CHAPTER 33

COMPENSATION FOR ASSETS DAMAGED

33.1 Introduction

TCGA 1992, s. 23

In the last chapter, we looked at how to calculate the capital gain when an asset was lost or completely destroyed. In this chapter, we shall consider the CGT implications of a taxpayer receiving compensation for an asset that is **damaged but not destroyed**.

If an asset is completely lost or destroyed, there is a full disposal for CGT purposes, the sale proceeds being equal to the compensation received. It therefore stands to reason, that if an asset is partly damaged but not completely destroyed, this is treated as a **part disposal** for CGT purposes.

As we are dealing with part disposals, to calculate the allowable cost for CGT purposes we will use the following formula:

$$\frac{A}{A + B} \times \text{original cost}$$

where A = compensation received
B = value of remaining asset ("unrestored" value)

The date of disposal for CGT purposes is the date that the compensation is received and not the date when the asset was originally damaged.

Illustration 1

Mark purchased a house for £90,000 in January 1987. In June 2009, the property was damaged in a flood. Mark made an insurance claim and in September 2010 received a compensation payment of £50,000.

The insurance company valued the house at £100,000 at this point. This is what we mean by the "unrestored" value.

As an asset has been partly damaged but not completely destroyed, there is a part disposal at the date that the compensation has been received – i.e. in September 2010.

2010/11	£
Compensation received	50,000
Less: allowable cost	
$£90,000 \times \frac{50000}{50000 + 100000}$	(30,000)
Chargeable gain	£20,000

Here we will assume that the house is not Mark's principal private residence. Under general principles, disposals or part disposals of one's PPR would qualify for principal private residence relief in the normal way.

33.2 Restoration of the asset

Presumably, having received compensation from the insurance company, the taxpayer would use all or part of that money in **restoring** the property. If the capital sum is spent on restoring the asset, we treat this as **enhancement expenditure** for CGT purposes.

Under normal principles, enhancement expenditure increases the base cost of the asset.

Illustration 2

Returning to the previous illustration assume that in March 2011, Mark spent £48,000 of his capital proceeds in restoring the property and Mark sold the house for £250,000 in August 2011.

Our requirement is to calculate the capital gain arising in 2011/12.

Sale proceeds are £250,000 from which we deduct Mark's base cost. Mark originally paid £90,000 for the property in January 1987. However when we calculated the gain on the part disposal in September 2010, we deducted £30,000 of this cost in arriving at Mark's capital gain.

Remaining base cost = £90,000 – 30,000 = £60,000.

To this we must add the enhancement expenditure – i.e. the money spent on restoring the property – in March 2011.

The calculation will be as follows:

2011/12	£
Proceeds	250,000
Less: remaining base cost	(60,000)
Less: enhancement expenditure	(48,000)
Gain	142,000

33.3 Claims to avoid this part disposal

TCGA 1992, s. 23(1)

The subject of compensation is dealt with by TCGA 1992, s.23. Under 23(1), the taxpayer may make a claim for the receipt of compensation not to be treated as a part disposal, as long as **one of three conditions** are satisfied.

1. The receipt of compensation is not treated as a part disposal for CGT purposes if **all of the compensation is used in restoring** or enhancing the asset.

2. A taxpayer can also make a claim under s.23 not to have a part disposal, if he does not use all of his compensation in restoring the asset, but the **amount retained is "small".** "Small" in this instance is defined by HMRC as being either **£3,000 or 5%** of the compensation received, whichever is the higher. TCGA 1992, s. 23(1)(b) RI 164

   This means that if a taxpayer receives compensation for damage to an asset, and after restoring the asset his proceeds retained are not more than £3,000, he will always be able to make a claim under s.23. However, if the taxpayer retains proceeds of more than £3,000, we must look at whether the proceeds retained exceed 5% of the compensation received. If the proceeds retained are not more than 5% of the compensation received, once again the taxpayer can make a claim under S.23.

3. A s.23 claim can always be made if the capital sum received by way of compensation is itself "small" – i.e. either not more than £3,000 or not more than 5% of the value of the asset.

Remember, that if a taxpayer does not make a claim under S.23 the receipt of compensation will be treated as a part disposal and a capital gain will arise in the usual way.

The claim must be made within 4 years from the end of the tax year of disposal.

Illustration 3

Going back to the illustration again, Mark bought a property in January 1987 for £90,000. The property was damaged and Mark received compensation of £50,000 in September 2010. In March 2011 he spent most of this money – i.e. £48,000 – in restoring the property.

The amount of compensation not reinvested by Mark is £2,000. Mark can make a claim under s.23, if the compensation not reinvested is "small". Anything not more than £3,000 is always regarded as small, therefore Mark will be able to make a claim under s.23.

Assuming Mark makes an appropriate claim, HMRC will not treat the receipt of compensation in September 2010 as a part disposal. Mark will not therefore have a capital gain in 2010/11. Instead HMRC will take the compensation received of £50,000, and **roll it over and deduct it from the base cost** of Mark's original asset.

Mark's base cost:

	£
Original cost	90,000
Less: compensation rolled over	(50,000)
CGT base cost	40,000

This will be used to calculate the capital gain when Mark eventually sells the asset. Remember that by reducing the base cost of the asset, HMRC are simply increasing the capital gain that will be charged in the future. Therefore a claim under s.23 does not extinguish the gain, but it simply **defers** it to a later period of time.

In August 2011 Mark sold the house and the capital gain will be calculated as follows:

	£	£
Sale proceeds (August 2011)		250,000
Original cost (January 1987)	90,000	
Less: Compensation "rolled over"	(50,000)	
	40,000	
Enhancement (March 2011)	48,000	
		(88,000)
Gain		£162,000

Cash profit:

	£	£
Cash received:		
Compensation	50,000	
Sale proceeds	250,000	
		300,000
Cash spent:		
Original cost	90,000	
Restoration	48,000	
		(138,000)
Cash profit		£162,000

33.4 Partial claims

TCGA 1992, s. 23(3)

If the compensation **proceeds retained** by the taxpayer are **not small**, a deferral claim can still be made under s.23, but this claim will be modified.

Illustration 4

Returning to the illustration again, assume that Mark spent £40,000 on restoring the property in March 2011. As you will see, Mark has retained £10,000 of the compensation he received.

We need to consider whether HMRC will regard this £10,000 as "small". As the proceeds retained are greater than £3,000 we must consider whether they are not more than 5% of the compensation received. Here £10,000 is clearly more than 5% of £50,000, so the proceeds retained are not small.

HMRC will allow Mark to make a claim under s.23, but this time the claim works in a different way. There **will be a part disposal** in 2010/11, but HMRC will **only tax the proceeds retained** of £10,000. This is on the basis that Mark only has £10,000 of cash available, so his sale proceeds are restricted to this amount.

As this is a part disposal, we must calculate Mark's base cost by using the following formula:

$$\frac{A}{A + B} \times \text{ original cost}$$

where A = compensation not used in restoration
B = the "restored" value of the property

Here the "A" in the fraction will be £10,000, whilst the "B" in the fraction will be the **"restored value"** of the property – i.e. the value of the house in March 2011, after the enhancement expenditure has taken place, which we shall assume is £190,000.

Do not forget that Mark received cash of £50,000 in September 2010. He will be taxed on £10,000 of these proceeds, leaving £40,000 worth of **proceeds used in restoration** to be **deferred.** This £40,000 will therefore be rolled over and will reduce the remaining cost of Mark's house on an eventual sale.

The calculation of the capital gain on the part disposal in September 2010 will be as follows:

Part disposal – September 2010	£
Compensation retained	10,000
Less: original cost $\times \frac{A}{A + B}$	
$90{,}000 \times \frac{10000}{10000 + 190000}$	(4,500)
Less: enhancement (March 2011) $\times \frac{A}{A + B}$	
$40{,}000 \times \frac{10000}{10000 + 190000}$	(2,000)
Gain	£3,500

Notice that in calculating the capital gain, HMRC also allow us to take a proportion of the enhancement expenditure incurred in March 2011. The restoration costs were £40,000, which we will multiply by "A over A plus B". The allowable restoration costs are therefore £2,000, giving Mark a gain of £3,500.

The final step is to calculate the capital gain on the sale of the property in August 2011. Mark sold the property for £250,000. From this we must deduct both the original cost remaining and any enhancement expenditure remaining.

Remaining base cost = £(90,000 – 4,500) = £85,500.

Enhancement expenditure remaining = £(40,000 – 2,000) = £38,000

Under the s.23 claim, £40,000 of the compensation proceeds were rolled over against the base cost of the house.

	£	£
Disposal proceeds (August 2011)		250,000
Original cost: (90,000 – 4,500)	85,500	
Enhancement: (40,000 – 2,000)	38,000	
	123,500	
Less: Compensation proceeds "rolled-over"	(40,000)	
		(83,500)
Gain		£166,500

A summary of the treatment for assets damaged with the s23 claims can be found at the end of this chapter.

Example 1

Violet bought a shop in January 1990 for £120,000 from which she runs a florists business.

In September 2010, the shop was damaged by a storm. It was valued at £150,000 at that point.

In October 2010 Violet received compensation of £100,000.

In December 2010 she spent £96,000 in restoring the shop.

Assuming a claim is made under s.23, calculate the base cost of Violet's shop for CGT purposes.

Example 2

Vincent bought a painting for £400,000 in May 2004.

The painting was damaged in a fire in October 2009. The fire-damaged painting was valued at £300,000.

On 12 April 2010 Vincent received £200,000 compensation from his insurance company.

In June 2010 the painting was restored at a total cost of £175,000. It was re-valued at £600,000 for insurance purposes.

Assuming appropriate claims are made, calculate Vincent's chargeable gain arising in 2010/11.

Answer 1

	£
Compensation received	100,000
Less: spent on restoration	(96,000)
Proceeds retained	£4,000

< 5% of £100,000 ∴"small"

No part disposal
Compensation fully rolled over

Base cost:	£
Original cost	120,000
Less: compensation rolled-over	(100,000)
Add: enhancement	96,000
Revised base cost	**£116,000**

Answer 2

	£
Compensation received (April 2010)	200,000
Less: spent on restoration	(175,000)
Compensation retained	£25,000

> 5% of £200,000 ∴not small

Tax the proceeds retained i.e. £25,000

Part disposal where A = £25,000
B = £600,000 (restored value)

April 2010	£
Compensation retained	25,000
Less: original cost × $\frac{A}{A + B}$	
$400,000 \times \frac{25000}{25000+600000}$	(16,000)
Less: enhancement costs × $\frac{A}{A + B}$	
$175,000 \times \frac{25000}{25000+600000}$	(7,000)
Gain	**£2,000**