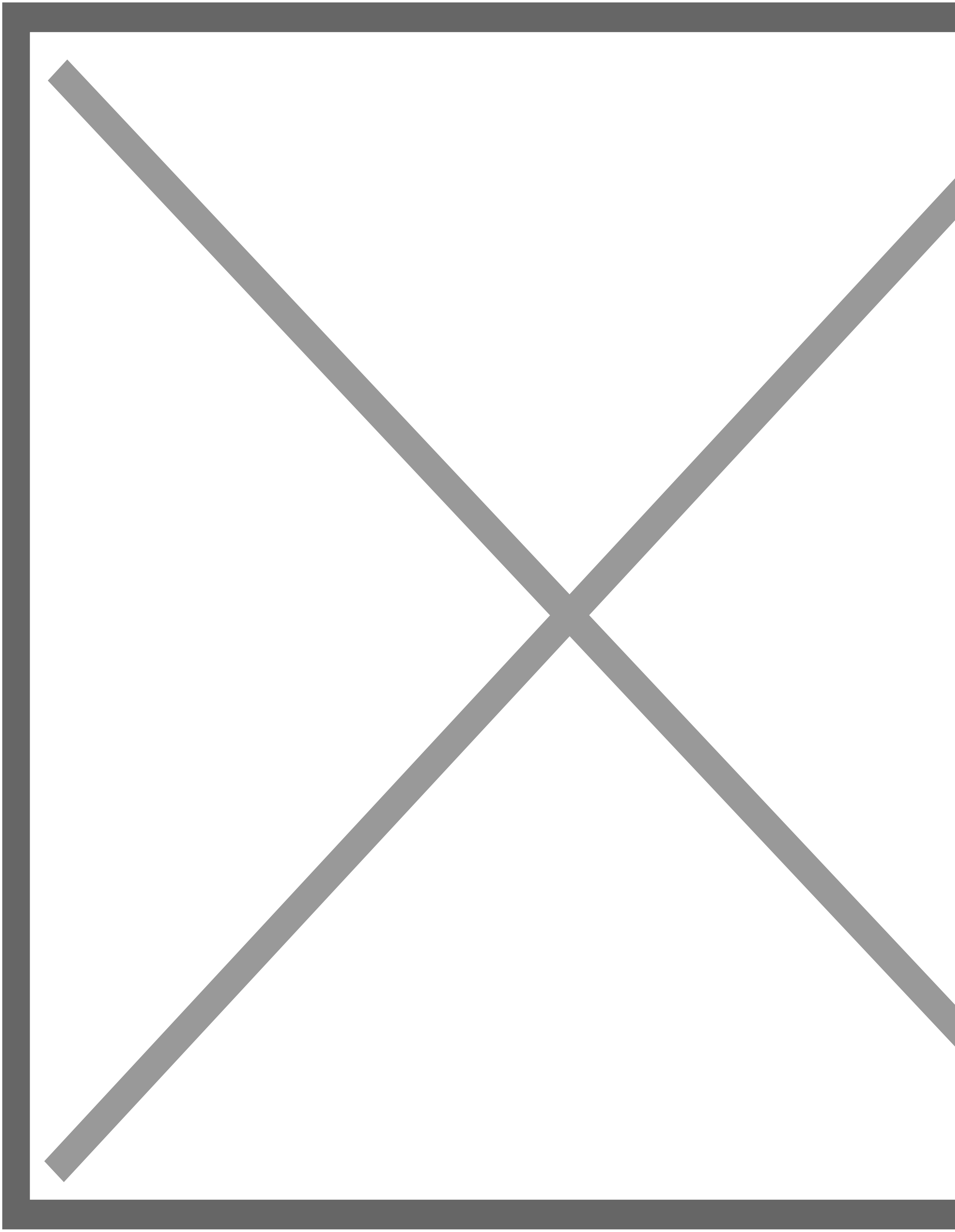
Basic Instinct

Management of taxes   OMB



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Keith Gordon considers a case which addresses the question as to whether a receipt is capital or revenue in nature

Key Points

What is the issue?

The recent decision of the First-tier Tribunal in *Thornton v HMRC* considers the distinction between different kinds of receipt or expenditure – and whether they are revenue or capital in nature.

What does it mean to me?

This case highlights a contemporaneous example of the capital/revenue divide in the context of a receipt.

What can I take away?

Tribunal did make it clear in its decision that the documentation before it suffered from a lack of clarity and the Tribunal's ability to elicit the facts was largely as a result of the articulate, clear and credible evidence given orally by Mr Thornton at the hearing.

A few years ago, the CIOT/ATT London Branch annual dinner had as its guest speaker Lord Justice Carnwath (now Lord Carnwath of Notting Hill). His entertaining talk reminded those present that much of tax law treats issues as if they were as distinct as chalk and cheese, whereas in real life the differences between them are in fact quite subtle and barely imperceptible to anyone who does not see everything though a tax prism. One such example was the distinction between different kinds of receipt or expenditure – and whether they are revenue or capital in nature.

The recent decision of the First-tier Tribunal in *Thornton v HMRC* [2016] UKFTT 767 (TC) considers this distinction in the context of a landlord's receipt from a departing tenant.

Facts of the case

Mr Thornton acquired the ownership of 18 flats, known as Jordan House. The flats were subject to a single lease granted to a housing association and the assignment to Mr Thornton was subject to this existing lease. Under the lease, the tenant (the housing association) was responsible for the upkeep of the flats. However, the tenant did not comply with this obligation.

Things got to a stage whereby the flats were required to be left vacant because of their uninhabitable state. However, the housing association continued to pay the rent although it and Mr Thornton were in extensive discussions regarding the termination of the lease which would enable Mr Thornton to obtain vacant possession and to effect the much-needed repairs.

When the lease still had approximately five years left to run, Mr Thornton was seeking a settlement figure of over £300,000, calculated by reference both to the estimated dilapidations of the flats and also a figure for the future rent. In the end, the parties agreed a figure of £250,000. There was no discussion between the parties as to how much of this related to dilapidations and how much should be attributed to future rent. As the Tribunal noted, ‘it was a single compromise bringing matters to a conclusion. [Mr Thornton] was very anxious indeed to regain possession’.

Mr Thornton used the funds to repair the building and by the time of the hearing (November 2016) the works were still ongoing. As at February 2013, however, the amount expended had already exceeded £273,000. Part of the building was re-let after a 10-month interval; some flats not for a further 18 months.

Mr Thornton did not account for the £250,000 receipt in his profit and loss account, but it did feature in his balance sheet as a creditor in the accounts for the year ended 31 August 2010.

HMRC enquired into the return. They subsequently concluded that the £250,000 should have been added to Mr Thornton’s income for the property business and amended his tax return accordingly. Following an unsuccessful internal review, Mr Thornton appealed against the decision to the First-tier.

Both parties agreed at the hearing that the £250,000 related somehow to the fact that the flats were in disrepair. However, they disagreed in respect of the tax consequences. HMRC argued that the £250,000 should be taxed as an income receipt because it covered the loss of rental income (being that income which would have been received but for the disrepair). On the other hand, Mr Thornton argued that the sum amounted to a capital receipt which enabled him to safeguard his capital investment and which was in fact used to repair the property.

The Tribunal’s decision

The Tribunal (Judge Anne Scott sitting with Member Peter Sheppard) referred to a number of earlier cases – some of which had been cited by HMRC but also some other cases on its own initiative. The Tribunal also noted that there were plenty of other cases which concerned the subject matter but which did not fall squarely in line with the facts of the case before it.
HMRC had relied upon the judgment of Lord Justice Diplock (later Lord Diplock) in *London and Thames Haven Oil Wharves Ltd v Attwooll (HM Inspector of Taxes)* (1966) 43 TC 491. That noted that if compensation is received in lieu of payment X, the compensation should be taxed in accordance with the way that X would have been taxed (had it been received in the first place).

Diplock LJ also noted that the method of computation of the compensation is not determinative of the correct tax treatment, although it is nevertheless a factor which could assist the Court when identifying the basis of the compensation receipt. In this regard, the Tribunal noted that the calculation of the £250,000 was largely based on the dilapidations.

Mr Thornton readily conceded that, in the course of negotiations with the tenant, he had sought recovery of six months’ rental income (reflecting the six-month notice period he was effectively waiving). However, the Tribunal decided that this line of argument deployed in the negotiations was no more than a bargaining tool – noting in particular the fact that the actual repair costs exceeded the £250,000 eventually received.

In particular, the Tribunal noted Mr Thornton’s keenness to regain possession of the flats and concluded that the compromise reached was to forgo the six months’ rental income. In short, the Tribunal concluded that the receipt related entirely to the dilapidations aspect of Mr Thornton’s claim.

The Tribunal then proceeded to consider whether the receipt was capital or revenue in nature. It noted that the property had suffered a significant diminution in value due (in a very large part) to the lack of upkeep on the part of the tenant. The Tribunal repeated its observation that the repair costs exceeded the receipt. It concluded that the receipt was made to make good the diminution in capital value of the property. Referring to the decision of Lord Keith in *Commissioners of Inland Revenue v West* (1950) 31 TC 402, the Tribunal agreed that ‘a sum paid for damage caused by abuse [cannot be] a trading receipt. It is money paid to enable the owner to restore his property, if possible … to compensate him for the loss or depreciation of a profit-earning subject’.

For all these reasons, the Tribunal concluded that the receipt was capital in nature.

Commentary

The main purpose of referring to this case was simply to highlight a contemporaneous example of the capital/revenue divide in the context of a receipt. (In the context of expenses, it must be recalled, taxpayers will usually be arguing that an item is revenue in nature.)

The Tribunal’s clear analysis of the facts could lead one to wonder why both the HMRC officer and the internal reviewer considered the receipt to be taxable. Indeed, readers might think that this case justifies a fear that HMRC will always choose the taxpayer-adverse treatment in any given set of circumstances.

However, to be fair, the Tribunal did make it clear in its decision that the documentation before it suffered from a lack of clarity and the Tribunal’s ability to elicit the facts was largely as a result of the articulate, clear and credible evidence given orally by Mr Thornton at the hearing.

The Tribunal’s decision also hints that the previous communications to HMRC on Mr Thornton’s behalf also muddied the waters, which might also have explained HMRC’s stance. Nevertheless, what is unclear is the extent to which HMRC fully considered the matter (as they understood it) in accordance with the case law or whether they were content to accept the factors pointing to the conclusion that the receipt was taxable.