Capital Revenue Divide Webinar – September 4, 2013

Chapter 1 –

1.1 Introduction

This webinar lecture has been prepared using the legislation and recent case law up to 30 June 2013. In addition, the Finance Act 2013 has been reviewed after it received Royal assent on 17 July 2013. This voluminous addition to the UK tax legislation is not thought to affect any of the ideas and principles within this paper. A new General Anti Abuse Rule (GAAR) is included in the FA 2013 but the planning points within this paper are all designed to achieve a commercial objective in a tax efficient way. As tax avoidance is not the driver, the GAAR should not affect in any way the contents of this paper. However, 'mission creep' in the application of our law has been and remains a problem so this is an area of developing law which needs to be considered before any transaction proceeds.

1.2 Measuring the taxable business profit

Business profits are measured for tax purposes on 'the full amount of the profits of the tax year' section 7(1) ITOIA 2005. Although the rules relating to corporation tax were comprehensively rewritten by the Corporation Tax Act 2009 (CTA 2009) this was done without any major changes to the underlying detail. Corporation tax is charged, for a given accounting period, on 'the full amount of profits arising in the accounting period' (section 8(3) CTA 2009).

For individuals, partnership and companies, the key principle is that the profits of a trade must be calculated in accordance with generally accepted accounting practices, subject to any adjustment required or authorised by law in calculating the profit (section 25 ITOIA 2005 and section 46 CTA 2009). The starting point is therefore the profit and loss account measure of profit but from this figure are made adjustments to calculate the taxable business profit. These adjustments are required or authorised by law or legal precedent.

Section 53(1) CTA 2009stipulates that in calculating the profits of a trade, no deduction is allowed for items of a capital nature. There are similar provisions to be found in ITOIA (section 33 ITOIA 2005) that deny a deduction in the computation of taxable profit for any items of capital expenditure. Prior to the Tax Law Rewrite, this prohibition against deducting capital expenditure was to be found in section 74 ICTA 1988.

The distinction between capital and revenue applies for receipts. The most common area of difficulty is often to be found in property transactions where what is in dispute is whether the asset which has been sold forms part of the trading stock in which case the receipt is taxable as a business profit or part of the capital assets in which case a liability to capital gains tax might arise. The other most common area relates to compensation payments.

The distinction between capital and revenue is equally applicable for expenditure and can be crucial if the expenditure will not qualify for capital allowances. Revenue expenditure is deductible in computing the profit. Capital expenditure on an asset which does not qualify for any allowances can increase the effective rate of tax which the taxpayer faces.

1.3 Why the difference between capital and Revenue matters.

For an individual, the differential in tax liability between capital and revenue is substantial. With entrepreneur's relief giving an effective rate at 10% compared to a top rate of tax currently at 62% if the NIC cost is included, there is an incentive to receive capital rather income. Entrepreneur's relief is only available on the disposal of a business or part of a business. It is not available to cover the sale of assets but with the annual exemption the effective rate of tax is often less than the headline rate of 28%.

On the expenses side, the currently very generous level of annual investment allowance being 100% of the expenditure being deductible from the profit may mean that for most small businesses the distinction between capital and revenue expense on qualifying plant and machinery is academic. The annual investment allowance has oscillated in recent years and is currently available on expenditure of up to 250,000 The rates of capital allowance have been falling and the distinction between capital and revenue expenditure is likely to return to significance in the near future especially where there is a significant difference between the rate of commercial depreciation and the statutory capital allowance rate available. If the asset does not qualify for capital allowances, the distinction between capital and revenue expenditure can have a significant impact on a particular year's taxable profit.

In determining whether an item is capital or revenue, the treatment in the accounts does not determine the question. In the preparation of accounts, the main expenditure question is when the item is consumed and therefore charged to the profit and loss account. Depreciation is a measure of this but it would not be allowed in deducting taxable profits.

Since 2009, HMRC are interested in the behaviour which gave rise to a mistake. If HMRC believe that a mistake arose from a failure to take reasonable care (or worse), there is a potentially serious penalty regime. If the mistake has been discovered as part of an enquiry, the penalty for a failure to take reasonable care will lie somewhere between 15% and 30% of the potential loss of tax.

1.4 Identifying the watershed between Capital and Revenue

Capital is not defined in the statute. Viscount Haldane in *John Smith and Sons v Moore [1921], 12 TC 266*said:

> 'Adam Smith described fixed capital as what the owner turns to profit by keeping it in his own possession, circulating capital as what he makes a profit of by parting with it and letting it change masters'.

In *Atherton v British Insulated & Helsby Cables Ltd [1925], 10 TC 155,* Viscount Cave defined:

> '… when an expenditure is made, not only once and for all, but with a view to bringing into existence an asset on an advantage for the enduring benefit of the trade, I think that there is

very good reason (in the absence of special circumstances leading to an opposite conclusion) for treating such expenditure as properly attributable not to revenue but to capital'.

It is important that this question must be looked at on an individual case-by-case basis. What is capital in one person's hand may well be revenue in another's. The vendor may be selling something which is the vendor's stock and trade but the buyer is acquiring a capital asset to be used in the buyer's trade. Whether expenditure is capital is a question of law. The accountancy treatment may be informative but it does not answer the legal question of whether the item is capital or revenue. Generally, capital expenditure will result in the acquisition, disposal or modification of an identifiable capital asset. That capital asset may be property or other tangible assets or intangible assets including, in particular, leases, rights and know-how.

In business, it often happens that the expenditure proves to be abortive. However the underlying principle applies and it is appropriate to question what treatment would have applied if the expenditure had achieved its objective.

It is not surprising that many of the cases concerning receipts arose and were considered by the courts prior to 1965. This was because capital gains tax was introduced in 1965 and prior to that time the distinction between capital and revenue was very important. If a particular receipt was capital, then it would escape taxation.

Chapter 2 – The Treatment of Receipts

2.1 Outline

An analogy is often drawn whereby the fixed capital of a business is the tree and the circulating capital is the fruit. The assets of a business are often obvious in deciding on which side of the Capital revenue divide they fall. A sale of something which is trading stock is a revenue receipt. A sale of the assets of a business will be a capital receipt but remember that if capital allowances have been claimed it may reduce the pool value carried forward or even create a balancing charge.

The disposal of intangible assets is often more difficult to resolve. In today's webinar, we shall concentrate on compensation and ties, both of which are more likely to be encountered than some of the more esoteric items.

The question whether an amount received as compensation for the cancellation of an agency constitutes an income or a capital receipt has caused difficulty in some cases. However, the tests for determining this question in the circumstances of any particular case appear to be well established by a line of decisions..

2.2 Compensation and Commercial contracts Where compensation is received for the cancellation of an agency which is merely one of a number possessed by the taxpayer and where the cancellation may be regarded as merely an incident in the course of carrying on his business, the amount so received is a receipt of income and not of capital. In Kelsall Parsons & Co v IR Commrs (1938) 21 TC 608, Lord President Normand observed that it was a normal incidence of the trade to gain and lose agency contracts. The firm carried on business as commission agents and had entered into a number of agency agreements, one of which, a three-yearly agreement, was terminated at the end of the second year in consideration of payment of compensation amounting to £1,500. It was held that the amount of compensation so received was assessable. This was the loss of a contract which formed a small part of the business but after the contract ceased, the business carried on much as before.

I do not think there are absolute percentages which can be applied but even a substantial contract which has a significant effect on the business may still fall to be treated as a revenue receipt. In IR Commrs v Fleming & Co (Machinery) Ltd (1951) 33 TC 57, the taxpayer carried on business as an agent and merchant for the sale of machinery and explosives for Imperial Chemical Industries Ltd (ICI). This agency contract represented 30 to 45 per cent of the company's business earnings, the loss of it having an adverse effect. The company had eight other agencies for machinery. In 1948 the agency with ICI was terminated by agreement, whereby:

- the taxpayer company received £5,320 as compensation for the loss of the agency;
- the taxpayer company and its directors gave a restrictive covenant in consideration of £590. This was accepted to be a capital receipt; and
- the company's explosives stores and magazines were assigned to ICI, for £800. Again this is a capital receipt

The company claimed that the amount of £5,320 was also not taxable. It was held that as the sum of £5,320 was received for the loss of one agency out of a number, the loss was a normal trading risk and the sum of £5,320 was a trading receipt.

Like Balfour's elephant, it might be difficult to describe but it is recogniseable when seen. There is a watershed. Lord Russell stated at p. 63 that when the rights and advantages surrendered were such:
'as to destroy or materially to cripple the whole structure of the recipient's profit-making apparatus, involving the serious dislocation of the normal commercial organisation, and resulting perhaps in the cutting down of the staff previously required, the recipient of the compensation may properly affirm that the compensation represents the price paid for the loss or sterilisation of a capital asset and is therefore a capital and not a revenue receipt. ... On the other hand when the benefit surrendered on cancellation does not represent the loss of an enduring asset in circumstances such as those above mentioned – where for example the structure of the recipient's business is so fashioned as to absorb the shock as one of the normal incidents to be looked for and where it appears that the compensation received is no more than a surrogatum for the future profits surrendered – the compensation received is in use to be treated as a revenue receipt and not a capital receipt.'

The other side of the watershed is illustrated by a series of decisions. In Barr, Crombie & Co Ltd v IR Commrs (1945) 26 TC 406, the company managed the ships of a shipping company for an agreed remuneration under an agreement which provided that in the event of the shipping company going into liquidation or ceasing to carry on business, the remuneration from the date thereof to the date of expiry of the agreement was to become immediately payable.

The shipping company went into liquidation approximately eight years before the expiry of the agreement and the sum of £16,036 was thereupon paid to the taxpayer company. From 1924 to 1940 only two per cent of the income of the taxpayer company was derived from sources other than the agreement in question and on liquidation of the shipping company it lost its entire business except for temporary wartime activities. It was held that the sum so received was a capital receipt. Using the analogy of the tree, what had been lost was the fixed structure of the business from which profit might have been earned.

In Sabine v Lookers Ltd (1958) 38 TC 120, the taxpayer company was the chief distributor of Austin vehicles in the Manchester area and virtually the whole of its business consisted of selling Austin products. Without that contract, the company did not have a business. But what about a payment for the variation of the contract rights and terms? On the amalgamation into the British Motor Company (BMC), a new contract was offered together with compensation of £7038 for varying the rights under the contract.

For each period from 1 August to 31 July, there was an agreement between the two companies regulating their trading relationship, and each agreement had a continuity clause providing for its renewal if the taxpayer company was carrying out its obligations. The agreement had been renewed for many years.

In 1953, the Austin Motor Co Ltd entered a group headed BMC Ltd, and on 30 July 1953 the former company wrote to the taxpayer company stating that a new standard form of distributors' agreement would be adopted. One of the alterations in the new agreement was in the continuity clause and another varied the territories allocated to distributors. In compensation for any loss resulting from these changes, a sum was to be paid to distributors who were appointed for a period from 1 August 1953 to 31 July 1954. The sum so received by the taxpayer company was £7,038, one half of which was paid in the relevant period. It was held that the sum so received by the taxpayer company was a receipt of capital.

In Van den Berghs Ltd v Clark (1935) 19 TC 390, the company received a compensation payment from a Dutch company for the loss of the world wide rights to manufacture margarine. Lord Macmillan said that although each case turned on its facts and no infallible criterion emerged, nevertheless judicial decisions afforded indications of the kind of considerations which may relevantly be borne in mind in approaching the problem of deciding whether a receipt was capital or revenue.

The British and Dutch companies were in competition but then entered into a profit-pooling agreement. This contract was the fixed framework from which profit was earned. Owing to war difficulties, disputes arose as to the respective rights of the companies and eventually a final settlement was reached for the termination of the agreement in consideration of a payment of £450,000 by the Dutch company to the British company. The House of Lords held that the £450,000 was a capital receipt and not income.

Lord Macmillan also said at page 442:
'On the contrary the cancelled agreements related to the whole structure of the appellants' profit-making apparatus. They regulated the appellants' activities, defined what they might and what they might not do, and affected the whole conduct of their business ... The agreements formed the fixed framework within which their circulating capital operated; they were not incidental to the working of their profit-making machine but were essential parts of the mechanism itself.'

2.3 Method of quantification does not determine what it might be

In Glenboig Union Fireclay Co Ltd v IR Commrs (1921) 12 TC 427, the appellant company was lessee of certain fireclay fields over part of which ran the lines of the Caledonian Railway Co. In many ways, this decision is explained by basic land law which provides that minerals under the ground are part of the land whereas minerals which have been brought to the surface are stock. A sale of stock would be a revenue receipt.

The railway company instituted an action to restrain the fireclay company from working the fireclay under the railway but was unsuccessful. The railway company then exercised its statutory powers to require part of the fireclay to be left unworked on payment of compensation.

The House of Lords held that the amount received by the appellant company for compensation in respect of the fireclay left unworked was not a profit earned in the course of the company's trade, but was a capital receipt, being a payment for the sterilisation of a capital asset. The fact that, in determining the amount of compensation, consideration was given to the profits that would have been earned from the fireclay left unworked was held to be immaterial and the point to be determined was for what the compensation was paid. The House of Lords thought that the compensation was paid for the loss of a capital asset and was, therefore, a receipt of capital.

Lord Buckmaster said at pp. 463–464:
'It is unsound to consider the fact that the measure, adopted for the purpose of seeing what the total amount should be, was based on considering what are the profits that would have been earned. That, no doubt, is a perfectly exact and accurate way of determining the compensation, for it is now well settled that the compensation payable in such circumstances is the full value of the minerals that are to be left unworked, less the cost of working, and that is, of course, the profit that would be obtained were they in fact worked. But there is no relation between the measure that is used for the purpose of calculating a particular result and the quality of the figure that is arrived at by means of the application of that test.'

In Burmah Steamship Co Ltd v IR Commrs (1931) 16 TC 67, the amount received from ship repairers as compensation for a delay beyond the time stipulated for the completion of repairs to a ship, was held to be in the nature of income.

In the current climate of government cutbacks, most people will be aware that contracts are cancelled. There has been talk of cancelling the two aircraft carriers currently being built, especially as the estimated cost of these carriers continues to grow. Again, in Short Bros Ltd v IR Commrs (1927) 12 TC 955 and Sunderland Shipbuilding Co Ltd v IR Commrs (1926) 12 TC 955, sums received for the cancellation of contracts to build ships were found to be a receipt of income and in the ordinary course of the company's trade.

A payment made for are the purpose of filling a hole in the profits of the trade, profession or vocation and are taxable receipts of the business. This follows the principles set out in London & Thames Haven Oil Wharves Ltd v Attwooll (1966) 43 TC 491. A jetty was damaged and the payment was made to cover loss of profits while the jetty was out of use. This was taxable as income.

The dividing line between income and capital can be very thin, making it difficult to determine on which side of the line a particular receipt or item of expenditure falls. As Lord Upjohn stressed in the case of Strick v Regent Oil Co Ltd (1965) 43 TC 1 at p. 343:
'... no part of our law of taxation presents such almost insoluble conundrums as the decision whether a receipt or outgoing is capital or income for tax purposes'.

An amount received by a financial intermediary company in consideration for entering into an exclusivity agreement was held to be revenue in nature; the taxpayer company had used its goodwill and turned it to account through the distribution agreement as its method of trading. It had not parted with the property, or any part of it, for a price (Countrywide Estate Agents FS Ltd [2010] TC 00557

The distinction between capital and revenue can have dramatic differences in the tax outcome. For an individual, the difference could be between 10% if Entrepreneur's relief applied and 62% (the top rate at the margin of PA clawback). For companies, it is the difference in the calculation which matters.

Friends Provident paid Countrywide £25 million in the year ended 1 December 2002 under an exclusive distribution rights agreement. This agreement provided that Friends Provident would be the only life insurance provider to whom the taxpayer would introduce customers.

Countrywide treated the sum as a capital receipt on the basis that it was received in return for disposing of the use of its goodwill for the period of the agreement. Not surprisingly, HMRC argued that the receipt was one of revenue being a normal incident of Countrywide's trading activities.

The key question I would have asked was whether Coutrywide Estate Agents Financial services company were significantly different as a result of having entered into this exclusivity agreement. Posed that way, I think most people would reach the same conclusion as the Tribunal chairman, Sir Stephen Oliver QC, that the receipt was taxable as income. The tribunal posed the key question as:

Whether Countrywide parted with "part of its property for a purchase price" or was this "a method of trading by which it acquires this particular sum of money (the £25 million) as part of the profits of its trade"?. Countrywide's business at the relevant time (and now) comprises the provision of a range of financial services which include providing advice in relation to the sale of mortgages, life assurance products and other general insurance products, predominantly through the estate agency chain of businesses operated by the Countrywide Group.

Countrywide's annual turnover for the year ending 31 December 2001 was £35.2 million. Annual turnover in the year ending 31 December 2002 was £42.2 million and in the year ending 31 December 2003 was £51.8 million. Using one measure of goodwill, this looks to me like the goodwill was growing rather than a significant element having been sold. The Tribunal concluded the Appellant was not, as regards this customer information, disposing of anything in the nature of a capital asset. It was using its access to customers by giving FP the right to be introduced to them. FP's £25 million payment was the consideration for the Appellant's undertaking to give FP access to the Appellant's position in the market and its enhanced ability to introduce FP product to customers of the Countrywide Estate Agents.

The fully reasoned decision can be read in full at:

http://www.bailii.org/uk/cases/UKFTT/TC/2010/TC00557.html

2.4 Planning to use the difference for commercial advantage

In McLaren v Needham (1960) 39 TC 37 the taxpayer conducted two service stations. He made an agreement with the Shell Petroleum Co Ltd whereby Shell agreed to pay to him:

- a contribution towards the cost of redecoration in Shell's standard colours;
- a contribution towards the cost of Shell advertisements; and
- such other items as might be mutually agreed between the parties.

In addition to amounts paid for redecoration and as a contribution towards Shell advertisements, Shell paid to the taxpayer the sum of £1,063 5s. 2d. representing the cost of a new canopy at the service station, the erection of a garage office and the installation of lighting to the new canopy. The order for the canopy was placed with the builder by the taxpayer. Cheques in payment were made out by Shell in favour of the taxpayer who passed them on to the tradesmen concerned. It will be observed that the payments in this case were also for capital improvements to the service station premises. These payments were capital receipts and can be a useful tool in obtaining a commercial tie.

The contrast to this decision which demonstrates the truism that in tax "it ain't what you do but the way that you do it" is in Evans v Wheatley (1958) 38 TC 216. In that case, the taxpayer, who was the proprietor of a garage and petrol filling station, entered into an agreement with the Regent Oil Co, whereby the latter undertook to reimburse him for sums expended by him on 'sales promotion, co-operative advertising and dealer display' in connection with the sale of Regent Oil Co's motor fuel at his garage. These items are all for revenue outgoings.

The maximum payment, calculated with reference to gallonage supplied, to be made for these purposes was £115 in any year and £1,150 over the period of ten years covered by the agreement. The respondent was to advertise the company's fuel exclusively and he was to buy from it his total requirements of motor fuel. He was not to part with his interest in his premises until the company had been given a first refusal and if he sold to another person he was to require that person to enter into a tie agreement with the company. If he breached the agreement, the respondent was to repay the sums he had received from the company. Ten days after making the agreement, the respondent received an advance payment of £575. The expenditure incurred by him on sale promotion, advertising and dealer display was no greater after making the agreement than it had been formerly. Wynn-Parry J held that the amount of £575 was a trading receipt and not a receipt of capital.

In practice, it is often advantageous for a manufacturer to obtain a tie with a retailer to guarantee that the retailer sells the manufacturers produce. Such ties are common with Oil companies and brewers. It is the practice of HMRC, in determining whether the sum paid by the supplier is income or capital, to look at the purpose for which the payment was made. In doing so, they will look at the particular agreement and the correspondence and discussions which supplemented its terms. If the payer stipulates a particular capital purpose, and the funds are spent accordingly, the receipt will be regarded as a capital receipt. By way of illustration, an oil company could offer to buy the canopy above the pumps of a petrol garage. That canopy does not qualify for capital allowances so there is no balancing charge on disposal. Effectively, and within reason, the garage proprietor has received a payment which is tax free. Of course, when the garage is eventually sold, that payment from the oil company reduces the qualifying cost for CGT purposes but now that indexation has been abolished and entrepreneur's relief is as generous as currently, that may be a price worth paying and acceptable to both parties.

2.5 If planning to minimise tax, greater care is necessary

If no such capital expenditure purpose is specified and the recipient is free to spend the funds as he wishes, HMRC will regard the sum as a taxable trading receipt, on the authority of Ryan (HMIT) v Crabtree Denims Ltd [1987] BTC 289. In other words "it ain't what you do it's the way that you do it."

A common arrangement is for a brewer to make a loan payable out of subsequent sales. If the payment from the brewer took the form of an abatable loan, the amount by which it is abated each accounting period is regarded as a trading receipt of that period, in accordance with the accountancy concept of accruals.

The watershed between Capital and Revenue is still being tested.

2.6 Recent developments: Was Territory Release Payment Goodwill and was CGT Rollover Relief Available?

In Mertrux Ltd v Revenue & Customs [2011] UKFTT 398, the company claimed rollover relief from CGT on the basis that it had sold goodwill when it received compensation for the loss of its Mercedes dealership. Mertrux received the sum of £1,705,502 as a payment for the sale of its business.

The distribution of Mercedes-Benz vehicles in the UK is organised through a UK subsidiary of the Daimler-Chrysler group – Daimler-Chrysler (UK) Ltd ("DCUK").

In 2000 DCUK decided to make substantial changes to its dealer network and terminate dealer agreements. DCUK significantly improved its terms following litigation, and entered into a compromise agreement with a group of dealers. This provided that the outgoing dealer would sell its business to Mercedes or a new dealer nominated by it and would receive a 'territory release payment'. The issue was whether this territory release payment was a sale of goodwill. HMRC argued that half was goodwill and half was in respect of the disposal of an asset not within the qualifying classes as defined for the purposes of roll-over relief by Section 155 of the Taxation of Capital Gains Act 1992 ("TCGA").

HMRC considered that the amount paid to the Appellant comprised two elements, namely a 'basic' TRP equating to goodwill and secondly an 'enhanced' TRP reflecting compensation paid for the early termination of its dealership. An apportionment of the TRP to fifty per cent goodwill and fifty per cent compensation was considered by HMRC to be correct. Accordingly HMRC issued a notice of amendment on 27 October 2009 to the Appellant's corporation tax return for the period ended 31 December 2003. The amendment showed gross capital gains of £852,751 on which corporation tax was chargeable.

I remember that when I first learnt about CGT and goodwill, the concept that I learnt was that goodwill was the value placed on the difference between the amount paid and the valuation of the tangible assets. It did not matter what it was called. On that basis, the HMRC argument looks untenable.

The question of the composition of goodwill was exhaustively examined by the Special Commissioner in *Balloon Promotions Ltd* [2006] STC (SCD) 167. In argument for the appellant company, it was submitted that the Special Commissioner's "Conclusions on the Construction of Goodwill in TCGA 1992" were set out at paragraphs.159-170 of the decision. For present purposes, the key paragraph was paragraph 163:

> "Goodwill should be looked at as a whole and includes whatever adds value to a business by reason of situation, name and reputation, connection, introduction to old customers and absence from competition. The precise composition of goodwill will vary in different trades and in different businesses in the same trade."

At paragraphs 248 and 249 of the decision the Special Commissioner said:

> 248. "I have previously set out my conclusions on the salient features of the legal concept of goodwill. My starting point is that the consideration paid for the appellants' business incorporated an amount representing the excess over and above the true and fair value of the tangible assets. The existence of that excess combined with the profitability of the businesses were indicative that the businesses had added value which is an essential characteristic of the legal concept of goodwill. The added value was inseparable from the businesses which were sold as going concerns.....
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> 249. I conclude from the above analysis that the added value as represented by the excess consideration conforms with the salient features for the concept of goodwill as construed in TCGA 1992. The fact that the added value was attached to the businesses and the appellants owned the businesses are persuasive that the appellants had goodwill to sell to PizzaExpress.

This goodwill was separate and distinct from the goodwill owned by PizzaExpress in its name and associated intellectual property rights".

The FTT found as a fact that Leadleys (the buyer) were offered the chance to buy the business as a going concern at a certain price. The price paid exceeded the value of the tangible assets and therefore the natural conclusion is that the balance of the payment was for the goodwill absent some extrinsic evidence that it was for some other asset. We found nothing to displace the fact that the excess was for the goodwill.

The price was paid for the business and nothing else. Leadleys had no reason to pay compensation for the loss of the dealership.

HMRC ran an interesting argument that the goodwill attached to Mercedes cars, the manufacturer. That is true but the goodwill is real for the business location and customer base. The FTT found that the whole of the consequential gain is therefore eligible for rollover relief.

An interesting decision and one which is worth a read:
http://www.bailii.org/uk/cases/UKFTT/TC/2011/TC01253.html

2.7 Was a bonus payment to an employee capital or revenue?

In Philip Manduca v Revenue & Customs [2013] UKFTT 234, the dispute was whether a settlement received only after redundancy and litigation was capital or revenue and if the latter could HMRC assess it to income tax?

The point at issue concerned the tax treatment of a payment received by the Appellant, Mr Manduca, from Dexia Banque Internationale à Luxembourg ("Dexia") under the terms of an out of court settlement of High Court litigation brought against Dexia by the Appellant (the "settlement sum"). The Appellant had in his self-assessment returned this payment as subject to capital gains tax. The closure notice gave effect to HMRC's conclusion that the settlement sum was assessable to income tax under Schedule D, Case VI.

Manduca and a Mr De Jerez set up a new hedge fund. The Appellant's and Mr de Jerez's contracts of employment with Dexia dated 18 April 2001 (the "employment contracts") provided that they would be paid a salary and would be entitled to participate in the performance related bonus for each financial year. In addition to the employment contracts, there was a separate document also dated 18 April 2001 signed by two managing directors of Dexia and addressed to the Appellant and Mr de Jerez (the "Investment Bonus Document"). This document stated that it was "to set out the manner on which we intend to recognise your role in transferring to [Dexia] the business of the so-called TCM".

Dexia terminated the employment of the Appellant and Mr de Jerez by reason of redundancy on 19 April 2002. They each received redundancy payments, the tax treatment of which is not in issue in these proceedings.

The Appellant and Mr de Jerez then brought proceedings against Dexia in the High Court, relating to Dexia's failure to pay the First Investment Bonus. The matter was settled out of court. Under the settlement, the Appellant received a specified sum from Dexia as compensation for the bank's failure to pay the First Investment Bonus. It is common ground that the correct tax treatment of the settlement sum follows the treatment that would have been appropriate to the First Investment

Bonus, if the Appellant had received it. Was it capital or revenue, and if revenue did it arise from the employment or some other contract in which case it would be case 6 of Schedule D?

At Paragraph 63: The Tribunal finds on its consideration of the evidence as a whole that the First Investment Bonus was a reward for the part played by the Appellant in enabling Dexia to acquire the OEF business from Tilney. It was not a capital sum. The conclusion of HMRC in this respect was correct. It follows that the “capital v revenue argument” fails.

The taxpayer’s return was under formal enquiry. Mr Manduca argued that HMRC were out of time to issue a closure notice and raise assessments on income received under contract (Case VI) but this argument was rejected. When a case is open and under enquiry HMRC can raise assessments and do not need to use the discovery provisions or the time limits in the statute.

http://www.bailii.org/uk/cases/UKFTT/TC/2013/TC02648.html

Chapter 3 – The Treatment of Expenditure

3.1 Outline

HMRC have published a toolkit on the Capital v Revenue divide for expenditure. At 18 pages, it is well written and worth reading. It is for 2012/2013 or FY2012. It can be found at http://www.hmrc.gov.uk/agents/toolkits/capital-v-revenue.pdf

This toolkit which was published in June 2013 has three key elements.

A checklist - to help you to address the areas of possible error that we identify as key risks for Capital v Revenue expenditure.

Explanatory notes - which identify the underlying risks of error, how to mitigate those risks and a brief outline of the tax treatment. We recommend that you review these notes, even if you are confident about answering the questions in the checklist.

Cross references - linking to the relevant guidance available online, so you can easily find more detailed guidance if required.

This HMRC toolkit does not reflect:

- any differences which may arise from the use of the ‘The Financial Reporting Standard applicable in the UK and Republic of Ireland’ (FRS 102).
- Simpler Income Tax for the Simplest Small Businesses, to be introduced for 2013-14. For further information see **Simpler Income Tax for the Simplest Small Businesses Technical Note**.
- any legislation the Department for Business Innovation and Skills may introduce following the EU approval for 'Simplified Accounting for Micro Companies' in February 2012.

I should like to emphasise that the toolkit is HMRC’s interpretation of the law but cases like that of David Howell (see32.) illustrate that HMRC make mistakes in this complex area.

3.2 HMRC risk assessment

As we shall see at the end of this chapter, this divide between capital and revenue is an area of error risk. HMRC observe that it is a common error and HMRC has published the toolkit to help improve compliance by giving guidance to their interpretation. Again cases like David Howell v R & C [2011] UKFTT 179,illustrate that all too often HMRC get this technical area wrong. His was a case about whether HMRC had made a discovery which then enabled them to assess profits in earlier years which HMRC thought had not been fully assessed.

In David Howell v R & C [2011] UKFTT 179, Mr. Howell appealed assessments raised using discovery powers to be found in s29 TMA 1970 after HMRC learnt of his receipt of £55,000 in settlement of his partnership capital account. He had originally invested £20,000 in 1995 and had been a partner entitled to a salary of £20,000 pa plus 5% of the profits plus 1% of turnover exceeding £750,000.

On the dissolution of the partnership, his former partner had disputed Mr. Howell's entitlement which was eventually settled by compromise as a Tomlin agreement. HMRC argued that the excess over the initial contribution of £20,000 represented partnership profits and assessed this to income tax reopening years back to 1996/97 up to 2003/04 on the argument that Mr. Howell had been at least negligent in these returns.

This was an outrageous contention yet somehow this case which appears devoid of any merit, made it through the HMRC review process and was heard by the tribunal.

The good news is that the tribunal decided in favour of Mr. Howell. HMRC could not have made a discovery because no new information emerged. He had disclosed the receipt which the tribunal agreed was capital. And to suggest that Mr. Howell had been negligent when he had correctly reported his income in all of the earlier years was so wrong.

http://www.bailii.org/uk/cases/UKFTT/TC/2011/TC01048.html

3.3 Determine what it is in reality

I have mentioned this case in this chapter rather than the previous one to contrast it with the next Case. In the case of Parnalls Solicitors Ltd v R & C Commrs [2010] TC 00261, a lump sum payment made to commute a liability to pay an annuity was found to be a capital payment. The Appellant had acquired the business of Parnalls, a solicitors' practice, on 1 January 2001 shortly after one of its partners, Mr Parnall, had retired. Although Mr Parnall was due an annuity on retirement, he had not enforced his entitlement at that stage and the obligation to pay the annuity was not reflected in the Appellant's balance sheet on incorporation, or in any other documentation regarding the transfer of the assets and liabilities of the business.

In 2005, following the announcement by Mr Parnall that he now wished to enforce his right to an annuity, the company made a lump sum payment to Mr Parnall in commutation of this obligation. The Appellant claimed a corporation tax deduction on the grounds that the payment was revenue in nature.

Finding against the company, the Tribunal ruled that the assumption of the obligation to pay an annuity to Mr Parnall was part of the consideration for the business. As such, it was capital in nature and so the annuity payments, had they been made, would also have been capital in nature.

For this reason, the lump sum payment was a capital item and a corporation tax deduction was not due.

The 'enduring benefit' test was postulated by Viscount Cave LC in British Insulated and Helsby Cables Ltd v Atherton (1925) 10 TC 155 at pp. 192–193:
'But when an expenditure is made, not only once and for all, but with a view to bringing into existence an asset or an advantage for the enduring benefit of a trade, I think that there is very good reason (in the absence of special circumstances leading to an opposite conclusion) for treating such an expenditure as properly attributable not to revenue but to capital.'

The general rule is that a payment made in order to commute or discharge a liability to make recurring, tax-deductible, revenue payments is itself a deductible revenue payment (Vodafone Cellular Ltd v Shaw (HMIT) [1997] BTC 247).

For example, in Anglo-Persian Oil Co Ltd v Dale (1931) 16 TC 253, a company paid £300,000 to put an end to an agency agreement which was costing it much more than had been envisaged. The Court of Appeal held that this was an allowable deduction against profits. Argument largely centred on the question of whether the payment constituted a revenue or a capital outlay, and Lawrence LJ's conclusion (at p. 269) was as follows:
'It is not open to doubt that under ordinary circumstances where a trader, in order to effect a saving in his working expenses, dispenses with the services of a particular agent or servant, and makes a payment for the cancellation of the agency or service agreement, such a payment is properly chargeable to revenue; it does not involve any addition to or withdrawal from fixed capital; it is purely a working expense.'

Size alone does not determine the right treatment. A deduction was allowed for a substantial payment of $30 million made to cancel an earlier agreement between two companies (Vodafone Cellular Ltd v Shaw [1997] BTC 247). The taxpayer company paid £20m paid to another company ('Millicom') for the release by Millicom of its right to receive a fee amounting to ten per cent of Vodafone's consolidated pre-tax profits for a period of 15 years. The agreement was to provide know-how and technical support in the establishment of a digital telephone network. As time moved on, the taxpayer was able to obtain alternative technology and the agreement became burdensome. The decision turns of the point of principle that a payment to avoid a revenue outgoing will be, with the exception of getting rid of a lease (see below), a revenue payment.

A payment for cancelling a management contract was also held to be revenue in nature in Croydon Hotel and Leisure Co v Bowen (HMIT) (1996) Sp C 101. The special commissioners decided that the payment, made by the owner of a hotel to terminate an agreement with Holiday Inns for the management of the hotel, was not a capital payment. The management agreement was an agreement that Holiday Inns should run the hotel as agent for the taxpayer, for a fee. The payment made as consideration for the termination of the agreement did not affect the whole structure of the taxpayer's operations but merely enabled the business to be run more profitably.

3.4 Capital Expenditure on leases

In (Rolfe (HMIT) v Wimpey Waste Management Ltd [1989] BTC 191) Dillon LJ found 'no difficulty' in upholding the High Court's decision that the expenditure was capital in nature. The company tried (unsuccessfully) to argue that repetition converted capital expenditure into revenue expenditure a number of wasting assets one after another which would be replaced when they were used up. The company incurred substantial expenditure in acquiring rights to use land for tipping waste material. Some of the sites were freehold, some were leasehold and some were licences. In order to use the sites, further expenditure was incurred on obtaining planning permission and waste disposal licences, and on providing roads, hard standing and other services. The projected life of a site was overall, from the start of preparatory work to its final state, filled in and restored, seven to ten years, with an earning life of four years.

In Cowcher v Richard Mills & Co Ltd (1927) 13 TC 216, a fishmonger had several shops, one of which was unprofitable. The lease of that shop was a rack rent lease for 14 years, which was due to expire in 1923. In 1916, the business at the shop was closed down, the lessor agreeing to accept a surrender of the lease in return for of a sum to be paid by annual instalments of £250 (equivalent to one-third of the rent for the rest of the term). The instalments were paid regularly (and allowed by the Revenue) until 1921, when the lessor accepted a payment of £600 from the company in satisfaction of all further liability under the agreement. The £600 was included in the company's accounts for the year ended 31 March 1922 but was disallowed as a deduction for tax purposes.

Rowlatt J was in no doubt that the latter treatment was correct:
'The question is whether this sum can be charged as an expense incurred in carrying on the business of fishmongers as the Respondents carried it on in the year in question ... Is this an expense of the fishmongers' business which they are carrying on? I think it is not; because they are carrying on a fishmongers' business at "A" premises and "B" premises, and "C" premises, and I dare say a good many premises, but not at these premises. What has a payment in respect of these premises got to do with a business of the character they carry on? It has to do with it as a matter of history. They used to carry on the business at these premises too, but these premises were abandoned and went out of the business. It ceased to be a part of the business ... It is not an expense in earning money in the business that is carried on. Neither the instalment, nor the commutation of the instalment was.'

The underlying point of principle brought out by a number of cases is that expenditure to acquire or dispose of a lease is capital expenditure. In Union Cold Storage Co Ltd v Ellerker (HMIT) (1929) 22 TC 547, the High Court held that a sum paid to cancel a 40-year lease ten years before its due expiry had not been laid out for the purpose of carrying on the company's trade but for the purpose of putting an end to the trade.

In Mallett v Staveley Coal and Iron Co Ltd (1927) 13 TC 772, a mining company acquired a 63-year mining lease under which it was bound to mine coal and support the surface. 40 years later, the company paid the lessors £3,500 to accept a surrender of part of the seams included in the lease. Under another mining lease of 21 years, the company was bound to restore the surface. Four years later, the company paid the lessors £3,000 to accept a surrender and to release the tenants's liability to restore the surface. Rowlatt J declared that 'all receipts and payments in connection with acquiring and disposing of leaseholds of minerals to be worked by collieries in this way are capital transactions', and the Court of Appeal affirmed his decision that both sums were non-deductible capital expenditure.

3.5 The watershed between a revenue repair and a capital improvement

A replacement is capital expenditure whereas a repair is revenue. HMRC often get this wrong and the area of dispute between a capital improvement and a revenue repair is contentious. In Wills v R&C 2010 UKFTT 174, the argument was that old chestnut of whether an expense was a repair or an improvement. HMRC lost. The taxpayer won a deduction for the expense of repairing an outbuilding.

The property had been owned for many years and was let. One of the outbuildings had become dangerous but as it was a listed building the owner had no option but to repair it.

The work was extensive but common sense should have told HMRC that this was a repair. It seems common sense was absent and just because the work done was expensive, HMRC argued wrongly that it had to be capital.

The important point of principle is the distinction between replacement of the entirety of an asset and renewal of a subsidiary part of an asset. In Lurcott v Wakely & Wheeler [1911] 1 KB 905 (not a revenue case), Buckley LJ said at p. 924:
'*Repair is restoration by renewal or replacement of subsidiary parts of a whole. Renewal, as distinguished from repair, is reconstruction of the entirety, meaning by the entirety not necessarily the whole but substantially the whole subject-matter under discussion.'*

The famous two cases involving the replacement of a factory chimney, it was held in one that the entirety was the chimney and thus the expenditure capital (O'Grady v Bullcroft Main Collieries Ltd (1932) 17 TC 93), and in the other that the entirety was the factory and thus the expenditure revenue (Samuel Jones & Co (Devonvale) Ltd v IR Commrs (1951) 32 TC 513. In some ways, this shows that establishing the facts can make the difference.

The doctrine of entirety was illustrated by the nature and size of the structure. In Phillips v Whieldon Sanitary Potteries Ltd (1952) 33 TC 213, a barrier protecting a factory against water seepage from a canal was held to be of sufficient size in relation to the factory to be regarded as 'premises' (or the entirety) for the purposes of the statute. The expenditure was capital.

But it is not always possible to effect a repair so that the repaired asset was the same as the old one. In Thomas Wilson (Keighley) Ltd v Emmerson (1960) 39 TC 360, the taxpayer argued that it was cheaper to raise and extend the building than to repair it as it was before. The work done was a renewal of the top floor and roof of a building, such that a higher roof was created, was held to be a capital expense. It was not possible to deduct the notional repair cost.

In Conn v Robins Bros Ltd (1966) 43 TC 266, repairs and alterations were carried out on a 400-year-old listed building used for business purposes by the taxpayer company. The work consisted mainly of renewing and strengthening the upper floors and roof. Modern materials and methods were used but the expenditure was still allowed as a repair. Buckley J held that the expenditure was incurred with a view to enabling it to continue to earn profits from its business, not by acquiring a new asset but by putting an existing asset into an adequate state of repair. The expenditure was allowed as a deduction.

This chapter started with a reference to the HMRC toolkit which was first issued in 2010. HMRC included the following comments on this topic:
'Risk
When a business carries out refurbishment of an existing or newly acquired asset, such as a property, some or all of the expenditure may relate to improvement or alteration of the asset. This expenditure will normally be capital for tax purposes, but it may have been included in repairs and renewals or other profit and loss account headings in the accounts. It is not possible to treat some of the expenditure on improvements as "notional repairs".
Explanation
A repair to an asset restores it to what it originally had been and is normally an allowable revenue expense. For example the cost of replacing roof tiles blown off by a storm. The cost of alterations, however, are normally capital for tax purposes as they involve improving or changing an asset and so providing an enduring benefit to the business, rather than simply restoring it to its previous state. For example extending the area of the roof or taking off the roof and building another storey.'

These comments are fair enough but they represent the extremes. In many cases, it is much less clear cut whether particular expenditure represents an improvement or merely a repair. The toolkit is helpful but it provides the HMRC viewpoint and interpretation of the law in what is often a difficult area. It is one in which the HMRC frequently get it wrong.

3.6 Recent decisions -Capital Revenue Divide:

3.6.1 HMRC lose again on farm driveway

Deciding whether something is capital or revenue often has significant tax repercussions. Individual accountants are often required to make difficult judgements on how to treat expenditure in the accounts and then again in the tax computation. The two are not always identical.

The amounts involved are often material and it is all too easy to get it wrong in what is often a difficult and complex area. Professionals should document their decision and the consideration given. That way if a mistaken view of the law is eventually determined the adjustment does not carry a penalty as a result of failing to take reasonable care. Good documentation of the decision and why it was made is important.

The difference between a repair and an improvement is a risk area in many annual computations. Careful consideration should be given to any repair which involves a replacement. A replacement of a part or parts is a replacement but a replacement of the entirety is likely to be capital expenditure .

A case which I reviewed earlier in the paper at page 10 was the persuasive decision in favour of the taxpayer that repairs to an outbuilding were properly expensed as repairs. There had been an element of improvement which made sense when dealing with a listed 400 year old dilapidated building attached to a rental property and the tribunal approved of the split between capital and revenue expenditure. In Christopher Wills [2010] TC 00479, the accounts showed around £63,000 as capital expenditure and nearly £44,000 as repairs. The latter related to work on an outbuilding which had become dangerous but was a listed building. The letting income from the main building had not increased as a result of the work to the outbuilding which was sited in the garden area and available for use to the occupiers of the rental property.

Farmers seem to receiving a number of enquiries on this capital revenue divide and several members have been seeking advice on the issue. Even when it is agreed that the expense of repairing say the farm driveway is properly revenue, there is argument about what restriction should be required for private use. It is certainly arguable that most of the wear and tear arises from the heavy farm machinery and visiting milk tankers and so a full deduction should be allowed and/or any private use adjustment for the family car(s) should be negligible.

3.6.2 Replacement farm access road was a repair

In G Pratt & Sons v Revenue & Customs [2011] UKFTT 416, the tribunal judge John Brooks decided in favour for the taxpayer that the replacement of the farm access road was a repair and properly allowable. The issue was whether re-surfacing the farm drive at a cost of £23,300 was a replacement or renewal of the drive, which is a capital expense and not deductible, or a repair which is a revenue expense and an allowable deduction.

The farm is family owned, having been in the same family since the 1880's. 90% of the output is liquid milk, with the remaining 10% comprising beef, eggs and arable produce. The working buildings of the farm are grouped around a farmyard at the end of the farm drive, which runs to the nearest public road. Near the farmyard there is a branch of the drive running to the farmhouse. This is adjacent to, but separate from, the farmyard.

The lane had last been tarmacked about 30 years before.

The work on the drive took three to four weeks and consisted of removing the top layer of tarmac until a stable sub-surface was reached, repairing the sub-surface as necessary, by using broken up pieces from the surface layers, and then re-surfacing. New kerbing was added as necessary to bring the drive up to modern standards. The total length of the drive from the road to the farmyard is 280 metres, of which 239 metres were re-surfaced. The section of drive from the fork to the farmhouse, 41 metres, was not re-surfaced.

Finding as a fact that the work done was allowable as an expense, the tribunal observed:

"We may have taken a different view if the drive had been altered to accommodate larger milk tankers or to allow access for larger lorries bringing farm supplies but it was not. Before the work on the drive the dairy sent 20,000 litre tankers for milk collections and they continued to do so following its completion, the same applies to deliveries by suppliers to the farm."

The full judgement which is succinct and readable can be read at:

http://www.bailii.org/uk/cases/UKFTT/TC/2011/TC01269.html

3.6.3 Is resurfacing of a touring pitch area capital or revenue expenditure?

Many years ago I and my family enjoyed several holidays in our caravan when it was parked at Cairnsmill caravan park near St Andrews so it was with some personal interest that I read this case.

In Cairnsmill Caravan Park v Revenue & Customs [2013] UKFTT 164, the issue was whether expenditure of surface restoration work amounting to £89,210 was capital or revenue.

In Autumn 2008 the Appellants decided to restore the surface of the pitches let out short-term to touring caravan customers. These extend to about three acres. The area had been in use for around 50 years and the grass surface had deteriorated.

The area occupied by the Appellants extends to about 51 acres. There is an undeveloped area of about 14 acres, accessible to all patrons for recreational use. Of the remaining area at the material time about 27 acres were devoted to providing sites for static caravans. These are plumbed in for water and sewage facilities. They are in use throughout the Year. The remaining five acres were occupied by touring caravans, which the Appellants allowed to park there from March to October each Year. There are a number of buildings on the site including a swimming pool, a shop, and a toilet block. Commercially the caravan park is run as one business, and all its sources of income are inter-related in that one entirety. It was valued before and after the surface restoration at around £4 million.
To restore the grass surface would have required the area to be left largely vacant for about two holiday seasons to allow the grass surface to become re-stabilised. Instead the Appellants replaced it with a hard-core surface, consisting of a foundation made up from a former airport runway surface (conveniently nearby for transport purposes and which had become available at a relatively cheap cost at that time) and a top surface of loose gravel.

HMRC argued that the works undertaken created a permanent and enduring advantage for the business. This accrued to its fixed capital. Accordingly the works represented more than a repair in that the land or surface had to be excavated, replaced by entirely different material, viz hard-core, and then surfaced with gravel. In effect a new asset had been acquired.

Maintenance costs of the new hard-core surface are, if anything, marginally higher. The hard-core has less aesthetic appeal: it is like any hard-surfaced car park. It is not suitable as a recreational area for children. Securing a typical camping awning on a hard surface is problematical inasmuch as fixing pins cannot easily be located. This, in fact, has generated customer complaints. Given that the grass had been used for 50 years, it is doubtful that the new covering would even be as durable and looking at the caravan park as the entirety the value had not been enhanced by the expenditure.

The tribunal found as a fact that the expenditure of £89,210 on re-surfacing with hard-core is a revenue expense, deductible for tax purposes.

http://www.bailii.org/uk/cases/UKFTT/TC/2013/TC02580.html

3.6.4 Was it a repair or was it capital when a road entrance was widened?

In Hopegar Properties Ltd v Revenue & Customs [2013] UKFTT 331, the issue was whether or not the amount of £240,992.60 was a repair (allowable) or capital expenditure. The expense relates to the main entrance road to an estate, which was built some 40 years previously. It was in need of repair and widening with the increase in traffic to the estate of heavier lorries, transporters and other vehicles, which was substantially in excess of the original weight expectations when the road was built.

In addition to the main road, the footpaths were beginning to break up. As a result of road damage, there was a risk to under-laid fibre optic cables belonging to British Telecom, and these had to be re-laid. The landlord felt that tenants should contribute to the repairs given the size and budget for the work. The tenants agreed and contribution payments were made over three instalments.

As a result of the road widening, there was attendant landscaping required. Trees had to be removed and fencing and railings installed to comply with local authority and safety requirements. The existing car park was re-sited, enlarged and repaired. The total works took approximately 15 weeks to complete. During that time, access to the estate was via a temporary access road, which was constructed for that purpose.

The Company is owned by the Mackley family. Its principal activity is buying, developing, managing and letting of land and buildings including the land and buildings on the Mackley Industrial Estate in West Sussex ("Industrial Estate" which had the entrance road widened). The estate has 67 rental units and comprises approximately 309,500 square feet. There is 1,130 metres of road. The total length of fibre optic cable on the whole estate is 285 metres and the total length of telephone cable is 2,100 metres. The length of diverted fibre optic and telephone cable was 143 metres.

The work to the main carriageway (£135,141) involved widening and repair. It was required because the road was old and breaking due to the impact of heavy lorries over a period of years. The expenditure on the road can be broken down to show money was spent on labour, plant and material (£73k) and road surfacing (£32k). There was additional expenditure to muck away (£18k), road planing or smoothing (£400), road markings (£1,950), landscaping (£6,000) and footpath resurfacing (£2,300).

The road has been widened in parts from 6 metres to 8.6 metres. Evidence was presented to show that the increase in the area of road was some 3% of the road network on the Industrial Estate. The road was originally constructed as a sub-base and more concrete over the top. The concrete was in the form of slabs and therefore lay in sections. This concrete was replaced with tarmac. In order to lay the tarmac, it was necessary to re-lay thicker sub-base for greater load bearing. It was decided that tarmac could be laid more easily and quickly since concrete required a 28 day setting period and this would facilitate an earlier completion of the work.

The expenditure must be either capital or revenue, it cannot be both. HMRC's approach may be understood if one accepts that expenditure on capital works may include an element of revenue expenditure. In such a case, as here, there will be a separation of the two types of expenditure.

The key to this decision is to be found at paragraph 74. *"The Tribunal finds that defective parts of the road were being repaired. The older material was dug up and replaced with a more modern equivalent which met current standards. It was a substantial repair but not if one starts with the entirety of 1,130 metres of road on the estate as a whole. The repaired part of the road is not meant to function separately; it is the access point for the estate and the other parts of the road network. By its nature it is not physically or functionally distinct; it is part of the aggregate of roads and access on the whole estate."*

Road building is not an exact science but the functionality of the main carriageway is very near the same as before the works. The Tribunal, on balance, can see no increased functionality of significance. The work was essentially to repair the road not to produce something entirely new. The overall effect of the work was to give the estate back a functional carriageway at the start of the road network. The new main carriageway laid as tarmac was better than the old but physically, commercially and functionally was very similar to what existed before. The expenditure was revenue and properly allowed as a deduction for corporation tax purposes.

An interesting part of this judgement relates to the creation of a temporary access road which was essential to allow access to the estate when the main access road was having the work done. The main carriageway temporary diversion costs is put at £23,226 which is comprised of tree stump removal (£825), muck away (£6,224), sub-bases (£2,433), temporary surfacing (£8,545), labour (£2,156), plant (£1,918 + £1,125 = £3,043). We know that expenditure which is incidental to revenue expenditure is revenue. The Appellant has deducted a proportionate part of the sub-base (£2,433) and a proportionate part of the temporary surfacing cost (£4,718) and they have accepted that these amounts should be treated as capital. The remaining amounts are revenue expenditure which is incidental to the expenditure on the main carriageway.

£31,469.54 was spent for the diversion of the BT cables and fibre optic and this can be broken down into component parts. The Tribunal accepts, like the road network, that the relevant asset was the cable network for the estate as a whole. The cable network did not operate in parts but rather was part of one whole.

The witness evidence presented suggests that the movement of the cable was necessary for the road repairs. To the extent that it was necessary for the widening of the road, then those costs would have to be treated as capital. The widening of the road expenditure has been accepted as capital. The moving of the asset from one location to another does not of itself create a new asset. The installation of new cabling was of such a minimal amount that it cannot be said that it created a new capital asset. A cable network must be seen as a whole over the whole estate and the part that has been repaired and/or replaced is *de minimis*. The expenditure therefore would be revenue and treated as a repair.

The costs of changing the car park and repairing the dilapidated footpaths could easily be analysed between what was an alteration and improvement (capital) and what was claimed as a repair. HMRC's argument that the car park needed to be examined as an entirety was rejected because functionally it did the same purpose and to the extent that part had been repaired that cost was allowable for tax purposes.

Dr Khan's lengthy judgement contains several good summaries of relevant case law and is worth a detailed read. It is persuasive authority and clarifies the watershed between allowable repairs and capital expenditure.

http://www.bailii.org/uk/cases/UKFTT/TC/2013/TC02734.html

3.7 Incidental Expenditure including legal fees

3.7.1 Market Southwest (Holdings) Ltd v Revenue & Customs (2010) UK FTT 121

Point at Issue:
Whether legal fees relating to a disputed planning application were allowable for tax purposes as being revenue in nature or fell to be disallowed because they were capital in nature.

Facts:
The Appellants incurred professional fees in a dispute relating to planning permission. The Appellants believed that they had the right to trade on days other than at the weekend and therefore the expenditure should be related to the maintenance and defence of an existing capital asset being the right to trade. However the defendants were erroneous in that belief and therefore they did not have the right to trade each Wednesday and were trying to acquire or extend an existing right to trade for the market. The expenditure was also unsuccessful and therefore no capital asset was created as a result of it.

The taxpayer promoted open air markets operating the Cornish market world in St Austell which was an indoor market comprising 300 stalls. The planning permission it had was to trade at the site on Saturdays and Sundays and an additional ten days in any year but from 2002 it opened every Wednesday. As a result, the council issued an enforcement notice banning the Wednesday opening and the taxpayer appealed against it.

The course of litigation to the High Court took a four year period and the legal fees were therefore incurred on a regular basis and could not be treated as one off lump sum capital payments. The rights had not been valued in the taxpayer's balance sheet but this did not affect the analysis.

Decision:
The question of whether an expenditure is of a revenue or capital nature is one of the most basic legal decisions in the tax code. There are a large number of cases in this area, many of which were cited in argument by the parties to this appeal. The expenditure had been incurred to seek an advantage of being free to trade for an additional 42 days each year. This was an attempt,

albeit unsuccessful, to create an enduring advantage for the trade or business. The Tribunal decided the payments were of a capital nature and therefore not allowable for tax purposes.
]

3.7.2 *Grant Bowman t/a The Janitor Cleaning Company v Revenue & Customs [2012] UKFTT* Capital/Revenue Divide

In *Grant Bowman t/a The Janitor Cleaning Company v Revenue & Customs [2012] UKFTT*, the issue was whether consultancy fees paid by the business were revenue or capital in nature. There was a secondary issue that if the expenditure was capital expenditure, could capital allowances be claimed on the expenditure.

The dispute concerned a consultancy payment of £11,000 which HMRC argued was capital with the result that the taxpayer's bill increased from £234 tax to £4,618.92.

The payment comprised two elements being:

1. A single payment of 3% of total contract value for the assistance given by Mr A S Asgari given in the negotiation and winning of a three contract with SMC valued at £300,000 and;

2. A fee of £2,000 for identifying and then assisting in the negotiations for the business planning and potential purpose of cleaner times.

The cleaning contract with SMC was cancelled after ten months. The potential purpose of cleaner times business fell through at the last moment and the fact that the sale did not proceed led to strained relationships between the Appellant and Mr Asgari.

Section 33 ITTOA 2005 provides that no deduction is allowed for items of capital expenditure in the computation of the profits of a trade.

Various court decisions have established a principle that if expenditure is incurred to acquire, dispose or modify a capital asset then the expenditure is capital.

In an appeal, it is the Appellant who has the responsibility for proving his case on the balance of probability. In this case the Appellant did not attend the hearing and the evidence provided by the Appellant was threadbare.

The Tribunal makes findings of fact which cannot be disturbed unless the finding of fact was so absurd that no reasonable person could make such a finding. This will not apply in a case like this and so the decision of fact by the Tribunal is final and conclusive. The Tribunal held that the fee of £2,000 was made in connection with the intended but abortive acquisition of an identifiable asset (the cleaner times business) and was in no doubt that the £2,000 fee constituted capital expenditure.

The fee of £9,000 was spent on securing an introduction to obtain a long term contract which would have provided the business with an annual income of £100,000 which exceeded its turnover prior to the acquisition. If it was part of the normal activity of the business to acquire new contracts then this should be revenue expenditure but in this case the contract being acquired exceeded the turnover of the previous business and securing that contract would have secured an enduring benefit to the Appellant's business.

The Tribunal therefore found as a fact that the £9,000 fee constituted capital expenditure.

To qualify for capital allowances, the expenditure must be shown to function as a tool in the trade. The Appellant had provided no rationale to justify a claim to capital allowances and so the Tribunal decided that none of the expenditure could qualify for capital allowances.

http://www.bailii.org/uk/cases/UKFTT/TC/2012/TC02284.html

Chapter 4 – Miscellaneous Points

4.1 Special provisions Contrary to general rules, there are special provisions, mainly of an anti-avoidance nature, which treat capital receipts as income/revenue receipts. The following are some of the main items so treated for income tax purposes:

- premiums, etc. received in respect of leases (ITTOIA 2005, s. 276–281 and s. 299);
- certain government grants and subsidies (ITTOIA 2005, s. 105);
- receipts by directors and employees for certain restrictive undertakings (ITEPA 2003, s. 225);
- certain receipts in respect of patent rights (ITTOIA 2005, s. 587–596);
- certain receipts for know-how (ITTOIA 2005, s. 192–194, s. 583–585 and s. 878);
- gains on some life assurance policies, etc. (ITTOIA 2005, Pt. 4, Ch. 9);
- capital sums received by settlors (ITTOIA 2005, Pt. 5, Ch. 5);
- tax advantages from securities (ITA 2007, Pt. 13, Ch. 1);
- transfers with accrued interest (ITA 2007, s. 632–633 and s. 664);
- transfers of assets abroad (ITA 2007, s. 716, 718, 720, 721 and 727–729);
- sales of income derived from personal activities (ITA 2007, s. 773ff.);
- gains from transactions in land (ITA 2007, s. 752.);
- land sold and leased back (ITA 2007, s. 681B);
- leased trading assets (ITA 2007, s. 681C);
- reverse premiums (ITTOIA 2005, s. 101); and
- receipts from disposals of telecommunications rights, etc. (ITTOIA 2005, s. 146–148 and s.614

Many of the above points are complex and would deserve a webinar by themselves to be covered satisfactorily. The list is not exhaustive but it is intended to highlight that the capital revenue divide is often complex and certain aspects like premiums or life insurance gains are very artificial and governed by prescriptive rules (rather than common sense or principle).

4.2 Consequences of an error: For returns made after March 2009, an error arising from a failure to take reasonable care could face a penalty of up to 30%. It is all too easy to make a mistake. In a difficult area like this, it is important to retain evidence that the point has been considered. Even if the wrong treatment is used in the tax computation, so long as the view taken was tenable (but wrong) there can be no possibility of HMRC imposing a penalty.

There are many decided cases which demonstrate that HMRC were wrong in their contention. It can be difficult, especially in those examples which are close to the capital/ revenue watershed, to resolve correctly the right tax treatment. I hope that this webinar will be of some help to you in dealing with those difficult decisions.

Has any expenditure on <u>essential repairs</u> to a newly acquired asset been treated correctly?

Has all capital expenditure on the <u>purchase of assets</u> been identified and allocated appropriately?

Has any <u>incidental expenditure</u> incurred when acquiring or disposing of an asset been treated correctly?

Have all items of expenditure on the <u>improvement or alteration</u> of an asset been treated correctly?

Have you documented the evidence considered in deciding whether the expenditure was capital or revenue?

4.3 HMRC Guidance on the Capital Revenue divide

In June 2013 HMRC have issued a new business brief on what is a repair after updating their business income manual.

This guidance is aimed at a general audience. The guidance applies to both trades and property businesses and replaces the existing guidance in the Business Income Manual at BIM46900 to BIM46935, and in the property Income Manual at PIM2020.

At 23 pages, I recommend every practitioner has a read of this. It covers:

BIM46901 Overview
BIM46905 Role of accountancy
BIM46910 What is a repair: the 'entirety'
BIM46915 What is a repair: improvements
BIM46920 What is a repair: different materials
BIM46925 What is a repair: changing technology
BIM46930 What is a repair: Notional repairs
BIM46935 What is a repair: effect of a change of ownership
BIM46945 What is a repair: Assets on which capital allowances given
BIM46950 What is a repair: Character of the asset
BIM46990 Renewals basis – Expenditure before 2013

http://www.hmrc.gov.uk/briefs/income-tax/draft-guidance.pdf

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