

Capital versus Current Expenditure - a hospitality industry perspective

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It is common knowledge that certain expenditures treated as expenses for accounting purposes need to be reclassified as capital outlay for tax purposes. These costs are then allowed to be deducted from income over a certain period of time as Capital Cost Allowance under the Canadian Income Tax Act (hereafter referred to as “the Act”).¹ The issue stems from the definition of the term “profit”. Court decisions in Canada have indicated that “profit” under GAAP (generally accepted accounting principles) is not necessarily the same as “profit” under the Act. The argument is that an accountant may be motivated by a desire to present a conservative picture whereas the Act is motivated by a desire to raise public revenue. Law and not accounting principles govern “profit” under the Act.

Hospitality financial professionals must thus be careful in the treatment of such expenses. If a current expense is later discovered in a government audit to be of a capital nature, the business becomes liable for an interest charge on the additional tax which cannot be deducted as an expense for tax purposes.²

The Act, however, does not define the concept of capital but provides a general guideline through Interpretation Bulletin IT-128R.³

The Canadian Institute of Chartered Accountants (CICA) Handbook Specific Items-Section 3060 also provides a guideline for capital expense treatment in accordance with GAAP.⁴

The Uniform System of Accounts for the Lodging Industry briefly mentions what is to be included in the Property and Equipment section of the Balance Sheet.⁵

Different court cases have dealt with the issue and have passed judgments over a period of time. These judgments also provide a framework for distinction. Some notable cases and the essence of their judgments are listed below in an attempt to provide an understanding of the process:⁶

- a) *British Insulated and Helsby Cables v. Atherton*, [1926] AC 205 (HL)
 - an outlay is of capital nature when it brings into existence an asset of lasting value and is made **once and for all**.
- b) *MNR v. Haddon Hall Realty Inc.*, [1961] CTC 509 (SCC)
 - acquisition of new refrigerators, stoves, and venetian blinds to be installed in an apartment building constitute capital outlays – application of **once and for all test**.
- c) *Gold Bar Developments Ltd. v. The Queen*, [1987]1 CTC 262 (FCTD)
 - **once and for all test** comes under question – replacement of the entire brick facing of the wall of an apartment building which was expected to last for the life of the building was a repair and fully deductible in the year in which it was incurred.
- d) *Johns-Manville Canada Inc. v. The Queen*, [1985] 2 CTC 111 at 119 (SCC)
 - a serious blow comes down on the **once and for all test** – there is no hard and fast rule, and a common-sense appreciation of all the relevant facts has to be taken into consideration to provide the ultimate answer.
- e) *Shabro Investments Ltd. v. The Queen*, [1979] CTC 125 (FCA)
 - the storm drains, plumbing, weeping tile, and electrical wiring located under a floor were broken when the floor, which had been laid on garbage fill, subsided. It was held to be irrelevant that the necessity for the work “was not due to wear, aging or deterioration resulting from use or passage of time.” Work done has resulted in an improvement to the building, the related cost may be classified as a capital outlay even if there is no increase in value.
- f) *Canada Steamship Lines v. MNR*, [1966] CTC 255 at 258 (Ex. Ct.)
 - the judge ruled that the replacement of the floors and walls of the taxpayer’s cargo ships represented repairs. Regarding the replacement of the ship’s boiler even though he expressed his opinion that it represented a repair and consequently a revenue expense, in his judgment he thought it was desirable to follow decisions made earlier in similar types of cases.
- g) *Thompson Construction v. MNR*, [1957] CTC 155 (Ex.Ct.)
 - an engine was replaced after many repairs had been made to it. The replacement cost was held to be a capital outlay. The extent of the replacement in relation to the total value of the machine was taken

into consideration. The factor of quantum influenced the judge in reaching such a conclusion.

- h) *Damon Developments Ltd. V. MNR*, [1988] 1 CTC 2266 (TCC)
 - among other things the case involved the replacement of drapes, washers and dryers, television, mirrors – items similar to those in *Haddon Hall*. Although *Haddon Hall* was referred to, the judgment was not followed, the reasoning being that the equipment was purchased for the operation of a hotel and not an apartment building. Appliances have shorter useful lives when used in the operation of a hotel than when used in an apartment building.
- i) *Alexandra Hotel (1960) Ltd. v. MNR*, [1971] Tax ABC 1135 at 1137
 - it was held that the replacement of carpeting for the floor of a beverage room in a beer parlor was ordinary maintenance since “the life of a carpet in such public room does not extend for more than two years.”
- j) *Central Amusement Co. v. The Queen*, [1992] 1 CTC 218 (FCTD)
 - it was held that the purchase and installation of replacement kits in amusement games constituted current expenses because their useful lives were temporary.
- k) *Aliments Krispy Kernels Inc. v. MNR*, [1990] 1 CTC 2546 (TCC)
 - the furnishing by a food manufacturer of display units of an average lifespan of three years was held to constitute a current expense.
- l) *Citation Investments Ltd. v. MNR*, [1978] CTC 2797 (TRB)
 - replacement of furniture was held to constitute a capital outlay even though it might be replaced as often as every two to three years.

The list goes on. It can be said with utmost certainty that even though the courts have attempted to clear the air, ambiguity still exists and there will be more and more cases that will come to the courts for decisions. Meanwhile extreme caution will be needed to treat these expenses properly.

Following is an attempt made by Evelyn R. Schusheim to summarize the general principles to address the distinction between Repairs vs. Capital Improvements:⁷

- 1) *Where an expense is incurred “not only once and for all, but with a view to bringing into existence an asset or an advantage for the enduring” benefit of the business, the expense will be considered to be capital in nature.*
- 2) *Expenses for the repair and maintenance of a building, such as painting, are considered to be current expenses and thus deductible in the taxation year in which they are incurred because the expenses relate to the building itself.*
- 3) *Where additional assets are acquired, even if they are replacements of assets in the building, such as a furnace or elevator, their purchase may be considered to be a capital outlay but there may be circumstances where similar expenses are running expenses.*
- 4) *Repairs undertaken for the purposes of reselling the property are not deductible but must be added to capital even if they are the type of expenses that would be running expenses if no intention to sell existed.*
- 5) *Repairs incurred for the purposes of acquiring a new tenant are deductible because such repairs relate directly to the income producing activity, even if some of the expenses may be of the type or quantum that would often cause them to be on account of capital.*
- 6) *Normally repairs required by reason of wear and tear to the property are deductible. However, where repairs are necessitated due to the flooding or the settling of land or poor construction, the expenses may be considered to be on account of capital.*
- 7) *The repair or replacement of fixtures in the building such as sinks and toilets necessitated by ordinary wear and tear would normally be an income expense in relation to maintenance. However, where replacement of the same fixtures is undertaken with a view to upgrading the property, the expense would be a capital outlay.*
- 8) *Where the expense is for the acquisition of equipment, the income treatment appears to be dependent on whether the equipment or machinery has a use function separate and distinct from the building itself and also appears to be dependent on the amount of the expenditure in relation to the building. Accordingly, sinks and toilets installed in a building become an integral part of it with the result that the expenditure in replacing such equipment is normally considered to be a deductible expense. It appears however that where the equipment is considered to be independent of the business itself*

- such as refrigerators, stoves, and similar fixtures, their acquisition is considered to be a capital asset rather than a repair.*
- 9) *Where the business being carried on is a hotel, items being replaced such as washers and dryers, television and mirrors, were held to be deductible on current account.*
 - 10) *Where a repair requires that old fixtures be replaced by new more modern ones, the expense may still qualify as a deductible repair provided the property is not upgraded as a result of the work. For example, where old electrical wiring no longer meets safety standards and new wiring is required, the replacement may be a deductible repair expense. Where, however, the electrical wiring forms part of a number of improvements to the building as a whole, the expenditure would be capital in nature. In one case, the entire brick facing on one side of a building had become unsound and had to be replaced with a metal covering. The court held that the work constituted the application of new technology and was not an improvement to the building and was therefore deductible as a current expense. On the other hand there are many examples of cases where renovations were treated as capital outlays even where the work was required by government authority or in order to maintain safety standards.*
 - 11) *Where a property has fallen into disrepair because of lack of maintenance, significant expenditures in order to carry out all the repairs that have accumulated over many years will not in itself result in the outlays being classified as capital. However, where a building is badly rundown and has as a result been acquired at a low cost, significant expenditures that have the effect of increasing the value of the property may be found to constitute capital outlays.*

This discussion is trying to raise the concern that enough time has already been spent on the matter and that attempts be now made to incorporate detailed specific guidelines into the Act. Without such a guideline financial professionals will always be at risk of being interpreted differently by the courts. Explosion in the Information Technology industry has added to the problem. With computer processors changing fast, practically within a year, computer hardware becomes obsolete but the Act has yet to allow treating computer equipment as current expenses.

While the process continues due care has to be taken in the treatment of those expenses and financial professionals in the industry should come together on a common platform and move this agenda for specific guidelines.

FOOTNOTES

¹The system of capital cost allowance (CCA) was introduced in 1949. Paragraphs 18(1)(b) and 20(1)(a) of the Act, RSC 1985, c.1, as amended, provides the basic deduction for CCA as regulation allows. PART XI of the Regulations sets out the details of the CCA system.

²Paragraph 18(1)(t) of the Act prohibits a deduction for any amount paid or payable under the Act; Interpretation Bulletin IT - 104R2 – Deductibility of fines or penalties (dated May 28, 1993) issued by Revenue Canada, Taxation discusses in detail the deductibility of fines or penalties.

³Interpretation bulletin IT-128R – Capital cost allowance – Depreciable property (dated May 21, 1985) issued by Revenue Canada, Taxation.

⁴CICA Handbook (Up to and including Release # 91) Section 3060.18 to Section 3060.30.

⁵Uniform System of Accounts for the Lodging Industry, Ninth Revised Edition, page 9.

⁶See John W. Durnford, “The Deductibility of Building Repair and Renovation Costs” (1997), Vol. 45, No. 3, Canadian Tax Journal, pp. 395-416, for discussions on the court cases.

⁷See Evelyn R. Schusheim, “Deductibility Versus Capitalization,” 1998 Ontario Tax Conference, (Toronto: Canadian Tax Foundation, 1998), 1:3-11 for a detailed discussion.

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