. However, following *Law Shipping*, rather than requiring any specific agreement as to a discount, the inquiry is rather if it could be reasonably inferred that the vendor could have sought a higher price for the asset had they undertaken the repairs themselves.[8] Further, courts have found that even when the need for repair was not known at the time of acquisition (and therefore could not have been accounted for in the purchase price), the expenditure may still be capital, as it would just mean that the cost of acquisition was higher than expected.
- The greater the extent to which the need for the work arose prior to the taxpayer's acquisition of the asset, the more likely it was to be part of the cost of acquisition. However, there were limits to this, and it did not mean that all repairs and maintenance necessary as a result of previous ownership would be capital, as confirmed by *Case T43* and *Case V167*. This is a matter of fact and degree.[9]

Condition of the properties

16. CCS argued that the properties were in a poor, but habitable state and this was due to deferred maintenance by the vendor. They also argued that the state of the properties was such that they were barely fit for the Taxpayer's intended purpose.

17. CCS relied on photographic evidence of various units to support their contention as to the condition of the properties. TCO considered that while some of the photographs depicted issues that could make the properties difficult to rent out, it was difficult to determine whether the photographs were reflective of the general condition of the properties, given the photographs were from only specific parts of a few of the units.

18. The Taxpayer said that the properties were fit for purpose. At the time of acquisition 95% of the units were rented. The Taxpayer said that the condition shown in the photographs were selective photographs taken for negotiation purposes.

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7 *Odeon Associated Theatres Ltd v Jones* [1973] Ch 288 (CA).

8 *The Law Shipping Co Ltd v IRC* (1923) 12 TC 62.

9 *Case T43* (1998) 18 NZTC 8,287; *Case V167* 88 ATC 1107.

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19. Consistent with arguments made by the Taxpayer, valuations done on the properties noted that the properties were in "average" condition, the damage was primarily cosmetic and could easily be fixed and stated that there was no need for immediate work.

20. TCO considered that the registered valuers were better placed to assess the condition of the properties and any effect on rental yield than either of the parties. As the valuers had considered the properties were in average condition, and they were rented out when purchased, this indicated that they were capable of being used in the Taxpayer's business.

21. However, following *W Thomas*, the focus was on whether the asset was suitable for use in the way intended by the Taxpayer. *Case W7* indicated that expenditure would be part of the cost of acquisition of an asset if a taxpayer recognised a need for further expenditure to bring the asset to the condition desired by a taxpayer for its long-term use:

    - The Taxpayer acquired the properties with the intention of renovating them to make them suitable for use in the way they intended, by making them attractive to tenants who would be willing to pay more rent and would look after them, and to bring them to the condition desired by the Taxpayer for its long-term use. This supported the view that the cost of the work was part of the cost of acquisition.
    - Making a property more attractive to a particular class of tenant does not necessarily point to expenditure being capital, but it is considered making a house more attractive to a particular class of tenant by making improvements for the purpose of improving rental yield and protecting the income stream points towards the expenditure being capital as part of the cost of acquiring the assets.

Whether the purchase price was discounted

22. Whether the purchase price was affected by the condition of the properties was relevant as it was central to the decision in *Odeon* where the purchase price of the theatre was not affected by its state of disrepair. This was in contrast with *Law Shipping* where it could be reasonably inferred that the vendor could have sought a higher price for the asset if they had done the repairs prior to sale and this indicated that the price was reduced to account for the condition.

23. CCS argued that the purchase price was significantly lower than the expected market values of the properties. After factoring the cost of the work, they estimated the value of each property, on average, would be higher at the time of purchase. They also

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noted that the purchase price was significantly lower than the valuations for each property.

24. However, the Taxpayer argued that the purchase price was close to the full value of the properties had the properties been renovated. This was also closer to the CCS estimate, but not quite as high.

25. The Taxpayer argued that usually a multi-property purchase would factor in a single transaction discount. The valuation was on a per property basis rather than a multi-property purchase. The valuers had noted that the sum of the individual properties may not be the value of a multi-property sale. This meant that it would be expected that the purchase price would be lower than the valuations as the properties were purchased in bulk. The decrease in price did not indicate that the discount, relative to the valuations was due to the condition of the properties.

26. TCO applied the law to the facts as set out below:

   - There were emails between the vendor and the Taxpayer that acknowledged the need for significant repairs for each property. This indicated the lower price was partially to account for the condition of the properties.
   - The Taxpayer used the photographs to attempt to negotiate a lower price but was unsuccessful. The Taxpayer paid the vendor's price and must have had in mind the costs of the work when doing so.
   - Consistent with *Law Shipping*, the vendor could have obtained a higher price for the properties had they undertaken the work themselves before sale. If the Taxpayer did not need to undertake the work to attract a higher calibre of tenants and increase rental yield, presumably it, or another purchaser, would have been willing to pay a higher price to avoid the extra time and cost involved with the work.
   - The fact that this cost would have been factored in determining a fair purchase price indicates that the cost of the work was more likely to be part of the cost of acquisition of the properties. Consistent with *W Thomas*, unexpected costs could simply mean that the cost of acquisition was higher than expected.

Cause of the need for the work

27. Regardless of whether a discount was received on the purchase price, the cause of the need to do the work will affect whether that expenditure is part of the cost of acquisition and, therefore, capital.

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28. The need arose from the property's prior rental use when owned by the vendor. Neither party has provided any evidence of further damage or issues arising after acquisition by the Taxpayer, and the work began shortly after acquisition.

29. TCO concluded that the cause of the need for the work was to remedy an inherited legacy of disrepair from the vendor's use of the properties. This supported the view that the cost of the work was part of the cost of acquisition of each of the properties.

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