From uncertainty to objectivity: reforming tax deductions for repair costs in Australia

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Abstract

In Australia, the cost of repairing an asset used to produce assessable income is immediately deductible under s 25-10 of the Income Tax Assessment Act 1997. To claim this deduction, the repairs must not be of a capital nature. The courts have developed three tests to distinguish repair costs from capital expenses. The first test, the 'initial repair test' is fairly sound. However, the other two tests, which focus on replacing and improving assets, are far less reliable. This article begins with a general discussion on repairs and critiques the three tests used for characterising repair costs. It explores the rationale for allowing immediate tax deductions for repair costs and the significant difficulty involved in producing coherent and consistent tax outcomes in practice. Next, the article demonstrates this difficulty through a survey of case law, arguing that the current rules need to be clarified. Lastly, the article recommends that new tax rules be adopted to deal with repair costs, to complement the existing regimes governing depreciating assets and capital works, simplify tax administration and reduce compliance costs.

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1 Introduction

The deductibility of repair costs is one of the foundational topics covered in income tax law courses in Australia. Section 25-10 of the *Income Tax Assessment Act 1997* provides that taxpayers can immediately deduct expenditure incurred for repairing a premises (or part of a premises) or a depreciating asset, to the extent that it is incurred for the purpose of producing assessable income.[1] This provision, which was included as a temporary, transitional measure in the original 1915 version of the Act,[2] has survived all the revisions made to the legislation since then.[3] Despite its long history, many tax law teachers and practitioners have difficulty explaining the law and the applicability of deductions for repair costs. This article attempts to address the conundrum.

According to one teaching resource and a ruling issued by the Commissioner of Taxation, section 25-10 is most likely redundant because the principal deduction provision (section 8-1 of the same Act) distinguishes between current and capital expenses and implies that repair costs are current expenses.[4] Nonetheless, deductions for repair costs have been dealt with almost exclusively under the repair provision in the Act since it was first introduced.[5] A question remains as to what constitutes a repair because if work is a repair, the cost must be immediately deductible. To explore the question, this article surveys case law on characterising repairs.

The word 'repair' is not defined in the income tax legislation but it takes its natural or ordinary meaning. In *W Thomas & Co Pty Ltd v FCT*,[6] Windeyer J said a repair is for the maintenance of an asset, which is distinguishable from the acquisition of an asset. His Honour noted it would be difficult to view a repair as being limited to work required to remedy a defect because naturally, repairs include work to prevent a defect from developing: 'A stitch in time is as much a repair as would be the nine it saves. And the cost of it may be in the same category as would be the cost of nine.'[7] This approach does not distinguish between repair

1 *Income Tax Assessment Act 1997*, s 25–10. It applies to any person who holds or uses an asset, not only legal owners. For example, in *Case 55* (1956) 6 CTRB(NS) 342 the taxpayers were lessees; in *Case 89* (1962) 10 CTBR(NS) 515 the taxpayer was a beneficiary with ownership responsibilities before title had passed to them.

2 See *Income Tax Assessment Act 1915*, s 18(d), as amended by *Income Tax Assessment Act 1918*, s 14(d). The provision limited deductions to an estimated annual average amount of repair costs in the first three years of operating the federal income tax law.

3 Previous versions of the repair costs provision include s 23(1)(d) of the *Income Tax Assessment Act 1922* and s 53 of the *Income Tax Assessment Act 1936*.

4 See Graeme Cooper et al, *Income Taxation: Commentary and Materials* (Thomson Reuters, 9th ed, 2020) [10.70]; Australian Taxation Office, *Income Tax: Deductions for Repairs* (TR 97/23) [7]. In contrast, Kerrie Sadiq et al, argue that s 25-10 is the most appropriate provision for deducting repair costs: in *Principles of Taxation Law 2020* (Thomson Reuters, 13th ed, 2019) [13.30]. Some authors speculate that the repair costs provision is wider in scope than the general deduction rule: see RW Parsons, *Income Taxation in Australia* (Law Book Co, 1985) [6.156]; Frank Gilders et al, *Understanding Taxation Law: An Interactive Approach* (LexisNexis Butterworths, 2nd ed, 2004) [9.7]. See also John Taylor et al, *Understanding Taxation Law 2017* (LexisNexis Butterworths, 8th ed, 2016) [9.7].

5 RW Parsons, *Income Taxation in Australia Principles: Principles of Income, Deductibility and Tax Accounting* (University of Sydney Library, 1985) [10.9]. See also Alan Gotterson, 'Expenditure on Repairs Fully Deductible' (1984) 54(7) *Chartered Accountant in Australia* 7.

6 *W Thomas & Co Pty Ltd v FCT* (1965) 115 CLR 58 dealt with repairs to gutters, roof, walls and floor of the premises. ('*W Thomas & Co Pty Ltd*').

7 Ibid 74.

and maintenance as capital works but does differentiate them from building a new asset.[8] Given that maintenance costs are deductible under the general deduction rule (if not under the specific repair costs provision), the distinction between repairs and maintenance is not significant. The tax system allows immediate deductions for both repairs and maintenance costs when they are incurred in the course of gaining or producing income.[9] The more important distinction is between repairs and capital expenditure because they are taxed differently, resulting in different tax options. This distinction has been the focus of much litigation.

Judicial approaches to distinguishing repair costs from capital expenditure are unsettled. Based on case law that has sought to distinguish repairs from capital expenditure in various ways,[10] some authors define repairs as work undertaken to remedy a defect, distinguishable from pure maintenance such as 'oiling a part which is in perfect working condition'.[11] According to others, repairs are more like ordinary maintenance than acquiring a new asset.[12] Some authors focus on the extent of the restoration work undertaken,[13] while others argue that the existence of a defect is one of the central attributes of a repair.[14]

This article examines three tests often employed by the courts for characterising repair costs. First, it explains the difficulty in stating that repair costs are always non-capital expenses based on certain criteria in a neutral income tax system. Next, a range of case law is surveyed, which demonstrates varying interpretations of the three tests. The first, the 'initial repair test', is sound from a tax policy perspective. However, the other two approaches, namely the 'replacement test' and 'improvement test', are ambiguous in that they produce tax decisions that are not always coherent and consistent. Lastly, to overcome these uncertainties, this article explores options for a new 'safe harbour rule' for dealing with repair costs that can also complement the existing capital allowance

8 In *Case 21* (1947) 14 CTBR 485, the taxpayer argued that the construction of a new revetment was a repair. In deciding the work had a capital nature, the Commonwealth Taxation Board of Review ('the Board') mentioned that the flood did not cause a defect but accelerated the natural process of the riverbanks changing their shape and washing away.

9 Wallschutzky found it interesting that TR IT 180 (issued on 10 December 1964) provides immediate deductions for repairs carried out after property ceases to be an income-producing property: see IG Wallschutzky, *Australian Income Tax Law* (John Wiley & Sons, 1986) [6.3]. See also deductible repair costs in relation to a home office: Australian Taxation Office, *Income Tax: Deductions for Home Office Expenses* (TR 93/30) [32]–[35].

10 Frequently cited cases are *Lurcott v Wakely and Wheeler* [1911] 1 KB 905, *Case J47* (1958) 9 TBRD 244, *FCT v Western Suburbs Cinemas Ltd* (1952) 86 CLR 102 ('*Western Suburbs Cinemas Ltd*') and *W Thomas & Co Pty Ltd* (n 6). Further discussion on the repair costs provision can be found in Gordon S Cooper, 'Repairs, Improvements and Depreciation' (Intensive Seminar Papers, Taxation Institute of Australia (New South Wales Division), 1990) 61; S Chapple, 'Treatment of Section 533 Repairs in the 1980s' (1990) 24(10) *Taxation in Australian* (Sydney) 736; RK O'Connor, 'Repairs to Premises, and Depreciation of Plant and Articles: The Law in relation to Deductibility of Expenditure' (1981) 16 *Taxation of Australia* (Sydney) 107; SJ McMillan, 'Improvements and Initial Repairs' (1990) 2(2) *CCH Journal of Australian Taxation* 15; Evan Lancaster, 'Deductions for Repairs' T*axpayers Australia*, 21 January 2002, 201–7.

11 See, eg, Kerrie Sadiq et al, *Principles of Taxation Law 2020* (Thomson Reuters, 13th ed, 2019) [13.33].

12 See, eg, Graeme Cooper et al, *Income Taxation: Commentary and Materials* (Thomson Reuters, 9th ed, 2020) [10.70].

13 RL Deutsch et al, *The Australian Tax Handbook 2020* (Thomson Reuters, 2020) [9.600]; Geoffrey Hart and Jas Sekhon, *Barrett & Green's Principles of Income Taxation* (LCB Information Services, 5th ed, 1996) [10.11]; Michael Kobetsky et al, *Income Tax: Text, Materials and Essential Cases* (The Federation Press, 7th ed, 2008) [11.40]; Cynthia Coleman, Geoffrey Hart and Margaret McKerchar, *Australian Tax Analysis: Cases, Commentary, Commercial Applications and Questions* (Australian Tax Practice, 5th ed, 2004) [10.030].

14 See, eg, Robin Woellner, Trevor Vella and Rodger Chippendale, *Australian Taxation Law* (CCH Australia Limited, 1987) [5-030]; JAL Gunn, *Gunn's Commonwealth Income Tax Law and Practice* (Butterworth & Co. (Australia) Ltd, 4th ed, 1954) [1412].

regime. A safe harbour rule is a clearly defined rule or standard that relies on objective criteria, which leave little or no room for subjective interpretation. The current approaches to characterising repair costs are far too subjective. Creating an objective framework for distinguishing repair costs from capital expenses would reduce opportunistic behaviour by taxpayers, simplify tax administration and reduce compliance costs.

2 The rationale for immediate deductions

It is widely accepted that repair costs are, by nature, current expenses. The question then, is whether this view aligns with tax policy principles. To achieve a neutral income tax base, current expenses should be immediately deductible because the benefits they produce are consumed or used during the year of expense. In contrast, a capital expense is an expense that brings benefits beyond the year of expense and is deductible only when and to the extent it diminishes one's economic position. Accordingly, repair costs must not be immediately deductible if the work brings long-lasting benefits. However, repairs often do so. For example, the benefits of maintenance work like oiling a car engine are clearly temporary, whereas the benefits of painting a building or replacing pavers will remain long after the end of the year in which the work is carried out. It is difficult to argue that repair costs must be immediately deductible based on neutral income tax policy criteria alone.

Accounting practice may provide some guidance on this issue. In accounting, repairs are considered day-to-day activities required to keep assets in good working condition for producing income, the cost of which immediately reduces revenue in the profit and loss statement. However, it must be noted that accounting practice embraces the materiality principle, which allows flexibility in reporting standards for immaterial transactions. There is no set rule for a materiality threshold but as a rule of thumb, varying or omitting a transaction that is less than 5–10% of net income is presumed not to be misleading. In contrast, the tax system permits no omissions or flexibility in characterising transactions, from the first dollar. If the goal is certainty, accounting practice provides no useful guidance for distinguishing repair costs from capital expenditure.[15]

Similarly, judicial rationales used to distinguish a revenue outgoing (including but not limited to repairs) from capital expenditure do not provide a clear answer as to why repairs are deemed to have a non-capital nature. In Australia, three main doctrines are used for this purpose. The first, imported from the English courts, is the 'recurrence test of outgoings', including continuous demand or once and for all payments.[16] Mostly used for recurring interest expenses or rent expenses, this test is often not conclusive for identifying revenue outgoings. The second test, which also originated in the English courts, is the 'enduring benefits test'. It assesses whether an expense is incurred 'with a view to bringing into existence an asset or an advantage for the enduring benefit of a trade'.[17] It points to the lasting quality of the benefit in return for the expense and supports the possibility that a repair cost may have a capital character. Under the third test, developed in the Australian courts, costs put towards the profit-yielding structure of a business are deemed to have

15 K Holmes and D McCallum, 'Distinguishing Expenditure on Repairs and Improvements for Tax Purposes: Can Accounting Help?' (1994) 17(4) *Accounting Forum (Adelaide)* 66. See also the comparative aspects in Mary A Kaidonis and Natalie P Stoianoff, 'The Interplay of Language between Taxation and Accounting for Repairs in Australia: Should a Stitch in Time Save Nine?' (2001) 27(1) *International Tax Journal* 72.

16 *Vallambrosa Rubber Co Ltd v Inland Revenue Commissioners* [1910] SC 519; *Ounsworth (Inspector of Taxes) v Vickers Ltd* [1915] 3 KB 267.

17 *British Insulated & Helsby Cables v Atherton* [1926] AC 205; 10 TC 155.

a capital nature whereas costs incurred in the course of day to day business processes are revenue outgoings.[18] While it may be argued that this test takes a similar approach to the accounting concept of capital, which focuses on the resources an entity uses to generate profits, it has also been used to characterise certain legal expenses (which would undoubtedly be deductible outright in accounting) as capital expenditure.[19] The application of this third test has been ambiguous ever since,[20] and there is still no clear reason why a repair cost should not be characterised as capital expenditure based on this test.

If repairs costs are assigned a capital nature, capital expenses should be deductible when and to the extent that the benefit diminishes. Some tangible assets may not last forever but depreciate very slowly. For instance, if repaired continuously, buildings may last for hundreds of years. When the benefit period of a repair is likely to be shorter than the 'effective life' of the asset, depreciating the repair costs over the effective life of the asset is disadvantageous to taxpayers. If a repair is assigned a capital character separately from the asset to which it relates, accurately measuring net income for the year based on neutral income tax policy criteria would require that outright deductions be allowed and that the value of any future economic benefits be added back into taxable income at the end of every year. This would ensure deductions are only allowed to the extent that economic benefits have been used or lost during the financial year. However, this is a burdensome process that requires taxpayers to track even the tiniest expenses (e.g., not only windscreen wipers and car tyres but also nuts and bolts for fixing a bookcase). Further, taxpayers are required to value each item, whether small or large, at the end of each financial year to account for consumption or loss in value. While capital expenses for a tangible asset are deductible during the asset's effective life, the benefit period for a repair is often undeterminable; it is often impossible to measure the depreciation of the benefits in a systematic way. For example, new flooring or painting may last until replaced or last as long as the building they are in lasts. The tax system relies on self-assessment and the benefit periods determined by taxpayers are likely to vary significantly. There is currently no sound solution to this problem. Treating repair costs as capital expenditure at all times may not be sensible. If immediate deductions for repair costs are to continue, a logical step would be to clarify the circumstances in which costs are deductible outright (i.e., a proxy). In doing so, it may be necessary to consider the accounting and record keeping habits of taxpayers to simplify tax administration and avoid overburdening taxpayers.

3 Initial repairs

Australian courts have sought to clarify the definition of 'repair' for the purpose of allowing immediate tax deductions. Broadly, there are three categories of capital expenditure that do not fall within the ordinary definition of a repair and are not eligible for immediate deductions under s 25-10 of the *Income Tax Assessment Act 1997*. The first category is 'initial repairs': work undertaken to repair damage or a defect that existed at the time an asset was acquired, where the work is required to make the asset fit for its income-

18 *Sun Newspapers Limited v FCT* (1938) 61 CLR 337.

19 See, eg, *Broken Hill Theatres Pty Ltd v FCT* (1952) 85 CLR 423; *John Fairfax & Sons Pty Ltd v FCT* (1959) 101 CLR 30.

20 Krever said almost all expenses can be found capital based on the criteria that expenses related to the structure of a business are capital expenses: in Richard Krever, 'Capital or Current: The Tax Treatment of Expenditures to Preserve a Taxpayer's Title or Interest in Assets' (1986) 12 *Monash University Law Review* 49, 74–5.

producing purpose. Ultimately, an asset's intended use and the pre existence of the defect are the determining factors in characterising work as an initial repair.

3.1 Intended use of an asset

The initial repair test examines whether a repair was undertaken to make an asset fit for its intended income-producing purpose. Firstly, it is necessary to identify the condition in which the taxpayer intends to use the asset. If a repair is clearly required to enable a taxpayer to use a newly acquired asset, the work is not an ordinary repair but work incidental to acquiring a new asset.[21] Such situations are relatively easy to identify: for example, when new owners decide to complete work left undone on a premises by the previous owner.[22] It would be unreasonable to expect the new owner to attract a tenant without undertaking repairs when a premises is run down. In such circumstances, the work would be an initial repair.[23] Similarly, when a taxpayer intends to carry on a particular business on a premises that is not equipped for that business, costs may be incurred to modify parts of the premises.[24] In the past, the courts have characterised the cost of bringing an asset up to standard for its intended use as well as costs incurred to remedy damage caused by a vacating tenant as initial repairs, as if they were part of the acquisition cost.[25]

It is generally accepted that repairs are initial repairs when a taxpayer purchases a rental property intending to repair and renovate it, then lease it out for a higher rental price.[26] Similarly, work undertaken to repair and renovate an inherited property that will be leased for increased rent can also be characterised as an initial repair.[27] These cases contrast circumstances where property is intended to be used in its run-down state. For example, in the English case, *Odeon Associated Theatres Ltd v Jones (Inspector of Taxes)*,[28] the cost of repairs to remedy defects that had occurred before acquisition were immediately tax deductible instead of being treated as initial repair costs. In that case, while the

21 This includes circumstances where work was undertaken in an attempt to fix a flood-damaged motor racing track, which was found to be preliminary to the construction of new bypasses that the taxpayer chose as a cheaper and more economical alternative to fixing the damaged track: see *Case 33* (1972) 18 CTBR(NS) 238; *Case D64* (1972) 72 ATC 390. See also *Mount Isa Mines Ltd v FCT* (1990) 90 ATC 4267, where construction of an embankment was not a repair to the retaining wall that was initially constructed to create a tailings dam but later submerged by the embankment.

22 See, eg, *Case 80* (1985) 28 CTBR(NS) 597; *Case S74* (1985) 85 ATC 534. In *Case W83* (1989) 89 ATC 731; *AAT Case 5306* (1989) 20 ATR 3927, the new owner paid for a special levy proposed by the body corporate of a strata building for upcoming repairs. The payment to the body corporate was characterised as being for repairs.

23 In *Case 55* (1956) 6 CTRB(NS) 342; *Case G59* (1956) 7 TBRD 336, the taxpayer needed to update the premises to attract a tenant and undertook various jobs including exterior and interior painting, removing rubbish, plumbing fixes to the roof, sewer and downpipes, electrical work and replacing safety locks on doors. See also *Case 55* (1950) 1 CTBR(NS) 212; *Case 28* (1950) 1 TBRD 82 (initial repairs including painting and replacing the roof, ceilings, paperhanging, stoves and lavatories), *Case V83* (1988) 88 ATC 580; *AAT Case 4371* (1988) 19 ATR 3540 (initial repairs for the electrical system and plastering of the 100-year-old property).

24 In *Case 4* (1961) 10 CTBR(NS) 16; *Case M6* (1961) 12 TBRD 30, the taxpayer carried out construction work to enable them to carry on a business. The work included signwriting, erecting a staircase, hoist hatches and partitions, painting and repairing the floor.

25 In *Case 93* (1959) 8 CTBR(NS) 542; *Case K11* (1959) 10 TBRD 69, the work to fix damage caused by the vacating tenant removing plant and equipment from a dry-cleaning business was characterised as an initial repair.

26 In *Case W7* (1989) 89 ATC 161; *AAT Case 4845* (1988) 20 ATR 3170, the taxpayer rented out the property to a student as a temporary residence while carrying on initial repairs. This rental income was considered incidental and the work's characterisation as initial repairs remained.

27 See *Case 93* (1957) 7 CTBR(NS) 626; *Case H116 (*1957) 8 TBRD 538.

28 *Odeon Associated Theatres Ltd v Jones (Inspector of Taxes)* [1972] 1 All ER 681.

cinema was already in a condition capable of producing income, exceptional wartime circumstances had prevented the previous owners from carrying out repairs before selling the cinema. The court determined that repairs would not have increased the acquisition cost had the seller undertaken the repairs (unlike repairs that affected the purchase price in *Law Shipping Co Ltd v Commissioner of Inland Revenue*, discussed in more detail below). In comparison, Australian courts have taken a wider approach, finding that initial repairs are capital expenses outside the scope of repairs that give rise to immediate deductions. This applies when repairs would not have affected the acquisition cost as well as when the existence of a defect was not known at the time of acquisition.

Similarly, establishment costs incurred while starting a business are not repair costs; rather, they are capital outlays and generally not deductible outright.[29] There are exceptions in the legislation, such as service fees paid to establish a small business,[30] but repair costs do not fall within any of those exceptions. Once it is determined that a repair is an initial repair, the cost is not deductible outright.

3.2 Pre-existence of a defect at acquisition

Until recently, many Australian cases have cited the UK case, *Law Shipping Co Ltd v Commissioners of Inland Revenue*,[31] as a precedent for the principle that the cost of initial repairs is a capital outlay rather than an immediately deductible repair cost. In that case, the taxpayer purchased a ship; a subsequent marine survey revealed that it required extensive repairs. The taxpayer incurred significant costs for repairs to keep the ship in good condition, which were treated as being in the nature of an acquisition cost because the sellers would have demanded a higher price if they had carried out repairs before the sale. In other words, an acquisition cost can include 'the cost of the arrears of repairs which their predecessor had allowed to accumulate'.[32] In *W Thomas & Co Pty Ltd v FCT*, Windeyer J said this principle was too obvious to require any specific case law authority for identifying an initial repair in this manner.[33] Similarly, the drafters of Australia's income tax legislation also mentioned that the sum spent to restore a property to a habitable condition after acquisition is of a capital nature because it would otherwise have been included in the purchase price of the property.[34] However, other cases demonstrate that the approach taken in *Law Shipping Co Ltd v Commissioners of Inland Revenue* is not the only workable approach to identifying initial repairs. While the courts have attempted to establish that a defect existed at the time of acquisition to characterise the repair cost as a capital outlay,[35] initial repairs have also been established in cases where the taxpayer was unaware of

29 In *Dalton v DFC of T* (1998) 98 ATC 2025, restoring a tractor and plant to a serviceable condition was not characterised as repairs because expenses were incurred in preparing to establish an orchard nursery. In contrast, repair costs for a bulldozer and equipment were deductible in *Case 16* (1986) 29 CTBR(NS) 127; *Case T12* (1986) 86 ATC 178 because the taxpayer's business growing blueberries had already started, though it was in its early stages.

30 *See Income Tax Assessment Act 1997*, s 40-880.

31 *Law Shipping Co Ltd v Commissioners of Inland Revenue* (1923) 12 TC 621.

32 Ibid 627.

33 *W Thomas & Co Pty Ltd* (n 6) at 73.

34 Explanatory Memorandum, Income Tax Assessment Bill 1935, 62.

35 The acquisition time approach applies where property is transferred to a company: see *Case 154* (1984) 27 CTBR(NS) 1206; *Case R101* (1984) 84 ATC 673 (property transferred from an individual to their company), Case 123 (1954) 4 CTBR(NS) 743; *Case E84* (1954) 5 TBRD 509 (property transferred from three partners to a company). The initial repair test can also apply when property of a deceased person is transferred under a will: see *Case 52* (1939) 9 CTBR 392, *Case 85* (1955) 5 CTBR(NS) 513; *Case F66* (1955) 6 TBRD 384, *Case 17* (1951) 2 CTBR(NS) 84; *Case B45* (1951) 2 TBRD 194, *Case 11* (1963) 11 CTBR(NS) 53; *Case N55* (1963) 13 TBRD 222 (renewal of gutters and repair of downpipes).

the defect at the time of acquiring an asset.[36] This includes circumstances in which the taxpayer paid higher consideration believing that the seller had already fixed the defect and that no repairs would be necessary, at least not for some time.[37] These cases reaffirm the general approach to characterising work as an initial repair based on whether the work is required to make an asset fit for its intended income producing purpose.

3.3 The timing of initial repairs

There is no specific timeframe for an initial repair. Provided that work is required to bring an asset up to standard for its intended purpose, the work can be undertaken as late as several years after acquisition and still be characterised as initial repairs.[38] Initial repairs may also occur after the asset has started producing income incidentally.[39] However, initial repairs do not include remedial work done several years after using the asset. For example, in one case, a taxpayer restored the floor of a transhipment facility after operating the facility for 15 years. The court found that the restoration expenses were for a regular repair, not an initial repair.[40] The Commissioner of Taxation did not apply the initial repair test, despite noting that the floor may never have been sturdy enough to handle heavy traffic from the beginning.

It can be difficult to apply the initial repair test to painting or paperhanging that is subject to natural wear and tear, particularly when initial repairs are not needed immediately. In some cases, work did not constitute initial repairs because there was no pre-existing defect at acquisition.[41] In other cases, natural wear and tear after acquisition was disregarded and

36 See *W Thomas & Co Pty Ltd* (n 6) at 74 (Windeyer J). In *Case 11* (1951) 2 CTBR(NS) 54; *Case B35* (1951) 2 TBRD 152, the taxpayer discovered serious damage soon after acquiring two investment properties: one with corroded and broken gutters hidden under leaves and olive berries covering the roof and the other with a collapsed roof from white ant infestation. However, the Board characterised the remedial work as initial repairs. Similarly, in *Case 36* (1952) 3 CTBR(NS) 198; *Case C38* (1952) 3 TBRD 217, the taxpayer found the subsiding marshalling yard of its furniture removalist business was caused by a cellar and well running four feet below the surface. Although the work was carried out six years after acquisition, the work was considered an initial repair. Work carried out to fix defects realised only after acquiring property was also characterised as an initial repair in the following cases: *Case 59* (1962) 10 CTBR(NS) 362; *Case M38* (1962) 12 TBRD 199 (claiming one-eighth of total bills for work carried out nine months after acquisition because the need for repairs was identified by the Licensing Commissioner), *Case 15* (1966) 13 CTBR(NS) 107; *Case S38* (1966) 17 TBRD 205 (various items in the nature of repair in the first few years of inheriting an asset, as instructed by the Licensing Commissioner), *Case 84* (1942) 10 CTBR 599 (spending a considerable sum for extensive work where only minor repairs and painting were intended right before acquisition).

37 See *Case 124* (1954) 4 CTBR(NS) 746; *Case E22* (1954) 5 TBRD 133. In this case, the purchase price was negotiated based on the second inspection during which there was no sign of leak from the 53-year terrace roof. Soon after acquisition, heavy rain caused leaks and the work undertaken to repair the roof was characterised as an initial repair.

38 See above n 36. However, timing may be indicative of initial repairs: see *Case 45* (1945) 12 CTBR 487 where work carried out soon after acquisition was considered an initial repair.

39 For example, in *Case 19* (1951) 2 CTBR(NS) 91; *Case B38* (1951) 2 TBRD 157, structural alterations to an eating house that were carried out by the lessee to comply with the Health Department's order were characterised as initial repairs where the business would not have been allowed to continue in breach of the order. The taxpayer had no property rights in the alterations and the court said there was no difference between whether these alterations were made to begin carrying on the business or later, after the business commenced.

40 In *Case W93* (1989) 89 ATC 785; *AAT Case 5379* (1989) 20 ATR 4014, the Commissioner of Taxation attempted to characterise work as initial repairs by arguing the deficiencies were already present when the taxpayer first occupied the property. However, the Board said, 'I know of no such authority as supports any such proposition.' It characterised the work as ordinary repairs and added that the floor was in a reasonable but imperfect condition when first used.

41 See, eg, *Case 137* (1959) 8 CTBR(NS) 770; *Case K39* (1959) 10 TBRD 203 (deductible costs for painting and water piping within first five years of acquisition); *Case 56* (1953) 4 CTBR(NS) 300; *Case D63* (1953) 4 TBRD 330 (deductible costs for painting on the basis that some deterioration must have occurred since acquisition).

repairs to painting or paperhanging were characterised as initial repairs along with other initial repair work.[42] Courts have also distinguished pre-acquisition and post-acquisition wear and tear, characterising the former as an initial repair of a capital nature and the latter as an ordinary repair that is eligible for an immediate deduction.[43]

4 Replacements versus repairs

The second category of capital expenditure that is not deductible as repair costs under s 25-10 of the *Income Tax Assessment Act 1997* is replacement costs. The 'replacement test' seeks to determine the degree of replacement or renewal of an asset. In *Lurcott v Wakely & Wheller*,[44] Buckley LJ said, 'Repair is a restoration by renewal or replacement of subsidiary parts of a whole. Renewal, as distinguishable from repair, is reconstruction of the entirety, meaning by the entirety not necessarily the whole but substantially the whole subject matter under discussion.'[45] The test is straightforward when the subject matter is clear but not so simple when the scope of the asset in question can be defined both narrowly and widely. This section of the article provides examples of how the replacement test has been applied. For example, in one year the owner of a rental property may improve the unit itself (thereby establishing a construction area and depreciation schedule under the capital works regime). Next year, the owner may improve the property's carport and that area then becomes a separate construction area, which is depreciable separately.[46] The varied timing of separate deductions connected to the same asset creates an unintended incentive for taxpayers to characterise capital works as repairs and to characterise costs connected to depreciating assets as repair costs, to gain access to immediate deductions. To maintain the integrity of the tax system, this issue must be resolved.

4.1 Replacing separately identifiable assets

Kitto J defined the subject matter of a replacement or repair as an income-producing unit or a separately identifiable capital asset.[47] Examples of separately identifiable assets include

42 See, eg, *Case 55* (1950) 1 CTBR(NS) 212; *Case 28* (1950) 1 TBRD 82 (initial repairs including painting painting and paperhanging within four years of acquisition), *Case 133* (1951) 1 CTBR(NS) 689; *Case B4* (1951) 2 TBRD 27 (obvious repair items characterised as initial repairs within two years of acquisition). Note the taxpayer's absence at the hearing in *Case 68* (1950) 1 CTBR(NS) 280; *Case 70* (1950) 1 TBRD 264, *Case 18* (1951) 2 CTBR(NS) 85; *Case B40* (1951) 2 TBRD 166, *Case 25* (1944) 12 CTBR 385.

43 See, eg, *Case 85* (1950) 1 CTBR(NS) 367; *Case 85* (1950) 1 TBRD 335 (costs for painting were deductible six months after acquisition), Case 18 (1950) 1 CTBR(NS) 67; *Case 41* (1950) 1 TBRD 128 (costs for painting an inherited property were deductible four years after acquisition, calculated based on the total time since last painting); *Case 36* (1952) 3 CTBR 201; *Case C30* (1952) 3 TBRD 176 (costs for repairs were deductible 18 months after occupying the property).

44 *Lurcott v Wakely & Wheller [1911] 1 KB 905*. See also Geoffrey Lehmann and Cynthia Coleman, Taxation Law in Australia (Australian Tax Practice, 5th ed, 1998) [6.70].

45 Lurcott (n 44) at 923–4. The case dealt with the lessee's obligations to pay for repairs under covenant, where the court decided that reconstruction of the front external wall was a repair upon defining the leased premises as the subject matter.

46 *Income Tax Assessment Act 1997,* ss 43-20, 43-75. Property investment has been discussed in Arthur Athanasiou, 'Tax Issues in Property Investment' (Conference Paper, Tasmanian State Convention of Taxation Institute of Australia, 16–17 October 2009) 13–14; Matthew Tripodi, 'SMSF Borrowing' (Conference Paper, 25th Annual Property Day of The Tax Institute, 3 February 2012) 7–10; John Weerden, 'Taxation of Real Estate' (Conference Paper, Taxation Institute of Australia, 29 April 1999) 7–11; Adrian J Bradbrook, 'The Development of Energy Conservation Legislation for Private Rental Housing' (1991) 8 *Environmental and Planning Law Journa*l 91, 94–5.

47 *Lindsay v FCT* (1961) 106 CLR 377, 385 ('*Lindsay*').

fences,[48] a gas water heater,[49] verandas or awnings,[50] window partitions,[51] a skylight,[52] a lighting system,[53] a pump in a fire safety control system[54] and a drainage or sewerage system.[55] Similarly, industrial equipment such as a boiler in a factory,[56] beer-drawing equipment[57] and a bake furnace used in manufacturing carbon anodes[58] have also been categorised as separately identifiable assets. Replacing an asset is not a repair; it is an acquisition of a new asset. A new asset may be installed in the same or different location, with or without physically removing the retired or redundant asset.[59] In the examples above, replacing a separately identifiable asset in its entirety, or nearly completely, was not generally characterised as a repair. In one case, replacing a wooden fence with a brick fence was not a repair but a capital work.[60] Conversely, if wooden vats are considered individual assets, then replacing the copper coils connected to the pipeline used to heat water in the vats is a repair because the copper coils are subsidiary parts of each vat.[61] However, this approach does not eliminate ambiguity. Based on this principle, replacing a single shelf in a bookcase is a repair whereas replacing the entire bookcase is a capital work; but what if the bookcase is a hutch permanently affixed to the desk on which it sits? In one case where work was deemed to be a capital expenditure, individual meters installed in a service station were considered separate assets. The taxpayer argued that replacing the meters was merely a repair and did not change the total number of meters

48 See *Case 58* (1962) 10 CTBR(NS) 360; *Case M34* (1962) 12 TBRD 187 (reconstructing fences on a tenanted property), *Case 45* (1977) 21 CTBR(NS) 497; *Case J24* (1977) 77 ATC 222 (a white ant infested wooden retaining wall replaced with a new structure using Besser blocks and bricks).

49 In *Case 56* (1966) 13 CTBR(NS) 396; *Case S27* (1966) 17 TBRD 163, replacing a depreciating asset was characterised as a repair to rental property. This case is an anomaly and the Chairman in dissent said a gas water heater was a depreciable asset for tax purposes.

50 See *Case 57* (1957) 7 CTBR(NS) 431; *Case H70* (1958) 8 TBRD 328 (a pillared veranda replaced with a cantilevered veranda), *Case 82* (1968) 14 CTBR(NS) 466; *Case T89* (1968) 18 TBRD 457 (a veranda replaced with a cantilevered awning).

51 See *Case 36* (1980) 24 CTBR(NS) 323; *Case M60* (1980) 80 ATC 424 (see below n 130).

52 See *Case 43* (1939) 8 CTBR 250 (window replacement and rewiring carried out while adding a second storey to the building).

53 Ibid.

54 In *Case V102* (1988) 88 ATC 657; *AAT Case* 4472 (1988) 19 ATR 3647, replacing a pump added to the fire safety control system was considered a repair but replacing other parts of the system was not. The pump allowed increased pressure from the mains supply in carrying out modifications to the old fire control system.

55 See cases dealing with a sewerage system replacing a septic system: *Case 2* (1975) 20 CTBR(NS) 13; *Case G29* (1975) 75 ATC 167, *Case 102* (1982) 25 CTBR(NS) 747; *Case P39* (1982) 82 ATC 182. See also the installation of a sewerage system in *Case 82* (1943) 10 CTBR 595.

56 See *Case 87* (1960) 9 CTBR(NS) 572; *Case L57* (1960) 11 TBRD 365 (replacing a boiler used in manufacturing vegetable oil). In contrast, in *Case 131* (1955) 5 CTBR(NS) 829; *Case G5* (1955) 7 TBRD 29, replacing a 50-foot tall steel smokestack bolted to a boiler was a repair, even though the boiler was supplied as a complete unit without the smokestack.

57 In *Case 33* (1953) 4 CTBR(NS) 188; *Case D82* (1953) 4 TBRD 425, replacing the piping for drawing beer from a cellar to a bar was deemed to create a new asset).

58 In *Re Alcoa of Australia Ltd v FCT* [2008] AATA 1128, refractory brick lining and waste gas ductwork were considered subsidiary parts of the bake furnace and therefore, replacing them was a repair. Although the work could be considered reconstruction of the 17-year-old bake furnace because such an asset typically had a useful life of about 15 years, this view was rejected on the basis that the refractory work represented only about 18% of the total costs required for the reconstruction of the entire bake furnace and much of physical materials of the bake furnace had in fact remained untouched.

59 In *Case 55* (1953) 4 CTBR(NS) 298; *Case D57* (1953) 4 TBRD 316, the taxpayer removed a cyclone damaged building structure and reset it in a different location. In *Case 107* (1957) 7 CTBR(NS) 691; *Case H88* (1957) 8 TBRD 402, an open drainage system was replaced by galvanised iron pipes in a new location to carry water away from the leased premises, also providing the advantage of increased drainage capacity.

60 *Case J24* (1977) 77 ATC 222 (a white ant infested wooden retaining wall replaced with a new structure using Besser blocks and bricks).

61 In *Case 131* (1955) 5 CTBR(NS) 829; *Case G5* (1955) 7 TBRD 29, wooden vats were considered separate assets. The case dealt with copper coils connected to pipeline used in steam-heating water in wooden vats.

for the existing electricity supply system.[62] In *Lindsay v FCT*, one of two shipways owned by a ship repairer was taken as an asset on its own, separately identifiable as an income-producing unit, and the court decided the work undertaken on it had a capital character.[63] Currently, it appears that for the purpose of applying the replacement test, the scope of a separately identifiable asset and its subsidiary parts must be determined on a case-by-case basis.

Once the subject matter of the work in question has been established, the replacement test pays little regard to the broader implications of the work. For instance, installing a skylight may require incidental structural alterations, but the replacement test is limited to assessing whether the replacement is for subsidiary parts of the skylight as opposed to the whole skylight.[64] Similarly, in one case, replacing external lavatories involved heightening the wall to which the lavatories were attached, which was not sufficient to change the capital character of the work into a repair.[65] Incidental structural alterations do not necessarily change the nature of a replacement. Replacing an asset completely or substantially is not a repair even though some old parts may remain intact.

For the purpose of characterising an expense as a revenue outgoing or a capital expense under the principal deduction provision, the courts seldom accept an expense as being immediately deductible merely because it would not have been incurred but for a non-personal, non-private purpose. Personal or private expenses are not deductible for tax purposes (e.g., premiums for travel insurance taken out for business travel, which mostly covers private items).[66] Similarly, a repair expense is not immediately deductible merely because there was no option but to incur it. Work undertaken to replace a capital asset remains a capital expense and will not be recharacterised as a repair just because there was no option to do repairs instead,[67] or because the work was required by law.[68] It will not be a repair merely because the work was necessary to avoid disrupting ongoing business operations[69] or because it was more cost-effective.[70] It may be argued that being closely connected to a revenue stream is likely to mean the work is an immediately deductible repair. However, it is unreasonable to think that there are depreciable capital assets that

62 *Case 36* (1949) 15 CTBR 356.

63 *Lindsay* (n 47).

64 *Case 43* (n 52).

65 See *Case 34* (1948) 15 CTBR 348 (replacement of external lavatories, while the wall to which the lavatories were attached not only remained in place but also was heightened).

66 See, eg, *Case T78* [1986] AATA 318; *Waters v FCT* [2010] AATA 846. The Commissioner of Taxation supports this position in *Deductions: Work Related Expenses of Employees* (ATO ID 2001/615).

67 For example, the taxpayer constructed an underground well a few yards away from the old structure because the option to repair it was too dangerous in *Case 58* (1957) 7 CTBR(NS) 434; *Case H58* (1957) 8 TBRD 268.

68 See, eg, *Case 22* (1958) 8 CTBR(NS) 107; *Case J47* (1958) 9 TBRD 244 (setting back a non-defective awning as instructed by local government), *Case 102* (1982) 25 CTBR(NS) 747; *Case P39* (1982) 82 ATC 182 (improvement achieved by replacing a broken-down septic system with the Council sewerage system, which was mandatory), *Case 2* (1975) 20 CTBR(NS) 13; *Case G29* (1975) 75 ATC 167 (replacing a working septic system with the Council sewerage system was mandatory).

69 In *Case 119* (1959) 8 CTBR(NS) 679; *Case K24* (1959) 10 TBRD 145, the taxpayer built a new roof five feet above the existing roof, so the factory production was not disturbed. It appeared that the taxpayer did not consider repair to be an option and the new structure resulted in improved ventilation function for the factory.

70 In *Case 49* (1971) 17 CTBR(NS) 319; *Case C53* (1971) 71 ATC 236, foam-like tiles made of a polyurethane material were falling off the flat galvanised roof as well as failing to absorb condensation, resulting in water dripping in the factory. The problem was fixed by replacing the ceiling with the cheapest available plasterboards nine inches below the existing ceiling. The taxpayer argued that the new ceiling merely restored the function of the old ceiling, while maintaining its inferior appearance. This was rejected because the work had improved ventilation in the building. The cost effectiveness of the materials did not change the characterisation of the work. Similarly, cost effectiveness did not lead to recharacterisation of replacing a worn-out, obsolete electricity system with a completely new system in *Case 39* (1958) 8 CTBR(NS) 189; *Case J52* (1958) 9 TBRD 270.

would not have at least some connection, whether close or remote, to revenue. Therefore, determining the character of work undertaken on an asset does not necessarily depend on whether it was carried out for the purpose of maintaining or increasing a revenue stream.[71] Also, while it is well-established that depreciation of a capital asset is based on its estimated effective life with balancing adjustment available upon disposal, it is unsound to reject the capital character of work on the basis that the asset involved will be abandoned sometime in the future.[72]

4.2 Replacing structural parts of buildings

The replacement test may be applied to one building or multiple buildings taken together, where repairs refer to work that replaces subsidiary parts of the building or buildings.[73] In *FCT v Western Suburbs Cinemas Ltd*, the ceiling was not a subsidiary, though it was a 'major and important' part of the theatre building.[74] The ceiling may serve an essential function in a building but that does not necessarily preclude the ceiling from being a separate asset.[75] It may be said that foundations, walls, roofs and other structural elements are subsidiary parts of a building or buildings. However, identifying which parts are structural subsidiaries, as opposed to separately identifiable assets, is not always intuitive: for example, in one case, replacing a bathroom vanity was characterised as a repair on the basis that it was connected to the building by plumbing.[76]

In *FCT v Western Suburbs Cinemas Ltd*, Kitto J mentioned that the cost of scaffolding could not be characterised separately as a repair cost, although it could be if the job was singular and not part of the replacement work undertaken on the ceiling.[77] In other words, capital works should not be arbitrarily broken down into individual jobs for replacing subsidiary parts of a larger whole to enable them to be characterised as repairs. In line with this, all expenditure incurred for a construction project may be given a capital character: for example, converting an obsolete premises into a modern emporium;[78] remodelling an old picture theatre to accommodate modern 70mm film;[79] structural modifications to provide employee amenities;[80] and upgrading, renovating or modernising of a rental property,[81] chemist,[82] service station,[83] department store[84] and picture theatre.[85] Case examples of

71 In *Case 36* (1980) 24 CTBR(NS) 323; *Case M60* (1980) 80 ATC 424, window partitions were installed to provide better soundproofing after the government changed the infrastructural plan and positioned a freeway nearby.

72 In *Case 138* (1959) 8 CTBR(NS) 777; *Case K38* (1959) 10 TBRD 201, connecting a septic sewage system to a group of nine shops was a capital work, providing better drainage than the sinking bore it replaced. Although the septic sewage system was subsequently abandoned, the characterisation remained.

73 In *Case 55* (1950) 1 CTBR(NS) 212; *Case 28* (1950) 1 TBRD 82, five rent-producing cottages were treated as one subject.

74 *Western Suburbs Cinemas Ltd* (n 10) at 106 (Kitto J).

75 See *Case 131* (1955) 5 CTBR(NS) 829, 832 (Cotes).

76 See *Domjan v FCT* (2004) 2004 ATC 2204; (2004) 56 ATR 1235; [2004] AATA 815.

77 Ibid 108–9.

78 *Case 30* (1951) 2 CTBR(NS) 134; *Case B56* (1951) 2 TBRD 232.

79 *Case 97* (1967) 13 CTBR(NS) 663.

80 *Case 9* (1953) 4 CTBR(NS) 58; *Case D81* (1953) 4 TBRD 418.

81 In *Case S94* (1985) 85 ATC 681, painting done nine months after acquisition did not qualify as being part of the extensive renovations completed to prepare the property to be rented out, to which the initial repair test also applied. In *Case W77* (1989) 89 ATC 698, the taxpayer attempted, but failed, to characterise the remodelling of bathrooms, power rooms and kitchens as maintenance items.

82 In *Case 109* (1960) 9 CTBR(NS) 708; *Case L35* (1960) 11 TBRD 201.

83 *Case 28* (1986) 29 CTBR(NS) 202; *Case T26* (1986) 86 ATC 252.

84 *Case 132* (1959) 8 CTBR(NS) 742; *Case K32* (1959) 10 TBRD 173.

85 *Case 38* (1960) 9 CTBR(NS) 228; *Case K80* (1960) 10 TBRD 429.

capital works also include extensive work carried out to bring a building up to modern standards, even though the work could have been characterised as repairs if it was carried out over many years.[86] There have been several other cases where taxpayers attempted but failed to characterise individual capital works as repairs.[87]

It would be fallacious to say the replacement test is as straightforward as it may appear in the examples above. These examples do not provide a complete picture. Other cases suggest that capital works may be broken down into individual jobs to characterise them separately as repairs,[88] but there is no clear reason for taking this alternative approach. It may be that individual assessments were undertaken for a project that did not affect a significant area of the building or multiple buildings as a unit. For example, in one case, multiple jobs undertaken within 3,600 square feet of factory space were characterised as repair items because the area was considered relatively small compared to the whole factory.[89] Similarly, in another case, multiple parts replaced in the cool room of a butchery were considered repairs, even though the work resulted in an almost new and upgraded version of the cool room overall.[90] In comparison, restoration work undertaken on half of a sugar mill building and manager's residence was assigned a capital character in another case, demonstrating the subjectivity involved in applying the replacement test.[91]

The difficulty involved in applying the replacement test increases even further when costs are spread over multiple years. In reality, work may start with a simple repair item, or an intention to carry out only basic repairs, but often progresses beyond the original scope of the job. The real extent of the work undertaken should be assessed overall when it is finished. Examples include cases where work intended to repair storm damage had to be extended to fix widespread white ant infestation,[92] and work intended to repair a white ant damaged floor that became a large-scale project that included fixing rotten limestone walls, a roof in danger of collapse and a rusted and leaking roof covering.[93] In another case, a taxpayer who was asked by their neighbour's architect to do minor work on an adjoining

86 See *Case 126* (1982) 25 CTBR(NS) 879; *Case P63* (1982) 82 ATC 306 (reconstructing interior floors, ceilings and walls).

87 See *Case 9* (n 80) (construction of employee amenities).

88 In *Case 54* (1968) 14 CTBR(NS) 291; *Case T44* (1968) 18 TBRD 224, the Board found 13 out of 22 jobs carried out with the intention to carry on a hardware business were repairs. In *Case 44* (1963) 11 CTBR(NS) 207; *Case P5* (1963) 14 TBRD 14, the Board characterised multiple jobs carried out for a project as repairs, including renewal of the roof, gas and water pipes, floorboards, paling fences, chairs, windows, doors, back-step and laundry piers. In *Case 9* (1954) 5 CTBR(NS) 51; *Case E29* (1954) 5 TBRD 175, deductions were allowed for unaltered parts of the building for partial replacement of the roof and replacement of timber veranda floors, internal walls and ceilings, although the works were carried out to convert the premises previously let to an apartment housekeeper into offices. See also *Case 43* (1949) 15 CTBR 384: conversion of the taxpayer's residence into two separate flats with the intention to rent out one, where deductions for the costs incurred prior to the conversion were denied because they were incurred too soon in time to create any nexus to rental income. Deductions for costs incurred after the conversion were denied because they were capital expenditures.

89 *Case 45* (1949) 15 CTBR 389.

90 In *Case 32* (1967) 14 CTBR(NS) 174; *Case T13* (1967) 18 TBRD 64, the work involved adding a false ceiling, affixing foam insulation to the floor and ceiling, rendering the whole interior with cement, replacing wooden rails and tracks with steel and electrical rewiring to rectify built-up moisture in the wall cavity.

91 *Case 47* (1966) 13 CTBR(NS) 308; Case S9 (1966) 17 TBRD 35 (work involving replacement of poles, roof and electrical cables, painting, alterations to water supply and new flyscreen fittings to the doors).

92 In *Case 10/98* (1998) 98 ATC 171; (1998) 39 ATR 1059, the work extended to replacing the wooden floor with a concrete floor and refurbishing a toilet block. The initial repair test also applied in this case.

93 In *Case 110* (1961) 9 CTBR(NS) 713; *Case L48* (1961) 11 TBRD 275, the work became extensive and was better described as a remodelling or modernisation project with ancillary repairs.

wall found the need for large-scale structural alterations, including floor replacement.[94] These examples demonstrate that generally, work will be characterised in accordance with the overall project, but jobs may also be assessed on an individual basis.

Furthermore, when applying the replacement test, an asset that requires work may be defined differently in different situations. In relation to structural improvements such as roads, the general view is that structural work (e.g., digging up the substructural bluestone pitchers and laying new foundations with a reinforced concrete superstructure) has a capital nature.[95] However, under the replacement test, this may vary. In one case, it was proposed that restoration of six metres of a 200-metre roadway would be a repair if the restoration was undertaken due to storm damage, but it could also be considered capital works if the restoration involved replacing the culvert underneath, limiting the subject matter of the repair to the six metre section instead of the whole road.[96] The replacement test attempts to define the subject matter of the work first, then assess the extent of the work in reference to the asset. However, the nature and scope of the work may alter the initial definition given to the subject, making the test more likely to produce inconsistent results.

5 Improvements versus repairs

The third category of capital expenditure that is not deductible as repair costs under s 25-10 of the *Income Tax Assessment Act 1997* is improvements. Under the 'improvement test', if work adds a considerable advantage to an asset, it cannot be characterised as a repair.[97] Improvement is concerned with the condition of an asset rather than the economic advantages it might produce, although an improvement expense may be characterised as a capital expense under the general deduction rule in some circumstances.[98] In contrast,

94 In *Case 33* (1957) 7 CTBR(NS) 174; *Case H25* (1957) 8 TBRD 96, in the end, the work created a completely new and modern shopfront, to which the initial repair test was also relevant. Similarly, in *Case 55* (1965) 12 CTBR(NS) 313; *Case R18* (1965) 16 TBRD 78, work that started with the need to repair the roof and walls turned into enlargement of a building and reconstruction of toilet facilities and cinema stages.

95 See *Case 30* (1948) 13 CTBR 157 (a bitumen-sealed roadway replaced with a concrete roadway due to instability caused by worn or broken pitchers). Generally, the improvement test would also apply to such work in assigning it a capital character.

96 See *Case 22/96* (1996) 96 ATC 274; (1996) 32 ATR 1065. In this case, replacing pipe culverts with box culverts was considered a repair because a small section of the road as deemed to be the subject of the work, rather than the whole road. This was also supported by the improvement test.

97 *Western Suburbs Cinemas Ltd* (n 10) at 106.

98 See *BP Oil Refinery (Bulwer Island) v CT* (1991) 33 FCR 594 (encases wooden piles on wharf in concrete to prevent their excessive attenuation by marine organisms), *Case 142* (1955) 5 CTBR(NS) 884; *Case G11* (1955) 7 TBRD 63 (grass tennis courts converted to gravel to more effectively maintain their playable condition), *Case 82* (1953) 3 CTBR(NS) 497; *Case C73* (1953) 3 TBRD 400 (a truck's petrol engine replaced with a diesel engine to increase fuel efficiency), *Case 121* (1954) 4 CTBR(NS) 732; *Case E40* (1954) 5 TBRD 243 (an electrical system upgraded from 32 volts to 240 volts for expected future cost savings). In *Case 120* (1954) 4 CTBR(NS) 730; *Case E81* (1954) 5 TBRD 508, the concrete surface was stronger and more durable than the bitumen surface for the roadway, parking area and driveway, which was seen to have brought considerable advantages for the taxpayer who required these areas to handle heavy traffic for its business of stevedoring and wool dumping. In *Case 37* (1960) 9 CTBR(NS) 225; *Case K72* (1960) 10 TBRD 385, resurfacing the factory driveway yielded the benefits of not only better material but also potential reduction of future repair costs as the new design (laying concrete in rectangular blocks) would enable water drainage problems to be confined to smaller areas. See also *Case T29* (1968) 18 TBRD 122 (characterising the replacement of the bituminous road surface in a parking area with concrete as an improvement). In contrast, in *Case 43* (1939) 8 CTBR 250, the extent of benefits fell short of being an improvement for the replacement of the tarred gravel surface with a granolithic protective coating.

repair restores an asset's functional efficiency without changing the asset's character.[99] For example, replacing timber uprights with wood and steel uprights was considered a repair when it served no function other than holding up a roof and wooden gallery in danger of collapsing before the work was done.[100] If work restores an asset but to a less functional or less efficient condition than before, the work is likely to be characterised as a repair.[101] Conversely, even if enhanced functionality is unlikely to be used, adding new benefits to an asset may result in the work being characterised as a capital work.[102] An improvement is not determined by appearance and it is still possible to characterise work as repairs even when modern, visually appealing materials or work methods are used.[103] It appears that in theory, the improvement test is similar to the capital allowance rule for depreciating assets, for which subsequent costs that bring economic benefits and are reasonably attributable to a balancing adjustment event are added to the cost base of a depreciating asset.[104] As discussed above, the replacement test can be difficult to apply because the focus, nature and extent of work undertaken, especially on buildings or structural improvements, can be defined in different ways. The improvement test only adds to the uncertainty by providing yet another subjective framework for distinguishing improvements from restoration of functional efficiency. The examples below illustrate the inconsistencies that applying the test can produce.

5.1 Ceilings and roofs

In *FCT v Western Suburbs Cinemas Ltd*, the court identified the theatre ceiling as the subject matter of the work.[105] Replacing the fibrous plaster ceiling with Tentest sheets was characterised as an improvement, which the court explained in terms of longer use, durability and decorative effects.[106] Similarly, in another case, replacing the old lining boards of lattice squares with rigid plaster sheets on new supports was considered an improvement, in both degree and kind, as the materials provided better strength and durability. Replacing plasterboards was also considered an improvement in a case where the new materials made the asset fire-resistant.[107]

In comparison, roofs are generally considered subsidiary parts of a building and replacing a roof would not amount to capital works under the replacement test. Such work has often been characterised as a repair, even when it seems obvious that an improvement has been made. For example, in one case, replacing a galvanised iron roof with a concrete tile roof was characterised as a repair despite the valuer confirming that the work added 30–35 years of useful life to the roof and increased the value of the cottage by £300–400.[108] In

99 *W Thomas & Co Pty Ltd* (n 6) at 72 (Windeyer J).

100 *Case 23* (1965) 12 CTBR(NS) 137; *Case Q45* (1965) 15 TBRD 218.

101 In *Case 86* (1955) 5 CTBR(NS) 514; *Case F77* (1955) 6 TBRD 446, the newly installed glazed casement windows and hopper windows were less functional than the wooden venetian blinds they replaced and the work was characterised as a repair.

102 In *Case 19* (1985) 28 CTBR(NS) 139; *Case S13* (1985) 85 ATC 171, the taxpayer restored and rebuilt broken retaining walls damaged by 'the highest king tide for something over 30 years, together with the arrival of a cyclone'. Extensive work was undertaken to reinforce the strength of the structures, possibly beyond what was necessary, after experiencing the devastation. While the extra work may not have brought more benefits other than restoring the functionality of the pre-damage structures, the restoration expenditure was considered being of a capital nature.

103 *Case 53* (1958) 8 CTBR(NS) 263, 285 [14]; *Case J62* (1958) 9 TBRD 319, 341 (O'Neill), which was supported by Kitto J in *Lindsay* (n 47) at 386.

104 *Income Tax Assessment Act 1997,* s 40-190.

105 *Western Suburbs Cinemas Ltd* (n 10).

106 *Case 25* (1960) 9 CTBR(NS) 166; *Case K83* (1960) 10 TBRD 440.

107 See *Case W68* (1989) 89 ATC 613.

108 *Case 51* (1960) 9 CTBR(NS) 328; *Case L13* (1960) 11 TBRD 80.

another case, replacing a corrugated iron roof with a corrugated asbestos roof was also characterised as a repair even though the original iron roof was about 60 years old and had probably reached the end of its life.[109] It was obvious that the new roof was better than the old roof (this was before the health risks associated with asbestos were known). Notably, these decisions show that the replacement test has never been particularly accurate for identifying the subject matter of work. Meanwhile, in another case involving the improvement test, the use of a cheaper but better material divided the court, which ultimately decided that the work was an improvement due to lack of evidence.[110] Simply using a cheaper (and not better) material has not generally been a factor used to characterise a roof replacement as a repair.[111]

5.2 Floors and floor coverings

The distinction between repairing, replacing and improving a floor is ambiguous, as will be demonstrated by the examples below. Completely replacing a removable floor or floor covering such as carpet, floating timber, linoleum or vinyl may be seen as akin to acquiring a new asset, whereas partially replacing a floor is likely to be characterised as a repair. When applying the replacement test, a floor that cannot be removed without causing damage will be considered structural, which means that any restoration work done on it is a repair, irrespective of whether the restoration affects parts or the whole of the floor. In the case law, the materials used play a significant role in determining whether the work adds benefits or merely restores the existing floor.

In several cases, courts observed that a concrete floor was better than asphalt or wood and often characterised the replacement as capital work because it improved the asset.[112] In another case, the court also characterised work as a capital work when one-sixth of a cake factory floor laid with jarrah wood was replaced with concrete covered with steel plates, for which various advantages were noted, such as bacteria resistance, durability, hygiene, easy maintenance and reduced future repair costs. Similarly, reinforced concrete was characterised as an improvement to a wooden floor, the court noting that the new floor provided the added benefit of acid resistance for a taxpayer who carried on a business manufacturing pickles, chutneys and sauces.[113] However, when a cheaper and better material was used, replacing a wooden floor with a concrete floor was characterised as a repair.[114] In that case, the concrete floor was not considered complete protection against existing dry rot and white ant infestation problems. In other cases, replacing rubber flooring

109 *Case 131* (1955) 5 CTBR(NS) 829; *Case G5* (1955) 7 TBRD 29.

110 See *Case 51* (1981) 25 CTBR(NS) 371; *Case N96* (1981) 81 ATC 513, in which a new roof was erected two metres away from the existing roof due to the high costs anticipated for fixing the existing roof. In characterising the work as repairs, the Board has also relied on evidence, such as lodgement to the Municipal Authority, to decide that pre-lodgement works were repairs and post-lodgement works were capital works (ie, *Case 10/98* (1998) 98 ATC 171; (1998) 39 ATR 1059). A lease agreement was used to decide that the excess work beyond the lessee's liability to repair was capital work incurred by the lessor: *Case 94* (1957) 7 CTBR(NS) 631; *Case H98* (1957) 8 TBRD 453.

111 In *Case V167* (1988) 88 ATC 1107; *AAT Case 12* (1986) 18 ATR 3056, a tile roof was replaced with a cheaper tin roof. Also, rewiring was characterised as a repair based on the use of the cheapest substitute.

112 See, eg, *Case 23* (1965) 12 CTBR(NS) 137; *Case Q45* (1965) 15 TBRD 218 (an asphalt floor replaced with a concrete floor), *Case 14* (1981) 25 CTBR(NS) 116; *Case N61* (1981) 81 ATC 325 (a wooden floor replaced with a concrete floor), *Case 111* (1961) 9 CTBR(NS) 717; *Case L47* (1961) 11 TBRD 271 (an expensive jarrah floor replaced with a concrete floor).

113 *Case 46* (1946) 12 CTBR 489.

114 *Case 32* (1957) 7 CTBR(NS) 171; *Case H24* (1957) 8 TBRD 93

with terrazzo tiles (which added long-lasting, decorative features and easy maintenance)[115] and replacing a bitumen floor with a thick concrete underlay and a granolithic covering (which added durability as well as potentially increasing the value of the premises) were characterised as repairs.[116] Notably, the improvement test may be applied to assign work a capital character as an alternative to the initial repair test or the replacement test.[117] In one decision that relied on the initial repair test, the court also mentioned that alternatively, work undertaken to fix subsiding land would have had a capital character under the improvement test.[118] In that case, the land was repeatedly subsiding due to a cellar and well located four feet underground, which the taxpayer found and fixed several years after acquisition.

5.3 Walls and staircases

Walls and staircases can be demountable or structural. Like floorings, tax disputes about deductions relating to complete replacement of demountable items have not been litigated frequently, whereas there are many cases concerning superficial or structural modifications. Case law shows that inconsistent approaches have been applied in respect of walls. A model example of a superficial modification is painting, which is widely accepted as a repair item. An example of a more extensive modification is installing Celuform cladding instead of repainting an external wall with a waterproof membrane, for which work was characterised as a repair despite it bringing long-term benefits like permanently fixing water penetration problems and lowering ongoing maintenance and cleaning costs.[119] While this case suggests that tiling may also be a repair, in another case, the taxpayer carrying on a hotel business was not able to claim immediate deductions because the court considered added durability to be a significant improvement to the walls in a stairway that was frequently damaged by guests' luggage and laundry baskets.[120]

Examples involving structural modifications also highlight the uncertainty and inconsistency inherent in characterising work using the current tests. Extensive work carried out to fix a cracking wall caused by shifting foundations was characterised as repair in one case,[121]

115 The decision in *Case 122* (1954) 4 CTBR(NS) 735; *Case E73* (1954) 5 TBRD 457 was likely influenced by the fact the taxpayer had made several attempts to remedy the problem by fixing frequent damage. The floor was originally rendered with cement, which was later reinforced with concrete, then overlaid with rubber flooring, re-laid again with rubber flooring with added waterproofing and weatherproofing and finally, replaced with terrazzo tiles.

116 In *Case 40* (1968) 14 CTBR(NS) 209; *Case T75* (1968) 18 TBRD 377, the taxpayer repaired a deteriorated bitumen floor laid on a gravel base 18 months after erecting the building. It soon deteriorated again and following advice from a local council building inspector, the taxpayer fixed it with a three-inch underlay of concrete placed on top of the bitumen and topped it with a granolithic render. This work was characterised as a repair.

117 For example, initial repairs were undertaken three and a half years after acquisition in *Case 68* (1950) 1 CTBR(NS) 280; *Case 70* (1950) 1 TBRD 264. The Board mentioned that initial repairs resulted in improvements from reroofing, reconstructing the front veranda, replacing a wooden floor with granolithic paving, reconstructing two bathrooms and reconnecting them to sewerage, painting the exterior, whitewashing a room and relining the kitchen stove.

118 In *Case 36* (1952) 3 CTBR(NS) 198; *Case C38* (1952) 3 TBRD 217 (above n 36), in addition to applying the initial repair test, the majority of the Board found that the work provided an entirely new and improved foundation for part of the yard.

119 *Case 156* (1984) 27 CTBR(NS) 1233; *Case R102* (1984) 84 ATC 676.

120 *Case 119* (1958) 7 CTBR(NS) 772; *Case J1* (1958) 9 TBRD 1.

121 In *Case V2* (1988) 88 ATC 107; *AAT Case 4012* (1988) 19 ATR 3038, the taxpayer bought the property on the condition that the vendor carried out work to strengthen the foundations. However, the problem with the cracking wall occurred again five years later and the taxpayer subsequently carried out extensive restoration. The work was characterised as repairs, except for work carried out in relation to the buttress wall, which changed its appearance and provided new functionality.

while in a similar case, replacing a brick wall cracked and bulged by unstable foundations with a monolithic concrete wall was considered a capital work.[122] The latter decision was influenced by the incidental benefits the taxpayer decided to take advantage of, such as adding a new window space, modernising the property's appearance and replacing a roller shutter door, which were prompted by the need for repairs. In another case, replacing a timber staircase with concrete was considered an improvement, although the decision could have been influenced by the extent of restoration work undertaken under a demolition order.[123]

5.4 Kitchen cabinets and shopfronts

While functionality is the main consideration in distinguishing between an improvement and repair, aesthetic effect may also add to functionality, especially when it improves the income producing potential of an asset. There is no set rule about this, but kitchen cabinets and shopfronts are good examples of when it may be important. Restoring kitchen cabinets and drawers that are significantly warped or damaged is likely to be an improvement, while minor fixes would constitute repairs.[124] Modernising shopfronts can also be an improvement.[125]

5.5 Miscellaneous items

The examples above show the inconsistent characterisations that can result from applying the improvement test together with the replacement test—and the inconsistency is not limited to replacing or restoring subsidiary parts of a larger whole. There are cases where replacing a leaking skylight with dome lights, which could be seen as replacing an asset in its entirety, was deemed to be a repair on the basis that dome lights were standard fittings at the time and the use of modern materials or methods alone should not change the character of the work.[126] Replacing plumbing pipes made of galvanised iron with copper pipes[127] and electrical rewiring[128] were also characterised as repairs on the basis that the advantages added by the work were insignificant.

As Windeyer J said in *WG Thomas & Co Pty Ltd v FCT*, characterising work is 'a question of fact and degree.'[129] Subjectivity is particularly evident when drawing the line between improvements and repairs in dealing with a diverse range of assets. To help address this, some cases dealing with the improvement test have sought to quantify the money spent

122 *Case 56* (1956) 6 CTBR(NS) 344; *Case G61* (1956) 7 TBRD 342.

123 *Case 132* (1958) 7 CTBR(NS) 845; *Case J21* (1958) 9 TBRD 111. Alternatively, the initial repair test applied.

124 See *Case V167* (1988) 88 ATC 1107; *AAT Case 12* (1986) 18 ATR 3056, *Case 6/99* (1999) 99 ATC 165; *AAT Case 363* (1999) 42 ATR 1055; [1999] AATA 363.

125 In *Case 58* (1956) 6 CTBR(NS) 352; *Case G69* (1956) 7 TBRD 370, the taxpayer carried out work involving replacement of mirrors and copper-covered wooden mouldings with black 'vitrolite' and 'silverite' mouldings to match alterations already made by the tenants and altered doorways and new doors. The case noted the aesthetic improvement achieved by the work in deciding that it had a capital character.

126 *Case 43* (1985) 28 CTBR(NS) 333; *Case S35* (1985) 85 ATC 311.

127 *Case 137* (1959) 8 CTBR(NS) 770; *Case K39* (1959) 10 TBRD 203.

128 *Case V167* (1988) 88 ATC 1107; *AAT Case 12* (1986) 18 ATR 3056. In this case, addition and relocation of power points for electrical rewiring was considered incidental, merely taking advantage of convenient locations. In contrast, in *Case 133* (1959) 8 CTBR(NS) 745; *Case K56* (1959) 10 TBRD 300, new service mains that replaced the original electrical wiring were deemed to have a capital character.

129 *W Thomas & Co Pty Ltd* (n 6) at 72.

on work, both in absolute and relative terms,[130] and determine whether incurring high costs was voluntary or compulsory.[131] However, the findings in these cases still do not clarify characterisation definitively. Installing Celuform cladding that cost significantly more than the alternative option to repaint with a waterproof membrane was deemed to be a repair in one case.[132] In another case, the £52,992 spent on replacing the glass tiles and steel windows of a 12-storey building façade with marble tiles and bronze windows was also deemed to be an ordinary repair cost.[133]

6 Recommendations

Sections 3, 4 and 5 of this article explored the definition of a repair and the three tests used to distinguish between repair costs and capital expenditure. The first, the initial repair test, operates fairly consistently and coherently with the capital allowance regime. Accordingly, no changes are recommended for that test.[134] However, using the other two tests—the replacement test and improvement test—to draw the line between repairs and capital expenditure is often problematic. On its face, the replacement test appears to hinge on the property law concepts of chattels and fixtures,[135] but the examples provided in this article show that determining the degree and extent of work is not straightforward, especially with regard to buildings and structural improvements on land. The improvement test adds further ambiguity by assigning varying weights to different factors when attempting to address questions of fact and degree. Both tests attempt to measure the effect a repair has on an asset rather than the effect it has on overall taxable income, unlike in accounting. Proponents once argued that the tests were sufficiently flexible to deliver sound outcomes.[136] However, a review of the case law suggests otherwise. Given the subjectivity inherent in

130 In *Case 36* (1980) 24 CTBR(NS) 323; *Case M60* (1980) 80 ATC 424, the taxpayer's claim that new glass partitions provided no advantage was rejected by the Tribunal, which decided that the high costs indicated enduring benefits. See also the decision in *Case 82* (1953) 3 CTBR(NS) 497; *Case C73* (1953) 3 TBRD 400, which identified works as capital works after considering the high costs incurred in absolute terms. Similarly, in *Case 28* (1971) 17 CTBR(NS) 167; *Case C31* (1971) 71 ATC 141, replacing the ceiling of a 24/7 boulevard arcade with asbestos sheets costing $2,300 to reduce potential future damage from wind and vandalism was characterised as capital works. The cost was considered relatively high compared to the alternative, using the existing material that would have cost only $350. In comparison, in *Case 137* (1959) 8 CTBR(NS) 770; *Case K39* (1959) 10 TBRD 203, work characterised as a repair where the replacement material (copper) was only about five per cent more expensive than the amount that would have been spent if the existing material (galvanised iron) was used for replacing plumbing pipes.

131 In *Case 67* (1962) 10 CTBR(NS) 411; *Case M51* (1962) 12 TBRD 267, the taxpayer paid £4,000 for a new shop awning after demolition of the old awning was ordered by a local authority. While the taxpayer was unable to prove the existence of a defect to characterise the work as a repair, the Board mentioned that voluntarily spending a one-off large sum, as opposed to small but frequent spending, indicated capital use of an asset.

132 *Case 156* (1984) 27 CTBR(NS) 1233; *Case R102* (1984) 84 ATC 676.

133 The decision in *Case 53* (1958) 8 CTBR(NS) 263; *Case J62* (1958) 9 TBRD 319 was based on the fact that the work restored the efficiency and functionality of preventing rainwater damage, despite the long-lasting quality of the new exterior.

134 Baxt et al pointed out the recommendation made by the Asprey Committee (below n 146) that immediate deductions should be allowed for initial repairs relating to normal maintenance such as painting and minor building repairs: see R Baxt et al, *Cases and Materials on Taxation* (Butterworths, 1978) 397. However, as mentioned in section 2 of this article, the definition of repairs and maintenance has not been consistent in this regard.

135 Depreciating assets and capital works may seem to refer to chattels and fixtures, respectively. However, chattels and fixtures are legal concepts in property law and the distinction between them is not always intuitive to laypeople. Furthermore, case law indicates these concepts provide no useful guidance for characterising repairs and capital works.

136 Commonwealth Committee on Taxation (Chaired by GC Ligertwood), *Report of the Commonwealth Committee on Taxation* (No. 100, 17 August 1961) [123]–[125].

the system, it is not unreasonable for a taxpayer to avail themselves of immediate tax deductions by characterising capital expenses as ordinary repair costs, for administrative simplicity. Overall, the evidence suggests the system requires reform. This section of the article explores options for substituting the replacement and improvement tests with new objective measures that allow immediate deductions for expenses incurred for maintenance, repairs and capital works that may have a capital character. First, it discusses the regimes governing depreciating assets and capital works. This section recommends that new rules be implemented to complement these existing regimes, which are referred to collectively as the 'capital allowance regime'. Next, it explores three alternative measures for deductions that could be adopted in Australia, inspired by recent developments in the UK and US: the per invoice or item approach, the total revenue or asset account approach and the asset value approach.[137]

6.1 Interaction with the capital allowance regime

If an expense is not a repair cost, it is characterised as a capital expense attributable to an asset, in which case deductions are allowed for wear and tear or depreciation of that asset. The rules governing this are mainly contained in two regimes within the current legislation: the 'depreciating asset' regime and the 'capital works' regime.[138] The preceding versions of the current repair costs provision in s 25-10 have included assets covered by the depreciating asset regime[139] and premises that became deductible under the capital works regime. Under the depreciating asset regime, the cost of acquiring an asset and any incidental costs constitute the asset's initial cost base.[140] Subsequent costs incurred to bring an asset to its present condition and location can be added to this cost base.[141] These costs are deductible for an effective life period determined by the taxpayer. The Commissioner of Taxation sets effective life periods for various categories of depreciating assets annually, which taxpayers have the option to adopt.[142] It is mandatory to reassess an asset's effective life when costs incurred in one year increase the asset's total cost base (including any amount used for tax deduction purposes) by 10% or more.[143] This could reduce the amount of depreciation that occurs during the asset's early life.[144]

137 Repair costs are immediately deductible in Canada and New Zealand but unlike in the UK and US, there have been no major recent developments. More information about the income tax system in Canada and New Zealand can be found in John W Durnford, 'The Deductibility of Building Repair and Renovation Costs' (1997) 45(3) *Canadian Tax Journal* 395; Andrew J Maples, 'Beware Technological Developments: A New Zealand Perspective on Repairs and Replacement' (2001) 30 *Australian Tax Review* 173 (discussing the New Zealand case, *Auckland Gas Co Ltd v CIR* [2000] 3 NZLR 6); *Income Tax Act 2007* (NZ) ss DA 1(1), 2(1); Interpretation Statements IS 12/03 (Income Tax – Deductibility of Repairs and Maintenance Expenditure – General Principles).

138 *Income Tax Assessment Act 1997,* Div 40 (see the definition of a depreciating asset in s 40-30) and Div 43 (see the definition of capital works in s 43-20), respectively. See also Australian Taxation Office, *Income Tax: Property Development: Deduction of Income Producing Capital Works, Including Buildings and Structural Improvements* (TR 97/25).

139 For example, the original repair costs provision applied to repairs of 'machinery, implements, utensils, rolling stock and articles', for which wear and tear was deductible under the *Income Tax Assessment Act 1915* s 18(e). The current repair costs provision also applies to repairs of 'depreciating assets'. Meanwhile, any depreciation in the value of assets is deductible under s 40-25 of the *Income Tax Assessment Act 1997*.

140 *Income Tax Assessment Act 1997,* s 40-180.

141 *Income Tax Assessment Act 1997,* s 40-190.

142 The list of depreciating assets can be found in TR 2019/5, *Income Tax: Effective Life of Depreciating Assets* (applicable from 1 July 2019).

143 *Income Tax Assessment Act 1997,* s 40-110(2)-(3).

144 *Income Tax Assessment Act 1997,* s 40-110.

In contrast, under the capital works regime, deductions are available for expenses incurred for construction projects on a building or structural asset on land. Deductions for expenditure on each project can be claimed within either a 25 or 40-year time limit. Note that the capital works regime does not operate based on individual depreciating assets; rather, it assigns a construction area and all expenditure incurred for that construction area depreciate together. From the taxpayer's perspective, characterising expenses as repair costs is preferable because, under the capital allowance regime, costs for repairing an income-producing asset are not deductible immediately. If assets are not used for income-producing purposes, repair costs may be factored in under the capital gains tax system when disposing of the asset and used to calculate net capital gain or loss.[145] Being able to claim a deduction for an expense the same year it is incurred is a considerable advantage.

Under the initial repair test, the costs of making an asset fit for its intended use are characterised as capital expenditure, closely mirroring the way expenses are accounted for under the capital allowance regime mentioned above. In contrast, the replacement test assesses the extent to which work will affect an asset; it is more likely to be a repair if the work restores parts of an asset but not the whole of it. Meanwhile, the improvement test distinguishes work that adds considerable advantages to an asset from work that merely restores the asset's functional efficiency; the latter would be characterised as repair work. Case law examples demonstrate the unreliable nature of the replacement and improvement tests in practice. It is worthwhile to consider a new, more objective rule to deem that the repair provision is not violated.

6.2 Deductions per invoice or item

In the 1970s, the Taxation Review Committee chaired by KW Asprey recommended that immediate deductions be allowed for low-cost repairs up to $200 per item.[146] However, that recommendation was never adopted in Australia. In the US, there is an immediate write-off for materials and supplies acquired for $200 or less. There is also a 'safe harbour rule'[147] that allows immediate deductions for expenditure up to $5,000 per invoice or item for reporting entities and since 1 January 2016, up to $2,500 per item or invoice for non-reporting entities (previously $500).[148] Using a dollar value makes it easy to set a threshold. In Australia, this approach is used under the capital allowance regime for depreciating assets to allow immediate write-offs in various circumstances. For example, non-business taxpayers can write off low cost items up to $300[149] and small business taxpayers can write

145 *Income Tax Assessment Act 1997* ss 110-25(4) and (5), 110-55(2). See Fiona Martin, 'Capital Gains Tax: What is Meant by Element 4 of an Asset's Cost Base When in respect of 'Initial Repairs' to Real Estate' (2002) 36(7) *Taxation in Australian* 367. See also Australian Taxation Office, *CGT: Inclusion of Initial Repair Expenditure Incurred After the Acquisition of a CGT Asset in the Cost Base* (TD 98/19).

146 Taxation Review Committee (Chaired by KW Asprey), *Full Report* (Parliament Paper No 136, 31 January 1975) [8.200]–[8.201].

147 A safe harbour rule provides a threshold within which certain conduct will not be penalised.

148 Immediate deductions are allowed for repair costs under the Internal Revenue Code (US) §162, whereas expenses for acquiring, producing or improving tangible property are capital expenses under the Internal Revenue Code (US) §263(a). See the thresholds in Income Tax Regulations (US) § 1.162–3(c)(iv) (materials and supplies), §1.263(a)-1(f)(i)(D) (capital expenditures for reporting entities), §1.263(a)-1(f)(ii)(D) (capital expenditures for non-reporting entities). See Internal Revenue Service (IRS), *Increase in De Minimis Safe Harbor Limit for Taxpayers without an Applicable Financial Statement* (Notice 2015-82). See also documentation issued by the Internal Revenue Service: 43 *Internal Revenue Bulletin*: 2013–43 331 (21 October 2013), 71(161) *Federal Register* 48590 (21 August 2006), 73(47) *Federal Register* 12838 (10 March 2008), 14 I*nternal Revenue Bulletin* 614 (27 December 2011), 76(248) *Federal Register* 81060 (27 December 2011), 51 *Internal Revenue Bulletin* 713 (20 November 2012), 77(242) *Federal Register* 74583 (17 December 2012).

149 *Income Tax Assessment Act 1997,* s 40-80(2).

off capital assets that cost less than $1,000 (or, for assets acquired between 12 May 2015 and 30 June 2020, up to $20,000, $25,000, $30,000 or $150,000).[150]

If applied to repairs, this per item write-off approach would eliminate the need to distinguish between repair and acquisition of a depreciating asset up to $300. Arguably, it would not apply in the context of any subsequent cost incurred for an existing depreciating asset because immediate deductions are only available when the taxpayer starts to hold an asset. This restriction does not apply to small business write-offs because the small business tax concession already allows immediate deductions for the cost of holding an asset or any subsequent cost in respect of a low-cost depreciating asset. There is also a temporary concession that allows medium-sized businesses to write off the acquisition cost or any subsequent cost of depreciating assets acquired between 2 April 2019 and 11 March 2020 when the cost is less than $30,000 (or $150,000 between 12 March 2020 and 30 June 2020).[151] Both measures for small and medium-sized businesses remove the need to distinguish between repair costs and capital expenditure. These current concessions for business taxpayers can be used as an alternative route for providing immediate deductions for repair costs and a legislative amendment can be made to include non-business taxpayers if necessary.

In relation to capital works, there is currently no equivalent threshold test that can be used as a surrogate safe harbour rule for repair costs. Like the solution proposed above for repair costs, one way to eliminate the character distinctions applied to work carried out on buildings and structural improvements on land might be to adopt the same thresholds used for other write-offs. However, this approach may not be sound because different taxpayers of a similar size may use a building in significantly different ways for income-producing purposes (e.g., manufacturers versus service providers).

6.3 Deductions per total revenue or asset account

In accounting, materiality thresholds are used to determine deductions, often in comparison with total revenues, total profits or total assets.[152] The US tried applying this to tax in 1996, when it was first proposed that a threshold test be adopted to provide reporting entities with immediate deductions for repair costs at either 0.1% of gross receipts assessable for tax purposes or 2.0% of total depreciation expenses in the taxpayer's annual financial statement, whichever was greater.[153] The trial was unsuccessful because taxpayers complained that the threshold amount was unknown until the end of the tax year. Also, large corporate taxpayers argued that the low materiality level (compared to the higher materiality thresholds used in accounting) created a high administrative burden by requiring them to track low-value depreciating assets. The US experience indicates that a test based on total gross income or total assets is likely too uncertain, while a threshold based on total net income is likely to be too volatile. It also suggests that a rollout to individual non-business taxpayers is unlikely to be successful.

150 *Income Tax Assessment Act 1997,* s 328-180. See the temporary thresholds in *Income Tax (Transitional Provisions) Act 1997,* s 328-180.

151 *Income Tax Assessment Act 1997,* s 40-82. See also the 'Backing Business Investment' measures in *Coronavirus Economic Response Package Omnibus Act 2020,* s 7.

152 See Australian Accounting Standard Board, *Accounting Standard AASB 1031: Materiality* (Canberra, 1995) [4.1.4].

153 Income Tax Regulations (US) former §1.263(a)-2T(g). This resulted in legislation of the current rules noted in above n 147.

6.4 Per asset deductions

The replacement test and the improvement test attempt to define an asset, then assess the degree to which work has affected the asset. The first alternative, the per invoice or item approach discussed above, may be suitable for easily identifiable items like plant and equipment but it is questionable for buildings and structural improvements on land. In the UK, an additional measure was introduced under the capital allowance regime to provide guidance when claiming deductions for subsequent costs in relation to buildings and other structures at a special rate of 8% (or 10% prior to April 2012).[154] It requires taxpayers to pool deductions for replacement costs incurred during any 12-month period when more than 50% of an 'integral feature' such as an electrical system, cold water system, water heating system, lift or external solar shading has been affected by the work; meanwhile other costs may be deducted immediately.[155] However, the difficulty with identifying an asset (or, in this case, an integral feature) still remains because the replacement test is subjective. While it may appear obvious that 50% refers to the degree of effect the work has on an asset, the case law examples discussed above regarding the improvement test demonstrate the subjectivity inherent in determining the extent of work relative to the functionality of assets. In comparison, the US has taken a less ambiguous approach to providing a special safe harbour rule for small business taxpayers who may not have a good record keeping system. There, small businesses can take advantage of immediate deductions for costs incurred for repairs, maintenance and improvements to a building during the tax year, up to $10,000 or 2% of the original cost of the building, whichever is less.[156]

In the Australian context, the first question is, what base is appropriate for creating a safe harbour rule for building and structure-related deductions? The holistic approach taken by the US, which examines total repair, maintenance and improvement costs, seems appropriate to avoid arbitrarily characterising work. One option is to use the total capital expenses incurred to date, comprised of the acquisition cost, any incidental costs required to bring an asset to the condition and location necessary for its intended use, and any subsequent costs. Due to inflation, this approach may be a disadvantage for buildings left in disrepair for a long time, because the threshold is relatively low. Buildings can last for a long time and a building's original acquisition cost may be nowhere near its current value. However, there is also an advantage in that it allows capital expenses for an asset that is still valuable, but has depreciated significantly, to be recaptured to recognise its current value. Another option is to use the book value as the basis for deductions, which significantly reduces the threshold. This may work well for assets that retain or enhance their value through ongoing repairs. However, if a building or structure is fully depreciated, any cost incurred for the asset will be treated as a capital expense from the first dollar, which is not appropriate for work that brings relatively short-lived benefits.

The second aspect to consider is whether the threshold test would modify taxpayers' reporting behaviour so that capital expenses are split across multiple years to avoid reaching the safe harbour threshold. Introducing tax rules that modify behaviour this way may not be advisable. However, rules allowing immediate deductions are based on the

154 *Capital Allowance Act 2001* (UK), ss 4(2), 33A-B, 104A.

155 Repair costs can be deducted outright under s 53 of the *Corporation Tax Act 2009* (UK) or s 33 of the I*ncome Tax (Trading and Other Income) Act 2005* (UK).

156 See the threshold in Income Tax Regulations (US), §1.263(a)-3(h) (improvement of tangible property for small business). If elected, a small business applies this safe harbour rule first to immediately deduct expenses. For any amount exceeding the threshold, the general rules, including the routine maintenance rule and the per invoice or item rule, may apply.

assumption that repair costs do not produce lasting benefits, which is unlikely to be true. To create a rule that is an exception to general tax principles, it is necessary to define the boundaries clearly and identify the specific target to which the exception applies. In this respect, the question is whether the proposed threshold is appropriate for claiming immediate deductions. An appropriate threshold must be agreed upon after consulting with the tax industry and taxpaying community and potentially, conducting studies of tax expenditure.

Once a deduction threshold for repair costs is set, the next issue to consider is how capital expenses should be dealt with. While buildings may last hundreds of years with good repairs, the current tax system only allows deductions to be claimed on buildings for a statutory period of either 25 or 40 years. To address this, a new statutory period should be set for capital expenses relating to buildings and structures, which can be applied to either existing construction expenditure areas or new construction expenditure areas.

Overall, the US approach, setting an upper limit on deductions (e.g., $10,000), may be necessary in Australia to avoid excessive immediate deductions being claimed for capital expenses relating to an asset, relative to its market value at a given time. It is not advisable to continue pooling all expenditure relating to buildings and structures and deferring the relevant deductions, because doing so adds unnecessary complexity to Australia's current income tax system. Interestingly, the items deemed to be 'integral features' in the UK system would generally be depreciating assets for Australian tax purposes. Should the per asset method be adopted for depreciating assets, prescribing a new statutory time limit would not be appropriate because different assets last for different lengths of time. The current approach for dealing with capital expenses in these cases is appropriate.

7 Conclusion

In the past, tax policy principles have not been actively examined to clarify why repair costs are immediately tax deductible. This article has argued that although repairs often bring lasting benefits, immediate deductions should still be allowed due to the difficulty involved in estimating the duration of those benefits and how they will depreciate. This is particularly so for low-cost items. The article sought to identify the principles that the courts have used for characterising repair costs. An extensive range of case law examples has been presented to demonstrate that there is considerable subjectivity involved in characterising repair work, highlighting that this area is in serious need of reform.

Over time, three tests have been developed to define the repair costs that are eligible for immediate deductions. This article recommends preserving the first, the initial repair test, because it is consistent with the approach to capital expenses incurred to make an asset fit for its intended use. The second test, the replacement test, which aims to determine whether work replaces the whole or subsidiary parts of an asset, is too ambiguous because an asset can be defined in various ways depending on the nature and extent of the work. If work is not of a capital nature under the replacement test, the third test, the improvement test, may be used to assign a capital character to the work. However, this test is too subjective to provide any clear guidance and, at times, it has undermined the replacement test. Neither the replacement test nor the improvement test is sound enough to provide clear, consistent guidance on when immediate deductions should be allowed.

If repairs are understood as providing a servicing function without changing the character of assets, it can be argued that immediate deductions should be allowed for all repair costs. This would also promote easy record keeping in relation to immaterial items and prevent excessive deductions relative to the cost base of an asset. To take advantage of these benefits, there must be objective criteria for immediate deductions. This article examined three options for setting a new threshold for deductions, based on recent examples from the US and UK. In Australia, to achieve consistency between immediate deductions and the existing capital allowance regime, a threshold can be set at a specific dollar value (e.g., $1,000 for business taxpayers) or a relative dollar value (e.g., 8% of the cost of an asset) for depreciating assets. In respect of buildings and other structures on land, a similar approach can be taken, using a set dollar value as a ceiling to limit excessive deductions. However, it is not advisable to set a threshold based on costs proportional to total income, profit, asset value or depreciation because that would likely cause high compliance burden. To implement new safe harbour rules, appropriate thresholds must first be agreed upon. Doing so would be an important step forwards for the Australian tax system.