QUESTION WE'VE BEEN ASKED QB 16/08

INCOME TAX – DEDUCTIBILITY OF THE COSTS OF OBTAINING A DETAILED SEISMIC ASSESSMENT OF A BUILDING

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

This Question We've Been Asked is about ss DA 1(1) and DA 2(1).

The risk of earthquakes is an ongoing reality in New Zealand. Since the Canterbury earthquakes and the introduction of the Building (Earthquake-prone Buildings) Amendment Act 2016, taxpayers are trying to determine how their buildings are likely to cope in an earthquake. One means of doing this is to obtain a detailed seismic assessment.

Question

1. Is the cost of obtaining a detailed seismic assessment (DSA) of a building deductible to a business?

Answer

2. With one exception, the costs incurred in obtaining a DSA (DSA costs) in the situations identified at [7], [9] and [10] are deductible. The exception is where a DSA is obtained as part of a capital project. In this case, the DSA costs take their nature from that project and are non-deductible capital expenditure.

Explanation

Introduction

3. A DSA is an engineering assessment that provides a detailed assessment of the seismic performance of a building. The focus of the DSA is on the likely behaviour of the building and its components in an earthquake. A DSA should identify any vulnerabilities in the building and give an earthquake rating (expressed as a percentage of the new building standard). It may also identify possible ways of mitigating the vulnerabilities and estimate the mitigation costs, depending on the owner's instructions.

4. This item covers DSA costs incurred by taxpayers who:

   - are in the business of renting out commercial or residential buildings;
   - own buildings used for their own businesses;
   - get DSAs on someone else's building where the safety of that building may impact on the taxpayer's business.

5. The Commissioner considers that the same considerations and conclusions apply to the costs of other less detailed seismic assessments (including initial seismic assessments) when they are obtained by taxpayers in the same situations as those identified in this item. Less detailed seismic assessments may be obtained as a less costly alternative to DSAs.

6. A DSA can be obtained in a variety of situations and for varying reasons. This item addresses the deductibility of DSA costs in the most commonly occurring situations. It does not address the deductibility of DSA costs incurred when buying a building.

7. A DSA is most commonly obtained when a city or district council has identified a building as potentially earthquake prone (more fully discussed at [8]). An

earthquake-prone building is often described as one that has an earthquake rating of less than 34% of the new building standard.

8. The Earthquake-prone Buildings Amendment Act 2016 requires city and district councils to actively identify and require owners to take action on earthquake-prone buildings. The process for doing this can generally be described as follows:

- **Identify potentially earthquake-prone buildings –** The council makes a high-level assessment of a building to determine whether the building is potentially earthquake prone.
- **Obtain further information –** For buildings identified as potentially earthquake prone, the building owner must obtain further information to determine whether the building is earthquake prone. This may involve the owner obtaining a DSA, because it provides a reliable and detailed assessment of the seismic performance of a building.
- **Take action on earthquake-prone buildings –** If a building is confirmed as earthquake prone, the building owner and the council may discuss the available options and develop an agreed approach for the building.

9. A DSA may also need to be obtained when a building consent is required under the Building Act 2004 to alter a building (s 112 of the Building Act 2004). It may also be required when the use of a building changes (s 115 of the Building Act 2004).

10. Taxpayers may also choose to obtain a DSA:

- as part of a project to seismically strengthen a building;
- to satisfy existing or potential tenants of a building's safety;
- to get insurance or to reduce insurance premiums;
- to identify possible damage after an earthquake;
- to evaluate the safety of someone else's building where the safety of that building may impact on the taxpayer's business.

11. This item briefly sets out the relevant principles of deductibility under the Income Tax Act 2007, being the general permission and the capital limitation. It then considers whether DSA costs incurred in the situations identified in this item are deductible.

Principles of deductibility

General permission

12. Expenditure must first satisfy the general permission under s DA 1 to be deductible. Therefore, to be deductible, DSA costs must be incurred either in deriving income (s DA 1(1)(a)) or in the course of carrying on a business to derive income (s DA 1(1)(b)).

13. Section DA 1(1)(b) applies only to taxpayers who carry on a business. As set out in [4], this item applies to DSA costs incurred by taxpayers in business. In contrast to s DA 1(1)(a), under s DA 1(1)(b) expenditure need not be directly related to the derivation of income but is deductible when incurred in carrying on a business for the purpose of deriving income. This allows a broader approach:

- To be expenditure incurred in carrying on a business, the expenditure must be incurred as part of the taxpayer's business operations to obtain assessable income: *FCT* v *Wells* 71 ATC 4,188 (HCA); *John Fairfax and Sons Pty Ltd* v *FCT* (1959) 101 CLR 30 (HCA).

- Whether expenditure has a sufficient relationship to the taxpayer's business operations is usually determined from objective matters. However, subjective matters may be relevant where the expenditure was incurred by choice and the relationship between the expenditure and the business operations is more indirect and remote: *CIR v Banks* [1978] 2 NZLR 472 (CA) at 477; *Magna Alloys & Research Pty Ltd* v *FCT* 80 ATC 4,542 (FCAFC) at 4,548, 4,558–4,559; *Fletcher* v *FCT* 91 ATC 4,950 (HCA) at 4,957; *Putnin* v *FCT* 91 ATC 4,097 (FCAFC); *Schokker* v *FCT* 99 ATC 4,504 (FCAFC).
- Longer-term objectives can be considered. A deduction is allowed for expenditure incurred to protect or advance a business or to avoid or reduce costs: *Europa Oil (NZ) Ltd (No 2)* v *CIR* (1974) 1 NZTC 61,169 (CA) at 61,196–61,197; *Cox* v *CIR* (1992) 14 NZTC 9,164 at 9,168.

14. The Commissioner's Interpretation Statement "IS 14/04: Income tax — Deductibility of company administration costs", *Tax Information Bulletin* Vol 26, No 7 (August 2014): 5, at [26]–[28] discusses the principles of deductibility under s DA 1 in more detail.

Capital limitation

15. The capital limitation in s DA 2(1) may override the general permission. The capital limitation denies deductions for capital expenditure or losses.

General principles

16. Two general principles form the basis for the distinction between capital and revenue expenditure. Dixon J formulated these principles in *Hallstroms Pty Ltd* v *FCT* (1946) 72 CLR 634 (HCA) at 647:

> … the contrast between the two forms of expenditure corresponds to the distinction between the acquisition of the means of production and the use of them; between establishing or extending a business organization and carrying on the business; between the implements employed in work and the regular performance of the work in which they are employed; between an enterprise itself and the sustained effort of those engaged in it.

And at 648:

> What is an outgoing of capital and what is an outgoing on account of revenue depends on what the expenditure is calculated to effect from a practical or business point of view rather than on the juristic classification of any legal rights secured, employed or exhausted in the process.

17. In *Commissioner of Taxes v Nchanga Consolidated Copper Mines* [1964] AC 948 the Privy Council applied the distinction between capital and revenue drawn in *Hallstroms*. Viscount Radcliffe stated at 960:

> Again courts have stressed the importance of observing a demarcation between the cost of creating, acquiring or enlarging the permanent (which does not mean perpetual) structure of which the income is to be the produce or fruit and the cost of earning that income itself or performing the income earning operations. Probably this is as illuminating a line of distinction as the law by itself is likely to achieve …

BP Australia *factors*

18. The Privy Council further developed these principles in *BP Australia Ltd v FCT* [1965] 3 All ER 209. The Privy Council set out several "factors" for helping to determine whether expenditure is revenue or capital under the general principles. These factors can be useful where the classification of expenditure as capital or revenue is unclear. The *BP Australia* factors, as applied and developed in later cases, are:

- the **need or occasion** that calls for the expenditure;

- whether the expenditure is **recurrent in nature**;
- whether the expenditure is on the **business structure** or whether it is part of the **income-earning process**;
- whether the expenditure creates an **identifiable asset**;
- whether the expenditure is of a once and for all nature producing assets or advantages of an **enduring benefit**;
- whether the expenditure is sourced from **fixed or circulating capital**; and
- how the expenditure is treated under **ordinary principles of commercial accounting**.

19. The Commissioner's Interpretation Statement "IS 12/03: Income tax — deductibility of repairs and maintenance expenditure — general principles", *Tax Information Bulletin,* Vol 24, No 7 (August 2012): 68, at [107] discusses the *BP Australia* factors in more detail.

20. In *BP Australia,* the Privy Council stated that it is not appropriate to determine the issue under any rigid test or description. It has to be determined from many aspects of the whole set of circumstances, some of which may point in one direction, some in the other. Many of the above factors will overlap, and some factors will carry more weight than others on particular facts: *BP Australia* at 264.

21. The Privy Council's approach in *BP Australia* has been recognised and applied in New Zealand cases, including:
    - *CIR v McKenzies New Zealand Ltd* (1988) 10 NZTC 5,223 (CA);
    - *CIR v LD Nathan and Co Ltd* [1972] NZLR 209 (CA); and
    - *Buckley & Young Ltd v CIR* (1978) 3 NZTC 61,271 (CA).

Costs incurred as part of one overall project

22. In addition to the general principles and the *BP Australia* factors, the courts have suggested that costs incurred as part of one overall capital project will likely take their nature from that project. It is not appropriate to separate out the different costs of the project for tax purposes where that project is capital in nature. This is regardless of whether that project concerns work done on a single asset or a group of assets: *Colonial Motor Co Ltd v CIR* (1994) 16 NZTC 11,361 (in the context of a seismic strengthening project) and followed in *Hawkes Bay Power Distribution Ltd v CIR* (1998) 18 NZTC 13,685 and *Case X26* (2006) 22 NZTC 12,315. Whether a DSA is obtained as part of a capital project is a question of fact in each case. (See Interpretation Statement IS 12/03 at [185]–[208] and examples 17, 19 and 20 for further discussion of the tax treatment of costs incurred as part of one overall project.)

Consideration of the capital or revenue issue in Trustpower

23. The Supreme Court recently considered a capital or revenue issue in *Trustpower Ltd v CIR* [2016] NZSC 91. The issue was whether expenditure incurred on obtaining resource consents for four proposed electricity generation projects was on revenue or capital account. The expenditure was described as feasibility expenditure on the basis that it was incurred to assist Trustpower to determine whether to complete the four generation projects.

24. The Supreme Court stated that the general rule is that expenditure referable to a proposed capital project will be capital. The court went on to acknowledge that early-stage feasibility expenditure referable to proposed capital projects may, nevertheless, sometimes be deductible. However, it considered that this would

not extend to costs that are intended to (or do) materially advance the capital projects in question.

Deductibility of DSA costs

General permission

25. It is part of a business's normal costs to keep important business structures in good working order. Buildings need to be checked throughout their lives to make sure they are performing and will continue to perform as required. Sometimes buildings need to be checked because of an external risk. The Commissioner considers that a building's possible earthquake-prone status is such a risk. It is an abnormal event resulting in DSA costs being incurred in carrying on a business. The DSA costs can be reasonably regarded as unavoidable and for the purpose of the business generally: *John Fairfax*. Therefore, the Commissioner considers that these DSA costs satisfy the general permission in s DA 1(1)(b). Such DSA costs are costs a prudent business incurs to ensure its ongoing ability to earn income.

26. However, as stated, the capital limitation in s DA 2(1) may override the general permission. Therefore, the rest of this item focuses on whether the capital limitation applies to deny a deduction for the DSA costs incurred in the situations identified at [7], [9] and [10].

Capital limitation

27. Considerable case law exists on the distinction between capital and revenue expenditure. According to Dixon J at 648 in *Hallstroms*, deductibility "depends on what the expenditure is calculated to effect from a practical or business point of view". *BP Australia* sets out factors for helping to determine whether a particular expense is capital or revenue. The fact that expenditure relates to a capital asset does not of itself mean it is capital in nature and, therefore, not deductible. For example, expenditure on repairs and maintenance on a building, rates and building warrants of fitness are all deductible despite relating to what is generally a capital asset for most businesses (that is, the building).

28. While *Trustpower* adds to that case law, the Commissioner considers that *Trustpower* is not relevant to the situations identified and considered in this item. This is because the DSA costs are incurred in relation to an existing capital asset (that is, a building). In *Trustpower,* the expenditure was incurred on projects that, if they came to fruition, would result in the acquisition or development of new capital assets. Those capital assets did not exist when the expenditure on the resource consents was incurred. Therefore, the following paragraphs consider the deductibility of these DSA costs under the general principles formulated in *Hallstroms* and applied and developed in *Nchanga*.

29. The starting point is to determine what the expenditure is calculated to effect from a practical or business point of view. The following paragraphs consider the *BP Australia* factors as a means of assisting in addressing this question.

30. In some situations, such as where a DSA is obtained when a building has been identified as requiring earthquake strengthening, the **need or occasion** for incurring the DSA costs is, arguably, to determine the extent of the strengthening work required on the building. This supports a capital outcome.

31. However, other instances may support a revenue outcome. An example is where a DSA is obtained to satisfy potential tenants of a building's safety. Arguably, in such cases the **need or occasion** for the DSA is to attract tenants or justify the rental charged. Similarly, where a DSA is obtained to get insurance or to reduce insurance premiums – the **need or occasion** is, arguably, to secure insurance or

reduce premiums. This also suggests the expenditure was incurred as part of ordinary business operations.

32. Where a DSA is obtained following the council identifying the building as potentially earthquake prone, it might be argued that the expenditure is necessary to satisfy the legal requirement arising from the council identifying the building as potentially earthquake prone, so is revenue in nature. However, the existence of a statutory obligation to incur expenditure does not necessarily mean that expenditure incurred in complying with the obligation is deductible: *FCT v The Swan Brewery Co Ltd* 91 ATC 4,637 (FCAFC)). On the other hand, it is arguable that the **need or occasion** for the DSA costs in this situation is to show whether the building is in fact earthquake prone (and by how much it fails or exceeds the required standard). From a practical or business point of view, the expenditure is incurred to determine whether any further action needs to be taken. This is so regardless of the outcome of the DSA (ie, that the building is or is not earthquake prone). While the expenditure relates to a capital asset, that does not preclude it from being deductible. This factor, which the Commissioner considers important in the context of DSA costs, supports a revenue outcome.

33. DSA costs incurred in any of the situations identified in this item are likely to be one-off expenses rather than **recurrent in nature**. However, simply because an expense is one off does not necessarily mean it is capital in nature. While obtaining a DSA to find out whether a building is earthquake prone may be a one-off occurrence, owners may regularly consider the viability of their buildings (for example, by obtaining an annual building warrant of fitness). Ensuring the ongoing usefulness of its building is likely to be a regular part of a business's undertaking. This would support the DSA costs being a revenue expense.

34. The next *BP Australia* factor is whether DSA costs are part of the **income-earning process** or incurred on the **business structure**. In the Commissioner's view, this is a significant factor in the context of DSA costs. Obtaining a DSA to attract tenants or justify the rental charged may be argued to be like a marketing expense, which is expenditure on the income-earning process. Also, DSA costs incurred to reduce insurance premiums are incurred to reduce an otherwise deductible expense. This is often argued to be part of the income-earning process and therefore deductible. Similarly, it is arguable that finding out whether a building is earthquake prone does not add anything to the business structure. This is also true where a DSA is obtained on someone else's building. Conversely, it might be said that gaining information about the structure of a building (a capital asset) is fundamentally a matter of capital. However, as stated at [27], the fact that expenditure relates to a capital asset does not of itself mean it is capital in nature and therefore not deductible. The result is that in most of the scenarios considered, the DSA costs more closely relate to the **income-earning process** than the business structure.

35. Turning now to whether the DSA costs create an **identifiable asset** or produce assets or advantages of an **enduring benefit**, the first point to note is that the Commissioner considers that the DSA itself is not a capital asset. In the scenarios set out above, a DSA will simply provide the building owner with information. Finding out whether a building is earthquake prone does not create an identifiable asset or produce assets or advantages of an enduring benefit. This is because nothing is being done to the building. It is what the business does with that information that can result in an enduring benefit. However, where a DSA is obtained as part of a capital project (such as a capital project to seismically strengthen a building), it may be part of a project specifically intended to produce an **enduring benefit**.

36. Finally, whether the DSA costs are sourced from **fixed or circulating capital** and how they are treated under **ordinary principles of commercial accounting** are not helpful in this case. These factors are not determinative, and the courts have rarely given them much weight. However, to the extent that it may be relevant, DSA costs are generally expected to be funded from circulating capital and expensed for accounting purposes.

Summary

37. DSA costs are incurred in a variety of situations as set out above. Correctly characterising what the DSA costs are calculated to effect from a practical or business point of view is important across the variety of situations. However, it is a matter on which different views can reasonably be held. The *BP Australia* factors have been considered as a means of assisting with this enquiry. The Commissioner considers that the *BP Australia* factors that should be given the most weight in the context of the deductibility of DSA costs all support a revenue outcome:

- The **need or occasion** for the DSA costs – the need or occasion for the DSA costs, while different from scenario to scenario, suggests that in the situations identified above the DSA costs are incurred as part of ordinary business operations.
- Whether DSA costs are part of the **income-earning process** or on the **business structure** – in the scenarios considered, a significant connection exists between the DSA costs and the income-earning process. Simply finding out whether a building is earthquake prone does not add anything to the business structure.
- Whether the DSA costs create an **identifiable asset** or produce assets or advantages of an **enduring benefit** – the DSA costs do not create an identifiable asset or produce assets or advantages of an enduring benefit. The DSA is not a capital asset, it simply provides the building owner with information about whether the building is earthquake prone. Nothing is being done to the building. It is what the building owner does with that information that can result in an enduring benefit.

38. The exception is where DSA costs are incurred as part of a capital project (such as the seismic strengthening project in *Colonial Motor*). The Commissioner considers that, as set out at [22], these DSA costs would be capitalised into the project and not deducted for tax purposes: *Colonial Motor, Hawkes Bay Power* and *Case X26*.

Conclusion

39. The Commissioner considers that, from a practical or business point of view, expenditure on a DSA in the situations identified in this item is incurred to obtain information so as to determine whether a building is earthquake prone (and by how much it fails or exceeds the required standard). Such expenditure should be treated as revenue in nature and deductible. This outcome is consistent with increasing certainty and reducing compliance costs.

40. However, where the DSA costs are incurred as part of a capital project they will be capital in nature and non-deductible.

References

Subject references

capital limitation
detailed seismic assessment
earthquake strengthening
seismic strengthening

Legislative references

Building Act 2004
Building (Earthquake-prone Buildings) Amendment Act 2016
Income Tax Act 2007 – ss DA 1 and DA 2(1)

Case references

BP Australia Ltd v *FCT* [1965] 3 All ER 209 (PC)
Buckley & Young Ltd v CIR (1978) 3 NZTC 61,271 (CA)
Case X26 (2006) 22 NZTC 12,315
CIR v Banks [1978] 2 NZLR 472 (CA)
CIR v LD Nathan and Co Ltd [1972] NZLR 209 (CA)
CIR v McKenzies New Zealand Ltd (1988) 10 NZTC 5,223 (CA)
Colonial Motor Co Ltd v CIR (1994) 16 NZTC 11,361 (CA)
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Cox v *CIR* (1992) 14 NZTC 9,164
Hallstroms Pty Ltd v *FCT* (1946) 72 CLR 634 (HCA)
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Other references

"IS 14/04: Income tax — Deductibility of company administration costs", *Tax Information Bulletin* Vol 26, No 7 (August 2014): 5
"IS 12/03: Income Tax — Deductibility of repairs and maintenance expenditure — general principles", *Tax Information Bulletin* Vol 24, No 7 (August 2012): 68