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Capital Allowances: Back to Basics

Introduction

For many years, property-based tax reliefs for developments such as nursing homes, crèches and student accommodation were a cornerstone of tax policy in Ireland. However, with the withdrawal of these reliefs, taxpayers must now go back to the basics of capital allowances to avail of tax benefits from property investments.

An Overview of Wear-and-Tear Allowances

Wear-and-tear allowances (WTAs) are a form of tax depreciation and are available where capital expenditure has been incurred on the provision of items of plant and machinery (P&M) that are in use wholly and exclusively for the purposes of a trade. They are claimed on the cost of providing the P&M on a straight-line basis over a period of eight years, at a rate of 12.5% per annum.

WTAs are a complex tax technical area that is largely governed by case law and precedent. As illustrated in Fig. 1 below, before calculating the WTAs available in respect of capital expenditure incurred, two criteria must be considered:

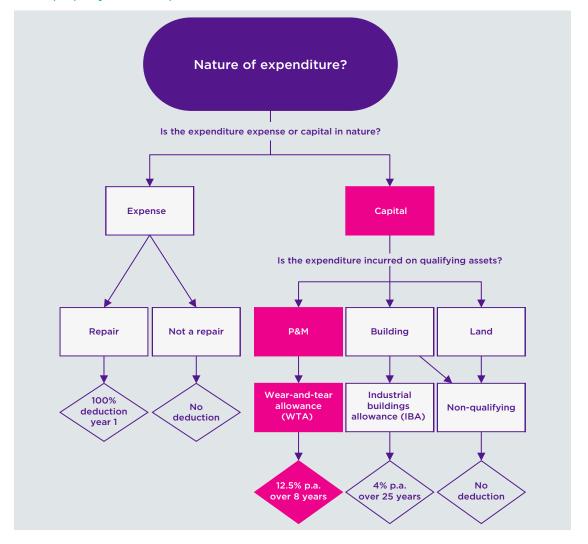
- Is the expenditure expense or capital in nature?
- If it is capital, is it incurred on qualifying assets - i.e. P&M or industrial buildings - or non-qualifying assets?

Where Do You Find Significant "Integral P&M"?

"Loose P&M" – for example, fixtures and fittings – is normally easily identifiable. However, less obvious for many taxpayers is the P&M that is included within the fabric of a building, or within leasehold improvements, often referred to as "integral P&M". Significant integral P&M can often be identified in:

- · the construction of new buildings;
- the purchase of second-hand properties;

Fig. 1: Determining qualifying expenditure for WTAs – the different potential treatments for property-related expenditure



- leasehold improvements;
- · landlord works;
- · tenant works;
- the fit-out, repair, refurbishment or extension of properties, including:
 - offices.
 - · retail and shopping centres,
 - factories, manufacturing plants, warehouses.
 - data centres,
 - restaurants,
 - nursing homes,
 - hospitals,
 - primary-care centres,
 - hotels,
 - banks.
 - mixed-use developments and
 - rental properties (apartments and houses).

Capital Expenditure Versus Expense Expenditure

The distinction between what constitutes expense and capital expenditure can be guite blurred, as illustrated by the large volume of case law on the subject that is often apparently conflicting. For example, in O'Grady v Bullcroft Main Collieries Ltd. [1932] 17 TC 93 expenditure was incurred on a new freestanding chimney designed to replace another that had become unsafe. The new chimney was larger and was determined to be an improvement; even though the chimney was part of the whole colliery complex, it was regarded as an entity or entirety in itself. As the expenditure incurred on the chimney was seen to be expenditure on the creation of an asset in its entirety, it was held to be capital in nature.

However, in contrast to the O'Grady case, in Samuel Jones & Co. (Devondale) Ltd. v CIR [1951] 32 TC 513 the replacement of a chimney

was regarded as a repair, as the new chimney in this case was not regarded as an appreciable improvement on the old. Furthermore, the rebuilding cost of the chimney was £4,300, compared to a rebuilding cost of the factory of £215,000. In this respect the chimney was not regarded as an entirety in itself but as "physically, commercially and functionally an inseparable part of an entirety which is the factory". Therefore the expenditure was not incurred on the creation of an asset but rather

on the repair of an asset and was therefore expense in nature.

The distinction between these cases is subtle and illustrates the importance of giving attention to the fact pattern; a well-argued case could make all the difference in the event of a challenge.

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Expenditure that is expense in nature is generally that which is incurred on the repair of assets; it may therefore be helpful to consider the following questions when assessing whether expenditure can be treated as an expense for tax purposes:

Was the expenditure incurred on a "like for like" replacement where there was no element of improvement to the asset?

Section 81(2)(g) TCA 1997 states that no tax deduction is available for "any capital employed in improvements of premises occupied for the purposes of the trade or profession". Given this specific provision, it is important that full consideration be given to whether the work carried out constitutes replacement or improvement.

Was the asset replaced with its "nearest modern equivalent"?

Although only the costs of reinstatement to the original state and condition may qualify as repairs, different materials from the original may be used for the reinstatement work; Revenue may allow the "nearest modern equivalent" to be accepted as a substitute for the original item. It follows that expenditure incurred on the nearest modern equivalent might be considered to be expenditure incurred on repairs. Care needs to be taken as the use of modern materials may give an apparent element of improvement because of the greater durability, superior qualities and so forth of the new material. The reality may be that the work simply means that the asset is in a fit state to be used as before; it does not do a different job or a better job.

Simply put, the work could be a

repair and not an improvement if,

as before. In addition, the work is

considered an improvement and

therefore disallowable as capital

expenditure if, as a result of the

work, more can be done with the

asset, or the asset can be used to

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after the work is carried out, the

asset can only do the same job

Simply put, the work could be a repair and not an improvement if, after the work is carried out, the asset can only do the same job as before. In addition, the work is considered an improvement and therefore disallowable as capital expenditure if, as a result of the work, more can be done with the

asset, or the asset can be used to do something that it could not do before.

before.

Examples of expense expenditure include:

- the repair of windows, doors, furniture or machines such as lifts,
- the repair of roof tiles or gutters and
- exterior or interior painting and decorating.

Once it has been established that the relevant expenditure is expense in nature, a claim for the expenditure can be made, i.e. a 100% deduction in the year in which the expense was incurred.

Capital

In general terms, capital expenditure is that which is incurred on creating an asset that has enduring benefit to the trade.

The following questions might help to identify capital expenditure:

- Was the expenditure incurred on creating an
- Was the expenditure incurred on improving the asset?
- Was the expenditure incurred on the replacement of an asset?
- Was the asset replaced in its entirety?

Once it has been established that the relevant expenditure is capital in nature, the next step

> is to determine whether it satisfies the criteria for P&M with a view to claiming WTAs.

What Is "Plant and Machinery"?

The term "plant and machinery" is not defined in Irish legislation and, unlike in other jurisdictions such as the UK, there is no approved list of assets that qualify as P&M in

Ireland. The identification of qualifying items can therefore be problematic, as each item of expenditure must be analysed on a firstprinciples basis.

Although the meaning of "machinery" is generally undisputed, the meaning of "plant" for tax purposes is very broad and in practice covers a wide range of items extending far beyond the obvious movable items or fixtures and fittings. For example, "plant" can exist in the fabric of a building or as part of civil and building contracts (e.g. certain mechanical and electrical installations, certain drainage and integration costs, a certain amount of design team fees etc.). Whether an item is considered P&M, and thereby qualifies for WTAs, is determined by reference to principles established in case law and Revenue practice.

Two cases in particular are considered the most significant when establishing whether an item

qualifies as P&M. The first, *Yarmouth v France* [1887] 19 QBD 647, concerned a worker's compensation and found that a horse was plant; Lindley LJ stated:

"There is no definition of plant...[b]ut in its ordinary sense it includes whatever apparatus is used by a business man for carrying on his business – not his stock in trade, which he buys or makes for sale; but goods and chattels, fixed or moveable, live or dead, which he keeps for permanent employment in his business".

The second case, *J Lyons & Co. Ltd. v Attorney General* [1944] 1 All ER 477, centred on the question of whether lamps and their fittings were plant, specifically whether they were used for carrying on the business or just regarded as part of the general business setting. Uthwatt LJ found that the lamps were not plant as they had no special feature in purpose, position or construction and they were part of the general business setting. He stated:

"I do not think that the use of the word plant...has the effect of confining the meaning of the word to such plant as is used for mechanical operations or processes...It does not include stock-intrade, nor does it include the place where the business is carried on."

However, this issue was further refined in the case of *Jarrold v John Good & Sons Ltd.* [1963] 40 TC 681, in which the judge noted that "the setting in which a business is carried on, and the apparatus used for carrying on a business, are not always necessarily mutually exclusive".

In a later case, *Wimpy International Ltd. v Warland* [1987] BTC 591, Hoffman J clarified the definition of setting:

"

"The items in dispute in that case were wall decor, plaques, tapestries, murals (which were in fact detachable), pictures and metal sculptures used to decorate

hotels. All of these were held to be chattels or trade fixtures and not integral parts of the premises. The Revenue refused them capital allowances as plant on the ground that they formed part of the 'setting', which in one sense, and probably the most obvious sense, they certainly did. But the House of Lords held that they nevertheless passed the business use test because they were used to please and attract customers, and therefore were for the promotion of the trade."

Tests To Determine P&M

The above and subsequent legal cases have resulted in a number of tests that can be applied when determining whether an item qualifies as P&M. The tests interact with one another and are not necessarily given equal weight; in certain cases, one test might supersede another. The tests are:

- function test (relating to the function of the item);
- business use test (whether the item is employed for carrying on the business);
- premises test (whether the item is part of the premises); in Wimpy International Ltd. v Warland [1989] STC 273, Hoffman J summarised the four factors to consider with respect to the premises test:
 - whether the item appears visually to retain a separate identity,
 - the degree of permanence with which it has been attached to the building,
 - the extent to which the structure would be complete without it and
 - the extent to which the structure was intended to be permanent;
- setting test (whether the asset itself plays a part in conducting the trade or is simply part of the decoration of the business premises);
 and
- completeness test (whether the building itself would be complete without the item under consideration).

Lists of P&M

One of the most common questions I am asked is: "can you give me a list of P&M that meets the requirements of the Irish legislation?". The answer is always the same: no, Irish legislation

does not provide a list, and you must establish whether an item is P&M from first principles. in all cases. The next question that is always asked is: "OK, but I have seen lists of P&M printed in textbooks, journals etc. - can I use them?".

Using pre-existing lists is not advised. What constitutes qualifying P&M in one setting may not be P&M in another. For example, demountable partitions are often listed as a qualifying item. However, if these partitions are effectively "walls" and it cannot be demonstrated that they are intended to be moved in the course of the qualifying trade,

plant.

In addition, these lists are often provided to people with limited or no knowledge of capital allowances to allocate expenditure, increasing the risk of error and leaving

no room for analysis of the expenditure. Furthermore, it is difficult for a tax consultant with limited building knowledge to know how reliable the cost allocations are, particularly when insufficient cost breakdowns are

> available. Invoices supplied by building take account of costs beyond the building contract, making it

contractors can also be delayed and, even when received, are unlikely to difficult to reconcile with the fixed-asset additions.

Conclusion

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In order to claim everything to which you are entitled, you need to be careful and ensure that you have the appropriate knowledge and experience and a proper and well-reasoned basis for the claim, taking account of all the case law and Revenue precedents.

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