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Capital versus Revenue for Landlords

In the first fact sheet **'What expenses can a landlord claim?'** the initial question you should be asking is, '**Was the expense incurred for the purpose of the property letting business?'** Answering yes to this question does not automatically mean that the expense is allowable for income tax purposes.

There is a second question to be answered: '**Was it a Capital or a Revenue expense?'** Only if the answer to the second question is 'revenue', will an income tax deduction be allowed.

Before you would even consider asking the second question (never mind being able to answer it) you would need to have an understanding of the distinction between capital and revenue in relation to repairs and improvements.

That is the aim of this fact sheet.

As these expenses can be some of the most significant a landlord will incur, it is important that landlords have a reasonable understanding.

Unfortunately, it is not possible to give a definitive list of expenses falling into each category. This is because, as we will see from the case law, **it is not so much the particular asset that is purchased that will dictate the tax treatment but, more so, the circumstances surrounding the purchase.**

Case law is considered alongside Her Majesty's Revenue & Customs (HMRC) guidance from their property income manual and their business income manual. HMRC also have a capital v revenue expenses toolkit at https://www.gov.uk/government/publications/hmrc-capital-vs-revenue-expenditure-toolkit which is worth a look at and will be discussed later in this fact sheet.

What is the Capital / Revenue divide & why is it important?

In general, works will be **capita**l if they constitute **improvements or the replacement of the entire asset.** If an expense is capital, **no income tax relief** is available at the time the expense is incurred. 'Capital' costs include the cost of the land & building itself, plus any refurbishment expenses that are not straight forward repairs. Relief for capital costs is provided when the property is sold. An example of a capital expense would be the creating of an ensuite bathroom where there was none there initially.

Expenses will be **revenue** if they constitute **repairs or the replacement of part of an asset. Income tax relief is given in the tax year the expense is incurred*** to reduce rental profits in the same way as loan interest and buildings insurance. Examples include: replacing kitchens & bathrooms, re-wiring, decorating, repairing roofs and gutters etc.

*This may not necessarily be the case in respect of a newly purchased property. Under the pre-letting rules touched upon in the fact sheet **'What expenses can a landlord claim?'**, it was noted that where a repair takes place in advance of an initial let, this will be deemed to have been incurred on the first day of letting (possibly in a later tax year to the one in which the expense was incurred).

However, where, for example, a 2nd property was purchased, say, in February 2016 and had to be repaired because of storm damage and was not let out until May 2016, although the 1st letting of property 2 is incurring in a later tax year, the expense will be claimable in the 2015/16 tax year (rather than 2016/17) so long as there was an existing property investment business in operation, i.e. other properties already being let out. See below '**When will the income tax relief be due?'** for further details.

Most property investors prefer costs to be 'revenue' because there is an immediate tax deduction against rental income, whereas relief for capital costs may not come until many years down the line when the property is sold. 'A bird in the hand etc.'

However, *'upfront tax relief'* may not necessarily be the best option in all cases. There is no point obtaining a large revenue deduction if a property is unlikely to generate an overall taxable profit in the first instance. Also, if a property has been purchased because of the likely capital appreciation, for instance in London & the South East, a capital deduction in the longer term may prove beneficial.

Whilst the decision on whether an expense is capital or revenue will be based on the facts, a few tweaks may be able to change the treatment in a direction that is the most valuable to the landlord.

Let us now consider capital and revenue through the property life cycle.

Stage 1 – Buying the property

There is no immediate tax relief: the purchase price, including stamp duty, legal fees, survey costs etc., are capital costs, to be set off against the proceeds of the eventual disposal of the property – which may be subject to Capital Gains Tax (CGT), if there is a gain.

What happens if the purchase falls through? Unfortunately, as these are capital costs associated with that particular property, there is no tax relief.

Stage 2 - Refurbishment before the first tenant

Often, landlords will complete a significant refurbishment before the first tenant moves into a to a newly-acquired buy to let property. There seems to be something of a misconception (both amongst landlords and HMRC) about whether the cost of refurbishment before the property is first let is an allowable expense for income tax purposes.

As at any other point in the property's tax life cycle the question turns on whether the expenditure is 'capital' or 'revenue'. The mere fact that repairs are undertaken not long after the property is acquired (and before first letting) does not, in itself, make the cost

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capital. However, the most likely timing of any capital works is before first let (a fact not lost on HMRC). **Only the costs of bringing a derelict or very run-down property up to an acceptable standard for letting are capital** and, therefore, disallowable. A low purchase price will suggest this.

Time to consider our first case law: - **Law Shipping Co Limited v CIR** (from the 1920's) involves the purchase of a ship in a very poor condition. The ship was, in fact, technically unseaworthy and after just one voyage a survey revealed that it needed **extensive repairs**. The costs or the repairs (making the ship seaworthy) **were capital** – in fact, they were part of the cost of acquiring the ship itself because, until they were completed, the vessel **was not fit for use in the trade.**

The other case involved cinemas (**Odeon Associated Theatres Limited v Jones**). During and shortly after the Second World War, Odeon were purchasing cinemas and refurbishing them. Most cinemas, though still open to the public, were in a pretty tired condition. The Inland Revenue (as it was then called) sought to deny a deduction for the costs of the refurbishment, on the basis of the same logic that applied to the dilapidated ship referred to above. The state of disrepair on acquisition had, unlike in the *Law Shipping* case, not affected the price paid for the cinemas and the company operated them as cinemas for months (sometimes years) before the refurbishments took place. Odeon won their case (**the work was repairs [revenue] not improvements and, thus allowable**). The crucial point was that the cinemas were **fit for use when acquired** (as opposed to the ship which had to be 'fixed' before being used). The costs were simply routine maintenance that had been neglected during the wartime years.

These are the two landmark cases that distinguish between revenue and capital costs at the time a property is first purchased. In the *Odeon* case the works were desirable but not essential to enable the buildings to continue to be used as cinemas. The repaired asset was the same asset as when it was in disrepair, not something different, improved out of all recognition.

Where works are carried out shortly after the acquisition of a building HMRC may to raise *Law Shipping* to demonstrate that they are capital. It is unlikely to be sufficient to defeat such a claim to show that the premises were usable on acquisition if, subsequently, the purchaser carried out refurbishment works *before* letting. This suggests that they were not fit for letting, which is much nearer the *Law Shipping* end of the line than the *Odeon* end.

On the other hand, if the purchaser actually lets the premises for several months prior to carrying out the work, HMRC's claim should be resisted strongly because this demonstrates that the premises were suitable for the use for which they were acquired and is much nearer the *Odeon* end of the line.

If mortgaged, the property will have been surveyed by the lender. On the survey report, the surveyor will have indicated if the property was in suitable condition to be let. If 'yes', this is good evidence that costs incurred, after purchase but before first let, were general repairs and so revenue costs (allowable). Similarly, if purchased from another landlord, letting until close to the date of disposal, this should be helpful.

If a retention is placed on the mortgage offer, again, this provides good evidence as to the proportion of the works that is capital versus revenue. Surveyors often state that, say, 'floorings, kitchen and electrical fittings need updating' - so, in the event of a £10,000 retention (say), we might treat £10,000 of the total refurbishment cost of £25,000 as capital, and the remaining £15,000 as revenue.

Other useful proof is video or photographic evidence - to show that the property was fit for letting before works were carried out.

Be sure to have tradesmen describe the works carefully on their invoices. It is likely that HMRC will only ever conduct a 'desktop' check of the tax treatment of costs. There are plenty of ‘easy pickings’ for HMRC where landlords do not have any or insubstantial records. If your records and visual evidence clearly correspond with the tax treatment indicated on your tax return, it is likely that HMRC will move on to the next (not so well prepared) landlord.

Finally, staying with HMRC checks, be aware that they have 6 years to open a discovery enquiry. I, for one, have little recollection, what I was doing 6 years ago. A great way to justify tax deductibility of any action is by keeping a diary.

In summary, the two questions you must ask yourself about repairs before the property is first let are:

- Was the property fit for letting when first purchased?
- Was the expenditure on routine maintenance costs, which perhaps had been neglected by the previous owner?

If the answer to both these questions is “Yes”, the expenses can be claimed as revenue costs.

When will the income tax relief be due?

It should be noted that rental income and expenditure is pooled for income tax purposes. This means that, with the exception of your first buy-to-let (BTL) for which tax relief will only be given when the property is first let, expenditure on subsequent purchases will be allowable at the time it is incurred, even if that particular BTL is not let out during the tax year in which the expense is incurred.

For example, if property 1 was purchased in March 2016, and you spent 3 months decorating it and finding a tenant before letting it on 1 June 2016, you cannot claim the maintenance cost in 2015/16, because first letting occurs in 2016/17 and this is the start of the letting business. Any costs will be deemed to have been incurred on the first day of letting.

If the expenses were incurred in March 2016 on property 2, the expense could be claimed on the 2015/16 tax return, regardless of whether this was let out prior to 06/04/2016.

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'Modern equivalents' works

A significant factor to be considered in deciding whether expenditure will be allowable is if there has been a material improvement on the asset which is being repaired/replaced. This can apply at any point in the life cycle of the property.

The concept of a revenue repair implies the replacement of like for like. Where any substantial improvement takes place, this suggests capital treatment. But, as is the way with tax, there will always be the exception to the rule.

Sometimes it is not always practical in terms of technology and materials to replace like for like and an inevitable improvement which is occasioned by the use of modern materials should not be regarded as a reason for treating what would otherwise be replacement/repair expenditure as capital.

It may be uneconomic to repair an asset, or, modernisation is better. Examples include replacing single glazing with double glazing or wooden gutters with modern plastic or aluminium. Where such 'modern equivalent' replacements are used, even if there is some improvement, the costs should be treated as revenue. The 'improvement' element would need to be substantial, for the costs to be treated as capital - for example, replacing an old conservatory with a new brick-built extension.

The HMRC property income manual has this to say on the matter:
http://www.hmrc.gov.uk/manuals/pimmanual/PIM2020.htm

'*What we regard as a repair will necessarily change with the passage of time to reflect technological improvements. This issue was considered in the tax case Conn v Robins Brothers Ltd [1966] 43TC266. As a result we accept that the replacement of a part of the 'entirety' with the nearest modern equivalent is allowable as a repair for tax purposes and not disallowable as improvement expenditure.*

An example is double-glazing. In the past we took the view that replacing single-glazed windows with double-glazed windows was an improvement and therefore capital expenditure. But times have changed. Building standards have improved and the types of replacement windows available from retailers have changed. We now accept that replacing single-glazed windows by double-glazed equivalents counts as allowable expenditure on repairs.

Generally, if the replacement of a part of the ***'entirety'*** *is like-for-like or the nearest modern equivalent, we accept the expenditure is allowable revenue expenditure'*.

Just as an aside, in the years prior to HMRC changing their stance on double glazing and updating their manuals accordingly, many landlords used to point out that that HMRC should be accepting double glazing as a revenue expense because other government departments were promoting double glazing because of the energy savings. Whilst this may make perfect common sense, it does not necessarily mean that, because one government department promotes an energy saving asset, another government department will follow suit by providing favourable tax relief. Very often, there will be different treatments between the taxes for the same thing. For instance, what HMRC regard as a dwelling for Stamp Duty Land Tax purposes is not the same as its' interpretation of a dwelling for capital allowances purposes.

Hopefully, as we move towards one Government website covering all departments rather than a website for each department (HMRC, DWP etc) this will have the desired impact of standardising treatments throughout.

In my experience of dealing with hundreds of landlords, it's rare for general works to be treated as capital and, where that is the case, it is usually beyond any doubt. This is an area where many landlords are sometimes overly cautious in their view of capital versus revenue - seek professional advice as, often, the sums involved are significant!

Stage 3 - Running the property business

I have highlighted the word 'entirety' in the previous section because this plays a significant part in determining whether the replacement of an asset will be deemed to be a *repair* because it is '*a replacement of a part'* or whether it is *capital* because it is '*replacement of a whole standalone asset'*. Once again, case law (this time involving the replacement of a factory chimney, of all things) leads the way.

O'Grady v Bullcroft Main Collieries Limited

In this case, the company demolished a chimney which stood apart from a colliery but connected to it by an underground pipe work system. The old chimney had become too dangerous for its use to be continued. A replacement chimney was constructed on a site close to that of the old chimney to allow the old chimney to continue to operate until the new chimney could be brought into use. As part of the replacement process the chimney design, whose build cost was significantly greater than the original chimney, was improved in that it was slightly taller and 50% wider than the old chimney. The case decision was that **the chimney was the asset in its entirety and, consequently, the expenditure incurred was capital in nature. No income tax relief was due.**

Samuel Jones & Co (Devondale) Limited v CIR

In this case, a factory chimney was again replaced, but the **chimney was an integral part of the factory** and the replacement stood in exactly the same location and, more or less, in the same format. The entirety was the factory as a whole. The chimney, which had become worn out, was just one part of the factory. As a result, its replacement was held to be **revenue in nature** and **income tax relief allowed**. This judgement confirms that, whilst certain costs may be substantial, they can still be repairs. The circumstances and not the actual asset will determine the tax treatment.

The above cases identify the fine line between capital and revenue items. The key question is to identify: **'what is the entirety and whether the whole item is being replaced or just part thereof'.**

In the context of the residential landlord the HMRC property income manual has this to say on the matter: http://www.hmrc.gov.uk/manuals/pimmanual/PIM2020.htm

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'In the case of residential accommodation we accept that the 'entirety' will normally be the house or the block of flats that is let. So if your roof is damaged and you replace the damaged area, your expenditure is allowable.

Even if the repairs are substantial, that does not of itself make them capital for tax purposes, provided the character of the asset remains unchanged. For example, if a ***fitted*** *kitchen is refurbished the type of work carried out might include the stripping out and replacement of base units, wall units, sink etc., re-tiling, work top replacement, repairs to floor coverings and associated re-plastering and re-wiring. Provided the kitchen is replaced with a similar standard kitchen then this is a repair and the expenditure is allowable. If at the same time additional cabinets are fitted, increasing the storage space, or extra equipment is installed, then this element is a capital addition and not allowable (applying whatever apportionment basis is reasonable on the facts). But if the whole kitchen is substantially upgraded, for example if standard units are replaced by expensive customised items using high quality materials, the whole expenditure will be capital'.*

http://www.hmrc.gov.uk/manuals/bimmanual/BIM46900.htm offers further detail in this area. If you refer to this guidance please be aware that it is HMRC's business income manual and, therefore, is relevant to all businesses rather than just property investment businesses. One tax relief that most businesses receive but property investment businesses do not, is capital allowances in respect of fixtures in a building.

If, say, a bookmakers business installs air conditioning in its trading premises this is a capital item. Similarly, if a landlord installs central heating in a BTL, this is also a capital item.

The difference is that the bookmaker will qualify for capital allowances on the full cost of installing the air conditioning whilst the landlord will receive no tax relief at all.

I highlight this because, in the HMRC commentary above, HMRC are commenting on the tax treatment of replacing a fitted kitchen (i.e. a fixture) and treating it as a repair. The cost of the initial installation of a fitted kitchen would not be allowable for a landlord but its replacement would be. Similarly, with other fixtures such as bathrooms and central heating systems (including boiler), the initial cost will be capital (not allowable) but the cost of replacements will be fully allowable.

The same principle as with the fitted kitchen would apply to other fixtures. It would have to be on a like for like basis. For instance, a central heating system could not be replaced by, say, solar panels combined with a ground source heat pump.

Projects with a mix of capital and revenue works

We have already ascertained that if the work undertaken does no more than restore an asset to what it originally had been, then that is a repair and the expenditure would normally be an allowable deduction in computing the profits of the trade.

If the work undertaken alters or improves the asset, then it is not a repair; the expenditure is capital and is not an allowable deduction.

But what if there is a mixture of the two? If the work amounts to an alteration or improvement then there is no revenue deduction for any part of the expenditure. This includes things like redecoration after the main work has been done (redecoration would ordinarily be a revenue expense). So in the case of the ensuite that did not exist previously, the decoration of the walls after the event would not be allowable.

Contrast this to a modified version of the example at http://www.hmrc.gov.uk/manuals/bimmanual/BIM46915.htm. A landlord decides to modernise a BTL that has been rented out continuously for 15 years but the in situ tenant has now vacated. The roof is totally renewed as is the bathroom and an open plan downstairs is created by demolishing an interior wall where originally there was a separate kitchen and lounge.

The new roof simply returns the roof to original condition. It is neither an alteration nor improvement; it is simply a repair of the building. In the same way, the refurbishment of the bathroom is simply a repair of the building. These are allowable revenue expenses.

The work carried out to create an open plan downstairs will be partially allowable for income tax purposes and partially disallowed as an alteration/improvement. The element of expenditure identified as capital expenditure will not be an allowable deduction.

It will be necessary, at a detailed level, to split the spend between capital and revenue, to find the revenue costs to be included in the rental accounts. Obviously, the demolition of the wall and the decoration surrounding it will be capital but it will be a surprise if there was not a kitchen there initially and there will still be a kitchen after the event. It has already been noted from:
http://www.hmrc.gov.uk/manuals/pimmanual/PIM2020.htm that a fitted kitchen will be allowable if the replacement kitchen is of a similar standard to the original kitchen and lots of new units are not added. Essentially, if a kitchen remains a kitchen it will be allowable but not if there has been a significant upgrade.

It should be noted that any stand alone items purchased for the kitchen will not be allowable as repairs (but consider renewals or the 10% wear and tear allowance* as a way of clawing back the cost). This includes white goods such as fridges, cookers and dish washers. However, if these were integrated into the kitchen they would form part of the overall allowable replacement of the kitchen even if such items were stand alone prior to the refurbishment.

*See the separate factsheet '**Replacement Furniture Relief**' which replaces the renewals basis and the wear and tear allowance from 06/04/2016.

Minor refurbishment works

Just as in the same way that a small element of revenue spend is not allowable where it forms the rump of the total cost of a capital project, the opposite occurs where the majority of the work is revenue but in addition there is a small degree of 'improvement'. Strictly this should be split out and treated as capital. However, by HMRC concession, such works are treated as fully revenue spend, since the capital element is small and incidental.

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Repair cost provisions

In accounting terms , a 'provision' is a deduction made in the accounts for the cost of works even if the work has not yet been completed, or, if it has been completed but the invoice has not been received or paid by year-end. Provisions are not generally allowable for accounting and tax purposes until the costs have actually been incurred.

However, repair cost provisions are allowable for tax purposes if the landlord has entered into a contractual obligation to have the work done.

Note - insurance proceeds, or grants received, must be offset against the cost of the works i.e. these are taxable.

Stage 4 – Disposal of the property

This may result in the cessation of the property business if there is only one BTL. Even if the business is ongoing (due to there being other properties in the portfolio), the sale will be subject to Capital Gains Tax (CGT): the deferred capital costs of acquisition / improvement incurred before, during or after the property was let are added together, and the total deducted from the sale proceeds – themselves net of selling costs, such as solicitors' and agents' fees.

It should be noted that for an improvement to be allowable for CGT purposes it must still be in existence at the date of disposal. For instance, with a 3 bedroom BTL where the box room is converted into an ensuite for the main bedroom this is allowable capital expenditure. However, if the ensuite is converted back to a 3rd bedroom prior to disposal, say, because the extra bedroom will increase proceeds by £10,000, neither the cost of the original work nor the remedial work will be allowable. Basically, the £10,000 increased proceeds (with potential increased CGT) must be worth more than the work undertaken initially and just before disposal.

Summary

Many landlords spend significant sums maintaining their property, ensuring a high standard which translates into higher rents and occupancy i.e. it makes business sense! Unfortunately, many tax inspectors seem to think that all actions are taken to avoid paying tax.

Care needs to be taken to ensure that the maximum amount of spend is treated as revenue, and so available for immediate tax deduction. As this is often one of the main areas that is looked at by HMRC in the event of a tax investigation, it makes sense to keep good records.

Given the harsh HMRC penalty regime, errors can result in substantial penalties plus interest over and above any tax underpaid that is identified.

It is worth spending some time, and taking good advice, to get the maximum legitimate tax deduction!

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For & on behalf of Tax Facts Limited

November 2015, updated May 2016.

Appendix 1 – Fact sheet – 'The HMRC capital v revenue toolkit'

Disclaimer

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- *Whilst care has been taken to ensure the accuracy of this fact sheet, no responsibility for loss or damage occasioned to any person(s) acting or refraining from acting as a result of any statement contained in this work can be accepted by the author.*
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