Hydro-electric claim

Ray Chidell and Jake Iles discuss the First-tier Tribunal decision in *SSE Generation*.

The decision in *SSE Generation Ltd* (TC6618) on capital allowances is the most important one in recent years. The direct subject matter – a vast hydro-electric scheme – will affect relatively few businesses, but some of the principles discussed are of wide significance, and we can expect to see references to this decision for many years.

The First-tier Tribunal gave its ruling at the end of July, and a summary of the case was in *Taxation* (27 September, page 6).

The scheme

The scheme involves a large reservoir holding more than 12 million cubic metres of water behind an impressive dam. The reservoir is filled naturally in part, but more than half of its supply comes through a 12 km network of man-made tunnels, which in turn are fed by 25 artificial water intakes.

Water exits the reservoir through a headrace – a conduit more than 6 km long with a diameter for most of its length of five metres. A narrowing of the conduit with a tapered steel lining allows the pressure to build to a maximum of 900 lbs per square inch as it reaches the huge underground 'power cavern'. This is 47 m by 20 m, with a height of 33 m, carved out of the rock and divided into four levels. Once the water has performed its function in generating the electricity, it is carried away through a tailrace leading into Loch Ness.

A much smaller 'transformer cavern' sits alongside the power cavern, stepping up the voltage for onward transmission to the National Grid.

Various tunnels serve different functions within the whole scheme.

Huge discrepancy

The case concerned the extent to which capital allowances could be claimed for the costs of creating this scheme. The parties agreed from the outset that no allowances were due for the cost of the dam and reservoir, so the technical dispute concerned other parts of the project: the water intakes, the conduits, most of the headrace, the power cavern, the transformer cavern, the tailrace, the access tunnels and the remedial works.

Key points

- There are still huge areas of potential dispute over what constitutes plant or machinery and the HMRC view cannot always be taken at face value.
- The restrictions of CAA 2001, s 21 and s 22 may be less severe than they seem.
- The interaction of those sections with more than 100 years of case law is complex and still open to different interpretation.
- The distinction between premises within which a trade is conducted and the apparatus with which it is conducted remains valid.

© Istockphoto/Easyturn

The costs, including rectification works after an early rock-fall, totalled some £300m. The company claimed £260m as qualifying expenditure but HMRC would accept only £34m. The huge discrepancy illustrates that after well over 100 years of case law and despite the statutory provisions beginning at CAA 2001, s 21, the definition of plant remains as imprecise as ever.

The result is not known in financial terms because the decisions were given in principle and the parties were sent away to work out the figures but, on the matters discussed, the tribunal found in favour of the company in most of the disputed areas. Yet again, HMRC has been found to apply the rules in this field too restrictively. Although not directly quoted in the judgment, the outcome of this case echoes the comments of Lord Lowry in the House of Lords decision in *CIR v Scottish & Newcastle Breweries Ltd* [1982] STC 296:

> 'I think that much difficulty is caused by seeking to place limitative interpretations on the simple word "plant": I do not think that the classic definition propounded in *Yarmouth v France* suggests that it is a word which is other than of comprehensive meaning.'

The decision also suggests that HMRC places 'limitative' interpretations when it applies the restrictive provisions of s 21 and s 22. Indeed, the line taken by HMRC was that all of the expenditure in question was disqualified by those sections, a view the tribunal rejected.

Overview of technical areas

The case explores in detail the interaction of s 21 (no allowances for buildings), s 22 (no allowances for structures, assets and works) and s 23 (expenditure unaffected by s 21 and

s 22). It manages to avoid a wholescale review of the extensive case law relating to the meaning of 'plant', but it does pick up a number of legal precedents as necessary. It also brings out some distinctions more clearly than any previous judgments. For this reason in particular, reference will be made to the decision for many years to come.

Order of play

A preliminary point concerned whether it is necessary to look first at the statutory restrictions and then at the case law definition of plant, or to approach it the other way round.

We confess that, on this matter only, we would have sided with HMRC. First, consider whether there is any statutory bar against claiming allowances and, if not, determine whether the asset in question would qualify as plant or machinery on established case law principles. Counsel for HMRC argued that to approach it the other way round would be 'eccentric'. In our opinion, he had a point.

The tribunal, however, came down against HMRC even on this approach, taking the view that the 'anterior question' was whether the item would qualify as plant under general principles. Only if it did would it be necessary to contemplate the restrictions imposed by s 21 and s 22.

At one level, this makes no difference: if the taxpayer falls at either hurdle, no allowances are due. However, the point is more than just a legal nicety, as the tribunal made clear:

> 'There are numerous cases in which the courts have grappled with the particular question of whether an agglomeration of assets should be considered as one item or as more than one item of plant for capital allowance purposes, and that is a question which must be answered before the "item" under consideration for the purposes of sections 21 to 23 can be identified.'

This issue was the subject of a recent discussion on the correct treatment of automatic ticket barriers. Should the whole asset be treated as a single machine – in which case any statutory bar is removed by item 1 at list C at s 23? Or should the barriers be seen as consisting of different elements – the ticket reader, the mechanical interior parts, the opening flaps – so that the statutory restrictions are considered in relation to each element in turn?

In the present case, the parties were agreed that a piecemeal approach was required (rather than viewing the entire scheme as a single asset). HMRC expressed little interest in how that approach should be undertaken, arguing that 'however the assets were analysed, most of them were disqualified'.

Language

An important point that often arises in practice is the language used by non-tax specialists to describe a particular asset. If the ticket barriers are described as 'gates' does that cause a problem because s 21 denies allowances for gates? If some of the assets in *SSE Generation* are described as tunnels, even though another description might be just as apt, does the same problem arise because s 22 prevents allowances for tunnels?

The tribunal came down on the side of counsel for the taxpayer, who had argued that 'the labels applied for convenience by engineers and others should not be determinative of the statutory meaning of words such as those involved in this appeal'.

Statutory effect of s 21 to s 23

The tribunal brought particular clarity to a point that is of wider interest and is best considered in two parts.

First, it is generally understood that the effect of s 23 is not to declare that specific items qualify as plant or machinery. Rather, the effect of that section is to undo the statutory damage caused by the restrictions in s 21 and s 22 ('expenditure unaffected by sections 21 and 22', as the heading to s 23 is worded). To give an example, expenditure on fire safety systems is initially disqualified by item 6 at list A in s 21. However, this restriction is disapplied by item 10 in list C in respect of 'fire alarm systems; sprinkler and other equipment for extinguishing or containing fires'. The treatment of sprinkler equipment can therefore be determined on case law principles. It will usually be clear that such equipment constitutes plant so allowances can be claimed.

"A piecemeal approach was required (rather than viewing the entire scheme as a single asset)."

The subtlety of s 21 and s 22 is perhaps less well understood. In each case, the section states that 'expenditure on the provision of plant or machinery does not include expenditure on' specified assets (buildings and structures, as defined for these purposes). So those sections are concerned with whether the expenditure qualifies, not with whether the underlying assets are in fact plant. As the tribunal said, the legislation 'does not purport to override the common law test of what amounts to 'plant'. The same point is made later in the judgment with different wording: 'The inclusion of an item in list B does not exclude the item from qualifying as plant, it merely excludes allowances for expenditure incurred on its provision.'

If we take the example of an aqueduct, s 22 says nothing about whether it is in fact plant; it merely states that expenditure on the aqueduct does not constitute expenditure on plant.

This may appear at first glance to be merely an arcane point of legalistic interpretation but, in reality, it has important implications. In this case, expenditure on some of the conduits was held to be expenditure on an aqueduct and, on the face of it, it should be disallowed.

Turning back to the relieving provisions of list C, however, item 22 applies to 'the alteration of land for the purposes only of installing plant or machinery'. The tribunal held that the plant in question must be the conduit itself. In brief, it found that, although the conduit was an aqueduct, it still functioned as plant on general case law principles. So, although the expenditure was initially disallowed as being on an aqueduct, it was possible to undo that restriction because the only purpose of altering the land was to install the conduit itself, the conduit being an item of plant or machinery:

> 'I consider the matter finely balanced, but standing back and looking at the matter realistically, the end result of the appellant's operations was to create in the appropriate place an item of plant (the aqueduct) which was an important element of the overall scheme where previously there had only been solid rock. Looked at in that way, I consider the alteration of land involved in the creation of the aqueduct to have been carried out for the purpose only of installing the aqueduct.'

It followed that the costs were allowed in full.

Some other conduits – known as 'cut and cover' – were created in such a way that the tribunal did not hold them to constitute an 'alteration of land'. Expenditure on these conduits was therefore disallowed by virtue of s 22 because they were an aqueduct, and not rescued by s 23 because they did not constitute an alteration of land. Even here, however, some of the associated costs – excavating the base and covering the finished item – did amount to an alteration of land and were therefore allowed.

> "HRMRC's restrictive interpretation of what qualifies for plant and machinery allowances is often open to challenge."

Rightly, the tribunal had no problem in reaching somewhat different conclusions for items that, because of the different construction method, were in essence performing the same function. It said: 'The difference in treatment flows logically from the terms of the legislation.'

Works involving the alteration of land

The question of altering land has already been touched on. In reality, the legislation uses this phrase twice. As we have seen, item 22 on list C at s 23 provides a reprieve for the cost of 'alteration of land for the purpose only of installing plant or machinery'. Section 22, however, initially imposes a bar on claiming expenditure on 'works involving the alteration of land'. At a quick reading, the s 23 reprieve merely undoes the s 22 restriction when there is a sole purpose of installing plant or machinery.

This decision tells us that there is more to it than that, on the basis that the concept of 'works' has a narrower meaning.

First, the tribunal made a general observation that 'many words are chameleons, and context can often provide colour'. This was followed by a more specific focus on the heading of s 22, namely 'structures, assets and works'. The tribunal was then led to the conclusion that 'the "works" referred to in s 22(1)(b) must be works where the alteration of land is the objective in its own right, not including works whose objective is the creation of some other asset or structure identified in list B'.

The decision at paragraphs 39 and 40 contains a detailed reasoning behind this conclusion, mainly revolving around contradictions and duplications that would arise on a different interpretation. The key result, however, is to give a narrower meaning to the restrictions imposed on works involving the alteration of land than would otherwise have been the case.

Conclusion

The tribunal's ruling was radical in its appraisal of the restrictions imposed by s 21 and s 22. In summary:

- the language used by non-tax professionals cannot be automatically transposed into the interpretation of those sections;
- an item may still constitute plant and machinery, even though s 21 or s 22 denies allowances for the expenditure in question;
- the concept of 'works' involving the alteration of land has a narrower interpretation than may previously have been thought; and
- it may be prudent to consider case law principles before statutory restrictions, and this may have a bearing on whether particular items constitute a single asset.

All of these factors weighed in favour of the taxpayer.

That is not to say, however, that everything went the taxpayer's way. The cost of excavating the huge caverns was disallowed on the basis that these 'amount merely to the setting or premises within which the generating trade could be conducted'. That was clearly the correct conclusion on the facts.

Similarly, the tribunal was right to reject the company's assertion that the cost of creating the caverns was expenditure on 'the alteration of land for the purpose only of installing plant or machinery'.

Overall, however, this was a clear victory for the company. HMRC is only doing its job when it takes a hard line on expenditure falling near to the dividing line. What is clear, however, is that HMRC's restrictive interpretation of what qualifies for plant and machinery allowances is often open to challenge. ●

Planning point

It may not be a simple matter to agree what items qualify for capital allowances but, as the decision in *SSE Generation* shows, HMRC's view should not always be accepted at face value.

Author details

Ray Chidell is a technical director of Six Forward Capital Allowances.

Jake Iles is managing director of Six Forward Capital Allowances.

Ray and Jake write *Capital Allowances* and *A-Z of Plant & Machinery* (Claritax Books).

FIND OUT MORE

- Fixing it: tinyurl.com/yaoo49a2
- SSE Generation: tinyurl.com/y7q7jrjz
- Irrigation project: tinyurl.com/yc3np6yl