

CAPITAL VS. REVENUE: SOME POINTS TO BEAR IN MIND IN DISPUTES WITH HMRC

by Laurent Sykes

1. This note sets out some of the points to bear in mind in disputes with HMRC over what is revenue and what is capital in the context of repairs and improvements.

SCHEME OF WORKS

2. HMRC are known to challenge the revenue nature of expenditure incurred as part of a wider project on the basis that the expenditure is incurred as a part of a “scheme of works” which viewed as a whole is of a capital nature. The statutory basis on which a deduction is resisted is s.74(1)(f) and (g) ICTA 1988 (now s.53 CTA 2009).
3. HMRC’s approach makes it determinative whether or not expenditure was, as a matter of fact, incurred as part of the same “works”. It is clearly wrong however to say that a repair is any less of a repair simply because it was undertaken at the same time as an improvement and as part of the same project. Such an argument was deployed by HMRC in the case of *Christopher Wills* (TC00479) where the argument was rejected (HMRC had submitted that the work undertaken and claimed as repairs was part of a wider capital scheme to convert the outbuilding into additional living space).
4. HMRC sometimes rely to support their case on a Tribunal case known as *Moonlight Textiles* (TC00755). The reliance is misplaced. Here the taxpayer had not provided any breakdown which would permit a closer categorisation and this was why the taxpayer lost. The FTT said: “As HMRC

had pointed out however, the Appellant had provided a list of items of expenditure which might have distinguished between repairs and improvement in any detail.” The Appellant had therefore not discharged the burden on it. It is clear from that decision that the work involved improving the premises and therefore in the absence of a breakdown the FTT took the only decision which it was able to.

5. Taking the “works” as a starting point is the wrong starting point and an irrelevant one because it depends on subjective questions as to whether an expense was incurred as part of the same project. The correct starting point is to identify the relevant asset or entirety. In *O’Grady v Bullcroft Main Collieries* 17 TC 93, Rowlatt J approved *Lurcott v Wakely* [1911] 1 KB 905, a non-tax case. He said:

“But the critical matter is - as was pointed out in the passage read from Lord Justice Buckley’s judgment, in the case which has been referred to - what is the entirety? The slate is not the entirety in the roof. You are repairing the roof by putting in new slates. What is the entirety? If you replace in entirety, it is having a new one and it is not repairing an old one.”

6. Vinelott J described the approach in *Brown v Burnley* [1980] STC 524 as follows:

“However, two general observations can be made. First, in the often-cited words of Buckley L.J. in *Lurcott v Wakely & Wheeler* [1911] 1 KB 905, at page 924: “Repair is restoration by renewal or replacement of subsidiary parts of a whole. Renewal, as distinguished from repair, is reconstruction of the entirety, meaning by the entirety not necessarily the whole but substantially the whole subject-matter under discussion.” The second and related observation is that the question, “Is this a work or repair?” prompts the further question, “A repair of what?”; or, as Buckley L.J. expressed it, “What is ‘the

whole subject-matter under discussion’?” In the case of a covenant in a lease it may be possible to identify the whole as the whole of the demised premises. In the context of s 130(d) there is no such guide.”

7. Identifying the entirety is important because a replacement of part of the entirety can be a repair, whereas a replacement of the whole (or substantially the whole) of an entirety cannot be. For instance, if I replace the sole of my shoe with a new sole, that is a repair. If I replace my entire shoe, that is not a repair. As Lord Nicholls said in the *Auckland Gas* case [2000] STC 527:

“To take a homely instance, replacement of a worn washer on a household tap is normally regarded as a repair of the tap even though one of its parts has been wholly replaced. The tap has been repaired by the replacement of one of its component parts.”

8. The point is also important because the mere relocation of a part of an entirety (even if it involves a replacement of that part, to be located somewhere else) does not of itself necessarily give rise to capital expenditure. In *Samuel Jones & Co (Devonvale), Ltd v Commissioners of Inland Revenue* 32 TC 513, the facts were set out by the Lord President as follows:

“The old chimney had been in existence for some 80 to 90 years and had been subjected to the usual overhaul, repointing and relining to which such appliances have to be periodically subjected; but, as a result of increasing age and subsidence of its foundations, it came to be in a dangerous state and on the advice of their experts the Company had to replace it. With the object of keeping the factory in operation they did so by erecting a substitute chimney close by the existing chimney and then taking down the old chimney whenever the new chimney was in a position to take over the functions previously dis-

charged by the old chimney. It is found as a fact that the new chimney is not an appreciable improvement over the old chimney. So far as function is concerned its suitability for boiler draught is exactly the same as that of the old chimney. No additional steam-raising plant has been installed.”

9. This reflects the facts as found in that case: “The new chimney was sited close to the old in the middle of the factory in a block of buildings which also contains furnaces and boilers. The new chimney is about the same height as the old one (approximately 100 feet), and projects through an aperture (rather larger than in the case of the old chimney) in the roof.” It was held that the expenditure was revenue.
10. This to be contrasted with the new chimney in *Bullcroft v O’Grady Main Collieries* 17 TC 93 where the chimney was also moved. The reason for the decision in that case was that the chimney was the entirety - see per Rowlatt J: “I think the chimney is the entirety here” (doubt was in any event cast on this conclusion in the *Samuel Jones* case by all three judges in the Court of Session¹). In the *Samuel Jones* case by contrast, it was not and the cost of the newly positioned chimney was allowed.
11. The entirety might be vast. In the case of a pipeline, road, rail or cable network, the relevant entirety could be the whole pipe, road, rail or cable network. (See *Transco plc v Dyll* [2002] STC (SCD) 199, *Highland Railway Co v Balderston* (1889) 2 TC 485 and the *Auckland Gas* case.)

CHANGE OF MATERIALS

12. There is no requirement in order for works to be a repair and to give rise to revenue expenditure that the materials used are exactly the same as the originals.
13. Thus in *Conn (H M Inspector of Taxes) v Robins Bros Ltd* 43

TC 266 the repairs were still revenue even though different materials were used: the slate roof was replaced with one of corrugated asbestos; oak flooring was replaced with concrete in the main shop; certain timbers were replaced with steel joists encased in oak. Overall, the result was in substance to repair what was there before and not to improve it, and the expenditure was revenue.

14. In the *Transco* case, polyethylene was inserted into existing pipe network. It was held by the Special Commissioners:
“... there has been no overall improvement in sections of the network, as polyethylene has only been inserted in pipes which required repair or which were at risk of fracture. What was done was a mere replacement of parts of the pipeline that were defective and the renewal of those parts. All that has been done was necessary to renew and relay the network as it was; only those parts of the pipes which were defective, or which were at a high risk of failure, have been renewed. The character and nature of the property possessed by Transco has not been changed nor indeed has it been materially improved. The material used (polyethylene) is cheaper than cast iron. To adapt the words of the Lord President, what was done was a mere insertion of polyethylene pipes into the old pipes, which were worn out or partially worn out, and renewing them in whole or in part along the whole network. That did not alter the character of the network.”
15. However substantial changes which alter the character of the entirety by upgrading it are unlikely to give rise to revenue expenditure (see the *Auckland Gas* case).
16. It should be noted that changes in modern methods may mean that there are differences, and indeed improvements, between, say, the materials or components used to effect the repairs and the original materials or components.

There are examples of this in *Conn v Robin Bros* and the *Christopher Wills* case. That does not mean the expenditure is not revenue. The point is also made in the *Auckland Gas* case where Lord Nicholls said: “It often happens that, with improvements in technology, a replacement part is better than the original and will last longer or function better. That does not, of itself, change the character of the larger object or, hence, the appropriate description of the work.”

APPORTIONMENT VS. NOTIONAL REPAIRS

17. It is not possible to obtain a deduction for so-called “notional repairs”. If one replaces an asset in need of repair with a different one which is superior then one cannot look at the expenditure which one *would* have incurred in replacing the asset with one of the same character.
18. However one should not view this as precluding, as HMRC sometimes seek to argue, the ability to apportion expenditure between that which is revenue and that which is capital. For instance, if I use concrete to repair a road and I also use concrete to extend the road, it is possible to apportion the cost of the concrete between the revenue and capital elements. This has nothing to do with notional repairs.

PATCHWORK REPAIRS

19. HMRC sometimes argue that a repair which avoids the need for more regular patching up repairs is capital. This is not so. Expenditure can be revenue if it is on repairs which are undertaken so that patchwork repairs which would otherwise be necessary are avoided. It is true of course that expenditure is not revenue just because it is incurred so that patchwork repairs are avoided. But similarly the argument that expenditure is not revenue simply because it prevents the

need for patchwork repairs is a nonsensical one. If I choose to replace the sole of my shoe rather than to patch up the holes in it periodically, that is still a repair.

20. Thus in *Conn v Robins Bros Ltd* the facts found by the Commissioners were that quite substantial works were carried out and yet these were held to be repairs. The head note summarises this as: replacing the slate roof with one of corrugated asbestos; inserting steel joists at first floor level and building new walls above; replacing oak flooring with concrete in the main shop; replacing the shop front, eliminating a bow window; and replacing certain timbers with steel joists encased in oak. On appeal by the Revenue, Buckley J, dismissing the appeal, said:

“It was, I think, expenditure which the Company incurred because, unless something had been done, the state of the property would have become so decrepit that it would have been impossible for the Company to continue to carry on its business there.”

21. Put another way, if the expenditure is not on a new entirety or an improvement to the entirety which alters its nature, it is still likely to be revenue.

22. In the Irish case of *Hodgins v Plundr & Pollak* [1957] I.R. 59 (which is referred to in the *Auckland Gas* case by Lord Nicholls), a weigh-house was substantially rebuilt, the relevant entirety having been found to be the entire factory premises and not the weigh-house. The Irish Supreme Court held this was revenue. Kingsmill Moore J, giving the leading speech with which the other members of the Supreme Court agreed, said:

“This building though small was large enough to enable part of it to be used as a store and a workshop. It was heavily damaged and the walls were cracked as the result of a storm so that substantial repairs became necessary, and the company decided that

the most effective way of meeting the damage was not to attempt a patchwork repair but to pull down and rebuild the old structure. This was done and a new weigh-house was constructed using the old foundations and some of the original materials.”

23. He went on:

“The Company now have a weigh-house which is in good repair instead of a weigh-house which was in danger of becoming ruinous, but there is no suggestion that it is more convenient, more effective or of greater capital value, than the old weigh-house would have been if it was in thorough repair. I am unable to see that any new capital asset has been created.”

24. Logically, all of this makes sense. It would be nonsensical if the tax system gave relief for patching up but not for repairs which for a good number of years obviate the need for patching up. Provided what is being incurred is in fact on a repair or in substance maintenance, and the character of the entirety has not been altered, then it is entirely logical that the law treats those in the same way.

REPAIR OF SOMETHING NOT YET DAMAGED

25. Expenditure can be revenue expenditure if it is incurred on replacing something which has not yet been damaged. In *Transco* part of the repairs were precautionary repairs as the Special Commissioners noted:

“Also, there has been no overall improvement in sections of the network, as polyethylene has only been inserted in pipes which required repair or which were at risk of fracture. What was done was a mere replacement of parts of the pipeline that were defective and the renewal of those parts. All that has been done was necessary to renew and relay the

network as it was; only those parts of the pipes which were defective, or which were at a high risk of failure, have been renewed. The character and nature of the property possessed by Transco has not been changed nor indeed has it been materially improved. The material used (polyethylene) is cheaper than cast iron. To adapt the words of the Lord President, what was done was a mere insertion of polyethylene pipes into the old pipes, which were worn out or partially worn out, and renewing them in whole or in part along the whole network. That did not alter the character of the network. Although some old cast iron pipes have had polyethylene pipes inserted into them, that has been done only where necessary for the purposes of repair, or precautionary repair, and has not been done to the whole network. Those considerations would point to the conclusion that the expenditure is properly chargeable as revenue expenditure.”

MATTERS OF FACT AND DEGREE

26. In dealing with a revenue vs. capital dispute, matters of fact and degree arise. One is required to view the changes in light of the overall effect on the relevant entirety. Lord Nicholls said in *Auckland Gas*:

“The nature of some objects and their component elements is such that replacement of one or more components will not necessarily be regarded simply as a repair of the larger object. This is particularly so if the replaced element differs from the damaged original in such a way as to change the character of the whole. A house is a simple example of this. Demolition and rebuilding of a dangerous flank wall

of a house would normally be regarded as repairing the house. The answer might not be so obvious if an entire derelict wing of a large house were demolished and rebuilt, especially if the new construction were substantially different from the original. Questions of degree may arise in such cases.”

CONCLUSION

27. It will be worth bearing the above points in mind in a capital vs. revenue dispute with HMRC.

Endnotes

1. Lord Carmont for instance said of the earlier High Court case: “Rowlatt, J., it is true, found that he could regard the chimney in the O’Grady case as being the unit or the entirety as he called it. In the present case I am clearly of opinion that the unit to be considered is the factory and the chimney cannot be taken in isolation. There was no improvement in the factory, on the findings of the Case, by the erection of the new chimney in place of the old. It is an entirely subsidiary matter in the factory.”