Capital Revenue Divide Webinar – September 4, 2013

Q1: My client has been in business for over 20 years. In the last accounting period I treated as a repair, the replacement of the toilet fittings. HMRC have questioned the accounting and taxation treatment for this replacement of toilet fittings and the inspector suggests that the expenditure should have been capitalised and capital allowances on integral fixtures claimed.

A: I think that I need more information about how the new toilet fittings compare with the previous ones. My initial reaction would be that unless you have claimed allowances on the renewals basis, the proper treatment is, as the inspector has suggested, to capitalise expenditure and then claim capital allowances.

I recognise that your argument is that this is merely a repair of the business premises and that the toilet fittings are not the entirety but merely a repair of the larger premises. I suspect that the answer will turn on the facts. What evidence have you that you have a like-for-like replacement rather than improvements installing new toilet and bathroom fittings? Do you know what treatment was applied when the toilet fittings were bought? If the original treatment was a claim to capital allowances, the inspector is right.

Q2: My client occupies rented premises for his business. He has fitted out the premises with shelves and counters. Can I write this expenditure off in the profit and loss account as there is no asset value if the client does not renew the lease and moves on?

A: I would have thought that this is capital expenditure and the shelves and counters will have been designed for an appreciable life. These assets are for use in the business and items such as shelves and counters designed specifically for your client's use will qualify for capital allowances.

Q3: My client has purchased a new network and several independent computers. Given the early obsolescence of servers and computers, would it be appropriate to treat this replacement of the old server network and computers as a repair or renewal expensing the costs through the profit and loss account?

A: The expenditure is capital. The advances in technology means that a replacement of a network of servers and computers will be a considerable improvement on the items replaced. The proper treatment would therefore be to consider making a short life asset election on the old server network if there are any balances to be claimed and on the new server and network capitalise the expenditure and claim capital allowances.

There can be an issue of materiality. I know of some firms who expense small items of computer equipment and this seems to be accepted by HMRC provided the amounts are small (less than £1,000) but in principle the purchase of computer equipment is capital expenditure and the proper treatment would be to capitalise it and claim capital allowances. With the current levels of annual investment allowance, the tax effect makes it academic.

Q4: You have just given an answer that suggests that materiality may affect the decision on whether or not something is capital or revenue expenditure. I disagree. I had an enquiry case recently which involved a number of issues including a private use adjustment for the expenditure of tarmacking the farmyard and the lane from the road to the farmhouse and farm buildings. The inspector discovered that I had expensed some food and water troughs, each costing £300. The inspector was adamant that it was capital expenditure and fell to be capitalised and allowances claimed.

A: I express myself badly and I am sorry for that. When I used the concept of materiality, I did not mean to suggest materiality in the accounting concept. What I was trying to suggest was that if the expenditure was trivial, HMRC would not argue about the accounting treatment. This is a pragmatic approach in practice. However, if the expenditure is capital, no matter how small, it is strictly capital and no deduction should be claimed for capital in the computation of taxable profits.

Your experience of facing a private use adjustment on the farm driveway repair is interesting. Although you did not ask this question, I have seen HMRC press this argument elsewhere and then concede the point on the basis that the wear and tear caused by private cars is insignificant compared to the wear and tear of heavy farm machinery and large milk tankers or even refuse collection. Please see also the example in Chapter 3 of G Pratt a,d the repair of the farm driveway.

Q5: My client purchased his business premises many years ago. He has purchased new premises and had been considering rolling over the gain and disposal from the old premises. However, the old premises are now worth considerably more because they have planning permission for the construction of residential property.

If the client develops the land himself and builds the residential properties, will the sale of the residential properties be liable to capital gains tax or will, at some point, a new trade have started?

A: This is an interesting example and one to which I am sure the questioner has given considerable thought. The case law in this area probably starts with *Hudson's Bay Co Ltd v Stevens [1909], 5 TC 424*. The company had been granted extensive land in Canada by Royal Charter. It sold the land over a period of time and the Inland Revenue attempted to assess the profits on the sales as profits arising from a trade of dealing in land. However, the land had been acquired without a profit seeking motive and therefore on sale was a realisation of capital assets. The profits were not assessable to tax.

At the level of principle, another case which springs to mind is that of *St Aubyn Estate v Strick [1932], 17 TC 412*. Lord St Aubyn had inherited the estate and if he had developed it realising the property he had inherited to its best advantage the profit on development would not have been a trading profit. However that is not what he did. He formed a company for the purposes of acquiring the settled fund and properties including the 1,200 acres of land. The company had been formed to develop the land and therefore the profit on sale was a trading profit of the company.

In your question you have not disclosed whether your client is an individual partnership or company but, if it is a company, its memorandum and articles of association may well allow it to be trading in land. Everything is telling me that there are material amounts of money and tax involved in this question. I therefore suggest that you should seek independent professional advice to resolve the answer. However in the spirit of this webinar, the answer that I would give would suggest that up to a point in time the original business premises were held as capital. There is going to be a point in time where your client's business became that of a property developer trading in the sale of the construction and sale of residential property. Up to that point in time, the increase in value would be liable to capital gains tax. From that point in time the growth in value would be on trading account.

When looking at the point in time, I suspect that section 161 TCGA 1992 would apply such that there would be a deemed disposal at the open market value (which I assume is considerably enhanced and reflects the obtaining of planning permission) to a trade. This figure would then form the opening balance which of course can then be deducted from the eventual sales realised for calculating the trading profit. So I think that if it was developed and sold as residential properties the total gain would include an element of capital gain and an element of trading profit.

I think there are a number of cases which would support this view and these cases include *Rellim Ltd v Vise [1951], 32 TC 254* and *CIR v Toll Property Co Ltd [1952], 34 TC 13.*

Q6: My client is a dentist. She incurred considerable costs in training in relation to implants and specialised surgery. The inspector is arguing that the training expenses should be capitalised. Is he right?

A: Training courses undertaken by the proprietors of businesses such as dentists must meet the usual cost criteria if it is to be deducted in computing the business profits. This means that the test of being wholly and exclusively must be satisfied and in answering this question I have assumed that the costs for training in relation to dental implants and specialised surgery do meet that test. The question is therefore whether the expenditure in training in this specialist area is capital or revenue. I think that training often provides examples which are borderline cases and where it is difficult to determine whether there is any residual benefit for the proprietor.

If attendance at a course is intended to give the business proprietor new expertise, knowledge or skills which were previously lacking, the HMRC view is that the course brings into existence an intangible asset in the form of know-how which is of enduring benefit to the business. Such expenditure should therefore be capitalised and any write off would be prohibited from being an allowable expense of the business. However allowances are available under the capital allowances regime for know-how.

In the case of dentists obtaining knowledge of implants and specialised surgery, the question I would ask is whether your client was merely updating expertise or whether this was a new skill being acquired. If attendance at the course updates expertise in an area of skill and practice which the dentist already possesses, I would have thought that the expenditure should be regarded as being revenue in nature and would therefore be deductible. Conversely, if a new skill is obtained by the training course, this is a capital asset of the business and should be capitalised with the appropriate know-how allowances being claimed through the capital allowances regime.

Your question does not say whether or not your client incurred the training expense to benefit herself as a dentist or whether it might have been incurred to improve employee skills.

HMRC gave a detailed explanation of their position in Technical Bulletin 27 which was published in 1997. This makes it clear that HMRC take the view that it would be difficult to imagine circumstances in practice where the benefit which the employer obtains can be viewed as an identifiable capital asset of the employer's business. HMRC recognise that factors such as the pace of technology and commercial change and an employee's right to resign and seek work elsewhere militate against a view that the training expenditure should be capitalised. It would therefore be appropriate to expense the training cost.

At this point, I should remind you that the exemption available for training costs provided by the employer to the employee is generous and can be found at section 250 ITEPA 2003.

For know-how, all qualifying expenditure should be placed in a single pool and writing down allowances are given for each year at 25% of the value of the pool on a reducing balance basis.

Q7: I have just taken on a new micro-brewery client. The beer is delivered in casks with the empty beer casks being returned and refilled. Are these beer casks revenue or capital expenditure?

A: I am sorry but I do not know the answer to this one. I am sure that there will be a trade agreement.

In recent years the nature of packaging has changed enormously. I am struggling to recollect how things like glass bottles were dealt with in milk dairies or in soft drink manufacturers. I think, but I not 100% certain, that they were treated as consumable stocks.

I anticipate, but I do not know, that the life of a beer barrel will exceed by a considerable margin the life of a glass bottle. However, my inclination would be to treat the purchase of these beer barrels as consumable stocks expensing the purchases through the profit and loss account but valuing at the year end the stocks of barrels held. The barrels are just a means of packaging what would otherwise be extremely difficult (and messy) to distribute. Do any of the others listening have experience in this specific area?

Q8 My client is self employed as a joiner and carpenter. His house is on a flood plain and has been the subject of regular flooding. Last year the heavy rain and flooding destroyed his garage which is used as a store and workshop for his business. The garage has been completely rebuilt at a cost of 13,773 and is exactly the same as the garage that was destroyed by the flooding. His property is uninsurable because of the regular flooding. Am I correct to treat the replacement of the garage as a repair and claim a deduction through the profit and loss of the business?

A8 This depends on the facts but the impression I have is that the garage is free standing and as such constitutes an entirety. This concept of 'entirety' has been considered in many tax cases and where an entire structure is replaced with a new entire structure, the expenditure is capital. In this case, what you describe is also the setting of the business and consequently most of the expenditure will not qualify for capital allowances.

Q9 Ian owns a number of residential properties as part of his portfolio for retirement. When the tenant vacates the property at 18 Acacia Avenue, Ian discovers that the tenant has inflicted considerable damage to the kitchen with numerous broken drawers, deep scratches to the worktop and several of the shelves inside units broken. The cooker, especially the oven, is in a dreadful state with the automatic ignite not working which creates a safety hazard for gas. The estimate for repair is actually more expensive that the cheaper option of replacing the cooker. Ian buys a new cooker that is identical to the old model and he decides to remove all of the units and replace them all with a new layout of kitchen units. Is this all repair expenditure and allowable against future income from the property?

A9 Despite the fact that the cooker has been replaced with an identical model, the cooker is free standing and can be detached from the gas supply so it is not part of the house. The expenditure on the cooker is capital expenditure. There is a prohibition on claiming capital allowances on expenditure for a residential property so no tax relief will be due for the cost of replacing the cooker.

The fitted kitchen is different from the units which were in the house previously but the entirety is the house and a replacement of a part of the entirety is a repair. Within reason, the expenditure will be a revenue expense and properly deductible for tax purposes even though the layout of the kitchen has been altered. What existed before was a functioning kitchen and the new kitchen is still just a part of the house. Those words "within reason" are a caveat. If the replacement was clearly an improvement, the expenditure would be capital but just because the layout is different does not mean there has been an improvement. That issue is one of fact and degree but unless the expenditure is disproportionately high, it is unlikely that HMRC would argue a slightly different kitchen was capital expenditure.