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**A SUPER MASSIVE 'BLACK HOLE'?  
THE TAX TREATMENT OF SEISMIC STRENGTHENING COSTS**

ANDREW J MAPLES\*

**ABSTRACT**

On 4 September 2010, an earthquake of magnitude ('M') 7.1 on the Richter scale rocked the Canterbury region. This has been followed by thousands of aftershocks, including the deadly M6.3 earthquake on 22 February 2011, which struck at a shallow depth near central Christchurch. The aftershocks have caused significant damage to property and buildings. A large number of typically older New Zealand buildings require earthquake strengthening to meet the current building code, in many cases at significant cost. It is expected that the building code will tighten in the future. This article considers the limited judicial authority on whether costs to strengthen an existing building to comply with the building code will constitute deductible repairs or alterations, or capital improvements.

## I INTRODUCTION

### *A Background*

On Saturday, 4 September 2010 at 4:35 am a powerful earthquake, magnitude 7.1 on the Richter scale, struck the Canterbury region. The earthquake (and subsequent aftershocks)<sup>1</sup> caused widespread property damage. The September earthquake was followed by a far more devastating earthquake, which struck at 12:51 pm on Tuesday, 22 February 2011 and — despite its smaller magnitude (of M6.3) — killed 185 people and caused substantial damage to property and buildings.<sup>2</sup> The M6.3 earthquake was centred 10 kilometres south-east of the centre of Christchurch at a depth of only 5 kilometres. The highest peak ground (vertical) acceleration (PGA) of 2.2g (ie 2.2 times the acceleration of gravity) recorded in this earthquake is the highest PGA ever recorded in New Zealand.<sup>3</sup>

The earthquakes have caused substantial damage to property and buildings. The Reserve Bank of New Zealand has suggested the total cost of insurance claims arising from the earthquakes could be NZ\$30 billion.<sup>4</sup> It is expected that 70–80 per cent of buildings in the Christchurch central business district (CBD) will ultimately be demolished as a result of the quakes.<sup>5</sup>

The Christchurch earthquakes have led to a greater awareness in New Zealand among, inter alia, central and local government, insurers, and building owners of the potential issues associated with buildings through-out New Zealand. It is estimated, for example, that there are 4,000 unreinforced masonry buildings in New Zealand and all of them are

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<sup>1</sup> Technically, the initial M7.1 event was an earthquake and subsequent events are classed as aftershocks not earthquakes as they were caused by the initial event. This article will use the terms aftershock and earthquake interchangeably.

<sup>2</sup> The M6.3 earthquake was shortly followed by two significant aftershocks of M5.8 and M5.9. In addition to the September and February earthquakes, on 13 June 2011 two major aftershocks measuring M5.85 and M6.4 struck the region. Further damage was caused by M5.8 and M6.0 earthquakes, which hit the Canterbury region on 23 December 2011. Since the initial 4 September 2010 earthquake, there have been to date (30 October 2012) 59 earthquakes of magnitude 5 and greater: Geonet, *Aftershocks* <<http://info.geonet.org.nz/display/home/Aftershocks>>. There have been in excess of 10,844 aftershocks in total since 4 September 2010 (to 30 October 2012): *Christchurch Quake Map*, <<http://www.christchurchquakemap.co.nz/>>.

<sup>3</sup> Geonet, 'Feb 22 2011 Christchurch badly hit by M6.3 earthquake', <<http://www.geonet.org.nz/news/feb-2011-christchurch-badly-damaged-by-magnitude-6-3-earthquake.html>>. The ground accelerations in Christchurch were as much as four times higher than the highest accelerations measured in the March 2011 M8.9 earthquake off the east coast of Japan: Rong-Gong Lin II and Sam Allen, 'New Zealand quake raises questions about L.A. buildings', *Los Angeles Times* (online), (Los Angeles), 26 February 2011, <<http://www.latimes.com/news/local/la-me-quake-california-20110226.0,5641999.print.story>>.

<sup>4</sup> Alan Wood, 'Rebuild momentum hit by recent quakes', *The Press* (Christchurch), 28 January 2012, C21.

<sup>5</sup> Claire Rogers, 'Fletcher reviewing Kiwi operations', *The Press*, (Christchurch), 23 August 2012, A13. New Zealand building standards take into account the earthquake risk, with building codes requiring a building with a 50 year design life to withstand predicted loads of a 500 year event. Initial reports by GNS Science suggested ground motion in the February 2011 earthquakes 'considerably exceeded even 2500 year design motions': 'No structure built to take it', *The Gisborne Herald* (online), (Gisborne). 5 March 2011, <<http://www.gisborneherald.co.nz/article/?id=21722>>.

considered earthquake prone.<sup>6</sup> Many New Zealand buildings currently require earthquake strengthening — in many cases at significant expense — to bring them up to the *Building Act 2004* (NZ) minimum. It is expected that reviews underway (see section II of this paper) will see a further tightening of these standards, which will impose even greater demands (and costs) on building owners in respect of strengthening existing buildings.

### **B The importance of the issue**

The objective of this article is, using a traditional ‘black-letter law’ analysis approach,<sup>7</sup> to consider what the NZ law is concerning the deductibility of seismic strengthening expenditure in light of the existing case law. The view often expressed in the business pages and by commentators is that all such expenditure is on capital account and consequently non-deductible.

This issue is especially important for three related reasons. First, due to the potentially significant number of existing buildings that do not meet the current — let alone any future, more stringent — building code, many building owners will be required to expend considerable sums to bring their buildings to the requisite compliance level. Second, the recent change to building depreciation means that, with effect from 1 April 2011, a nil rate of depreciation applies for all buildings, ie in effect, owners can no longer claim depreciation on a building.<sup>8</sup> They are still able to claim depreciation deductions for fit-outs which are not considered part of the building. The denial of depreciation deductions for buildings will itself create:

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<sup>6</sup> Ben Heather, ‘September’s quake “saved 300 lives”, *The Press* (online), (Christchurch), 7 November 2011, <<http://www.stuff.co.nz/the-press/news/christchurch-earthquake-2011/5919747/Septembers-quake-saved-300-lives>>. More recently, concerns have been expressed about 1980s buildings constructed of ‘brittle’ block in Wellington: Hank Schouten, ‘How safe are the capital’s office buildings?’, *The Dominion Post* (online), (Wellington), 2 June 2012.

<sup>7</sup> Salter and Mason define the ‘black-letter law’ analysis approach as ‘a research methodology that concentrates on seeking to provide a detailed and highly technical commentary upon, and systematic exposition of, the content of legal doctrine.’: Michael Salter and Julie Mason, *Writing Law Dissertations — an Introduction and Guide to the Conduct of Legal Research* (Pearson Longman, 2007) 49. I acknowledge the limitations of this approach, including the subjective nature of interpreting and applying rules (including case law) and the dynamic nature of law: *ibid* 113. Salter and Mason contains an extensive consideration of the ‘black letter’ law approach: *ibid* 109–118. For a discussion of legal research techniques see also Peter Cane and Herbert M Kritzer (eds), *The Oxford Handbook of Empirical Legal Research* (Oxford University Press, 2010) and Margaret McKerchar, *Design and conduct of research in tax, law and accounting* (Lawbook Co, 2010).

<sup>8</sup> The nil rate applies to both commercial and residential buildings, and to rental and owner-occupied buildings, irrespective of when they were purchased or constructed. Building owners will still remain liable for the recovery of previously accumulated depreciation upon their future sale. The introduction of the nil rate followed a recommendation by the Victoria University of Wellington Tax Working Group, *A Tax System for New Zealand’s Future: Report of the Victoria University of Wellington Tax Working Group* (2010). For a discussion of this change and its implications see Mark Keating, ‘Problems Flowing from the Nil Depreciation of Buildings’ (2010) 16(3) *New Zealand Journal of Taxation Law and Policy* 307.

a massive new category of black-hole expenditure,<sup>9</sup> with all the problems that presents ... To limit the adverse tax effect from this change, taxpayers will undoubtedly seek to recharacterise the nature of their expenditure on buildings ... in order to mitigate the tax effect of disallowing all depreciation.<sup>10</sup>

In the event that seismic strengthening costs are treated as capital improvements based on case law — and thus the expenses are capitalised to the building's cost — building owners will not be entitled to claim tax depreciation on these costs. There will be little taxation incentive, therefore, to strengthen a building. However, as indicated, to continue to satisfy current and future requirements of local councils, and demands of insurers, seismic strengthening work will be required of building owners. Finally, it is hoped that this article will also provide some valuable insight for other jurisdictions. Recent earthquakes in other countries such as Japan, Haiti, and Italy, as well as the potential for such seismic events in areas such as California, may lead to a renewed focus both on strengthening existing buildings in these zones and on the related characterisation of such expenditure from a tax perspective. The conclusions of this article, particularly with reference to 'minor' strengthening work and the treatment of mixed work, could also be applicable to such work undertaken in the interests of public safety in general in response to, for example, recommendations from engineering and geotechnical reviews of a property.

In Interpretation Statement *IS 12/03: Income Tax — Deductibility of Repairs and Maintenance Expenditure — General Principles*<sup>11</sup> ('IS 12/03'), the Inland Revenue observes that the nature of expenditure, whether characterised as repairs or something more extensive, 'does not change if the repairs are carried out as a result of a significant event, for example, fire, flood or earthquake.' The same principles are applied to determine the tax treatment of repairs arising as a result of a significant event as are applied for repairs arising for other reasons.<sup>12</sup> Accordingly, aspects of the analysis in this article potentially have wider application, for example for certain leaky home expenditure.<sup>13</sup>

The remainder of this article is arranged as follows. Section II outlines the central government response to the Canterbury earthquakes as at 30 October 2012. The legislative and case law setting for the capital-revenue distinction in New Zealand is outlined in Section III. The two New Zealand cases considering the tax treatment of seismic strengthening costs are analysed in Sections IV and V, respectively. Section VI briefly reviews IS 12/03, the Inland Revenue Department's recently released

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<sup>9</sup> Blackhole expenditure is expenditure that is not immediately deductible (if it is on capital account, for example) and cannot be deducted by way of depreciation over the life of the asset to which it relates (nor over any other period).

<sup>10</sup> Keating, above n 8, 308.

<sup>11</sup> Inland Revenue, *Income Tax — Deductibility of Repairs and Maintenance Expenditure — General Principles*, IS 12/03, (2012) 24(2) *Tax Information Bulletin* 68 ('IS 12/03').

<sup>12</sup> *Ibid* 70 [27].

<sup>13</sup> In NZ during the 1990s a considerable number of houses were built using methods that, due to problems involving design, and installation of materials, leak when it rains. In some cases the materials themselves were used inappropriately. This has led to extensive damage to the fabric and structure of many houses constructed at this time and has required substantial remediation of affected properties.

interpretation statement on repairs and maintenance. Section VII considers whether seismic strengthening may be deductible in certain circumstances. Concluding observations are made in Section VIII.

## II CENTRAL GOVERNMENT RESPONSE TO THE EARTHQUAKES

### *A The rebuild and recovery*

Initially, after the February 2011 earthquake, a national state of emergency was imposed. This was lifted on 23 April 2011. The Canterbury Earthquake Recovery Authority ('CERA') was subsequently established by the government to lead and coordinate the ongoing recovery effort following the earthquakes. Its role includes:

- Providing leadership and coordination for the ongoing recovery effort.
- Focusing on business recovery, restoring local communities and making sure the right structures are in place for rebuilding.
- Enabling an effective and timely rebuilding.<sup>14</sup>

CERA, which reports to the Minister for Canterbury Earthquake Recovery (the Minister), is also tasked with working closely with local councils and engaging with local communities, including Ngāi Tahu (the local Māori tribe), the private sector, and the business sector. Special powers have been vested in the Minister and CERA in order to 'enable an effective, timely and co-ordinated rebuilding and recovery effort.'<sup>15</sup>

With respect to the central city, in April 2012 the Central Christchurch Development Unit ('CCDU') was established within CERA and was charged with preparing a development blueprint, which will provide guidance on where public buildings and 'strategic city blocks' will be located.<sup>16</sup> The 120 page finalised blueprint — titled the *Christchurch Central Recovery Plan* ('the recovery plan') — was released to the public on 30 July 2012,<sup>17</sup> and outlines the future development of central Christchurch. The recovery plan directs the Christchurch City Council to make a series of changes to its District Plan to ensure the objectives of the Recovery Plan are met, and also requires that all people making decisions on matters covered by the *Resource Management Act 1991* (NZ) (and related statutes) must not act inconsistently with the recovery plan.<sup>18</sup>

In October 2012, CCDU announced it was close to finalising the first deals for land needed to implement the recovery plan.<sup>19</sup> In addition, an 'Invest Christchurch' service

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<sup>14</sup> Canterbury Earthquake Recovery Authority, <<http://cera.govt.nz/about-cera>>.

<sup>15</sup> Ibid.

<sup>16</sup> Central Christchurch Development Unit, <<http://ccdu.govt.nz/>>.

<sup>17</sup> Central Christchurch Development Unit, *Christchurch Central Recovery Plan* (2012), <<http://ccdu.govt.nz/the-plan>>.

<sup>18</sup> Central Christchurch Development Unit, *The Recovery Plan*, <<http://ccdu.govt.nz/faq/general>>.

<sup>19</sup> Canterbury Earthquake Recovery Authority, *Greater Christchurch Recovery Update* (October 2012), 2, <<http://cera.govt.nz/news/2012/greater-christchurch-recovery-update-issue-14-october-2012CERA>>.



has also been established by CCDU to engage with potential investors at all levels (local, national, and international).<sup>20</sup>

### **B The Building Code**

Following the 22 February 2011 Canterbury earthquake, the Department of Building and Housing ('DBH') appointed leading New Zealand engineering consultants to undertake a technical investigation of the performance of four relatively modern multi-storey buildings in the CBD where there had been serious structural failures. The four buildings were the Canterbury Television ('CTV'), Pyne Gould Corporation ('PGC'), Forsyth Barr, and Hotel Grand Chancellor buildings. An Expert Panel oversaw their work and peer reviewed their findings, which are available on the DBH website.<sup>21</sup>

In March 2012, DBH announced the review of the earthquake-prone building policy framework established under the *Building Act 2004* (NZ).<sup>22</sup> The review will consider, inter alia, whether current regulatory requirements are adequate (ie existing buildings have to meet one third of the new build standard requirements) and whether there should be regulations specifying the level(s) of upgrade required of earthquake-prone buildings. One of the main outputs of the review, which will be informed by the Royal Commission's findings (see following paragraphs), is expected to be a Building Amendment Bill, with the regulatory changes to be passed in May 2013.

A Royal Commission was established on 14 March 2011 to inquire into the Canterbury Earthquakes, and is chaired by Justice Mark Cooper, a sitting New Zealand High Court judge.<sup>23</sup> The purpose of the Royal Commission is to examine issues around the built environment in the Christchurch CBD, including, but not limited to, the four buildings already mentioned in this section, and to consider the adequacy of the relevant building codes and standards.

Part One of the Royal Commission Final Report,<sup>24</sup> containing 70 recommendations intended to inform early decision-making about the central city's recovery from the Canterbury earthquakes, was released to the public on 23 August 2012. The recommendations 'focus on technical engineering issues, including seismicity, recommendations to change concrete structures, structural steel and earthquake actions standards, providing guidance or training to structural engineers and low-damage

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<sup>20</sup> Ibid 2.

<sup>21</sup> Ministry of Business, Innovation and Employment, *Canterbury Earthquakes — Investigation Reports* (2012), <<http://www.dbh.govt.nz/canterbury-earthquake-technical-investigation>>.

<sup>22</sup> Ministry of Business, Innovation and Employment, *Terms of reference — Earthquake-prone building policy review* (March 2012), <<http://www.dbh.govt.nz/epb-terms-of-reference>>.

<sup>23</sup> Canterbury Earthquakes Royal Commission, <<http://canterbury.royalcommission.govt.nz/>>.

<sup>24</sup> Part One of the Royal Commission Final Report is comprised of the following three volumes: New Zealand, Canterbury Earthquakes Royal Commission, *Volume 1 Summary and Recommendations in Volumes 1–3, Seismicity, Soils and the Seismic Design of Buildings* (2012); New Zealand, Canterbury Earthquakes Royal Commission, *Volume 2 The Performance of Christchurch CBD Buildings* (2012); New Zealand, Canterbury Earthquakes Royal Commission, *Volume 3 Low-Damage Building Technologies* (2012).

building technologies.<sup>25</sup> Some of the recommendations, which align with the DBH technical investigation referred to above, have already been implemented.<sup>26</sup>

Further volumes, including those covering quake-prone building policy, will be delivered in the coming months. The Royal Commission's final report will be delivered no later than 30 November 2012.<sup>27</sup> In addition, as part of the inquiry into the failure of buildings in the Canterbury earthquakes, the Royal Commission conducted a public hearing about the CTV building collapse, where 115 lives were lost.

The government expects to issue a 'full and comprehensive' response to the Royal Commission's complete findings in early 2013.<sup>28</sup>

### ***C The need for central government intervention?***

Due to the limited judicial authority on seismic strengthening costs and (now) the nil depreciation rate for buildings, a number of commentators have called for government intervention in this area.<sup>29</sup> The Property Council has requested:

the Government to fix the 'dreadful mistake' of removing tax depreciation on commercial property. It also said earthquake strengthening must be made tax-deductible. 'There's no incentive now for bringing buildings up to earthquake standards, and that affects all our cities, not just Christchurch.'<sup>30</sup>

This comes at a time when there have also been calls for incentives, such as accelerated depreciation on plant, to encourage businesses to commit to Christchurch.<sup>31</sup>

The Minister of Revenue, The Hon Peter Dunne, in announcing the government tax policy work programme for 2012-13, made reference to issues concerning blackhole expenditure, but in the context of certain fixed life resource consents and company administration costs.<sup>32</sup> Due to fiscal constraints, consideration of other forms of blackhole expenditure, such as the amortisation of capital raising costs, are not included in the work programme.<sup>33</sup> No reference is made in the speech to the 'black hole' of

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<sup>25</sup> Marc Greenhill, 'Report will influence construction — minister', *The Press* (online), 23 August 2012, <<http://www.stuff.co.nz/the-press/news/7535537/Report-will-influence-construction-minister>>.

<sup>26</sup> Ibid.

<sup>27</sup> Canterbury Earthquakes Royal Commission, above n 23.

<sup>28</sup> Greenhill, above n 25.

<sup>29</sup> International accounting firm PWC believes that tax relief is required from a social policy/public benefit perspective: PWC, *Facts on Tax 2011 Series 2 Suggested Solutions* (2011), 12. See also 'Calls for earthquake strengthening costs to be depreciable', *Landlords For Kiwi Property Investors* (online), 16 September 2011, <[http://www.landlords.co.nz/read-article.php?article\\_id=4043](http://www.landlords.co.nz/read-article.php?article_id=4043)>.

<sup>30</sup> Liz McDonald, 'Rebuild "at risk" in new city plan', *The Press* (Christchurch), 8 February 2012, A1.

<sup>31</sup> Tamlyn Stewart, 'Coca-Cola plant expands in Christchurch', *Fairfax NZ News* (online), 18 January 2012, <<http://www.stuff.co.nz/business/rebuilding-christchurch/6276345/Coca-Cola-plant-exp>>.

<sup>32</sup> The Hon Peter Dunne, 'Address to IFA annual conference' (Speech delivered at the IFA Annual Conference, Queenstown, 16 March 2012) 7-8 <<<http://taxpolicy.ird.govt.nz/news/2012-03-16-new-tax-policy-work-programme-announced-speech>>. The work programme is available at Inland Revenue, *Government tax policy work programme for 2012-13* (16 March 2012), <<http://taxpolicy.ird.govt.nz/work-programme>>.

<sup>33</sup> Dunne, above n 32, 8.

seismic strengthening costs — quite possibly for similar fiscal reasons. Further, the reference in the Minister's speech to the Canterbury earthquakes does not mention this issue.<sup>34</sup> More recently, the Minister's speech to the 2012 NZICA<sup>35</sup> Annual Tax Conference<sup>36</sup> contains no reference to this matter.

### III THE STATUTORY AND CASE LAW SCHEME

#### A *The Income Tax Act*

Section DA 1(1) of the *Income Tax Act 2007* (NZ) — called the 'general permission' — allows a deduction for an amount of expenditure or loss incurred in deriving assessable income or carrying on a business for the purpose of deriving assessable income. The *Income Tax Act 2007* (NZ) applies from the beginning of the 2008-09 income year.<sup>37</sup> The equivalent provisions in the earlier Income Tax Acts considered in the cases analysed in this article were *Income Tax Act 1994* (NZ) s BD 2(1) and *Income Tax Act 1976* s 104 ('the earlier acts').

Section DA 1 *Income Tax Act 2007* (NZ) is subject to the general limitations in s DA 2 of that Act, including the 'capital limitation' (*Income Tax Act 2007* (NZ) s DA 2(1)), which denies a deduction for an amount of expenditure or loss to the extent it is of a capital nature. The equivalent capital prohibitions in the earlier acts were *Income Tax Act 1994* (NZ) s BD 2(2)(e) and *Income Tax Act 1976* (NZ) s 106(1)(a), respectively. Deductions for repairs and maintenance are dealt with under the general permission and are subject to the general limitations.<sup>38</sup>

For the purposes of this article the wording of ss DA 1 and DA 2(1) *Income Tax Act 2007* (NZ) have essentially remained unchanged from the earlier acts; hence, case law (and related Inland Revenue statements) on the interpretation of the equivalent sections in the earlier acts are still applicable.

#### B *The judicial view*

The term 'capital' is not defined in the *Income Tax Act 2007* (NZ), nor in earlier tax acts. The courts have developed a series of indicative tests for distinguishing between capital

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<sup>34</sup> Ibid 9.

<sup>35</sup> New Zealand Institute of Chartered Accountants (NZICA).

<sup>36</sup> The Hon Peter Dunne, 'Keynote Address to NZ Institute of Chartered Accountants (NZICA) 2012 Tax Conference' (Speech delivered at NZICA Annual Tax Conference, Auckland, 26–27 October 2012), <<http://taxpolicy.ird.govt.nz/news/2012-10-26-speech-nzica's-20th-annual-tax-conference-speech>>.

<sup>37</sup> The *Income Tax Act 2007* (NZ) represents the final stage of the rewrite (and reorganisation) of the New Zealand income tax legislation.

<sup>38</sup> In the *Income Tax Act 1976* (NZ) repairs and maintenance expenditure was governed by a separate provision (s 108). That section allowed a deduction for repairs and maintenance expenditure up to the amount usually expended in any year for repairs. Beyond that, the second proviso of s 108 provided a deduction if '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 ...'. Section 108 was not re-enacted with the passing of the *Income Tax Act 1994* (NZ).

and revenue expenditure. In New Zealand, the 'governing approach is exemplified in the observations of Lord Pearce'<sup>39</sup> in *BP Australia Limited v FCT* [1966] AC 224 ('*BP Australia*'), including:

The solution to the problem [of distinguishing between capital and revenue] is not to be found by any rigid test or description. It has to be derived from many aspects of the whole set of circumstances some of which may point in one direction, some in the other ... [T]he line of distinction is often hard to draw in borderline cases; and conflicting considerations may produce a situation where the answer turns on questions of emphasis and degree. That answer:

'depends on what the expenditure is calculated to effect from a practical and business point of view rather than upon the juristic classification of the legal rights, if any, secured employed or exhausted in the process'

(per Dixon, J. in *Hallstroms Pty Ltd v Federal Commissioner of Taxation* (1946) 72 CLR 634 at p 648).<sup>40</sup>

The passage Lord Pearce quoted from *Hallstroms Pty Ltd v Federal Commissioner of Taxation* is hereafter referred to as the '*Hallstroms test*'.

The leading New Zealand authorities on the treatment of repairs and maintenance and capital improvements are the Supreme Court (now the New Zealand High Court)<sup>41</sup> decision in *Auckland Trotting Club (Inc) v CIR* [1968] NZLR 193 ('*Auckland Trotting (SC)*') and the New Zealand Court of Appeal decision in *Auckland Trotting Club (Inc) v CIR* [1968] NZLR 967. Moller J in the Supreme Court (affirmed on appeal), outlined a two step analysis to determine whether the work undertaken is a 'repair' or 'alteration', or something more.<sup>42</sup> The first step is to identify the relevant asset upon which the work has been done.<sup>43</sup> The second step is to consider the nature and extent of the work done on the asset.<sup>44</sup> Expenditure incurred to repair or maintain an asset 'without changing its character'<sup>45</sup> will be on revenue account. If the work undertaken on the asset results in the reconstruction, replacement, or renewal of the asset, or substantially the whole of the asset, the work will amount to capital expenditure. Lord Nicholls in the Privy Council decision in *Auckland Gas Co Ltd v CIR* (2000) 19 NZTC 15,702, 15,706 ('*Auckland Gas (PC)*') observed that the words 'repair' and 'replacement' 'are not technical expressions with a special meaning' but bear an ordinary, everyday meaning.<sup>46</sup>

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<sup>39</sup> *CIR v Thomas Borthwick & Sons (Australasia) Ltd* (1992) 14 NZTC 9 101, 9 103.

<sup>40</sup> *BP Australia* [1966] AC 224, 264-5.

<sup>41</sup> The Supreme Court was renamed the High Court in 1980 and is not to be confused with the new Supreme Court, which, since 2004, is New Zealand's final court of appeal, replacing the Privy Council in that function.

<sup>42</sup> *Auckland Trotting (SC)* [1968] NZLR 193, 201.

<sup>43</sup> See generally Inland Revenue, IS 12/03, above n 11, 69 [10]-[12].

<sup>44</sup> See generally Inland Revenue, IS 12/03, above n 11, 70 [16]-[27].

<sup>45</sup> *W Thomas & Co Pty Ltd v Commissioner of Taxation of the Commonwealth of Australia* [1965] 115 CLR 58, 72 ('*W Thomas & Co*').

<sup>46</sup> See generally Andrew Maples, 'Case note. The Distinction between Repairs and Replacement Revisited, *Auckland Gas Company Limited v Commissioner of Inland Revenue* (Privy Council)' (2001) 2 *British Tax Review* 92; Andrew Maples, 'Beware Technological Developments: A New Zealand Perspective on Repairs and Replacement' (2001) 30(3) *Australian Tax Review* 173.

#### IV COLONIAL MOTOR COMPANY LTD v CIR.<sup>47</sup>

##### *A The facts*

In this case, the taxpayer company, Colonial Motor Company ('CML'), owned a 60 year old, eight storey building in Courtenay Place, Wellington. By the 1970s, the building, which had originally been used as a motor assembly plant for Ford motorcars, was an earthquake risk and the Wellington City Council ('WCC') required its demolition or strengthening by 1988. In 1981, the company's directors considered five options, adopting the fifth, ie 'Reinstate building as acceptable to Earthquake Seismic Code and Refurbish building for 50 year life'.<sup>48</sup> The Managing Director noted, in respect of the work to be undertaken to the then partially vacant building: 'Strengthening becomes *equivalent of [a] new building* — say 50 years future life — for half the costs of a new building.'<sup>49</sup> (Emphasis added.)

The company undertook extensive seismic strengthening work, including the construction of two internal reinforced concrete shear walls from ground floor to sixth floor ('an entirely new structural addition')<sup>50</sup> and the installation of diagonal steel bracing on the seventh and eighth floors. In addition, CML added a ninth floor penthouse. As a result, the building was transformed from a warehouse type structure with a value of NZ\$1.6 million into an office building with a government valuation of NZ\$16.5 million.

The total cost of the work, which was expended over five tax years (1984–88), was NZ\$5.7 million. The expenditure was divided into three categories: seismic strengthening (NZ\$1.28 million), repairs (NZ\$942 706), and capital (NZ\$3.47 million). At issue was the first category of expense. CML claimed a deduction for the NZ\$1.28 million strengthening costs on the basis that they were repairs and alterations and did not increase the capital value of the building. The Commissioner of Inland Revenue ('the Commissioner') denied the deduction on the basis, first that the work was not repairs or alterations but capital expenditure;<sup>51</sup> and second that the work increased the value of the building by more than the cost of the work.<sup>52</sup> In the High Court, Ellis J concluded that the seismic strengthening was an integral part of the overall expenditure,<sup>53</sup> and the work in its entirety had substantially increased the building's capital value and therefore could not be characterised as alterations. The taxpayer appealed to the New Zealand Court of Appeal.

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<sup>47</sup> *Colonial Motor Company Ltd v CIR* (1994) 16 NZTC 11 060, 11 061 (*Colonial Motors* (HC)).

<sup>48</sup> *Ibid* 11 061.

<sup>49</sup> *Colonial Motor Company Ltd v CIR* (1994) 16 NZTC 11 361, 11 363 (*Colonial Motors* (CA)).

<sup>50</sup> *Ibid* 11 366.

<sup>51</sup> *Income Tax Act 1976* (NZ) s 106(1)(a).

<sup>52</sup> *Income Tax Act 1976* (NZ) s 108 (second proviso).

<sup>53</sup> *Colonial Motors* (HC) (1994) 16 NZTC 11 060, 11 063.

## **B The New Zealand Court of Appeal**

The comparatively short judgment of the New Zealand Court of Appeal was delivered by Richardson J. His Honour confirmed Ellis J's finding in the NZ High Court that there was one overall construction project and it had to be considered as such;<sup>54</sup> to be deductible the total work undertaken on the building would have had to constitute repairs or alterations. On the facts in this case, the work 'could not sensibly have been the subject of two independent unrelated contractual projects, one for strengthening the building and the other for new and repair work'.<sup>55</sup> The allocation of the total expenditure to different categories did not change the character of the expenditure: 'It was a *single project* which converted the eight storey warehouse-type structure otherwise destined for demolition into a nine storey office block with a 50-year revenue earning life.'<sup>56</sup>

The Court briefly considered, based on an assessment of work undertaken both inside and outside the building, whether the work was 'alterations' or 'repairs and alterations'. Richardson J concluded that the work was an entirely new structural addition, and rejected as an oversimplification the taxpayer's submission that nevertheless it was the same building: 'What was done was a substantial reconstruction and improvement of the original premises.'<sup>57</sup> The Court had sympathy with Inland Revenue's argument that the work went beyond alterations and changed the building's character. However, ultimately the Court concluded it did not need to decide this matter as the work undertaken on the building failed to meet the second proviso of s 108 of the *Income Tax Act 1976* (NZ) on the basis that it had increased the building's capital value by more than the cost of the work and was therefore on capital account.

## **V TRA CASE X26**

### **A The facts**

The taxpayer in *TRA Case X26* (2006) 22 NZTC 12 315 was a member of a two person partnership which owned a 100 year old building in Wellington. The partners were advised by the Wellington City Council in a letter of 18 March 1999 that the building failed to comply with the earthquake strength capacity required by the relevant 1965 Loading Code. The conclusion was that the building might collapse in a moderate earthquake. The letter advised that under the *Building Act 1991* (NZ) the WCC could barricade the building and give notice for the owner to reduce or secure any danger within a specified period of time. The policy of the WCC was to allow property owners some time to remedy any defects before invoking its powers under that Act.<sup>58</sup> As the

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<sup>54</sup> 'This was despite the fact that the dispute only concerned the expenditure on the seismic strengthening and not the expenditure that the Commissioner and the taxpayer had already agreed was either revenue and deductible or capital and non-deductible.' Inland Revenue, IS 12/03, above n 11, 96 [187].

<sup>55</sup> *Colonial Motors (CA)* (1994) 16 NZTC 11 361, 11 366.

<sup>56</sup> *Ibid* (emphasis added).

<sup>57</sup> *Ibid*.

<sup>58</sup> Judge Barber accepted that in fact the WCC never directly threatened to barricade the building and that local authorities are reluctant to close down the letting of buildings because of the need for seismic strengthening: *TRA Case X26* (2006) 22 NZTC 12 315, 12 326.

building was a 'heritage property', the partners were entitled to financial assistance from the WCC to undertake the earthquake strengthening.

A report to the partnership by consulting engineers in October 1999 recommended remedial work be carried out, including the installation of a new structural steel and concrete frame towards the front of the building and a steel frame into the rear brick wall, as well as the addition of new steel in the floor bracing and wall/floor trim. This work was carried out at a total cost of NZ\$107 210.45. The WCC provided NZ\$45 000 as financial assistance and the partnership paid the balance. The work was expected to take six to eight weeks to complete but ultimately took about 12 weeks.<sup>59</sup> The building remained operational during the strengthening work.

The partnership claimed a deduction under *Income Tax Act 1994* (NZ) s BD 2(1) for the net cost of the strengthening work on the basis it constituted repairs and maintenance. Inland Revenue considered that the work was on capital account as it went beyond the repair and maintenance of the existing asset and resulted in a better asset than previously existed. Inland Revenue adjusted both the partnership returns and the two partners' assessments to reflect this conclusion. One partner disputed the adjustment. The case was heard by the Taxation Review Authority ('TRA') in its small claims jurisdiction.

## **B The findings of the Taxation Review Authority**

### **1 The small claims jurisdiction of the TRA**

A TRA is a one member authority<sup>60</sup> that sits as a judicial authority for hearing and determining objections and challenges to assessments of tax, and to other decisions or determinations of the Commissioner, and is governed by the *Taxation Review Authorities Act 1994* (NZ). Prior to 29 August 2011, every TRA had two levels of jurisdiction — general and small claims.<sup>61</sup> A major difference between the two jurisdictions is that, unlike the TRA's general jurisdiction, findings of the small claims jurisdiction have no precedential effect,<sup>62</sup> other than for the affected taxpayer.<sup>63</sup> The decision of Judge Barber therefore technically has no precedential value, which is disappointing given the lack of judicial authority in this area. However, due to the paucity of case law on the matter, the case will effectively act as de facto precedent, especially as the reasoning and approach

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<sup>59</sup> There was suggestion in the case that in fact the work took only seven weeks and the engineers billed for the work over a four month period: *ibid* 12 326.

<sup>60</sup> *Taxation Review Authorities Act 1994* (NZ) s 3.

<sup>61</sup> A taxpayer's right to elect for their dispute to be heard in the small claims jurisdiction was removed with effect from 29 August 2011. Taxpayers could elect to have a tax dispute heard in the small claims jurisdiction where: the facts were clear and not in dispute, there were no 'significant legal issues' involved and the tax to pay did not exceed NZ\$30 000: *Tax Administration Act 1994* (NZ) s 13B(1) (now repealed). Somewhat curiously, and despite observing the small claims jurisdiction 'seems inappropriate' because the case involved significant legal issues for the taxpayer, Judge Barber agreed to deal with *TRA Case X26* under the small claims jurisdiction — rather than transferring it to the TRA's general jurisdiction: *TRA Case X26* (2006) 22 NZTC 12 315, 12 316. It is also of some note that the Inland Revenue apparently did not seek to have the case transferred to either the general jurisdiction of the TRA or the High Court.

<sup>62</sup> *Taxation Review Authorities Regulations 1998* (NZ) reg 18(5).

<sup>63</sup> *Taxation Review Authorities Regulations 1998* (NZ) reg 18(6).

adopted by the TRA in *TRA Case X26* clearly follows (and applies) *Colonial Motors (CA)*, which in turn applies principles established in leading capital–revenue cases. In addition, Judge Barber in *TRA Case X26* considered a number of arguments which were not raised in *Colonial Motors (CA)*. For these reasons I would expect that taxpayers and Inland Revenue will use relevant aspects of *TRA Case X26*, along with *Colonial Motors (CA)*, to support their respective positions with regards the tax treatment of seismic strengthening expenses, both in the pre-litigation (dispute resolution) phase and litigation phase itself.

This expectation concerning *TRA Case X26* is supported by the view of the Inland Revenue. IS 12/03 acknowledges that as the case was decided under the TRA's small claims jurisdiction it is therefore 'of *limited precedential value* given the level of jurisdiction' (emphasis added).<sup>64</sup> However, the statement adds that Inland Revenue 'considers the correct approach to the application of the capital/revenue tests was adopted in this decision.'<sup>65</sup>

## 2 *Expenditure on capital account*

At the commencement of his judgment, Judge Barber stated that the expenditure undertaken on the building was clearly on capital account.<sup>66</sup> It was undertaken to create advantages of a lasting character which improved an identifiable asset (the building) as part of the partnership's income-earning structure (as distinct from its income-earning process). Applying the *Hallstroms* test, Judge Barber stated that, from a practical and business point of view, the project was intended to make a major alteration to the structural integrity of the building so that it would meet the relevant statutory requirements:

Prior to the project the building, according to the disputant's own engineer: 'has a capacity less than 50% of the 1965 code ... and that the building may collapse in a moderate earthquake ...' The project was 'to achieve full compliance ... in terms of applied loadings'. ... Accordingly, the project did not merely maintain or repair the property but substantially improved it: going from less than 50 per cent earthquake strength compliance to full compliance. The end result was a substantially improved property.<sup>67</sup>

If the strengthening work had not been undertaken and the building had been barricaded by the WCC, it would have effectively become useless and taken away the partnership's income earning structure:

There was work undertaken to improve the building's earning-capacity by making it earthquake code-compliant and thus avoiding the sterilisation of the asset. While the work in this case was to make the building earthquake-code compliant, it ensured the continued

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<sup>64</sup> Inland Revenue, IS 12/03, above n 11, 83 [109]. In my view it would have been preferable had the statement referred to *TRA Case X26* as being persuasive.

<sup>65</sup> *Ibid.*

<sup>66</sup> *TRA Case X26* (2006) 22 NZTC 12 315, 12 319.

<sup>67</sup> *Ibid* 12 320 (emphasis in original).



availability of the asset as part of the income-earning structure of the taxpayer's partnership.<sup>68</sup>

Judge Barber followed *Colonial Motors (CA)* even though 'in the present case the work undertaken was not as extensive as that' undertaken in *Colonial Motors (CA)*.<sup>69</sup> In both cases, *Colonial Motors (CA)* and that before him, from a practical and business point of view, the total work undertaken transformed an unsound building with a limited or possibly non-existent revenue generating capacity into a sound building capable of earning income. The finding that the expenditure was on capital account was supported by the total cost of the strengthening work as a proportion of the valuation of the property, and evidence that the work increased the capital value of the building.

Judge Barber rejected arguments that the costs were incurred to undertake deferred repairs and maintenance, which were no more than accumulated repairs and thus of a revenue nature. Unlike *Odeon Associated Theatres Ltd v Jones* [1972] All ER 681 (*Odeon Theatres*) there were no restrictions preventing normal repair and maintenance from occurring. In addition, the effect of the strengthening in *TRA Case X26* was not merely to maintain the building, but also to improve its structure dramatically, and hence, unlike the work in *Odeon Theatres*, it was not repair work.

Judge Barber also distinguished the High Court decision of *Sherlaw v CIR* (1994) 16 NZTC 11 290, 11 291 (*Sherlaw*), where the owner of a boat-shed sought to repair its slipway, floor, and piles.<sup>70</sup> Having commenced this work, some of the repairs became a much larger undertaking than anticipated (including replacing a substantial part of the roof),<sup>71</sup> and it was decided to do other deferred maintenance. In *Sherlaw*, the work did not change the dimensions of the building. The work carried out was held to be on revenue account, although in my view the case sat right on the capital-revenue border. Judge Barber noted that the decisive factor in *Sherlaw* was that, unlike *TRA Case X26*, the work undertaken was not a consequence of a single pre-determined plan to improve the asset; rather, the taxpayer had chosen to repair the boat-shed and, as a result of that decision, he was faced with consequential repair work and upgrading.

Finally, Judge Barber observed that the fact that the strengthening work undertaken by the taxpayer was a statutory requirement was irrelevant to determining the character of the expenditure.

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<sup>68</sup> Ibid.

<sup>69</sup> Ibid 12 323.

<sup>70</sup> The case bears some similarity to the Australian case *Lindsay v FCT* (1961) CLR 307, where the taxpayer was denied a deduction due to the extensive nature of the work undertaken. The case concerned a taxpayer who was a member of a partnership that carried on the business of ship repairing in premises that included two slipways. One of the slipways, which was constructed mainly of timber, was replaced with concrete because timber was unavailable. The resultant slipway was longer than the original one although this did not result in greater efficiency. During the course of the work, substantially the whole of the slipway had been demolished and replaced. As a consequence, the High Court of Australia held the work constituted the replacement of the slipway, which was an entirety in its own right and not a subsidiary part of some other asset.

<sup>71</sup> The repiling work caused the roof and the floor of the boat-shed to be substantially damaged; hence the work required on those components of the building.

## VI THE INLAND REVENUE INTERPRETATION STATEMENT

### *A General overview*

Inland Revenue Interpretation statement IS 12/03 deals with the deduction of costs incurred by a taxpayer to repair or maintain their property. It contains a useful flowchart that helpfully summarises Inland Revenue's process of analysis with respect to the capital limitation,<sup>72</sup> and includes references to seismic strengthening work (along with one specific, worked example) and discussion of *Colonial Motors (CA)* and *TRA Case X26*. One of the reasons specified for issuing the new interpretation statement (replacing a five page 1994 statement) was the Christchurch earthquakes.<sup>73</sup>

There is no specific section of the interpretation statement dedicated to such expenditure. Initially this is perhaps a little surprising given that it is published after the 2010 and 2011 Christchurch earthquakes and at a time when there is a heightened awareness nationally of building safety issues. However, the interpretation statement makes it clear that:

The nature of the expenditure does not change if the repairs are carried out as a result of a significant event, for example fire, flood or earthquake. The same principles must be applied to repairs arising as a result of a significant event as are applied to repairs arising for other reasons (*TRA Case F67*).<sup>74</sup> *The focus is on the work done.*<sup>75</sup> (Emphasis added.)

Inland Revenue's view is therefore that the income tax treatment of seismic strengthening work (and expenditure) requires an application of general case law principles. While this is correct, given the scale of strengthening work required to New Zealand buildings in the future, and the significant cost of that work in many cases, greater certainty over the location of the capital-revenue boundary line — perhaps through a series of worked examples in IS 12/03 on the point — would have been useful.

Example 17 in IS 12/03 does consider earthquake strengthening work. No case law is mentioned in this example, nor any of the other examples outlined in the statement. The example,<sup>76</sup> which is arguably broadly based on *Colonial Motors (CA)*, concerns an older commercial building which requires earthquake strengthening work to comply with council requirements for buildings of that type. The building owner 'decides that the building would benefit from a complete refurbishment, including structural changes that will extend the floor plan and enhance the common areas as well as earthquake-

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<sup>72</sup> Inland Revenue, IS 12/03, above n 11, 71 [35].

<sup>73</sup> Ibid 71 [28]. Other reasons included new case law, such as *Auckland Gas (PC)*, and the change to building depreciation: ibid 71 [28].

<sup>74</sup> In *TRA Case F67* (1983) 6 NZTC 59 897, the taxpayers carried on business as hotel proprietors. Part of the hotel's business included owning and renting a two-storeyed building adjoining the hotel. Significant repair work was carried out after extensive damage was caused by fire on this building. The taxpayers claimed a deduction against their income for the portion of the repairs that insurance did not cover. Judge Barber disallowed the deduction on the basis that, due to the extent of the work undertaken, it was capital expenditure. See also Inland Revenue, ibid 71 [81]–[83].

<sup>75</sup> Ibid 70 [27], 100 [219].

<sup>76</sup> Ibid 104 [232].

strengthen the building.<sup>77</sup> As one would expect, based on *Colonial Motors (CA)*, Inland Revenue concludes that all the expenditure incurred is capital expenditure as it forms part of a single overall project to significantly change the character of the building.

In addition, there are three examples that may provide taxpayers with more general guidance in respect of earthquake-related expenditure on buildings. In Example 21,<sup>78</sup> concerning dilapidated assets, the taxpayers acquired a property at a discounted rate because of earthquake damage. The expenditure is on capital account on the basis that the costs relate to getting the property to a tenable state and therefore form part of the acquisition costs of that asset.

Example 22<sup>79</sup> relates to a commercial property that was damaged in an earthquake. Over time, and prior to the earthquake, the property had become dilapidated, so when the earthquake occurred the roof of the property was in a poor state and other repairs were required. Inland Revenue concludes that the expenditure undertaken by the owners is for accumulated repairs and revenue in nature. The work done brings the building back to the standard it was when the taxpayers acquired it.<sup>80</sup>

The third example, Example 23,<sup>81</sup> concerns a residential rental property that was significantly damaged in an earthquake. In order to bring the property back into a tenable state, the owners undertake extensive work including replacing the property's severely damaged foundations and rebuilding three of the property's collapsed external walls. On the basis of the extent of the work undertaken, Inland Revenue concludes the expenditure is on capital account as it 'results in the reconstruction, replacement or renewal of the asset, or substantially the whole of the asset'.<sup>82</sup>

There are other examples in IS 12/03 which, while not specifically addressing earthquake-related work, may also provide some assistance to building owners undertaking work on their buildings.<sup>83</sup>

IS 12/03 acknowledges that 'where there is one overall capital project involving a group of assets, the nature of the expenditure on any repair work done on those assets is taken from the character of that one overall project, and the repair work is not looked at in isolation.'<sup>84</sup>

It is disappointing that the examples in IS 12/03, particularly, Example 17 (and also Example 23), add little to the decided cases, essentially describing extensive

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<sup>77</sup> Ibid.

<sup>78</sup> Ibid.

<sup>79</sup> Ibid.

<sup>80</sup> Ibid.

<sup>81</sup> Ibid.

<sup>82</sup> Ibid.

<sup>83</sup> Example 18 includes repair of an uneven floor due to subsidence: *ibid* 103 [232]. Example 14 considers major repairs to a leaky building, including removal and replacement of all external cladding and replacement of large sections of the building's timber framing: *ibid* 94 [175].

<sup>84</sup> *Ibid* 98 [200], 102 [232]. This view is based on a number of cases including *Colonial Motors (CA)*, *TRA Case X26*, and *Hawkes Bay Power Distribution Ltd v CIR* (1998) 18 NZTC 13 685.

undertakings where realistically there would be no issue as to the characterisation of the expenditures.<sup>85</sup> In its submission on what is now Example 17, NZICA argued for 'another example on earthquake strengthening where the work was not as extensive.'<sup>86</sup> Unfortunately for taxpayers, that call went unheeded.

The approach adopted by Inland Revenue of providing only one specific example of seismic strengthening (which closely follows existing case law), and ensuring other examples of earthquake-related building work are generally far from the capital-revenue boundary, may reflect the view that all seismic expenditure is capital and not deductible based on *TRA Case X26* and *Colonial Motors (CA)*. Alternatively, it may simply be an acknowledgement that the capital-revenue boundary in this context is unclear and, in Inland Revenue's view, further guidance is not possible at this stage.

## VII DISCUSSION: TO DEDUCT OR NOT TO DEDUCT, THAT IS THE QUESTION

### *A Introduction*

Determining whether expenditure is on capital or revenue account is essentially a factual enquiry. As such, there will always be scenarios coming before Inland Revenue, taxpayers (and their advisers), and ultimately the courts, with fine (and not so fine) factual differences from the decided authorities. As a consequence, it is not possible to state categorically in advance what the tax treatment of certain expenditure will be for a given specific scenario. However, irrespective of the type of expenditure, the aim should be to ensure that taxpayers, their advisers, and the revenue authority have clear guidelines and principles to work to in order for there to be as much certainty as possible.

Turning to the question of whether or not seismic strengthening costs can be deducted, on first blush, the likely answer to this question is 'no'. The two cases that have considered the seismic strengthening work have both concluded that such work is on capital account. A reading of IS 12/03, including the one specific example which is an application of *Colonial Motors (CA)*, reinforces this conclusion. In addition, if 'minor' strengthening work may in fact fall on the revenue side of the capital-revenue divide, *Colonial Motors (CA)* and *TRA Case X26* provide little, if any, assistance in discerning where such a divide exists. Unfortunately, the interpretation statement is also essentially silent on this issue.

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<sup>85</sup> It is interesting to observe that Inland Revenue, in both Examples 22 and 23, has modified the respective facts, compared with the equivalent examples in the exposure draft, to move the examples further from the capital-revenue divide, thereby reducing their utility. Thus, in Example 22, which illustrates repairs, the roof is now simply repaired rather than replaced (as in the exposure draft). Similarly, in Example 23, which illustrates reconstruction work, two collapsed external walls have now become three such walls, requiring rebuilding; in addition, now the floors of the rental property also require reconstruction.

<sup>86</sup> NZICA, *Income tax — Deductibility of Repairs and Maintenance expenditure — General principles*, 23 May 2012, 5. PWC describes many of the examples in the interpretation statement as 'either too extreme to be helpful or [they] do not contain sufficient information to support the Commissioner's view as to how the expenditure should be treated.': PWC, 'Repairs and maintenance – the Commissioner's view on the capital/revenue distinction' (2012) 4 *Tax Tips* 3.

Whether seismic strengthening costs are deductible depends on, first, identifying the relevant asset that is being repaired or worked on; and second, considering the nature and scale of the work undertaken to that asset, and whether, inter alia, the expenditure has changed the character of the asset. Where the seismic strengthening relates to a building, determining the asset will usually not be in dispute; the asset will be the building itself. The pessimism (at least from the taxpayer's perspective) expressed in the foregoing paragraph with respect to the deductibility of strengthening expenditure is essentially as a result of the application of the second step. As a general proposition, it is likely that due to the nature and extent of much strengthening work, the work will be on capital account, ie it will be reconstructive rather than remedial. This is the hurdle facing building owners. The expenditure will often result in a better asset than previously existed, normally a seismically strengthened building with an extended life expectancy (and potentially increased rental potential). By ensuring the continued availability of the asset as an income-producing structure, the work creates an advantage of a lasting character.

Against this somewhat negative background, the following paragraphs discuss the tax treatment of earthquake strengthening expenditure in different scenarios based on the existing case law and IS 12/03.

### ***B Strengthening an 'unsound' building***

The first scenario considers the income tax treatment of strengthening work undertaken on a building that is 'unsound'. In this case the subject building does not comply with the minimum Building Code standard and may, for example, not be safe to occupy or be under (possible) threat of closure or of being barricaded in the future. It is clear from the decisions in *Colonial Motors (CA)* and *TRA Case X26* that this expenditure will be on capital account. From a practical and business perspective, the work undertaken to make the building code compliant will transform it from an unsound (non-compliant) building with potentially a limited rental life into a compliant, sound building capable of being able to generate a future income stream. The expenditure creates an advantage of a lasting character and will prevent the potential sterilisation of the asset. It is likely that such work will result in a reconstruction, replacement, or renewal of substantially the whole of the asset.

The key to this determination is not that the building owner is compelled — perhaps on threat of a demolition order if work is not undertaken — to carry out the work. This is made clear in *TRA Case X26* where Judge Barber rejected the taxpayer's submission, based on the Canadian case of *Marklib Investments LL-A Ltd v R* (1999) 1 CTC 2 413,<sup>87</sup> that the need to comply with statutory or regulatory requirements in fact made the expense one of revenue. He observed that the issue of the income tax treatment of an expense 'is always the character of the particular expenditure.'<sup>88</sup> However, the

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<sup>87</sup> In this case, the taxpayers were required by the local municipal authorities to undertake substantial work otherwise they would be subject to penalties including fines and rent freezes. The expenditure was considered to be on revenue account.

<sup>88</sup> *TRA Case X26* (2006) 22 NZTC 12 315, 12 323.

compulsion is an indicator both of the present (unsound) state of the building and the effect on the asset of any subsequent strengthening work.

Similarly, in *TRA Case X26* Judge Barber acknowledged that the possible barricading of the building in question had the work not been undertaken offered 'a *strong indicator* that the work was to protect a part of the income earning structure'.<sup>89</sup> This view is, however, not conclusive; indeed, he also observed that 'there could be a situation where a building was threatened with closure due to lack of repairs and maintenance. That threat would not convert the cost of remedial work into capital expenditure'.<sup>90</sup>

This discussion assumes that any such strengthening work undertaken on an 'unsound' building is by its very nature a major undertaking. In the unlikely event that only minor work is required to bring a non-compliant building up to code, in my view, such expenditure would be on capital account as it has still changed the building's character, transforming it from an unsound into a sound building.

### ***C Major strengthening of a 'sound' building***

A taxpayer may own a building which is sound, for example it currently complies with minimum Building Code standards and is not under threat of being barricaded. The continued occupation of the building is therefore not an issue. In this scenario, the owner may decide to strengthen the building (to a higher percentage of the building code) perhaps to attract or retain tenants. Alternatively, the owner may be required by its insurer to strengthen the building. The work undertaken by the owner may range from minor work to more extensive work.

The tax treatment of such strengthening work will again require a consideration of the nature and scale of the work undertaken. In *W Thomas & Co*, Windeyer J (cited in *Auckland Gas (PC)*) stated that a repair 'involves a restoration of a thing to the condition it formerly had *without* changing its character'.<sup>91</sup> Unlike the first scenario, above, in this case the character of the building is not transformed from an *unsound* to a *sound* building. However, where the work is extensive ('major') and results in a seismically strengthened building with an extended life expectancy (as well as potentially resulting in higher rentals and occupancy and reduced insurance premiums), the work will go beyond repairs and (minor) alterations, and will be on capital account. As a result of the expenditure, substantially the whole of the asset may have been reconstructed, renewed, or replaced.

This discussion raises an important issue. In the context of major seismic strengthening expenditure, a consideration of the nature and extent of seismic strengthening expenditure will include determining whether there has been the reconstruction, replacement, or renewal of *substantially the whole* of the asset. IS 12/03 provides no

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<sup>89</sup> Ibid 12 321 (emphasis added).

<sup>90</sup> Ibid 12 320.

<sup>91</sup> *W Thomas & Co* [1965] 115 CLR 58, 72 (emphasis added).

guidance on how the highlighted phrase is to be interpreted.<sup>92</sup> PWC suggests, based on a variety of authority, that the highlighted term means:

- not necessarily the whole, but as far as reasonably possible, the whole
- nearly all, only slightly less than all
- something less than a significant or substantial proportion
- all of the key components
- more than 75%.<sup>93</sup>

These suggested interpretations of the term ‘substantially the whole’ indicate that a high threshold is required before, in the case of a building for example, work undertaken will affect ‘substantially the whole of the asset.’ This high threshold may work in the taxpayer’s favour.

### ***D Minor strengthening of a ‘sound’ building***

#### *1 Introduction*

It is clear from the preceding analysis that much seismic strengthening work will not be deductible either because it transforms an ‘unsound’ building into a ‘sound’ building or because the extent of the work means substantially the whole of the asset has been reconstructed or renewed. This raises the question whether there may be arguments that smaller scale (‘minor’) strengthening work on a ‘sound’ building is deductible as repairs or minor alterations. After a general discussion of this issue in the following paragraphs, this section of the article considers specific factors which are indicators of the nature and extent of work undertaken on an asset and which may, depending on the specific facts, assist a taxpayer considering deducting seismic strengthening costs.

#### *2 General discussion*

In its submission on the exposure draft, NZICA gives the example of a building that requires strengthening to meet a change in the building code; however, the building is not ‘unsound’ and can be occupied. NZICA suggests: ‘Where there has been a change to building regulation such that some strengthening work is now required, we do not see this as necessarily being capital in nature if the work is minor only.’<sup>94</sup> The issue is what will constitute ‘minor’ work in this context? Would the addition of a steel beam ‘here or there’, the ‘odd column or two’, or a ‘bit of bracing’, be deductible repair work (assuming for example that the building remains the same size and layout)?

Neither *Colonial Motors (CA)* nor *TRA Case X26* consider this issue. In addition, due to the factual nature of the capital–revenue determination, care needs to be taken when arguing by analogy from other cases. The English case *Conn v Robins Bros Ltd* [1966] 43

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<sup>92</sup> With reference to the word ‘substantial’, Judge Barber observed that the relevant property had been substantially improved as it had gone ‘from less than 50% earthquake strength compliance to full compliance’: *TRA Case X26* (2006) 22 NZTC 12 315, 12 320.

<sup>93</sup> PWC, above n 86, 4.

<sup>94</sup> NZICA, above n 86, 5.

TC 266 (*Robins Bros*) is an example of the proposition that structural work can be deductible, albeit in *Robins Bros* the work undertaken was not necessarily of the nature and scale of that evident in the two cases considered in this article. In *Robins Bros*, extensive alterations were made to a building, parts of which were 200 and 400 years old, including replacing the slate roof with corrugated asbestos, removing walls, and inserting steel girders to the upper storeys. No additional space was created. Despite the substantial work undertaken on the building, the expenditure was on revenue account. In *Robins Bros* Buckley J stated:

unless something had been done, the state of the property would have become so decrepit that it would have been impossible for the company to continue to carry on its business there ... the fact that there were alterations in the structural details of the building does not seem to me to be a good ground for proceeding upon the basis that the work produced something new [and on capital account].<sup>95</sup>

The taxpayers in *Colonial Motors (CA)* and *TRA Case X26* did not argue *Robins Bros* in support of their position, possibly on the basis that they believed the very unique facts in that case — a building which in part was 400 years old — distinguished it from the situations before them.<sup>96</sup> Inland Revenue in IS 12/03 also suggests that, on the basis of *Auckland Gas (PC)*:

if similar facts as in *Robins Bros* arose under the [*Income Tax Act 2007 (NZ)*], the expenditure would be found to be capital in nature on the basis that the character of the building had changed, or the work amounted to a reconstruction, replacement or renewal of substantially the whole of the asset, or both.<sup>97</sup>

*Sherlaw* may provide some support for building owners who, as a consequence of undertaking repair work, find seismic strengthening work is also required. In *Sherlaw*, the scheduled repair work had a flow-on effect of damaging the roof and floor of the boat shed, requiring their repair. What is interesting in this case is that overall the repairs were extensive, and critical to the boat-shed's continued use,<sup>98</sup> and yet the New Zealand High Court still held that the expenditure was deductible. Of crucial importance

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<sup>95</sup> *Robins Bros Ltd* [1966] 43 TC 266, 274.

<sup>96</sup> It is essentially this basis (that the Court took a long term view of maintaining/repairing a 400 year old building) that Inland Revenue suggests enables the case to be reconciled with *FCT v Western Suburbs Cinemas Ltd* [1952] 86 CLR 102 (*'Western Suburbs'*), where the taxpayer unsuccessfully claimed a deduction for the replacement of a damaged ceiling with a new ceiling because it was impractical to repair: Inland Revenue, IS 12/03, above n 11, 87-88 [138]-[142]. The work undertaken in *Western Suburbs* was capital expenditure as the ceiling was replaced with one of more modern materials and had considerable advantages over the old ceiling: *ibid* 87 [138]. Inland Revenue observes that where, as in these two cases, major components of an asset are replaced rather than repaired, a judgement has to be made as to the nature of the work undertaken to the asset: *ibid* 88 [140]. According to Inland Revenue, the work undertaken in *Western Suburbs* improved the building while in *Robins Bros* the work was a natural part of the repair process and no improvement in the building was sought: *ibid* 88 [141]. In addition, in *Robins Bros* the 'building remained the same size and in the same location, and the court considered that the work did no more than maintain the building's inherent utility': *ibid*.

<sup>97</sup> *Ibid* 88 [142].

<sup>98</sup> Doogue J stated: 'I am satisfied beyond doubt that this work was entertained solely to ensure the survival of the boat-shed and its ability to be used by the taxpayer for the purposes for which he was then using it.': *Sherlaw* (1994) 16 NZTC 11 290, 11 291.



to the High Court's finding was the manner in which the work was undertaken. Inland Revenue observes:

[The case] highlights a situation where repairs are undertaken and those repairs have a flow-on effect, causing further repairs to be required. *The repairs when looked at as a totality might be extensive.* However, they were *not undertaken as a single overall plan* to improve the building or to replace or renew an asset.<sup>99</sup>

Had the work in *Sherlaw* instead been undertaken as part of one overall project, given the extensive nature of the work in combination, it seems likely that it might well have been on capital account. It may therefore be arguable that if additional, unscheduled 'minor' strengthening work is required on a sound building as a consequence of repair work, provided the building is not transformed, the entire expenditure may be deductible, even though had the work been undertaken as one pre-planned project it would have been on capital account.

A comment by the Privy Council (obiter) in *Auckland Gas* (PC) may also provide some limited support for the deduction of some earthquake strengthening work. Lord Nicholls commented with respect to the characterisation of work as repairs or replacement:

*Demolition and rebuilding of a dangerous flank wall of a house would normally be regarded as repairing the house.* The answer might not be so obvious if an entire derelict wing of a large house was demolished and rebuilt, especially if the new construction was substantially different from the original. Questions of degree may arise in such cases.<sup>100</sup> (Emphasis added.)

It is clear that if there is a programme to do seismic strengthening work on an asset, simply staggering or spreading the work over a number of years will have no impact of the characterisation of the expenditure. The taxpayer in *TRA Case X26* argued that she could have spread the work out over a period of years and charged it to repairs, but for the sake of the tenants in the buildings, she decided to complete the strengthening project as a whole. Judge Barber stated that he could only deal with facts as they were presented, but if the taxpayer had so proceeded, the character of the expenditure year by year would still have been of a capital nature. This approach is consistent with other cases, including *Auckland Gas* (PC), where Lord Nicholls in the Privy Council stated that the fact that the replacement work in that case was spread over a number of years did not change their Lordships finding (that the expenditure was of a capital nature).<sup>101</sup> Lord Nicholls also observed that 'the speed or slowness with which the work was carried out cannot affect its nature or, hence, its proper characterisation'.<sup>102</sup>

### 3 *The cost of the work undertaken*

The cost of the work done compared with the value of the asset can be an indicator of the nature and extent of the work undertaken. For example, if the cost of the work as a

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<sup>99</sup> Inland Revenue, IS 12/03, above n 11, 97 [192] (emphasis added).

<sup>100</sup> *Auckland Gas (PC)* (2000) 19 NZTC 15 702, 15 706.

<sup>101</sup> *Ibid* 15 708.

<sup>102</sup> *Ibid*.

percentage of the pre-improved value of the building is small, this may indicate the work undertaken is not major. The issue is what is 'small' relative to the value? In *TRA Case X26*, the total cost of the project was 9.9 per cent.<sup>103</sup> Judge Barber indicated that when the project's scope and expense were considered the expenditure was on capital account.<sup>104</sup> On a reading of the case it appears that the key determinant in this conclusion was the actual extent of the work undertaken and not the expense.

In my view, it is arguable that if the project work was less extensive, perhaps on the capital–revenue boundary, of itself this level of expense (as a percentage of the project) would not have made the expense on capital account. In fact, in a hypothetical example, PWC suggests that where work is undertaken on a house (to the walls, floor, and two external walls) costing NZ\$185 000 or 53 per cent of the value of the house, while the cost is significant, it 'doesn't suggest that substantially the whole house has been rebuilt.'<sup>105</sup> Indeed, in *Sherlaw* the cost of the repair work was NZ\$34 449, ie it exceeded the value of the property before the work was commenced (NZ\$22 000). However, this factor needs to be applied with caution: 'Sometimes the cost of repair work can be very high, for example, if the replacement parts are expensive or the repair work is difficult.'<sup>106</sup> As illustrated by the finding in *Auckland Gas*, where the cheaper replacement option was chosen, it may be more expensive to repair an asset than to replace it 'but the saving does not change the character of the work done from being capital.'<sup>107</sup>

#### 4 *Recurring expenditure?*

In *TRA Case X26* Judge Barber made it clear that the fact that, in the future, the regulatory authority might require further work to be undertaken on the building did not mean that the current work lacked an enduring benefit. Rather, when 'the words "permanent" or "enduring" are used in this connection it is not meant that the advantage which will be obtained will last forever: *Sun Newspapers Ltd and Associated Newspapers Ltd v FC of T* (1938) 61 CLR 337, at p 355 per Latham CJ.'<sup>108</sup> Judge Barber also stated: 'Earthquake strengthening is not necessarily an ongoing process as, hopefully, buildings are now built to more than comply with current standards of compliance.'<sup>109</sup>

In my view, Judge Barber downplayed the taxpayer's submission that earthquake strengthening may be an ongoing process (at least for older buildings) as building standards continue to be updated. Evidence was presented in the case that the WCC's

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<sup>103</sup> *TRA Case X26* (2006) 22 NZTC 12 315, 12 320.

<sup>104</sup> *Ibid.*

<sup>105</sup> PWC, *Facts on Tax 2012 Suggested Solutions Winter Series* (2012), 56 (Question 15).

<sup>106</sup> Inland Revenue, IS 12/03, above n 11, 91 [172]. See *Poverty Bay Electric Power Board v CIR* (1999) 19 NZTC 15 001, 15 008 (*Poverty Bay Electric*).

<sup>107</sup> Inland Revenue, IS 12/03, above n 11, 91 [172]. In this case the option adopted by the taxpayer to repair the gas reticulation network — the insertion of polyethelene piping inside the existing cast iron and steel pipes — was chosen in part because it was less expensive than the alternative of repairing the leaking joints and replacing those parts that were corroded. The irony was that, had the taxpayer adopted the second but more expensive alternative, its costs would instead have been deductible as repairs — a point noted by the Privy Council: *Auckland Gas* (PC) (2000) 19 NZTC 15 702, 15 707.

<sup>108</sup> *TRA Case X26* (2006) 22 NZTC 12 315, 12 324.

<sup>109</sup> *Ibid.*

standards for seismic strengthening had changed four times in a 14 year period.<sup>110</sup> It is reasonable to assume that the building code will be subject to greater scrutiny (and amendment) in the coming years as a result of various reviews by DBH, the Royal Commission and ongoing seismic research. This raises the question, 'if as a result of continual changes to the code, a building owner regularly undertakes 'minor' seismic strengthening work on their building, at what point could it be argued the work is regular and recurring (and deductible)?

PWC, with respect to a hypothetical example of the refurbishment of fuel pumps every 10 years, observes that: 'the degree of recurrence depends on the asset in question. When looking at whether the expenditure is recurrent the nature and life of the asset needs to be considered. In this case the pumps have a reasonably long life and the expenditure is recurrent, albeit at long intervals.'<sup>111</sup>

In *BP Australia*, the Privy Council considered what length of trade-tie agreement would point to recurrent revenue expenditure (on the basis at the end of the specific period BP Australia would renew the trade-tie). Their Lordships commented:

Had the agreements been only for two or three year periods that fact would have pointed to recurrent revenue expenditure. Had they been for 20 years, that fact would have pointed to a non-recurring payment of a capital nature. Length of time, though theoretically not a deciding factor, does in practice shed a light on the nature of the advantage sought. The longer the duration of the agreements, the greater the indication that a structural solution was being sought.<sup>112</sup>

While the trade-tie periods varied between 3 and fifteen years, the predominant number of agreements was for a 5 year period. Their Lordships found this length of time 'to be neutral, and in itself indicates neither capital expenditure nor revenue by its mere length. It therefore does not add effectively to the argument either way.'<sup>113</sup> There may be a weak argument, based on *BP Australia*, that earthquake strengthening expenditure incurred regularly (less than 5 years) is deductible whereas expenditure incurred on a longer frequency is capital. I acknowledge that this is a very tentative proposition and, given the context of the statement in *BP Australia*, may not be applicable to such a different factual scenario. It also arguable, given the nature of this work, that strengthening is unlikely to occur at such frequent intervals.

## 5 *Duration of the undertaking and dislocation*

The taxpayer in *TRA Case X26* supported its contention that the work was not a major project by pointing to the fact that the work was only spread out over seven weeks to spread disruption to the tenants, the building remained operational during the work, and the rents continued to come in.<sup>114</sup> Judge Barber acknowledged these to be relevant

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<sup>110</sup> Ibid 12 325.

<sup>111</sup> PWC, above n 105, 54. It would appear in the PWC example the useful life of the particular fuel pumps is at least 30 years.

<sup>112</sup> *BP Australia* [1966] AC 224, 267.

<sup>113</sup> Ibid.

<sup>114</sup> *TRA Case X26* (2006) 22 NZTC 12 315, 12 325.

factors;<sup>115</sup> however, in his view the overall nature and extent of the work before him outweighed these factors.

#### 6 *The impact on the capital value of the asset*

The effect of the work on the value of the property is another indicator of character of the expenditure. The evidence in *Colonial Motors (CA)* and *TRA Case X26* was that the work undertaken increased the value of the building — substantially in the former case. Judge Barber observed that there would be an immediate threat of loss of the income from the property, as an income-earning structure, if it were to be barricaded by the WCC, which could reduce the value of the property. It could therefore be argued that if seismic strengthening work has a negligible impact on the value of the building once the work is completed, this indicates the work undertaken is not reconstructive but remedial and deductible.

However, focussing on the post-improved value of a building is not necessarily a reliable indicator for the reason that repair work (as is also the case with reconstructive work) will often add value to the asset being repaired. It is to be expected that this will generally be the case even with 'minor' seismic strengthening work. Blanchard J in *Poverty Bay Electric* stated: 'It is worth observing that it is hard to see the adding of value as an essential element in capital expenditure when restoration or repair work usually adds value to the object which is restored or repaired.'<sup>116</sup> This position is supported by *TRA Case T43* (1998) 18 NZTC 8 287 which concerned repairs to a dilapidated wall, leaking roof, and rotten floorboards. The TRA concluded that the fact that the building may have a greater value as a result of the repairs did not convert the 'repairs' into an 'improvement'.

#### 7 *The useful life of the asset*

It may be that following seismic strengthening work (of a minor nature) the building's useful life is not extended, indicating that the expenditure is revenue in nature. However, again this may not be a reliable indicator. The Court of Appeal in *CIR v Auckland Gas Co Ltd* 19 NZTC 15 011, 15 024 observed that where the work done creates a new asset it is not essential that the life of the original asset be extended for the work undertaken to be capital in nature. Conversely, in that case, had the gas mains been repaired, the network's life would also have been extended, yet the work would still have been deductible.

#### 8 *The asset's functionality*

It is expected, unlike in *Colonial Motors (CA)* for example, that in many cases of seismic strengthening that the function of the building will remain the same, eg an office building will continue as such once strengthened. However, Lord Nicholls in *Auckland Gas (PC)* stated that a comparison of the functional position of an asset before and after

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<sup>115</sup> Ibid.

<sup>116</sup> *Poverty Bay Electric* (1999) 19 NZTC 15 001, 15 008.

work is done is not a reliable guide by itself as to whether the work undertaken is capital or revenue in nature.<sup>117</sup>

### 9 *The impact on the income earning capacity of the asset*

It could be argued that the fact that income earning capacity of the building remains the same after seismic strengthening work is undertaken demonstrates the building has not been improved. In *TRA Case X26*, the taxpayer argued that the expenditure did not increase the rentals the building was capable of generating (upon annual reviews), which showed that the expenditure did not improve the building. Judge Barber responded by observing that the expenditure was necessary to maintain the existing revenue stream and that, citing *Highland Railway Co v Balderston (Surveyor of Taxes)* (1889) 2 TC 485 (*Highland Railway*), 'an increase in revenue is not a necessary concurrent result of a capital expense which improves a capital asset'.<sup>118</sup>

While these factors discussed in this section may not be determinative, where the characterisation of minor expenditure to strengthen a building is finely balanced between capital or revenue expenditure, they may point to the work carried out on a building being repairs and therefore deductible.

### **E A recently acquired asset**

Where a taxpayer acquires a building that is in need of seismic strengthening — whether or not the building is 'sound' — based on existing case law,<sup>119</sup> it is likely that such subsequent strengthening expenditure will form part of the capital cost of acquiring the asset. However, there is an exception to this principle.<sup>120</sup> A deduction may be allowed for expenditure on repairs of a newly acquired asset if the purchase price of the asset was not affected by the state of disrepair and when the asset was acquired it could be used as intended despite its state of disrepair. It is unlikely this exception will apply to buildings requiring seismic strengthening, even if capable of continued occupation, as the purchase price will normally be reflective of the (possibly significant) work required.

### **F Mixed work and apportionment**

Inland Revenue's view, as outlined in section VI, is that repair work that is undertaken as part of a wider capital project will also be on capital account.<sup>121</sup> From a practical perspective, this interpretation is both disappointing for building owners and 'ignores

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<sup>117</sup> *Auckland Gas* (PC) (2000) 19 NZTC 15 702, 15 708.

<sup>118</sup> *TRA Case X26* (2006) 22 NZTC 12 315, 12 323. In *Highland Railway* the taxpayer incurred the expense of replacing steel rails with iron ones without deriving any extra revenue as a result. The expenditure was considered on capital account because the asset had been materially altered and improved.

<sup>119</sup> *Law Shipping Co Ltd v IRC* [1924] 12 TC 621 and *W Thomas & Co* [1965] 115 CLR 58: Inland Revenue, IS 12/03, above n 11, 99–100 [212]–[218].

<sup>120</sup> *Odeon Theatres* [1972] All ER 681.

<sup>121</sup> Inland Revenue, IS 12/03, above n 11, 98 [200], 102 [232].

commercial reality',<sup>122</sup> as many building owners, faced with having to undertake strengthening work, will take the opportunity to carry out (unrelated) repairs and maintenance.

PWC appear to take a broader view on this matter<sup>123</sup> — and on the Inland Revenue's position — stating:

We submitted [in respect of the exposure draft] that, if the taxpayer can clearly separate the work undertaken as part of a single overall project into capital and revenue expenditure, they should be able to treat it according to its capital or revenue nature. We are pleased to see that Inland Revenue has amended the final statement to allow scope to do this.<sup>124</sup>

NZICA was also critical of the Inland Revenue position in the exposure draft — that repair costs within a capital project cannot be separated out — observing in its submission that in *Colonial Motors (CA)*, which is cited by Inland Revenue as authority for this proposition, part of the project expenditure was treated as on revenue account and deductible.<sup>125</sup> In its submission NZICA concludes, on the basis, inter alia, of *Buckley & Young Ltd v CIR* (1978) 3 NZTC 61 271, that 'where a project is of an overall capital nature, it could still be possible to split out repair costs and treat them as deductible if there is sufficient evidence to do so.'<sup>126</sup>

An observation (obiter) by Judge Barber in *TRA Case X26* arguably also contradicts Inland Revenue's stated position on mixed work. In response to a submission by the taxpayer, Judge Barber acknowledged that had some of the alterations in that case been of a 'cosmetic' nature 'that amount [of expenditure] might be deductible as revenue depending on the precise character of that "cosmetic" alterations work'<sup>127</sup> (despite all being part of one project).<sup>128</sup>

In this respect, the position in Australia is also arguably more taxpayer friendly.<sup>129</sup> Australian Tax Office Taxation Ruling TR 97/23<sup>130</sup> permits taxpayers to distinguish and deduct genuine repairs even when they are undertaken as part of a larger capital project:

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<sup>122</sup> NZICA, above n 86, 7.

<sup>123</sup> PWC bases its view that repairs that are part of an capital project are deductible on statements such as Blanchard J in *Poverty Bay Electric* (1999) 19 NZTC 15 001, 15 008: 'an apportionment of an amount of expenditure is possible and appropriate — where a part of the money spent has been applied to work which is truly a repair and at the same time some upgrading of a capital nature has been done.': PWC, above n 105, 55. NZICA also cited this passage as support of this proposition: NZICA, above n 86, 6.

<sup>124</sup> PWC, above n 86, 3.

<sup>125</sup> NZICA, above n 86, 6. IS 12/03 considers this matter in more detail than the exposure draft, but the Inland Revenue view, as originally expressed in the exposure draft, remain. Inland Revenue, IS 12/03, above n 11, 98 [197]–[201].

<sup>126</sup> NZICA, above n 86, 7.

<sup>127</sup> *TRA Case X26* (2006) 22 NZTC 12 315, 12 325.

<sup>128</sup> As no evidence was presented to the TRA on this point, Judge Barber reserved leave for the taxpayer to apply in that respect.

<sup>129</sup> Keating, above n 8, 314.

<sup>130</sup> Australian Tax Office, *Income Tax: Deductions for Repairs*, TR 97/23, 3 December 1997, 13–14 [55].

The character of a repair does not necessarily change because it is carried out at the same time as an improvement. If, for example, a shopping centre is extensively renovated or restored (the project combining repairs and improvements) and if some parts of the project can be effectively separated and considered in isolation from the rest of the project, they may still be repairs. It is necessary to examine separately the individual parts of the total project to determine whether any part, if considered in isolation, is a repair. It is not appropriate to have regard only to the result of the entire work done. It is inappropriate to regard the whole project as an affair of capital. In other words, if individual parts of the total project can be separated and characterised as repairs, and if their cost can be segregated and accurately quantified, their cost is deductible.<sup>131</sup>

However, TR 97/23 does qualify this statement, noting:

If however, repair work is inextricably bound up with work of an improvement nature, and the repair work cannot be separately segregated and its cost accurately quantified independently from the cost of the improvements, [the Australian Tax Office] regard the cost of the entire work as being of a capital nature.<sup>132</sup>

In my view this issue requires further judicial clarification in New Zealand.

The interpretation statement does accept that apportionment may be appropriate where 'it can be demonstrated that the [repair] work done is not part of that [overall] project'.<sup>133</sup> In the context of a capital project, this will mean that it is crucial that, where additional work of a repair nature is undertaken, the taxpayer can demonstrate 'from a practical and business point of view'<sup>134</sup> that the claimed repair work is *not* part of the overall project to change the character of the property.<sup>135</sup> In its submission on the exposure draft, NZICA stated that it believed 'taxpayers ... need specific guidance as to what would constitute a "project"'.<sup>136</sup> They questioned whether the test would be one of timing: 'If repair work is done at the same time as capital work, would this be sufficient to make it capital in nature?'<sup>137</sup> Would the answer be different if the repair work was carried out 'soon after' the capital work.<sup>138</sup> NZICA's submission also noted that in *Colonial Motors* (CA), Inland Revenue accepted repair work as deductible where estimates for the work, and subsequent dockets and invoices, were separated into three categories (including repairs and maintenance).<sup>139</sup> NZICA added:

If two different streams of work are carried out at the same time, using different project managers and different contractors, we assume that this would constitute two separate "projects". However, what would be the situation were there merely two different cost

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<sup>131</sup> Ibid.

<sup>132</sup> Ibid 14 [56].

<sup>133</sup> Inland Revenue, IS 12/03, above n 11, 98 [205].

<sup>134</sup> Ibid 99 [206].

<sup>135</sup> See Example 20, *ibid* 104 [232].

<sup>136</sup> NZICA, above n 86, 7.

<sup>137</sup> Ibid.

<sup>138</sup> Ibid.

<sup>139</sup> Ibid.

centres? The two workstreams accounted for separately? Two different quotes for the work?<sup>140</sup>

Taxpayers will need to take clear, practical steps to ensure any repair work undertaken on a building at the same time as capital work is treated as a separate project. This would best be demonstrated by the taxpayer using different project managers and different contractors. However, for a number of reasons this may not be possible. Determining whether there is more than one single overall project and, in the event that the answer is in the affirmative, how the expenditure is to be apportioned between projects, has the potential to be a fertile ground for dispute between Inland Revenue and taxpayers.

Finally, based on *Sherlaw*, apportionment of expenditure between capital and revenue will be appropriate where the primary work undertaken is a repair, but at the same time some upgrading of a capital nature occurs.<sup>141</sup>

### VIII CONCLUSION

Discerning the capital–revenue boundary can be difficult, hence the large volume of case law. However, there is little judicial guidance on the tax treatment of strengthening work undertaken on a building. The two cases discussed in this article conclude that at least significant strengthening work undertaken on a building is on capital account. However, the cases present difficulties in terms of precedent, *TRA Case X26* because, as a decision of the TRA in its (former) small claims jurisdiction, it is in fact non-precedential, although the reality is that it will be used as some form of ‘authority’ given the limited case law on the topic. *Colonial Motors (CA)*, on the other hand, as a decision of the Court of Appeal, is significant. However, again its precedential value is ‘muddied’ as the seismic work was part of a wider project and was considered accordingly. Further, the Court did not conclusively determine whether the strengthening work was ‘alterations’ or went beyond that, preferring to conclude based on the now repealed *Income Tax Act 1976* (NZ) s 108 (ie the work undertaken had increased the capital value of the building by more than was expended.)

The greatest hurdle taxpayers have to overcome to successfully claim a deduction for seismic strengthening is that the effect of such work from a business and practical perspective is to significantly strengthen a capital asset and by its very nature the work will normally provide an enduring benefit and positively impact the taxpayer’s business structure. Where minor strengthening work is undertaken on a sound building there may be arguments that such work is on revenue account. Likewise, where work on a building is comprised of more than one project, the repair component may be deductible. However, based on the case law, including *Hallstroms*, and the nature of the work, it is likely the majority of all such strengthening work will be capital expenditure. Support for this view can be drawn from a consideration of the potential consequences if no action is undertaken. In such a scenario, the landlord could find retaining and

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<sup>140</sup> Ibid 8. See generally Stephen Tomlinson and Frank Burgess, ‘Repairs and Maintenance’ (Paper presented at NZICA Annual Tax Conference, Auckland, 26–27 October 2012) 16.

<sup>141</sup> Inland Revenue, IS 12/03, above n 11, 99 [206].



attracting tenants difficult and also face issues with obtaining ongoing insurance cover.<sup>142</sup> Ultimately, the owner could be subject to threats of building closure or demolition by the local council, ie the sterilisation of the asset.

To the extent that seismic strengthening costs are therefore not deductible because they are capital expenditure, such expenditure, which previously would have been depreciated along with the building, will now not be depreciable. This will place even greater pressure on the boundary between repairs and capital improvements and may see taxpayers test it in the future. Keating's observations with respect to the nil building depreciation rate are similarly applicable to the tax treatment of seismic strengthening expenditure: 'Taxpayers are incentivised to adopt aggressive or questionable interpretations in an attempt to have the expenditure recharacterised as another class of deductible or depreciable expenditure.'<sup>143</sup>

Due to the large number of buildings in New Zealand which will require seismic strengthening in the future, in my view, there is an argument to incentivise (or at least support) building owners through the tax system to undertake what may be very expensive work. This could be achieved either by legislating a specific deduction for earthquake strengthening costs or permitting the depreciation of such costs. The latter is more feasible in terms of its impact on the fiscal purse, and more realistic as it recognises the on-going benefit from the work undertaken on the building. It is acknowledged that there may be boundary issues where seismic strengthening and other unrelated structural work may be undertaken on a building; however, such issues arguably could be determined by reference to the structural engineers report or relevant council documents. Other options to assist building owners could include central or local government grants or low or interest-free loans to assist with the expenditure incurred. A future study could consider these and other options.

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<sup>142</sup> Williams comments that unreinforced masonry buildings may become uninsurable without strengthening work: David Williams, 'Insurance hurdle for old buildings', *Fairfax NZ News* (online), 2 March 2012, <<http://www.stuff.co.nz/businesses/6509555/insurance-hurdle-for-old-buildings>>.

<sup>143</sup> Keating, above n 8, 311.