

The Identification of Repairs

Introduction

When building works are carried out to an existing property, there is very likely to be an element of revenue expenditure incurred on repairs that will qualify for a full tax deduction in the year of expenditure. Works of alteration or improvement will generally be capital expenditure and therefore, no tax relief will be available unless the expenditure qualifies for capital allowances. The problem, therefore, when analysing building works carried out to an existing property, classified in the accounts as a fixed asset or investment property, is where to draw the line between capital and revenue expenditure.

The recent case of *Moonlight Textiles Ltd. -v- HM Revenue & Customs (2010)* highlighted the confusion that can often arise when the identification of revenue expenditure is attempted in respect of a building project that is primarily one of improvement or alteration.

The Moonlight Textiles Ltd. case

This case was published on 8 November 2010 and involved a company that manufactured and retailed curtains and accessories. The company carried out extensive works to a two-storey building with a showroom and warehouse on the ground floor, together with a workshop, offices, boardroom and kitchen on the first floor.

The work included a complete replacement of the roof, major alterations, redecoration and improvement of the kitchen and involved a reconfiguration of the stairs, removal of the wall, extension of the floor, installation of new steps, a false ceiling and disabled access. The result was a larger refurbished showroom at the premises and a reduced warehouse facility.

The total expenditure of £67,987.00 was treated in the company's accounts for the period 1 February 2004 to 31 January 2005 as follows:

Repairs: £53,333.00
 Expenditure qualifying for capital allowances: £11,494.00
 Professional fees: £ 3,160.00

The company claimed the cost of repairs and professional fees as revenue deductions in its accounts and the corresponding deductions claimed in the company's tax return were the subject of an enquiry by HM Revenue & Customs (HMRC), which opened on 18 November 2005.

It was agreed by HMRC that the expenditure on the roof repairs totalling £7,131.00 and an element of the cost of kitchen refurbishment costing £1,650.00, should be treated as revenue expenditure and allowed as a deduction from profits.

HMRC regarded the majority of the rest of the expenditure as incurred on alterations and improvements and therefore, capital in nature.

The company appealed against the decision by HMRC to disallow the expenditure that had been claimed as revenue expenditure. The appeal was heard by the First-Tier Tribunal (Tax Chamber) on 16 August 2010.

It was contended by Moonlight Textiles Ltd. that there had been a replacement of parts and an alteration of the layout without any additions and consequently the work was not capital. The company further contended that any improvement had been restricted to using modern equivalents and in essence, therefore, involved replacement and repair, rather than alteration and improvement.

It was contended by HMRC that the works amounted to a scheme of alterations and improvement that should be taken as a whole, rather than a piecemeal series of works. As we have already seen above, HMRC did allow certain parts of the works as repairs and acknowledged that such an approach is permissible in the Property Income Manual at PIM 2020 as follows:

"Work commissioned on a property may include expenditure on capital works and also separate expenditure on repairs at the same time. Here the expenditure on repairs remains allowable."

HMRC went on to contend, by reference to its manuals (PIM 2020, BIM 35460 and 46904), that alterations or improvements, no matter how small, are not repairs.

The outcome of the case was that the Tribunal rejected the company's appeal and provided the following statement at paragraph 18 of its decision:

"From the plans and other documentation available, it was clear that there had been a significant improvement of the premises through the repairs and alterations effected. The work had changed the character of the building as a whole. It was also clear that the appellant company had chosen to adapt its premises to its needs and failing compelling reasons to the contrary this would be regarded as capital expenditure as an alteration. The appellant argued that expenditure is not endowed with a capital nature merely because repairs involve the replacement or renewal of parts of the premises. Instead of simply undertaking repairs, the appellant company had taken the opportunity of substantially altering and improving them and in the absence of any itemised breakdown of expenditure distinguishing between repairs and improvements in detail, no

deduction can be allowed for “notional repairs,” that is what it would have cost to simply repair the asset had that course been taken.”

The mention of “notional repairs” is curious because they are not allowable in accordance with existing case law. The Tribunal may have simply been alluding to the fact that the company had not provided any information concerning expenditure on like-for-like replacements, restorations to original condition or replacement necessitated by modern equivalents and therefore, the question of repair or improvement could only be decided on the information available.

Conclusions and recommendations

It is not unusual for an inspector of taxes to argue that if a building project is largely one of alteration and improvements, that no revenue expenditure has been incurred because the project must be viewed as a whole. Such an argument is inconsistent with HMRC’s manual at PIM 2020 and is insupportable by reference to case law. The taxpayer should always insist that the component parts of any expenditure incurred on an existing building should be viewed on a piecemeal basis.

A key lesson to be learnt from the Moonlight Textiles case is that the taxpayer should provide details of all the component parts of the expenditure, including any supporting arguments that the elements of improvement or alteration involved amount only to the replacement of modern equivalents, or are limited to small improvements or alterations that are incidental to repairs. If this information is not provided, then there is no fall back position for the taxpayer and the courts must decide on an all-or-nothing basis. A full analysis of the expenditure is, therefore, always advisable.

Finally, where the expenditure does not qualify for a revenue deduction because it constitutes an alteration or improvement, the taxpayer should always consider the maximisation of all available capital allowances. This should involve the identification of works incidental to the installation of plant and machinery, which will qualify for capital allowances as if the expenditure was incurred on the plant and machinery itself. Again, this highlights the importance to the taxpayer of having a full and detailed analysis of any project expenditure carried out for tax purposes.

For further advice concerning any of the issues raised, please contact one of our key individuals detailed below, or alternatively call our helpline on 0800 526262. Information on other property tax related topics can also be found on our website at <http://bankingtaxfinance.davislangdon.com>.

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