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Taxing issues

Builders and designers can assist clients with the complex tax issues around remediating leaky buildings and earthquake strengthening.

A KEY TAX QUESTION for building work is the distinction between capital and revenue expenditure. In most cases, the difference is clear. However there are some traps that can be difficult to navigate and carry some hefty consequences.

Capital vs revenue expenses

Up until 2012, classifying expenditure on a building as capital meant that tax depreciation could be claimed, compared to revenue expenditure where a deduction for the full amount could be claimed when incurred.

However, with the removal of tax depreciation deductions for buildings, there is now usually no deduction available for capital building expenditure. This makes identifying whether the expenditure is capital or revenue even more vital for both taxpayers and Inland Revenue.

Helping your clients

Builders, architects and designers working on leaky buildings or earthquake strengthening can help clients by providing full information and cost breakdowns of the work done.

Clients can use this to calculate the true after-tax cost of any remedial building work that directly impacts on the project's viability. It can also shape decisions made during the design and build.

Awareness of earthquake rating

Since the Canterbury earthquakes, local authorities, building owners and their tenants have become more conscious of the earthquake strength of commercial property.

Strengthening costs can be significant, and whether they are capital or revenue will be a key concern.

> Builders, architects and designers working in these areas can help their clients by providing full information and cost breakdowns of the work done.

Inland Revenue ruling

An Inland Revenue Interpretation Statement outlines that work undertaken to strengthen a building, whether or not earthquake damaged, is considered to be an improvement to the building and capital in nature.

This is likely even in circumstances when the work was required by law, such as to comply with council consents. This contrasts with work done to repair a building back to its original state. These would usually be deductible repair costs.

Separating strengthening and restoration

Clients may want to carry out deferred repairs and maintenance at the same time as earthquake-strengthening work. It could be helpful if the costs and work undertaken to strengthen a building are clearly separated from expenditure incurred to restore the building to its original condition or from other work that would ordinarily be classified as repairs and maintenance.

Split invoices or separate analysis when the building work is done and work is invoiced would be useful. Your clients can then use this information to decide on the tax position they want to take.

Call for tax deductions

There has been a call to change the law to enable a tax deduction to be claimed for earthquake-strengthening costs.

The government said it will not make any decision on any tax concessions until after the Royal Commission of Inquiry into the Canterbury earthquakes issues its final report, so the matter remains unclear.

Leaky buildings and capital expenditure

There is a similar issue with work to repair leaky buildings and other remedial building work. Inland Revenue considered the tax deductibility of repair costs on a building with leaky building syndrome and decided the factors indicating capital expenditure are:

- the damage repaired is fundamental to the structure of the building
- the expenditure does more than renew or replace defective parts and renews or replaces substantially the whole asset
- the work changes the character of the property, for example, recladding the property in a different material as a permanent solution to prevent water access
- the work results in a significant increase in the value of the asset, although this is not determinative in itself.

Buyer knowledge a factor

Sometimes a taxpayer purchases property at a reduced cost knowing that there is a leaky building problem and that major expenditure would be required.

In these cases, Inland Revenue would be more likely to assert that the costs of bringing the building up to an acceptable state are capital because the work significantly increases the value of the asset.

There may be an arguable position for the tax deductibility of expenditure incurred to repair a leaky building provided the taxpayer was unaware of the problem and did not pay a lower price because of it.

Tax position could influence materials choice

Given the complex issues arising from expenditure of this nature, where the building will be used to derive rental income, clients will need full information in both the design and build phases to help them determine their tax position. At the design phase, deciding what materials to use could be influenced by the tax result.

As with other remedial building work, being aware of the issues and being prepared to provide clients with the necessary information could potentially reduce your client's after-tax cost.

Note Staples Rodway is an affiliation of independent chartered accountancy firms.