

Gains on destruction of business property (Lecture B1390 – 14.35 minutes)

In this article we are going to consider the implications for a trader whose main business premises is completely destroyed by fire.

Insurance proceeds are received split into loss of earnings, loss of equipment and loss of the building.

The loss of earnings will be taxed as income for the business and the compensation for the loss of equipment will be dealt with through capital allowances, with the proceeds being disposal proceeds for this purpose. The complication arises with the commercial building.

The clients have not yet decided if they are going to rebuild since the land may have greater value if they can get planning permission to rebuild as residential, rather than commercial, property. They will not be able to make a decision about this until they have consulted with planning officers.

Before considering the specific issues that this scenario raises, it might be worth starting by considering the legislation which underpins this situation.

S.24 TCGA 1992 states that there is a disposal of an asset on the occasion of 'the entire loss, destruction, dissipation or extinction' of that asset. If no proceeds are received, you would effectively get a capital loss arising equal to the allowable costs.

However, it appears that HMRC treat this as only applying where no disposal proceeds are received.

S.22 TCGA 1992 brings into charge as a disposal of an asset any sums received as compensation (typically by way of insurance but it would cover any compensation) for the damage or destruction of property. S.22(2) specifically states that the date of disposal is treated as being when the sum is received.

S.23 TCGA 1992 then allows for such a receipt not to be treated as a disposal where the capital sum is applied in replacing the asset.

There are two sets of provisions. The first is where the asset is not wholly lost or destroyed. In that case, the whole of the sum has to be used in restoring the asset, other than an amount which is small compared to the total receipts. In that case, the amount not used does not become chargeable, but instead is deducted from the base cost of the asset such that the gain on any subsequent disposal is reduced. If the base cost is very low such that you cannot deduct the full amount of the unused monies, the balance comes into charge.

In this context, the HMRC guidance at Capital Gains Manual paragraph 15703 states that 'small' represents 5% or less of the capital sum that has been received. If this is not met, so if more than 5% of the receipt is not utilised in replacing the asset, then the whole of the insurance receipt will become subject to tax.

The second set of provisions apply where the asset is wholly lost or destroyed. If the monies are used in replacing the asset, then there are specific provisions to mitigate the gain arising on the receipt. The mechanism is slightly different.

The consideration for the disposal of the old asset is treated as if it were of an amount so that no gain or loss arises on the disposal of the old asset. The excess of the consideration over this amount

reduces the base cost of the new asset so that the gain on that asset going forward would be greater.

This will only apply if the money is used within one year of receipt although the legislation does say 'or such longer period as the inspector may allow'. The HMRC guidance states that officers may extend the period to two years but cannot extend it beyond this point without referral to the technical specialists. The relief under s.23 has to be claimed and the guidance states that an extension to the replacement period can only be considered once the replacement asset has been acquired (or built in this case).

So, which of these provisions applies?

There is an issue with the interpretation of that provision when we are talking about buildings. This is because any building on land is part of the underlying land. You cannot destroy land so even if the buildings are completely destroyed, you do not have the entire loss of the asset as the land remains. However, the legislation treats the land and building as two separate assets. This means that the second set of provisions will apply.

In this current scenario, if there is a replacement of the property, the insurance proceeds are not subject to tax other than any amounts not utilised. It is correct that CGT would be due on any money remaining after the rebuild. It should be noted that the legislation refers to replacement of the asset. It does not have to be an absolute 'like for like' rebuild but it has to have the same function and facilities as the asset it replaced.

The caveat here is the timing of the rebuild. If there is a delay, then there may be a refusal by HMRC to apply the provisions of s.23 such that the whole of the insurance proceeds would fall within the charge to CGT. As noted, HMRC will not give an indication of whether they will extend the time limit until the project is complete.

As noted above, the date of disposal if any amounts become liable to CGT would be when the money is received. If it was thought that the buildings would be rebuilt, but then a decision was made not to do so, then any return that had been submitted on the basis that no gain would be arising (due to the rebuild) would have to be amended. It is appreciated that a decision has not yet been made, and may not be able to be made, before planning has been explored. If an amendment had to be made to an earlier return, HMRC would take that into account in determining if reasonable care had been taken in completing the earlier return. Interest would still arise on any tax which was paid late.

If the decision is made not to rebuild, then the insurance proceeds will be treated as disposal proceeds and the costs relating to the part of the assets destroyed (i.e., the building) will be allowable as a deduction in computing the potential gain. So, you would need to ascertain the value of the original build cost of the building that was destroyed.

You can do this in one of two ways and it appears that HMRC will accept either. If you know the original build costs for the property (and presumably it will be the cost of the original barns not the rebuilt barns) then you can use that.

Otherwise, you would get a value of the land now and apportion the original purchase price for the whole site using the formula:

$$\text{Cost} \times A/(A+B)$$

Where A is the insurance proceeds and B is the value of the land which remains.

In each cost, the proceeds would be net of allowable costs.

Again, the tax point is when the proceeds are received.

There is a provision which enables relief under s.23 to be obtained if you construct a replacement building somewhere else. However, it would have to be a replacement for the building that has been destroyed. Whilst there is no commentary on this in the HMRC manuals, it is likely that HMRC would focus on the use to which any new building is to be put. HMRC would expect the same use to be made of the new building.

If it was not a replacement of the existing building, then CGT would be payable as indicated above in relation to the situation where no rebuild occurs at all. This would apply in this scenario if the decision was made to build a residential unit on the same land although it is not clear whether they would seek planning and then just sell the land to a developer.

If they were to decide to sell the land for development but then buy a new piece of land to build on for the business, then HMRC might argue against this being replacement of the old asset, so there is no guarantee again that the tax can be mitigated.

There are also complications from a compliance perspective if the gain is not included on the tax return on the assumption it is to be reinvested and then that does not happen. Interest and late payment penalties will become due on the tax which has to be paid and there is the risk that HMRC could argue there has been an incorrect return submitted with consequential penalties.

Contributed by Ros Martin