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PUB00286: Can a fit-out of an existing building be "improvements" for the purposes of s CB 11?

Introduction

1. The New Zealand Law Society (Law Society) welcomes the opportunity to comment on draft Question We've Been Asked: *Can a fit-out of an existing building be "improvements" for the purposes of s CB 11?* (draft QWBA). The Law Society's Tax Law Committee (committee) has considered the draft QWBA and its comments are set out below.

2. It is important to clarify the scope of section CB 11 of the Income Tax Act 2007 (the Act). The meaning of the word "improvements" is not, however, the only aspect of section CB 11 that requires clarification. In addition to commenting on what constitutes an "improvement", this submission sets out other issues that arise in relation to the application of section CB 11, which could usefully be addressed in subsequent "Questions We've Been Asked". Some of these issues arise (but are not addressed) in the examples included in the draft QWBA.

3. The committee agrees that the definition of "improvements" in section YA 1 of the Act could include fit-out, and that the extensive fit-out referred to in the key example in the draft QWBA could not fairly be described as "minor". However, the committee disagrees with general statements made in the draft QWBA about the meaning of the words "by a person erecting a building or otherwise", and also the manner in which the draft QWBA approaches the issue of whether such "improvements" are "minor".

Intended scope of section CB 11

4. Paragraphs 12 and 13 of the draft QWBA consider the meaning of the phrase "erecting a building or otherwise". Paragraph 12 notes that:

> *Under s YA 1, "improvements" means "improvements to land … made by a person [or an associated person] erecting a building or otherwise". The words "improvements to land … made by a person erecting a building" provide an example of the most common type of improvements to land – the erecting of a building.* ***However, the words "or otherwise" make it clear that the erecting of a building is not the only improvement to land that can meet the definition of "improvements", and that "any other improvements to land" are also included. This interpretation is consistent with the common law and the legislative history of s CB 11."*** [emphasis added]

5. This interpretation effectively renders the wording “erecting a building or otherwise” nugatory to the interpretation of section CB 11. As a matter of statutory interpretation, the committee does not agree that the words “erecting a building or otherwise” in the definition of “improvements” are ineffectual and have no bearing on the type of enhancements that are treated as “improvements” for the purpose of section CB 11. It is unlikely that Parliament included the words “erecting a building or otherwise” if the intention was simply for *any* improvements to land to be caught by the definition. Parliament must have contemplated that these words would limit in some way the type of enhancement that triggers a liability for tax under section CB 11. This is supported by the New Zealand Parliamentary Debates (*Hansard*) when the forerunner to section CB 11 was enacted in 1973.

6. The forerunner to section CB 11 (section 88AA(1)(c) of the Land and Income Tax Act 1954) was introduced as clause 8 of the Land and Income Tax Amendment Bill 1973 (the Bill). Clause 8 of the Bill was replaced fully via Supplementary Order Paper, and was not referred to the Statutes Revision Committee. Accordingly, the speech by the Minister introducing the Bill (the Hon. W. E. Rowling) in *Hansard* about the intended scope of clause 8 is the best indication of Parliament’s intention in enacting the forerunner to section CB 11:

> “*Profits and gains from real property will now be assessed when, firstly, the property was acquired with the intention as well as the purpose of resale, and, secondly the property was acquired by a land dealer and either was held as part of his land dealing business and later sold – in which case the profits will be assessable irrespective of the period between acquisition and sale – or, if it was not held as part of his land dealing business but is sold within 10 years of acquisition, for example, claimed to be held as an investment but sold within this 10-year period.* ***Similar provisions to those I have just mentioned will apply with respect to a builder. He will be assessed if he acquires property and erects a building thereon, and either the erection of the building was part of his building business – in which case the profit will be assessable irrespective of the period between erection of the building and sale – or the building was not erected as part of the building business but the property was sold within 10 years of its being erected***.” [emphasis added] (*Hansard*, 6 September 1973, pages 3,313 and 3,314)

7. It is clear that the type of improvement that Parliament had in mind in enacting the forerunner to section CB 11 was the erection of a building. This is consistent with the mischief that Parliament sought to prevent in enacting section 88AA(1)(c) (now section CB 11), which is builders plying their trade to enhance the value of land owned by the builder or by an associated person without the resulting gain being taxable. While the words “or otherwise” must refer to something other than the erection of a building, they should be interpreted consistently with the mischief that Parliament sought to prevent.

8. In light of the above, the committee considers that the ‘builder tests’ should only apply where the enhancement to land arose from activities which could fairly be described as being part of a builder’s business. One example of an enhancement that would not ordinarily be part of a builder’s business is the demolition of an unsafe structure from the land (referred to as an “improvement” in paragraph 9 of the draft QWBA). Another example would be landscaping.

9. Similarly, there is a difference, for the purposes of section CB 11, between the construction or alteration of fit-out that is intended to meet the needs of an incoming tenant and the construction or alteration of fit-out that improves the value of the land/building per se. When commercial tenants change there will usually be changes to fit-out, and these changes will often be "not minor". However, these changes should not be "improvements" for the purposes of

section CB 11 if they are not carried out to improve the value of the land per se, but rather to meet the needs of the incoming tenant.

10. Notwithstanding the above, constructing fit-out of a nature referred to in the key example in the draft QWBA could fairly be described as an activity that a builder could carry out in the course of their business. As such, the committee agrees that that fit-out could constitute an "improvement" as contemplated in section CB 11, and that such an interpretation is likely to be consistent with Parliament's intention when the forerunner to section CB 11 was enacted. This does not mean, however, that all enhancements to land would constitute an "improvement" for the purposes of section CB 11, and the draft QWBA should make this clear.

Determining whether improvements are "minor"

11. Paragraphs 15 and 16 set out the factors that need to be taken into account in determining whether improvements are "minor". The draft QWBA draws on the four factors set out in interpretation guideline IG0010 "Work of a Minor Nature" in *Tax Information Bulletin* Vol 17, No 1 (February 2005). Those factors originated from Richardson J's judgment in *Lowe v C of IR* (1981) 5 NZTC 61,006 (CA) in the context of section 88AA(1)(d) of the Land and Income Tax Act 1954 (the forerunner to section CB 12 of the Income Tax Act 2007).

12. The question considered in *Lowe* (and also in IG0010), was whether the work involved in a scheme or undertaking involving the development of land or the division of land into lots was "of a minor nature". The enquiry under section CB 11, on the other hand, is whether the improvement is minor, not whether the work involved in effecting the improvement is minor. As such, the enquiry under section CB 11 is different from the enquiry under section CB 12.

13. By importing the factors that the Commissioner considers relevant in determining whether work is minor for the purpose of section CB 12, Inland Revenue appears to be signalling to taxpayers that case law on section CB 12 (and forerunners) also applies for the purpose of determining whether improvements are minor for the purpose of section CB 11, which is an entirely different purpose.

14. The focus of section CB 11 on the "improvements", rather than the "work" involved in effecting those "improvements", necessitates a different approach. Whether an enhancement is "minor" is a question of fact and degree and, while the factors listed in the draft QWBA may be relevant, they should not be determinative. In particular, undertaking repairs and maintenance should never be treated as an "improvement", irrespective of the cost involved.

15. Notwithstanding the above, the committee agrees that the nature of the fit-out referred to in the key example in the draft QWBA could not fairly be described as "minor" irrespective of the tests used to characterise the nature of those enhancements.

Issues arising in Example 3 but not addressed in the draft QWBA

16. Example 3 of the draft QWBA needs to make it explicit that Braavosi Building Limited was carrying on the business of erecting buildings at the time Tyroshi Tenements Limited started fitting out the office block. If Braavosi Building Limited was not carrying on the business of erecting buildings at that time, then Tyroshi Tenements Limited's office block would not be "tainted by association" with Braavosi Building Limited, notwithstanding that Tyroshi Tenements Limited and Braavosi Building Limited were "associated persons" at the time the office was fitted out.

17. Example 3 of the draft QWBA also raises an important issue that is not addressed in the draft QWBA. That is, whether the definition of "improvements" in section YA 1 requires the person who owns the land (or an associated person) to actually make the enhancements or merely pay

for those enhancements. Case law on the forerunner to section CB 11 implies that the former is correct, which is consistent with the mischief that Parliament sought to prevent when enacting the provision in the first place (as set out in paragraph 7 above). If the taxpayer in Example 3 (Tyroshi Limited) had paid a non-associated person to carry out the fit-out, then the office block should not be "tainted by association" with the builder (Braavosi Building Limited). Any other interpretation would make no sense and be inconsistent with the reason Parliament initially enacted the forerunner to section CB 11.

Other issues arising in respect of the application of section CB 11

18. Other issues arise with respect to the interpretation of section CB 11 in practice, which could usefully be clarified in future Questions We've Been Asked items. These issues include:

    a) What constitutes a business of erecting buildings;

    b) Whether a person who erects buildings to derive rental income, and not for sale, would be treated as being in "the business of erecting buildings";

    c) When does a "business of erecting buildings" commence and when does it end;

    d) What constitutes a separate "improvement" for the purpose of section CB 11;

    e) When does an "improvement" begin and when is an improvement "completed"; and

    f) Will an "improvement" be treated as having been "made by a person" if that person does not physically make the "improvement", but pays a non-associated person to make that improvement (addressed in paragraph 17 above).

19. The committee considers that (b) and (f) are the most pressing, and would be available to assist Inland Revenue with those if required.

Conclusion

20. If you wish to discuss this further, please contact the Tax Law Committee's convenor Neil Russ, via the committee secretary, Jo Holland at jo.holland@lawsociety.org.nz, (04) 463 2967.

Yours faithfully

Kathryn Beck
President