QUESTION WE'VE BEEN ASKED QB 14/08

INCOME TAX — COSTS OF DEMOLISHING AN EXISTING BUILDING ON A BUILDING SITE

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

This Question We've Been Asked is about ss DA 1, DA 2, EE 6, EE 7, EE 31(2), EE 31(3), EE 44, EE 45(1), EE 45(2), EE 48, EE 61(3B) and YA 1, definition of "dispose", para (f). This item applies where the building demolished and the replacement building are used in deriving assessable or excluded income, or in the course of carrying on a business to derive such income, but not where either building is a revenue account asset.

This item updates and replaces the item "How costs of clearing a site are treated for tax purposes", published in *Public Information Bulletin* No 45, p 9 (April/May 1968). That item explains that no income tax deduction is permitted for the costs of demolishing a building to prepare a site for construction of a new building. The item says that those costs are part of the cost of the site, are capital, and cannot be included in depreciation claimed for the new building. The current relevance of this information was identified during an ongoing review of content published in *Public Information Bulletins* and *Tax Information Bulletins* before 1996. The Public Information Bulletin review has now been completed, see "Update on Public Information Bulletin review" *Tax Information Bulletin* Vol 25, No 10 (November 2013).

Question

1. When erecting a new building on a site are the costs of demolishing an existing building on the site included as part of the cost of the new building and are the costs deductible for income tax purposes?

Answer

2. The costs of demolishing the existing building are not part of the cost of the new building and are not deductible for income tax purposes as they are of a capital nature. Instead, the costs are taken into account under the depreciation rules in determining the consideration received by the taxpayer from the disposal of the demolished building. Different rules apply for temporary buildings.

Explanation

3. Demolition costs are expenditure incurred by a person in removing a building from a site. Where a person removes a building themselves, rather than paying a demolition expert to do the whole job, examples of demolition costs include wages paid to staff who carry out the work, the cost of hiring equipment to carry out the work, the cost of carting demolition material from the site and tip fees for dumping that material.

4. A person is entitled to a deduction for expenditure incurred in the course of deriving their assessable or excluded income, or incurred in the course of carrying on a business for the purpose of deriving such income (s DA 1(1)) but only if, relevantly, the expenditure is not of a capital nature (ss DA 2(1) and DA 2(7)).

5. *CIR v McKenzies NZ Ltd* (1988) 10 NZTC 5,233 (CA) contains a discussion of the general principles for determining whether expenditure has a capital nature. In discussing *BP Australia Ltd v Commissioner of Taxation of the Commonwealth of Australia* [1965] 3 All ER 209 (PC) the Court of Appeal in *McKenzies* said at 5,236:

> Amongst the factors weighed by the Judicial Committee in *BP Australia* were: (a) the need or occasion which called for the expenditure; (b) whether the payments were made from fixed or circulating capital; (c) whether the payments were of a once and for all nature producing assets or advantages which were an enduring benefit; (d) how the payment would be treated on ordinary principles of commercial accounting; and (e) whether the payments were expended on the business structure of the taxpayer or whether they were part of the process by which income was earned.

6. Subsequently, in *CIR v Lyttelton Port Company Limited* (1997) 18 NZTC 13,273 (CA), the Court of Appeal considered whether a port company was entitled to a deduction for building demolition costs. The company did not want the buildings and had been forced to acquire them as part of a port restructure plan. The court noted there were no New Zealand cases on demolition costs and referred to the Australian cases of *Commissioner of Taxation of the Commonwealth of Australia v Broken Hill Pty Co Ltd* (1967) 120 CLR 240 (HCA) and *Mount Isa Mines Ltd v FCT* 92 ATC 4755 (HCA). The Court of Appeal considered the facts of the case before it were very similar to those in the *Mount Isa* case. The Court of Appeal noted that the court in *Mount Isa* relied on *Tucker v Granada Motorway Services Ltd* [1979] 2 All ER 801 (HL). The Court of Appeal, at 13,276, quoted the following from the speech of Lord Wilberforce in *Tucker*:

> I think that the key to the present case is to be found in those cases which have sought to identify an asset. In them it seems reasonably logical to start with the assumption that money spent on the acquisition of the asset should be regarded as capital expenditure. Extensions from this are, first, to regard money spent on getting rid of a disadvantageous asset as capital expenditure and, secondly, to regard money spent on improving the asset, or making it more advantageous, as capital expenditure.

7. The Court of Appeal then went on to say that:

> …the identifiable asset test is one which has relevance to the present case. The respondent obtained a long-term benefit as the result of clearing the area of an unwanted building and improving the standard and extent of the wharf area. This benefit can only be characterised as an improvement in a capital asset.

and later, at 13,276-13,277, that:

> Effectively, this was the disposition of a disadvantageous asset. Moreover, the demolition improved the respondent's capital asset by providing an upgraded and additional uncluttered wharf area. …The effect of the demolition was to enhance the assets deployed by the respondent in the production of revenue.

8. Accordingly, where a building being demolished is a capital asset, the demolition expenditure will be capital expenditure and not deductible under s DA 1(1). Expenses that are not otherwise deductible may, in some cases, be taken into account under the depreciation rules.

9. Buildings are depreciable property (ss EE 6 and EE 7). For buildings with an estimated useful life of 50 years or more, the depreciation rate is 0% (ss EE 31(2)(d), EE 31(3)(c), EE 61(3B) and EZ 13(2)(c)).

10. Section EE 48 applies where a person has consideration from the disposal of depreciable property (s EE 44). Disposal of an asset includes destroying it (s YA 1, para (f) of definition of "dispose"). Section EE 45(1) provides that the consideration for disposal is the amount the person derives (excluding GST where they are a registered person):

> minus the amount (the **disposal cost**) that they incur in deriving the amount, to the extent to which the disposal cost-
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> (a) is not allowed as a deduction to the person, other than as a deduction for an amount of depreciation loss; and
> (b) is not counted in "the amount that a person derives".

11. The consideration can be zero or a negative amount (s EE 45(2)). Where the building (or its neighbourhood) is damaged rendering the building useless for deriving income and it is demolished, the consideration consists of any insurance,

indemnity or compensation received plus any consideration received for the disposal (s EE 45(8)).

12. Section EE 45 applies to the demolition costs as they are costs of disposing of a depreciable asset, the building, and the taxpayer is not allowed a deduction for the costs because of their capital nature. This means that, in calculating the consideration from the disposal of a building, the costs of the disposal are deducted from any amount a person derives from the disposal. For example, if it costs $10,000 to demolish a building and the owner sells various items from the demolished building for a total of $11,000, then the consideration from the disposal of the building will be $1,000 (ie, $11,000 - $10,000). On the other hand, if the only proceeds received are from the sale of some doors for $900, the consideration for the disposal of the building will be -$9,100 (ie, $900 - $10,000).

13. Where consideration from the disposal of depreciable property is more than the property's adjusted tax value, a taxpayer derives assessable income. However, this is limited to the total amount of depreciation previously claimed for the asset (s EE 48(1)).

14. Generally, where the consideration received on disposal of a depreciable asset is less than its adjusted tax value, the taxpayer will have a depreciation loss (s EE 48(2)). However, under s EE 48(3), no depreciation loss on disposal can arise in respect of a building unless:

- the building was rendered useless for the purpose of deriving income;
- the building was demolished as a result of damage to the building or the building's neighbourhood; and
- the damage was caused by a natural event not under the control of the taxpayer, their agent or associated person and not as a result of a failure to act by the taxpayer, their agent or an associated person.

15. An example of where demolition costs may be taken into account in calculating a depreciation loss is where a building is demolished after being rendered useless for deriving income as a result of a cyclone or an earthquake. For information on changes to the depreciation and other tax provisions introduced in response to the Canterbury earthquakes see *Tax Information Bulletins* Vol 24, No 10, (December 2012): 23 and Vol 23, No 8, (October 2011): 65.

16. Where a building is sold cheaply for removal, rather than being demolished, any loss on that sale would also be on capital account. No deduction would be allowed for that loss because of the application of s EE 48(3).

17. Where the building demolished is a temporary building as defined in s YA 1, a person will be allowed a deduction for a loss that they incur under s DB 20. This section overrides the capital limitation.

References

Subject references

Capital expenditure
- Consideration from disposal of depreciable property

Demolition costs

Legislative references

Income Tax Act 2007, ss DA 1, DA 2, EE 6, EE 7, EE 31(2), EE 31(3), EE 44, EE 45(1), EE 45(2), EE 48, EE 61(3B) and YA 1 , definition of "dispose", para (f)

Case references

BP Australia Limited v Commissioner of Taxation of the Commonwealth of Australia [1965] 3 All ER 209

CIR v McKenzies NZ Ltd (1988) 10 NZTC 5,233

CIR v Lyttelton Port Company Limited (1997) 18 NZTC 13,273

Commissioner of Taxation of the Commonwealth of Australia v Broken Hill Pty Co Ltd (1967) 120 CLR 240

Mount Isa Mines Ltd v FCT 92 ATC 4755

Tucker v Granada Motorway Services Ltd [1979] 2 All ER 801