IS YOUR HOUSE IN ORDER?

Julie Butler reviews two recent UK tax tribunal cases on property transactions being considered trade or capital

Two recent tax tribunal cases have looked at whether transactions are of a capital gains tax (CGT) or a trading nature. In *J A Thornton* v *HMRC*,[1] the taxpayer was successful: the UK First-tier Tribunal (FTT) found that a settlement paid to a landlord as compensation for dilapidation of his flats was a capital receipt. An earlier FTT case, *Rebecca Stayton* v *HMRC*,[2] considered whether a taxpayer can trade in property without having an intention to trade.

INTENTION TO TRADE

Stayton looked at a position that was finely balanced. The big tax questions asked by the FTT were: whether or not Mrs Stayton had to have an intention to trade for there to be 'an adventure in the nature of a trade' for income tax purposes; and whether or not Mrs Stayton had this intention to trade at the time a property was acquired. The FTT looked at the very basics on the question of trading: the nine 'badges of trade' set out in the case of *Marson* v *Morton*.[3]

CAPITAL v REVENUE

The facts in *Stayton* were that Mrs Stayton was married to a property developer. In April 2005, Mrs Stayton bought a property, which she renovated and then sold in May 2007. Mrs Stayton stated that, although she had originally planned to occupy the house, the venture had been a trade. HMRC considered that she had held the property as a capital asset and CGT was due on the proceeds. HMRC also imposed penalties for failure to notify chargeability and submitting an incorrect return. Mrs Stayton appealed to the FTT.

It might be considered unusual that the taxpayer wanted the profit treated as trading income rather than capital, as so many taxpayers seek the advantages of CGT when disposing of property, particularly with regard to the annual exemption for CGT and lower rates of tax.

NOT AN ADVENTURE IN THE NATURE OF A TRADE

The FTT found as a fact that the taxpayer had no intention of developing the property as an adventure in the nature of a trade. The judge referred to the badges of trade, which were presented as common-sense guidance. It can be argued that what a tax tribunal sees as common sense might not reflect everyone's viewpoint. The FTT decided that, viewed as a whole, although the taxpayer bought the property with a view to living in it, she changed her mind after a dispute with the neighbours. It was a single transaction, and it was unrelated to any trade the taxpayer carried on.

The case is a timely reminder of the distinction between capital and revenue, and the need for tax advisors to carefully review the facts and evidence of any proposed transaction before the event. Many would argue for the 'forensic' approach to examining what is a very common dilemma for those who buy and sell property – what is the correct tax treatment? The case looks with particular interest at the single-property transaction.

The transaction was financed by a loan to the husband's property development company, which undertook the refurbishment; Mrs Stayton had no involvement with the company. It was considered that Mrs Stayton had no more involvement with her husband's company than 'that of any owner who asks a third-party to renovate his home'. The house was held as a capital asset and was subject to CGT on disposal.

Many tax advisors might seek to take guidance from Mrs Stayton's problems with HMRC, using the CGT argument on future single-property transactions. The tribunal upheld the penalties and decreased the mitigation allowed by HMRC on the grounds that the amount of tax involved was substantial.

J A THORNTON – CAPITAL RECEIPT

Some taxpayers might feel perplexed by the apparent confusion or fine balance between the activity of the trade and the activity of the capital disposal. Many UK taxpayers have caught the property renovation 'bug' – and some look to 'buy to let'. In *J A Thornton*, the receipt of compensation by a property owner for dilapidation work not carried out by the tenant was deemed to be a capital receipt, as the payment was used for repairs. That is, the payment was to make good the fall in capital value, and was therefore a capital receipt and not subject to income tax.

Many tax advisors might read these two cases and decide they are more confused where matters are finely balanced between capital and income. However, the messages from the tribunals are clear – tax advisors and taxpayers must understand the nature of the transaction/operation, and tax reporting and planning must ensure that the correct evidence of the understanding of the underlying facts behind the receipts by the taxpayer has been scrutinised.

DEVELOPMENT LAND

The question of capital versus trade can also apply to the question of the tax treatment of the development of land for building. The sale of land for development that has been held as a capital asset may be treated as a trade in exceptional circumstances – i.e. to give rise to an income tax liability if, for example, the vendor receives a share in the developer's subsequent profits. The leading case in this connection is *Page* v *Lowther*.[4] HMRC may assert that an individual is trading in land under general principles if, for example, the taxpayer enjoys frequent property deals or they borrow money on a short-term basis, suggesting that a disposal is likely to follow an acquisition quickly.

In addition to concerns over 'slice of the action' schemes, there are the difficult provisions in s752 of the *Income Tax Act 2007*,[5] which extend the normal trading provisions to embrace situations where, for example, land is acquired with the sole or main object of realising a gain from disposal. All the more reason, therefore, for a taxpayer who is uncertain whether they might be deemed to be trading to consider the use of a limited company to conduct the development activity and take advantage of the lower corporation tax rates.

THE GARDEN DEVELOPMENT

Concerns can also rest with the development of the garden. A straight sale for a fixed sum of part or all of the permitted area of a residence should qualify for main residence relief. Some care may be needed in confirming that the area is actually used as a garden or grounds, and has not been fenced off in anticipation of a sale. Photographic evidence may be helpful here, because the stakes may be high in terms of tax saving.

FINELY BALANCED

The practical points are that the HMRC decision as to capital versus revenue is finely balanced. All transactions should be carefully reviewed and understood before a decision as to the tax treatment is made. For tax planning purposes, the transactions should be reviewed in anticipation of the disposal or receipt of monies. The capital or trading status can be used to maximum advantage to ensure that the correct evidence is in place.

To summarise, there is no place for bland processing or generic assumptions in complex transactions, especially where the tax treatment is known to be finely balanced.

KEY POINTS

WHAT IS THE ISSUE?
There is a 'fine balance' between a transaction of a capital nature and a transaction of a trading nature.

WHAT DOES IT MEAN FOR ME?
The researched definition of a capital or trading transaction can be used to maximise the tax advantage, provided that the evidence and understanding is in place.

WHAT CAN I TAKE AWAY?
An understanding of the nature of each transaction, especially where both tax advantage and protection can be achieved through this research.

1 (TC5494) [2016] UKFTT 767 (TC)
2 (TC5104) [2016] UKFTT 0345 (TC)
3 [1986] STC 463
4 [1983] STC 799
5 Formerly s776, *Income and Corporation Taxes Act 1988*

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