

Property compensation – Thornton

The question of whether receipts and expenditure relating to property are of a capital or revenue nature has been a long-running debate between the taxpayer, tax advisers and HMRC, and there is often a fine line between capital or revenue and the treatment thereof. A recent tax tribunal case looked at the position of compensation for the non-payment of dilapidations of a property being received, and yes, there was the question of whether this should be treated as a capital receipt or an income receipt.

Compensation for dilapidations

In *J A Thornton v HMRC* [2016] TC 5494 the First-Tier Tribunal (FTT) found that a settlement of monies, paid to a landlord, Mr Thornton, by the tenants as compensation for the dilapidation of his flats, was a capital receipt. The facts were that the tenants were responsible for the upkeep of the flats but they failed to comply with their responsibility regarding dilapidations and monies were paid to Mr Thornton. The apartment block, known as Jordan House, which had previously been subject to a lease between Silk Estates and Albyn Housing Society, was assigned to Mr Thornton. Later the flats were vacant for a year because they were no longer fit for habitation, although the tenant continued to pay the rent to Mr Thornton but failed to carry out repairs to remedy the dilapidations. Negotiations were entered into with the aim of reaching a settlement so that the lease would be terminated and Mr Thornton could recover the flats to prevent further disrepair. These negotiations resulted in the payment of a £250,000 settlement being received by Mr Thornton from the tenant.

HMRC had argued that the settlement received by the landlord, Mr Thornton, should be treated as an income receipt because it covered the loss of rental income due to the dilapidated state of the flats. Mr Thornton, however, insisted that the compensation should be treated as a capital receipt, on the basis that the settlement allowed Mr Thornton to protect his investment and that the monies had been used to repair the property, therefore the receipt was capital in nature.

The FTT agreed that it was clear that the property, Jordan House, had reduced in value mainly because of the lack of maintenance by the tenant, and the settlement had been used for repairs by Mr Thornton. However they

were of the view that this was to reclaim the capital value. The FTT argued with HMRC on the side of the taxpayer, Mr Thornton, that the aim of the settlement payment was to compensate for reduction in capital value. The FTT decided that the monies received should therefore be treated as a capital receipt and not an income receipt. Many tax advisers might find this decision confusing as it highlights the 'fine line' of tax interpretation between capital versus revenue and the treatment of compensation for repairs.

In practical terms, this is another clear example of the need to fully scrutinise the nature of property transactions, receipts, payments and the basic facts underlying every case. The need for tax advisers to forensically review and understand the documentation, evidence and facts in tax treatment terms is essential. In the *Thornton* case, the Tribunal commented on the lack of documentary evidence. Essentially the case had to be decided on the basis of the taxpayer's testimony. He was accepted as a credible witness. He testified that the basis of the capital value of the freehold had been reduced and that reduction had formed the basis of his claim, and the amount agreed to be paid. By contrast the Revenue sought to argue that the claim was for a loss of rental income, but this seemed not to be supported by any evidence. This is an example of the decision of the FTT overturning that of the HMRC to agree with the arguments put forward by the taxpayer. The need for tax advisers to understand the legal documents surrounding capital transactions is highlighted by this case. There is a need for professional advisers to work together and for tax advisers to ensure full legal documentation of the transactions is available. The words 'forensic analysis' in tax work is possibly considered overused but it is essential to 'drill down' to find what the real facts are in every case.

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