Repairs or remedying initial design faults: Lawrence v IRD (NZ)

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Repairs are again in the spotlight. The ATO said in June that most rental property owners are making errors in their tax returns, despite 86% using a registered tax agent ("Rental property owners in spotlight: ATO warns", 2024 WTB 24 [431]). Repairs and maintenance, as against capital expenditure, remains a common mistake according to ATO.

The recent New Zealand case of *Lawrence* illustrates the principles

Leaky houses have cost the New Zealand economy tens of billions of dollars. So, the Lawrences engaged a building consultant to do a pre-purchase inspection report on a rental dwelling in Tauranga. The report stated that the dwelling "did not have any of the design features that could be described as a leaky home".

Were the substantial costs later incurred by the couple in remedying water penetration repairs or on capital account? In *Lawrence v Commissioner of Inland Revenue* [2024] NZHC 905, Andrew J found that rectification of the issues present at date of purchase were on capital account, and thus not immediately deductible in full.

The New Zealand tests in sections DA 1(1) and DA 2(1) mirror positive and negative (capital) limbs of section 8-1 in Australia. New Zealand has no specific "repairs" provision, but applies the same HCA authorities, and a Privy Council decision applying those HCA authorities, *Auckland Gas Co Ltd v Commissioner of Inland Revenue* [2000] 3 NZLR 6; [2000] 1 WLR 1783; [2000] UKPC 24.

Section DA (2)(1) denies the deduction for expenditure to the extent that it is capital in nature. The essential question was whether the remediation works that the Lawrences undertook were repairs and therefore of a revenue nature.

From the judgment, we do not know when the Lawrence's house was built, and thus whether it was caught up in the epidemic of poor building practices caused by deregulation, and relaxations in roofing, cladding and timber standards. But the pre-purchase inspection report specifically referred to the "leaky home" issue.

We also do not know whether the Lawrences were entitled to compensation under the leaky homes statutory scheme. We do know from the facts in this case that substantial work had to be done.

Worse, no sooner would the Lawrences complete one set of works, but the place sprang more leaks. Finally, there was something of a root and branch solution, including the kitchen and main bedroom.

And yet, the Lawrences had bought this rental property based on a report that it was free of the usual characteristics of leaky houses. In principle, could they say that there were no initial

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repairs required, but rather works to bring the place up to the standard they expected based on the pre-purchase report? Unfortunately, life does not work that way.

Andrews J summarised guidance from earlier decisions. In part, his Honour said:

[69] In accordance with the leading Privy Council decision, Auckland Gas Co Ltd v Commissioner of Inland Revenue (Auckland Gas), there is a two-step enquiry to determine the nature of the expenditure:

(a) The first step involves identifying the asset/object on which work has been done.

(b) The second step requires identifying the nature and extent of the work on the physical object to ascertain the effect of the work on the asset/object.

[70] In addressing the issue of the nature and extent of the work, the following tests are applied:

(a) whether the work resulted in the reconstruction, replacement, or renewal of substantially the whole of the asset;

(b) whether the work changed the character of the asset; and

(c) whether the work formed one project of work.

Critically, and following the Privy Council in *Auckland Gas*, above, Andrews J noted at [73] that:

...the desire to solve a maintenance problem was not inconsistent with carrying out work of a capital nature. The nature and extent of the work carried out to the physical asset are what determines the character of the work.

The Lawrences' expert witness said that the remediation works did not change the character of the building. The Commissioner's expert witness said that the works went beyond maintenance. The remediation went well beyond the sort of repairs and maintenance required to keep the parts of the building performing as expected. The changes to the building were in all aspects of its appearance, and improved its performance, durability and useability: at [85].

Andrews J preferred the latter evidence. The original design was altered, including the roofline and guttering which had made the house vulnerable to penetration by water. The original design was replaced with a design, materials, products and systems which were superior. There were new or enhanced elements such as a retaining wall and stormwater disposal: [91].

Andrews J found the works were of a capital nature: (underlining added).

My ultimate finding is that this is actually a very clear-cut case. The nature and <u>scale</u> of the remediation works here resulted in the reconstruction or renewal of substantially the whole of the house and the works changed the character of that asset. The Lawrences have failed to establish that the Commissioner's assessments are wrong and that the capital limitation does not apply.

The mention of scale comes from *Auckland Gas Co Ltd v Commissioner of Inland Revenue*, above. But New Zealand commentators have questioned whether the extensiveness of works, alone, should tell against the works being repairs: Brown & Handford, [2024] NZLJ 230, 245. They favour also considering (as of greater significance) whether the work "improves the asset

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beyond its original state (such as by curing design defects) as opposed to restoring the asset to its former state following damage or wear and tear".

There is something in that, but Windeyer J said in *W Thomas & Co Pty Ltd v Commissioner of Taxation* (1965) 115 CLR 58, 75:

> *It was thus apparent that, whether or not this expenditure was properly described as for repairs, the work was extensive and costly considered in relation to the value of a building newly acquired. In my view the information that the Commissioner had would lead inevitably to the conclusion that prima facie this expenditure was of a capital nature.*

So, scale, or extensiveness, of works could be a decisive consideration in Australia.

Lawrence stands as a caution for Australian landlords, where works are effectively initial repairs or go beyond restoring the asset.

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