TC05494

Appeal number: TC/2015/07230

Income tax – discovery –dilapidations- ransom payment to exit a lease – revenue or capital –capital - appeal allowed

FIRST-TIER TRIBUNAL
TAX CHAMBER

JAMES ALLAN THORNTON **Appellant**

- and -

THE COMMISSIONERS FOR HER MAJESTY'S REVENUE & CUSTOMS **Respondents**

TRIBUNAL: JUDGE ANNE SCOTT
MEMBER: PETER SHEPPARD

Sitting in public at Inverness on Tuesday 1 November 2016

The Appellant in person and Mr J B Weir

Matthew Mason, Officer of HMRC, for the Respondents

DECISION

1. The matters under appeal were the Closure Notice issued on 23 April 2015 in terms of Section 28A Taxes Management Act 1970 ("TMA") assessing additional duties of £22,232.19 for the year 2010/2011 and two assessments both issued under Section 29 TMA on 23 April 2015 in the sums of £6,651.28 and £8,041.54 for the years 2011/2012 and 2012/2013 respectively.

2. At the heart of this appeal was the treatment of a receipt by Mr Thornton of £250,000 on Friday 30 July 2010. That payment was described as being "… in full and final settlement in relation to all issues associated with the lease of Jordan House to Albyn Housing Society Limited".

Preliminary and Procedural matters

3. I pointed out at the outset of the hearing, there was a lamentable lack of relevant documentation and also a lack of clarity in what little had been produced in the joint bundle of documents lodged.

4. We did consider whether or not to adjourn to enable both parties to produce better documentation but we had due regard to Rule 2 of The Tribunal Procedure (First-tier Tribunal) (Tax Chamber) Rules 2009 ("the Rules") a copy of which is annexed at Appendix A and decided to attempt to elicit the factual background from Mr Thornton who was very articulate. Mr Thornton gave very clear and credible evidence and very fairly admitted he could not remember the whole detail. At the end of the hearing we recapped the evidence which forms the basis of our Findings in Fact and both parties agreed that that was as accurate an account as could be achieved in the circumstances.

The Facts

5. On 17 October 2006 the appellant took entry to 18 flats, known as Jordan House, Nairn, for which he had exchanged missives in six different sets of missives. All of those flats had previously been the subject matter of a lease between Silk Estates Limited and Albyn Housing Society Limited ("Albyn"). That single lease was assigned to Mr Thornton personally on the same date.

6. Mr Thornton traded under a variety of different names but always as a sole trader. The rental income for the flats was paid into a bank account for Allan Thornton Rentals but it was for Mr Thornton's personal benefit.

7. The lease for the flats was a standard tenants repairing and insuring lease whereby the tenant was responsible for the upkeep of the flats. They did not do so.

8. Latterly, although the flats were vacant for a period of at least a year, because they were not fit for habitation, Albyn continued to pay the rental due in terms of the lease to Mr Thornton whilst extensive negotiations were conducted in regard to a possible

settlement whereby they would no longer be liable in terms of the lease and Mr Thornton could recover the flats to prevent further disrepair.

9. In terms of the lease Albyn were entitled to give six months' notice of termination. Rental was paid six monthly in advance. Alan Torrance Associates were appointed by both parties as surveyors to assess the level of dilapidations.

10. Ultimately, at the point where Mr Thornton was negotiating for a figure in excess of £300,000 (reflecting not only dilapidations and other matters but also a payment for rental discounted from the then open market rental which was in excess of the payment due in terms of the lease) Albyn wrote to Mr Thornton in the terms set out in paragraph 2 above. The lease had approximately five years still to run.

11. Mr Thornton was clear that eventually the settlement at £250,000 ("the settlement") was arrived at in order to dispose of the matter and there was no break-up of the issues or constituent parts of that figure since there was no detailed agreement between the parties. It was a simple compromise bringing matters to a conclusion. He was very anxious indeed to regain possession of the flats in order to prevent yet further disrepair.

12. Mr Thornton used the funds that he received in order to repair the building and expenditure is still ongoing. In February 2013 (see paragraph 16 below)Mr Thornton's then agent confirmed that £273,000 had already been expended on repairs. The flats remained vacant for at least ten months not least because, in his opinion, the building was dangerous. One wing was re-let after a period of ten months and further flats some 18 months later.

13. The receipt of the £250,000 was not included in the profit and loss account for the year ended 31 August 2010 but was included in the balance sheet as a creditor.

14. On 20 June 2012, HMRC wrote to Mr Thornton advising him that they were carrying out a check of the 2010/2011 self-assessment tax returns which had been received on 29 July 2011. That return included a claim for repairs and renewals of property and equipment amounting to £69,479 and other items.

15. On 17 September 2012, HMRC issued a Notice in terms of Schedule 36 of the Finance Act 2008 and fruitless correspondence ensued until 14 February 2013. In the interim period penalties (which are not the subject matter of this appeal) had accrued.

16. On 14 February 2013, Mr Thornton's then agent provided some information indicating that the settlement was really a payment in advance of the expenditure which would have to be incurred. Ultimately on 6 December 2013, Mr Thornton's then agent wrote to HMRC enclosing correspondence (which was not available to us) and stating:

> "… I trust that this information will be helpful to you in the decision regarding the amount of compensation paid over to Mr Thornton which basically is in respect of dilapidations … and we trust that … you can agree that this is a Revenue matter which can be offset by the eventual expenditure carried out in the repairs etc".

17. A new agent was appointed in 2014 and on 23 April 2015, in the absence of any further response from that agent, HMRC issued a Closure Notice for the tax year 2010/11 and the notices of further assessment for the two subsequent tax years. Those are the subject matter of this appeal.

18. The review conclusion letter upheld the original decision.

19. In the Notice of Appeal submitted to the Tribunal, Mr Thornton's new agent argued that the settlement should be treated as a capital receipt as the payment was required solely to meet the costs of the required repairs. That was confirmed orally at the outset of the hearing.

The Arguments

HMRC

20. HMRC argue that the settlement should be treated as an income receipt because it covered the loss of rental income due to the dilapidated state of the properties.

The Appellant

21. Mr Thornton argued that it should be treated as a capital receipt since it allowed him to safeguard his capital investment and had been used to repair the property.

Preliminary and procedural matters

Discovery

22. It was evident that prior to the hearing the relevance of HMRC's references to discovery in the Statement of Case had not been fully understood by Mr Thornton's representative and that was presumably because there was no overt reference to *Burgess and Brimheath v HMRC*[1]. Ultimately, after discussion, it was conceded that in relation to the competence and time limit issues identified in paragraph 53 of that decision, HMRC had discharged the burden of proof in those respects and therefore the Closure Notice and Assessments had been validly made.

23. As indicated above, it transpired that the joint bundle was very seriously deficient in that it did not even include correspondence and a lease which had been lodged with the Tribunal. Crucially, in the course of the hearing having heard evidence, it transpired that it also did not include what was described as "Appellant's Further Responses to Statement of Case" dated 17 October 2016 or the original Response dated May 2016.

24. After considerable debate, and having regard to Rule 2, Mr Weir accepted and agreed that the various matters which he had raised in the course of correspondence and in the two Responses had been covered, to his satisfaction, in the course of the hearing and therefore those could now be treated as withdrawn.

[1] 2015 UKUT 578 (TCC)

Discussion and decision

25. Although HMRC had referred to a number of authorities in the Statement of Case including *London and Thames Haven Oil Wharves Ltd v Attwooll (Inspector of Taxes)*[2] ("London and Thames") there was no discussion, by either party, of the relevant case law on dilapidations and the distinction between capital and income receipts.

26. HMRC's reliance on *London and Thames* was in respect of the quotation from Diplock LJ reading:-

> "Where, pursuant to a legal right, a trader receives from another person compensation for the trader's failure to receive a sum of money which, if it had been received, would have been credited to the amount of profits (if any) arising in any year … The compensation is to be treated for income tax purposes in the same way as that sum of money would have been treated if it had been received, instead of the compensation … The damages here were applicable to the purpose of filling the hole in the respondents income caused by the fact that they were not able to obtain as much rent for the premises as they could have obtained."

27. At all relevant points prior to termination Mr Thornton received the rental payable in respect of the lease.

28. We agree with Diplock LJ at page 815 of *London and Thames* where to paraphrase, in short, he indicates that where pursuant to a legal right, compensation is received, then the source of that legal right is relevant in order to identify for what that compensation was paid. Therefore what was the source of the legal right pursuant to which Mr Thornton received the payment from Albyn? We find that the legal right pursuant to which the payment was received derived from the lease and the subsequent negotiations and is therefore circumscribed by that.

29. Diplock LJ goes on say at page 816:-

> "The method by which the compensation has been assessed in the particular case does not identify what it was paid for; it is no more than a factor which may assist in the solution of the problem of identification."

30. The calculation utilised in the negotiations had largely been by reference to dilapidations. One element in the negotiations had also been a figure reflecting the six month rental payable on premature termination of the lease. We did not have a precise figure for that but it would have been the rental payable in July 2010 for the following six months. There appears not to have been any argument about loss of rental going forward.

31. Mr Thornton, for it was he who largely conducted the hearing, conceded that the six month rental element had been argued but if it was included within the £250,000 he believed that the rental element should not be the full six month rental but should rather be allocated *pro rata* looking to the figure of approximately £280,000 which

[2] 1967 CH 772

had been at the heart of the negotiations, if not the approximately £300,000 which was later in dispute.

32. By contrast Mr Mason argued that it should be the full amount of the rental and, if not, a figure of approximately £31,000 which had been referred to in correspondence, to which we were not privy. Mr Thornton stated that the £31,000 figure had simply been used as a bargaining tool since that reflected some 70% of what he believed to be the then current market value of the rental rather than the actual rental which was of the order of £23,000.

33. What part, if any, of the settlement was attributable to rental? Whilst we note the arguments of both parties it is certainly also open to us to decide that since the dilapidations clearly amounted to rather more than the £250,000 no part of the settlement was attributable to rental. Mr Thornton was extremely anxious to regain physical possession of the flats in order to commence repairs. We find that his compromise was to forgo the six month rental and rental going forward and that all of the settlement related to dilapidation.

34. We referred the parties to Lord MacDermott CJ in *Harry Ferguson (Motors) Ltd v Inland Commissioners*[3] at page 42 where he stated that:-

> "There is so far as we aware no single infallible test for settling the vexed question whether a receipt is of an income or a capital nature. Each case must depend on its particular facts and what may have weight in one set of circumstances may have little weight in another. Thus the use of the words 'income' and 'capital' is not necessarily conclusive; what is paid out of profits may not always be income; and what is paid as consideration for a capital asset may on occasion be received as income. One has to look at all the relevant circumstances and reach a conclusion according to their general tenor and combined affect".

35. The fact that the payment had been disclosed as a creditor in the accounts is not in any way binding and the question as to whether it is to be treated as income or capital for taxation purposes has to be considered in the context of the particular facts of this case.

36. In summary, the facts in this case can be distinguished from the many authorities (to which we were not referred) as, unsurprisingly, it is not wholly in point with any.

37. It was clear that the property had suffered a significant diminution in value due, in very large part, to the lack of upkeep on the part of the tenant. It is equally clear that all of the settlement, and more, had been expended on the repairs. Shortly put, we have identified that the nature of the liability in this particular case was to make good the fall in capital value attributable to, and calculated by reference to, the dilapidations that the tenant had failed to make good. When the lease was terminated, due to the inaction of Albyn, Mr Thornton had suffered a permanent diminution in the capital value of his investment and the settlement was to make good that loss.

38. We referred the parties to Lord Keith in *CIR v West*[4] at page 533 which reads:-

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[3] (1951) 33 TC 15

> "… I cannot agree that a sum paid for damage caused by abuse, or a non-stipulated use, of the thing hired is a trading receipt. It is money paid to enable the owner to restore his property, if possible, to the condition in which it may again become suitable for use or hire, or, if restoration is impossible, to compensate him for the loss or depreciation of a profit-earning subject".

39. For all these reasons, in these particular circumstances, the receipt of the funds falls to be regarded as a capital receipt in the hands of Mr Thornton.

40. This document contains full findings of fact and reasons for the decision. Any party dissatisfied with this decision has a right to apply for permission to appeal against it pursuant to Rule 39 of the Tribunal Procedure (First-tier Tribunal) (Tax Chamber) Rules 2009. The application must be received by this Tribunal not later than 56 days after this decision is sent to that party. The parties are referred to "Guidance to accompany a Decision from the First-tier Tribunal (Tax Chamber)" which accompanies and forms part of this decision notice.

ANNE SCOTT
TRIBUNAL JUDGE

RELEASE DATE: 16 NOVEMBER 2016

[4] 1950 SC 516

2.—Overriding objective and parties' obligations to co-operate with the Tribunal

(1) The overriding objective of these Rules is to enable the Tribunal to deal with cases fairly and justly.

(2) Dealing with a case fairly and justly includes—

(a) dealing with the case in ways which are proportionate to the importance of the case, the complexity of the issues, the anticipated costs and the resources of the parties;

(b) avoiding unnecessary formality and seeking flexibility in the proceedings;

(c) ensuring, so far as practicable, that the parties are able to participate fully in the proceedings;

(d) using any special expertise of the Tribunal effectively; and

(e) avoiding delay, so far as compatible with proper consideration of the issues.

(3) The Tribunal must seek to give effect to the overriding objective when it—

(a) exercises any power under these Rules; or

(b) interprets any rule or practice direction.

(4) Parties must—

(a) help the Tribunal to further the overriding objective; and

(b) co-operate with the Tribunal generally.