How not to claim...

Ray Chidell and Jake Iles discuss the First-tier Tribunal's decision in *Tevfik*.

The years 2018 and 2019 have been bumper ones for First-tier Tribunal decisions on capital allowances, covering everything from tools to underground caverns to nuclear plants. Most have been concerned, at least in some way, with allowances for buildings or structures.

Capital allowances for properties

Structures and buildings allowances are now available for the newest commercial properties. But at just 2% a year – not to mention a major sting in the tail in terms of the computation of any capital gain on sale – these allowances are a poor relation. The more valuable tax savings for properties still lie within the regime for plant and machinery allowances (PMAs).

But the question of whether PMAs are available for property remains a complex one. Section 21 of the Capital Allowances Act 2001 (all statutory references in this article are to that Act) denies allowances for buildings, which are very widely defined. Section 22 adds to the restrictions in relation to structures. Section 23 then mitigates those restrictions, but only in relation to very specific assets or categories of assets. Even then, the case law hurdles remain.

Commercial versus residential properties

After those initial hurdles have been negotiated, it is necessary to draw a distinction between, broadly, commercial properties – for which PMAs are generally available – and residential properties – for which they are generally not. But this distinction tripped up the taxpayer in the recently reported *Tevfik* case (TC7383).

One can feel a great deal of sympathy for the appellant, because he had sought professional advice from a company, no longer in existence, that purported to be a specialist in the field of capital allowances. In the event, however, the claim was flawed in many different ways, and HMRC used discovery powers to assess tax for the year 2011-12. The discovery rules are a whole topic in themselves, but this article looks solely at the capital allowances angles.

There were several fundamental problems with the claim. We mention three of these but focus mainly on the question of how allowances are restricted for dwelling houses.

Key points

- Proving entitlement to claim allowances is an essential first step, before time is spent on valuations or apportionments.
- Annual investment allowances may only be claimed for the year in which the expenditure is incurred.
- In most cases, the statutory restrictions for dwelling houses mean that allowances are restricted or denied altogether for non-commercial properties.
- Care is needed with houses of multiple occupation, when subtle factual distinctions may lead to different tax outcomes.

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Part ownership

The claim concerned three properties, but for two of these the taxpayer owned only a 50% share. The claim was made on the basis that the taxpayer fully owned all three properties, a serious professional error, suggesting that no analysis was made of the actual entitlement to claim.

Annual investment allowances

The taxpayer had claimed annual investment allowances (AIAs), now familiar to all practitioners, but only introduced from 6 April 2008 (1 April for corporation tax) and not available for expenditure incurred before that date (s 38A). In this case, the expenditure had been incurred in 2001, 2005 and 2006. The claim for AIAs was therefore simply wrong, with no possible statutory justification.

Further, AIAs may be claimed only for the chargeable period in which the expenditure is incurred (s 51A(2)). In this case, the claim was for the tax year 2011-12 so, even if the expenditure had been incurred in, for example, July 2008, after the start date for AIAs, no claim would have been possible for 2011-12.

So the AIA claim failed on two counts, both of which were black and white technical issues in which there was no wriggle room at all.

Annual investment allowances, however, are merely a way of accelerating tax relief for qualifying expenditure on plant or machinery. So the fact that AIAs were unavailable was a second way in which the tax return was incorrectly made, but was not in itself fatal to claiming allowances in the first place. If that was the only problem, the relief would have been given – albeit more slowly – by way of writing-down allowances over several

years. Unfortunately, however, there was a third error of principle.

Restrictions for dwelling houses

Section 35 denies allowances when expenditure 'is incurred in providing plant or machinery for use in a dwelling house'. In simple terms, this is the reason why a landlord letting out an office block can claim allowances for fixtures in the property, but one who is letting out residential accommodation may be prevented from doing so. However, there are all sorts of reasons why the restriction is not as simple as it seems.

First, s 35 only prevents allowances for certain types of 'qualifying activity'. The dwelling house restriction prevents claims for ordinary property businesses (UK and overseas) but not, for example, for trades or for furnished holiday lettings businesses (s 35(1)). For this reason, a person who runs a furnished holiday lettings business can claim for the cost of fixtures in the property, even though it is a dwelling house. Once more, this is usually clear cut; though, for example, the owner of a pub who allows an employee to reside over the property, perhaps for a nominal rent, may have to consider whether the qualifying activity is the pub trade or a separate property business.

Meaning of dwelling house

The issues become cloudier when we seek to define 'dwelling house'. Because there is no statutory definition of 'dwelling house' for plant and machinery allowance purposes, we have to rely on the everyday meaning of the term and, where appropriate, on case law guidance. It is also helpful, though not determinative, to know what HMRC has to say about the matter.

HMRC guidance in the *Capital Allowances Manual* at paragraphs CA11520 and CA23060 is that the term 'takes its ordinary meaning':

> 'A dwelling house is a building, or a part of a building. Its distinctive characteristic is its ability to afford to those who use it the facilities required for day-to-day private domestic existence.'

Crucially for the *Tevfik* case, the guidance goes on as follows:

> 'The common parts of a building which contains two or more dwelling houses will not comprise a dwelling house, although the individual dwelling houses within the building will do so.'

See ***Block of flats***.

So far, this is uncontroversial. There will undoubtedly be readers who have clients who own blocks of flats for which allowances have not been claimed, and where a valid claim can be made, even if the property was acquired many years previously.

Houses in multiple occupation

Living accommodation comes in many guises and, as with all tax matters, the precise factual details will be essential in determining the correct tax treatment. Compare the ***Block of flats*** example with the facts in *Tevfik*.

Block of flats

A landlord generates income from a block of flats. Each flat has its own front door, bathroom, bedroom(s), kitchen, etc. Each also has its own share of plant and machinery, including a central heating system, bathroom fittings, electricity switchboard, etc. In this scenario, each flat constitutes a dwelling house in its own right and no capital allowances can be claimed for these items because they constitute 'plant or machinery for use in a dwelling house'.

However, there are also three lifts that serve the whole building. The building itself – the block of flats as a whole – does not constitute a dwelling house. There is therefore no restriction on claiming allowances for the lifts, as they are not for use in a dwelling house. The same applies for lighting costs in hallways and on the staircases.

The same block of flats has a reception area on the ground floor, serving the whole building, with a desk and security system; allowances will be available for these items. A claim may also be available for items that are external to the property, such as dry (or wet) risers forming part of the fire protection system for the property as a whole.

In *Tevfik*, the properties were houses in/of multiple occupation/occupancy (HMOs). The distinction here was brought out in a letter from HMRC to the taxpayer dated 14 April 2016 where, according to the case report:

> 'HMRC responded that in their view, where a house has a number of separate bedrooms with or without en suite facilities occupied by a number of unconnected individuals who share other facilities such as kitchen, bathroom and lounge, then the whole of the house is a dwelling house. He further commented that (conversely) for a dwelling house that has been converted into a number of individual flats, each flat with its own entrance, cooking, washing and sleeping facilities, then each separate flat is a dwelling house and that all areas within each flat comprise the dwelling house. The officer added that common areas between the flats such as hallways and stairways are not part of the dwelling houses.'

It is perhaps helpful to think of a typical family home. Such a home may have several bedrooms, some or all of which may have en suite bathroom facilities. The family members will then make shared use of a kitchen and of other rooms within the property. This clearly constitutes a single dwelling house. An HMO property is like this, except that the individuals living in the property are unlikely to be members of the same family.

HMRC guidance on the meaning of 'dwelling house' was issued in 2008 and then revised in 2010, with a particular focus on student accommodation, but also referring to HMO properties.

The tribunal in *Tevfik* seems to have thought that it was following HMRC guidance, but it is not entirely clear that it was in fact doing so, even though it ended up reaching the correct conclusion for other technical reasons. The tribunal said:

> '[The term] "dwelling house" should take its everyday meaning. A definition based on the presence of the facilities required for day-to-day private domestic existence

is a better everyday description. Each flat in multiple occupation comprises a dwelling house. The individual bedrooms alone would not afford the occupants "the facilities required for day-to-day private existence" (*Gravesham*). A communal kitchen and lounge are also part of a dwelling house.'

The difficulty here is the statement that 'each flat in multiple occupation comprises a dwelling house'. Unfortunately, there is no clear statement of the facts within the case report, and HMO properties come in all different shapes and sizes. Let's consider two contrasting scenarios.

Scenario 1

There is a single entry door to the building from the street, and the property is on two floors. On each floor, there is a lockable door to the internal part of the building. Each floor then has three bedrooms, occupied by unrelated individuals, and a shared kitchen and bathroom. Each floor is therefore in effect an HMO in its own right.

As such, the property contains two entirely separate HMO flats. No allowances are due for any fixtures within the flats, but allowances are in principle due for any areas that are in communal use by everybody within the whole property.

If this is indeed the scenario in *Tevfik*, the tribunal's conclusion is correct. The tribunal would have been willing to grant allowances for the communal areas, but in the end did not do so because the taxpayer had offered no factual basis on which to make an apportionment.

Scenario 2

Suppose the facts are slightly different. As before, there is a single entry door to the building from the street, and the property is on two floors. Each bedroom has its own lock. There are two bathrooms (one on each floor) that are in use by any of the occupants, and the single kitchen is shared by all. The small entrance hallway has an electrical switchboard, a boiler that serves the whole property and an under-stairs storage area.

In this case, the correct view would seem to be that the whole property, including the entrance hallway, constitutes a single dwelling house (akin to a family home) and that there is no communal area outside the dwelling house area. In that case, no allowances are due for any fixtures in the property at all.

The tribunal in *Tevfik* sought to draw a distinction between 'communal parts' – a shared kitchen – no allowances available – and 'common parts' – a shared stairway. That is a valid distinction in the first scenario above, but not in the second one. As the tribunal noted, the HMRC officer 'said that he would not accept a capital allowances claim for plant and machinery relating to any parts (communal or otherwise) of HMOs or similar properties,' it may be that the facts were closer to those of scenario 2. It would have been helpful if the tribunal had explored this distinction and the underlying facts of the case in its ruling.

The tribunal also said:

> 'The "common parts" of the building such as the common entrance lobby, corridors, stairs or lifts and those parts of the building which do not provide any living facilities would not, however, comprise a "dwelling house". Neither are installations to the building such as mains, gas or electrical services, nor security and communication systems.'

That is a dangerous paragraph which could easily be misunderstood, because it is not the case that a claim is invariably possible for the common parts of an HMO building. For the scenario 2 option, at least, the HMRC guidance at CA11520 is unambiguous and, in our opinion, clearly correct:

> 'We are aware that some taxpayers have submitted claims for plant and machinery allowances in respect of shared parts of houses in multiple occupation (such as hallways, stairs, landings, attics and basements within the houses). They contend that these shared areas are not part of the "dwelling house" and that allowances are therefore available. We disagree with this position. If you come across such a claim, please notify the SME capital allowances specialists.'

The key

To summarise, the key is to identify the extent of the dwelling house. For HMOs, this will often be the entire property, in which case no capital allowances will be due. In a few cases, however, it is possible that there will be several HMOs within a single building, in which case there may still be shared areas that are within the property but that do not form part of any of the HMO areas as such, and a limited claim may be possible. As ever, the only route to a secure claim is to understand the nuances of the legislation and associated guidance and case law.

Planning point

It may be possible for clients who own HMOs within a single building to obtain capital allowances on shared areas. But this will be fact specific.

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