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Capital v Revenue

1. Introduction

The distinction between revenue and capital is important both in relation to receipts and expenditure. For receipts, income is taxed under various potential headings and capital receipts will be subject to capital gains treatment. For deductions, there is no deduction for capital expenditure when computing income profits (although there may be some alternative treatment such as capital allowances) and income expenditure cannot be deducted in computing capital gains.

It can therefore make a significant difference when computing the amount of tax to pay as to the nature of receipts and expenditure. It has been an area which has been extensively considered in the Courts leading to a body of case law.

This module will consider the capital vs revenue area by looking at a series of case studies. There is no right or wrong answer but the intention is to consider what the different arguments might be from each side.

Additionally changes occurred in F(No2)A 2017 in respect of the capital v revenue distinction for unincorporated property businesses. This has been addressed later in this module.

2. Case study one

CarsRUs Ltd operates as car dealers with an extensive network of dealerships around the country.

In one location, a car showroom underwent substantial refurbishment. During this time, about eight months in total, the showroom remained open for business. This was to honour the agreement with the manufacturer and maintain custom, especially for the MOT centre. The company obtained quotes from the surveyors and builders involved in the refurbishment on two bases. Firstly that the showroom would close and give them a clear site to work on and secondly that the showroom would remain open. The additional costs in keeping open the showroom were £40,000. This second option was taken. Are the costs of refurbishment, including the additional amount, revenue in nature?

The company also operates a petrol filling station at one of its car showrooms. The company entered into an agreement with Texaco to sell only Texaco products for a period of five years, in return for a one off payment of £250,000. In the accounts, the amount is being written down by equal monthly amounts over the five year period.

<u>Part one</u>
Are the repairs and the additional costs an allowable deduction?

There is an issue with repair expenditure because arguably repairs will involve some element of improvement to capital assets. However, the replacement of old parts with new ones does not make the expenditure capital. The Courts have used the concept of the ‘entirety’ to distinguish revenue repairs from capital expenditure. If the entirety is replaced then the expenditure is capital. If less than the entirety is replaced then the expenditure may be a repair if there is no element of improvement.

The company will wish to argue that the costs relate to deferred repairs and do not represent enhancements or improvements to the property. The case of *Odeon Associated Theatres Ltd v Jones* may be relevant. In that case, repair expenditure on cinemas that had accumulated over a number of years due to the war and were therefore extensive by the time it was undertaken but was still revenue in nature as the use of the asset had not been restricted in the interim period. There does not seem to have been a restriction in the use of the showroom in this case.

Whether these are repairs or enhancements would depend on an extensive review of the work done. So HMRC would want to look at what was there before and what is there afterwards. It is not possible to make a definitive judgement without detailed information.

Although it is likely that there would have needed to be repair expenses incurred even if the refurbishment work had not been done, it is not possible to claim a deduction for notional repairs. In the case of *Thomas Wilson (Keighley) Ltd v Emmerson* [1960] 39 TC 360, the roof and top storey of a building were in a dangerous condition. Reconstruction took place but the building was heightened during this. The company claimed the cost of the roof element of the work as a repair, but it was held that one could not make a claim for notional repairs. So it is unlikely that the company would be able to claim for notional repairs if the overall scheme is found to be capital.

What about the additional costs?

The company might wish to argue that the purpose of the expenditure was to maintain the company's trade and to make profits during the period of expenditure. The case of *Atherton v British Insulated & Helsby Cables* is often quoted in capital v revenue arguments as it contains the famous quote:

'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 the trade, I think that there is a very good reason for treating such an expenditure as properly attributable not to revenue but to capital.

It should be remembered, in connection with this passage, that the expenditure is to be attributed to capital if it be made 'with a view' to bringing an asset or advantage into existence.

The company in this case could argue that the additional expenditure of £40,000 was not bringing into existence an asset which was for the enduring benefit of the trade but was merely for the temporary benefit of the trade to keep the showroom open.

HMRC will argue that whatever the effect of the additional expenditure it is simply part of the cost of the building work and thus if that is of a capital nature then so will the additional payment..

Conclusion?
The facts are based on the case of *Mann Crossman & Paulin Ltd v Compton* [1947] 28 TC 410.

The Special Commissioners decided on appeal that the extra expenditure was capital expenditure and not an allowable deduction; this decision was upheld in the High Court. It should be noted that the underlying expenditure had been found to be capital.

Atkinson, J. said that:

'I have come to the conclusion that the extra expenditure being part of the cost of bringing into existence an asset for the enduring benefit of the trade was a capital expenditure, and none the less a capital expenditure because the trade benefited included that being carried on during the process of the work........A company incurs expenditure on an enduring asset in order that profit may be made. That is capital. A company incurs expense in the making of profit. That would normally be revenue.

'This expenditure was not incurred in the making of profit, but an expenditure incurred so that profit in fact could be made. Further, the protection of that particular trade was clearly also for the enduring benefit of the trade in that it protected and prevented the loss of goodwill which is undoubtedly a permanent asset. So that in protecting the trade something was protected which was of enduring benefit to the trade.'

<u>Part two</u>

Is the receipt of a payment from Texaco to sell only their products capital or revenue? There have been a series of cases on this point.

The case *Evans and Wheatley (1958) 38 TC 216* was one in which the taxpayer received a series of payments, and the agreement which he signed stipulated that these sums were to reimburse him in respect of sums which he was to expend on sales promotion and advertising i.e. revenue expenditure. The respondent in this case never spent any money on such items, but nevertheless the terms of the agreement stamped the payments as revenue receipts rather than capital receipts.

In *Walter W Saunders Ltd v Dixon (1962) 40 TC 329*: a garage proprietor entered into a 20-year exclusivity agreement with a petrol company under which a maximum of £20,000 was to be paid to him in reimbursement of expenditure on sales promotion, etc. The full £20,000 was eventually paid to him, or on his behalf, in four amounts to meet expenditure on new premises. The Chancery Division held that the £20,000 was a capital receipt. The payment was made to reimburse the taxpayer in respect of revenue expenditure which he had laid out but the money was used for capital purchases i.e. new premises.

Could it be argued that if the contract was taken away, it would affect the whole profit making structure of the company? This was the case in *Van de Berghs Ltd v Clark (1935) 19 TC 390*, where the cancellation of the contract destroyed virtually the whole of the taxpayer company's business. If the contracts were revoked, it would mean that the petrol filling station could not function properly, because it would not have any petrol to sell. It is very possible that they could probably conclude another such contract with another petrol company, but until such a time as they did, they could not sell any petrol. It could therefore be argued that the profit-making structure would be seriously affected which would make the receipt capital in nature.

HMRC might argue the other side of this in that the payments were revenue in nature, because they were the result of a contract which should be characterized as a commercial agreement. They dealt with the disposal of one of the company's products and could be viewed as ordinary commercial contracts made in the course of carrying on GM's trade.

The notes tell us that company operates a petrol filling station at the site of one of its car showrooms so its business is not limited to the operations carried out at the garage. It would need to be established the proportion of turnover which relates to sales of petrol as compared to the total turnover. One would also need to consider the restrictions placed on the company by Texaco in the agreement to determine whether they affected the whole structure of their business which is unlikely.

Conclusion?
The facts are based on the recent case of *Tanfield Limited v Carr [1998] SpC 198.*

It was held that the receipts were of a revenue nature. The payment was not made under a contract the cancellation of which would effectively destroy or cripple the whole structure of the taxpayer's profit-making apparatus, but was under an ordinary commercial contract made in the course of carrying on the trade, and as such, it was not a capital receipt. Since Tanfield Ltd's business was not limited to the operations which it undertook at the petrol filling station, the restrictions placed on Tanfield Ltd by the petrol company did not affect the whole structure of Tanfield Ltd's business, but concerned only a small part of it. Moreover, the relevant agreement could be viewed as an ordinary commercial contract made in the course of carrying on Tanfield Ltd's trade. The payment made by Esso to Tanfield Ltd was therefore to be characterized as a receipt of a revenue rather than a capital nature.

3. Case study two

Clubolderia Ltd is in the hospitality trade operating a number of pubs and restaurants. For many years Sunday opening of pubs has not been permitted in Walesia, although clubs and restaurants have been permitted to open. The company, in conjunction with the brewery landlord of its pub sites in Walesia and others in the trade, campaigned continuously to change the law which they argued, among other things, was unfair and discriminatory. Eventually, an Act was passed permitting the question of Sunday opening to be decided by poll in each borough. The company spent £75,000 stimulating interest and obtaining the signatures necessary to require polls to be held. As a result of the polls only 16 of the pubs where operates a restaurant now remain closed on Sundays.

In a separate transaction, the company has lost ten of its restaurants in theme pubs when the brewery took back the tenancies. The tenancy agreements were determinable on notice without compensation. The brewery paid the company £50,000 in compensation.

<u>Part one</u>

The question is whether the payment to remove trading restrictions (effectively) is revenue in nature.

Lord Cave's test in *Atherton*, though often decisive is not universally applicable, such that one might sometimes have expenditure which was clearly of an income character but which nevertheless produced an advantage for the permanent benefit of the trade, for example, money spent on an advertising campaign.

In *CIR v Nchanga Consolidated Mines [1964] AC 948,* it was made clear that 'securing a benefit' for the business is not prima facie a capital matter. In that case there was a £1.4m payment to another company to keep it out of production for a year. In *Anglo-Persian Oil Co Ltd v Dale (1932) 16 TC 253* payments were made in relation to trading contracts and it was emphasised that the nature of the advantage secured must be closely examined. Here the advantage is clearly a revenue one in that it produced increased turnover and is thus analogous to an operating cost. It was like, say, expenditure on advertising to produce increased turnover. Expenditure on floating capital is not made with a view to acquiring an enduring asset. What capital benefit can be said to have been obtained?

The company may find assistance in the words of Lawrence L J in *Mitchell v B W Noble Ltd*, the company:

'neither enlarged the area of its operations nor improved its goodwill, nor embarked on a new enterprise; it merely effected a change in its business methods ...... leaving its fixed capital untouched'.

In *CIR v Carron Co* 45 TC 18, a company incurred substantial legal and other costs in altering the charter which established the company. The original charter restricted its borrowing powers and prevented the setting up of a modern management structure. The payments were held by the House of Lords to remove an impediment to the trade and were thus of a revenue nature.

Lord Wilberforce:

'The present expenditure cannot be brought within the capital class. It procured indeed an advantage - important and not of a transitory nature - but one essentially of a revenue character in that it enabled the management and conduct of the company's business to be carried on more effectively.'

Morgan v Tate & Lyle Ltd (1954) 35 TC 367 is authority for the proposition that money spent for the purpose of preserving the trade from destruction can properly be treated as wholly and exclusively expended for the purposes of the trade within the meaning of s74 (1)(a).

In *Morgan v Tate & Lyle Ltd* the company claimed a deduction for the costs of its campaign against proposals to nationalise the sugar-refining industry, on the basis that it was protecting the business and assets of the company against an external threat. The House of Lords held that the expenditure was allowable.

HMRC are likely to contend that the expenditure was incurred to bring into existence an asset or an advantage for the enduring benefit of the company's trade and was therefore of a capital nature and not allowable. The advantage was the removal of the statutory prohibition on Sunday opening, which would be an advantage of an enduring character for the benefit of the company's trade.

If the leases had contained clauses forbidding opening on Sundays and the company paid the landlord to have the clauses removed, the expenditure would clearly be capital, as in *Tucker v Granada Motorway Services (1979) 53 TC 92*.

Templeman J in the High Court concluded:

'The authorities show that payment of a lump sum which reduces a burden on revenue, albeit a burden which would otherwise extend over a long period is an income expense if the reduction is a direct and only consequence of the payment. But where a lump sum is paid to acquire, dispose of, improve or modify a fixed capital asset, the lump sum payment is capital expenditure although as a result of the dealing with the capital asset, the future revenue expense of the taxpayer is reduced.'

In the Court of Appeal, Stamp L J found this proposition convincing. The lease was a fixed capital asset and insofar as the payment operated to increase the value of the lease to the company, the advantage produced was of a capital nature.

Expenditure on the poll could be analogous to this.

Conclusion
The facts are based on the case *Cooper v Rhymney Breweries Ltd (1965) 42 TC 509*.

The Special Commissioners held that the expenditure was merely one of the incidents of carrying on the company's business and was a revenue expense and allowable. The decision was upheld in the High Court.

Cross J, observing that the case was not easy, eventually decided that the commissioners were correct:

'It is a case which is near the line but....I think it is more reasonable to regard the expenditure as a mere outgoing for the purpose of earning profits in the normal course of the business than as expenditure with the object of acquiring an advantage for the enduring benefit of the trade.'

<u>Part two</u>

Was the receipt income or capital?

It can be argued that the receipts in question were not revenue receipts, nor did they arise from the company's trade. They arose from the brewery's willingness to make ex gratia payments by way of compensation for the loss of capital assets consisting of the company's interest in the premises.

However, the test of whether or not receipts are revenue receipts lies in whether or not they are related to services or supplies whether present, past or future. In this instance, they were not negotiated or calculated by reference to profits and they did not relate to services or supplies and are not revenue receipts. This contrasts the position in the case of *CIR v Falkirk Ice Rink (1975) 51 TC 42* where a receipt from an affiliated curling club to the ice rink was found to be trading as its intention was to supplement the income to cover costs.

It might be capital if it feel within the *Van den Berghs* principle ie that related to the whole of the profit making apparatus of the company but this seems unlikely.

In the case of *Watneys London Ltd (and Avon) v Pike (1982)* 57 *TC 372*, where payments were made to remove tied tenants so that the group could increase the number of group-managed houses, it was held that the obtaining of vacant possession was an operation undertaken for the benefit of the group as a whole and that the payments were made on capital account since, although they created no new asset, the change to managed houses was effected with a view to a permanent improvement in the group profits derived from the exploitation of the premises.

HMRC could argue that the sums were trading receipts being compensation for loss of profits suffered by the company as a result of the disruption of some of its trading operations, received as an incident of the trade and thereby constituting 'annual profits or gains arising from any trade' (s18(1) ICTA 1988).

Ordinarily, an amount received by the trader in consideration of the cancellation, breach or variation of a trading contract will be a revenue receipt. For example:

- compensation and damages relating to a contract for the purchase or sale of trading stock or consumables (Short Bros v (1927) CIR 12 TC 955, Green v Gliksten (1929)14 TC 364, Creed v H & M Levinson Ltd (1981) 54 TC 477)
- if business is carried on by operating as agent for a number of manufacturers and the receipt is referable to one such contract (*Kelsall Parsons and Co v CIR (1938) 21 TC 608*

The making of tenancy agreements was a necessary part of the company's business and the cancellation of them did not affect the structure of the business, *Kelsall & Parsons & Co v CIR (1938) 21 TC 608*.

Conclusion
The facts are based on the case *Murray (H.M.I.T.) v Goodhews (1977) 52 TC 86*.

The Special Commissioners held that the receipts were capital receipts, not trading receipts. This decision was upheld in the High Court and the Court of Appeal.

The Court of Appeal held that a case of a voluntary payment must be considered on its own facts to ascertain the nature of the receipt in the recipient's hands.

Buckley L J stated that:

'The five features of a voluntary payment catalogued in *Simpson v John Reynolds & Co* were features of the facts of that particular case. They cannot be treated as criteria for the decision of other cases.'

(*Simpson v John Reynolds & Co* concerned the treatment of an ex gratia payment made at the end of a long established working relationship. In this particular case it was held to be non taxable)

It is the character of the receipt in the recipient's hands which is significant; the motive of the payer is only significant so far as it bears upon that character.

It was found as fact that the payments were made to maintain the brewery's name, goodwill and image in the trade and was not linked with any future trading relations between the two companies. The amounts paid were not connected with the profits earned or the amount of sales, which tended to contradict any suggestion that the payments were in the nature of compensation for lost profits. Thus, the receipt did not arise from the trade or business of the company.

4. Simplified cash basis for unincorporated property businesses

Under F(No2)A 2017, 2017/18 sees the introduction of the statutory simplified cash basis for unincorporated property businesses. For each type of property business run (UK, Overseas, FHL etc), the simplified cash basis must be used rather than the accruals basis unless any of the following conditions apply:

- The business is carried on by a company, an LLP, a partnership with a corporate partner or a trust;
- The gross property income exceeds £150,000 for the tax year, reduced proportionately if the business is only carried on for part of the year;
- The business is owned jointly by spouses or civil partners and the profits are shared 50:50, where one party makes an election for the accruals basis to apply then the other party must also use the accruals basis;
- Business premises renovation allowances have been claimed in relation to the property business and there would be a balancing adjustment in the tax year if the profits were calculated under the accruals basis;
- The owner makes an annual election to use the accruals basis.

Capital and revenue expenditure
Expenses are recognised when paid and must be incurred 'wholly and exclusively' for the purpose of the property business. Care needs to be taken where expenditure has a dual purpose. Only the business element will be tax deductible.

Under the simplified cash basis, the capital versus revenue distinction is removed and all expenditure incurred wholly and exclusively for the purposes of the property business is allowed as a deduction from income unless it falls into any of the categories below:

- acquisition or disposal of a the whole or part of a property business ;
- provision, alteration or disposal of:
    - land;
    - an asset used in a dwelling house (this exclusion does not apply to FHL businesses in the UK or EEA) ;
    - non-depreciating assets (useful life of 20 years or more);

- assets not acquired or created for use on a continuing basis in a trade (eg expenditure on goodwill);
- cars, although capital allowances can be claimed by commercial and furnished holiday letting businesses;
- intangible assets (unless the asset has a definite, fixed life of fewer than 20 years);
- financial instruments.

Capital allowances cannot generally be claimed under the simplified cash basis. Therefore adjustments will be required for capital allowances on entry into the simplified cash basis. Generally, on entry into the simplified cash basis, balancing adjustments are required to reduce all the capital allowances pools to nil.

As long as the capital expenditure would have been deductible under the simplified cash basis, had it applied at the time the expenditure was originally incurred, and the asset has been fully paid for, the balancing allowances generated can be deducted from the cash basis profits.

Practically, many small property businesses may not be affected by this transitional rule because they will have no unrelieved expenditure in capital allowances pools as it has been covered by the annual investment allowance.

The capital expenditure rules for the cash basis for property businesses also apply for trades.