McKie&Co

Case Note: **Simon McKie**

Underwood v Revenue and Customs Commissioners: ''A Dark Wood Where the Straight Way was Lost''[1]

Capital gains tax; Completion; Contracts for sale of land; Sale of land

It is regrettable that the Court of Appeal has lost an opportunity to clarify the concept of a CGT disposal in Underwood v Revenue and Customs Commissioners.[2]

The taxpayer's appeal in *Underwood v Revenue and Customs Commissioners* from the decision of the High Court has been heard by the Court of Appeal. The decisions of the Special Commissioner and of the High Court were examined in an article which appeared in two parts in P.C.B. in 2008.[3] In that article I said that the case brings ''sharply to the fore the question of what exactly is a disposal for capital gains tax purposes'' and explained that the High Court's decision, if it stood, would have:

> ''. . . profound effects upon two categories of very common transactions. It is to be hoped that it will be appealed so as to provide clarity both on the narrower issue of the taxation of contracts where, due to the interaction with another contract, the purchaser does not receive an unfettered right to the subject matter of the contract and

[1] Dante Alighieri, Divina Commedia, Inferno, Canto 1, line 1.

[2] *Underwood v Revenue and Customs Commissioners* [2008] EWCA Civ 1423; [2009] S.T.C. 239. The reference for the High Court decision is *Underwood v Revenue and Customs Commissioners* [2008] EWHC 108 (Ch); [2008] S.T.C. 1138 and for the Special Commissioner's decision is *Underwood v Revenue and Customs Commissioners* [2007] S.T.C. (S.C.D.) 659; [2007] S.T.I. 1795. In this article the Court of Appeal, High Court and Special Commissioner's decisions are referred to respectively as the ''Court of Appeal Decision'', the ''High Court Decision'' and the ''Special Commissioner's Decision''.

[3] Although the facts of the case were set out in the first article, for readers' convenience a summary is given in the box on pp.176–178 at the end of this article (to which reference should also be made for definitions of the terms used in this article).

> on the wider issue of the nature of a disposal for capital gains tax purposes.''

The decision

The Court of Appeal's decision has now been published and was again in favour of HMRC. It is disappointing, to say the least.

The leading judgment was delivered by Collins L.J. Goldring L.J. simply agreed with that judgment without further comment, whilst Lord Neuberger agreed with Collins L.J. in a two-page judgement which he described as ''no more than a coda to the more fully expressed judgement of Collins L.J., with which I wholly agree . . .''.[4]

A question of important principle?

Collins L.J. says in his introductory remarks that:

> ''The appeal does not raise any issue of principle, but concerns the (by no means easy) task of characterising, as a matter of law, what the parties did or must be taken to have done when the tripartite transaction was effected in 1994.''[5]

So the reader knows almost immediately that it is unlikely that the judgment will deal adequately with the fundamental issues at stake in the case.

The Special Commissioner's reasoning confirmed

As I explained in my previous article, both the Special Commissioner and the High Court took as their starting point that a disposal for capital gains tax purposes is the transfer of a beneficial interest in the subject matter of the disposal from one person to another. They both concluded that Mr Underwood's transactions did not constitute a disposal under the 1993 Contract, but they did so on significantly different grounds. The Special Commissioner accepted that the transactions taking place on November 30, 1994 completed both the 1993 Contract, the Resale Contract and the Brickfields Contract but held that there was no transfer of a beneficial interest in the property from Mr Underwood to Rackham Ltd under the 1993 Contract because:

[4] *Underwood v Revenue and Customs Commissioners* [2008] EWCA Civ 1423; [2009] S.T.C. 239 at [69].

[5] *Underwood v Revenue and Customs Commissioners* [2007] S.T.C. (S.C.D.) 659; [2007] S.T.I. 1795 at [7].

> ''. . . [T]here was no moment in time when the rights in the Property vested in Rackham Ltd because the very event which constituted payment by Rackham Ltd of the consideration under the contract also constituted payment by [Mr Underwood] under the [Resale] Contract made . . . in exercise of the option. The payment being by set-off there was not and could not be a moment in time when Rackham Ltd paid the appellant but the appellant had not paid Rackham Ltd.''[6]

In the High Court, however, Briggs J. held that neither the 1993 Contract nor the Resale Contract had been completed and it was for this reason that there was no transfer of the beneficial interest in the property under either Contract.[7]

In stating his decision, Collins L.J. specifically approved as correct ''the reasoning of the Special Commissioners''[8] but confusingly, in apparent contradiction of the Special Commissioners, he stated that:

> ''Mr Cunningham did not complete the sale of the property to Rackham Ltd and the Option was not actually exercised.''[9]

Lord Neuberger, who said that he wholly agreed with Collins L.J.'s judgement,[10] specifically endorsed the Special Commissioner's reasoning rather than that of Briggs J.:

> ''To that extent, I would agree with the Special Commissioners rather than Briggs J (although the difference between their respective analyses is very refined and pretty slight). While, as Briggs J said, it is a somewhat artificial analysis, the two contracts between Mr Underwood and Rackham Ltd were, in my opinion, performed, rather than cancelled, by the payment of the £20,000.''[11]

The outcome of the Appeal, therefore, seems to be consistent with the expectations which I expressed in my previous article:

> '' . . . the High Court's decision surely cannot stand, because it is based on a substitution of the facts found by Briggs J. for the facts found by

[6] *Underwood v Revenue and Customs Commissioners* [2007] S.T.C. (S.C.D.) 659; [2007] S.T.I. 1795 at [668].

[7] *Underwood v Revenue and Customs Commissioners* [2008] EWHC 108 (Ch); [2008] S.T.C. 1138 at 1156 and 1157.

[8] *Underwood v Revenue and Customs Commissioners* [2008] EWCA Civ 1423; [2009] S.T.C. 239 at [55].

[9] *Underwood v Revenue and Customs Commissioners* [2008] EWCA Civ 1423; [2009] S.T.C. 239 at [48].

[10] *Underwood v Revenue and Customs Commissioners* [2008] EWCA Civ 1423; [2009] S.T.C. 239 at [70].

[11] *Underwood v Revenue and Customs Commissioners* [2008] EWCA Civ 1423; [2009] S.T.C. 239 at [65].

> the Special Commissioners and not on an application of the law to the facts found by the fact-finding tribunal.

That may not help Mr Underwood, however, because, contrary to Briggs J.'s view, there is no logical contradiction between the fact that Rackham Ltd did not obtain a beneficial interest in the Property and that payments were made under the contracts by way of set-off . . . It seems clear to the author that both contracts were . . . performed. Unfortunately for Mr Underwood, the mode of performance did not involve Rackham Ltd acquiring a beneficial interest in the Property for even a *scintilla temporis* except a limited and temporary interest under the doctrine of the estate contract and, on the admittedly rather opaque authority of *Jerome v Kelly (Inspector of Taxes),* that did not constitute a disposal.''

What is a disposal?

In his judgment Collins L.J. does pose the question which is crucial to the case: ''What then is a disposal of land for the purposes of capital gains tax?''.[12]

His consideration of that question, however, is cursory. He concludes it by recording that:

> '' . . . it was common ground in this Appeal that . . . [a disposal] . . . meant the disposal of the entire beneficial interest in the assets.''[13]

He does not examine the case authority for this definition of a disposal. No doubt a disposition involving the transfer of the entire beneficial interest in an asset is a disposal for capital gains tax purposes, but holding that only such a disposition can be a disposal raises severe difficulties.

Difficulties with the definition

If there is only a disposal where the entire beneficial interest in an asset has been transferred, how can one have a part disposal within s.21(2)(a)? For under Collins L.J.'s definition if the entire beneficial interest in the asset were not transferred there would be no disposal at all and not a disposal of part of the asset. So it appears that under Collins L.J.'s definition the grant by a freeholder of a tenancy in common would not be a disposal. Even if one accepts the argument that the word ''disposal'' in the phrase ''part disposal'' in s.21(2)(a) bears a different meaning from its meaning when it is used without the adjective in the same

[12] *Underwood v Revenue and Customs Commissioners* [2008] EWCA Civ 1423; [2009] S.T.C. 239 at [39].

[13] *Underwood v Revenue and Customs Commissioners* [2008] EWCA Civ 1423; [2009] S.T.C. 239 at [40].

sub-section so that the transfer of a beneficial interest in less than the whole of an asset would constitute a disposal, it would then be difficult, as I explained in my previous article, to reconcile the decision in *Jerome v Kelly (Inspector of Taxes)*[14] with the doctrine of the Estate Contract and with *Lysaght v Edwards*[15] in particular.

Bed and breakfast and sub-sale transactions

A major difficulty with Collins L.J.'s definition of a disposal and his application of it to the 1993 Contract is that it has the result of overturning the long-established and accepted treatment of bed and breakfast transactions and of sub-sales.

I pointed out in my previous article that the same reasoning that led the Special Commissioner (and now Collins L.J.) to conclude that there had been no disposal by Mr Underwood to Rackham Ltd under the 1993 Contract would also lead to the conclusion that there are no disposals in the common form of bed and breakfast contractions and only a single disposal from the original vendor to the final purchaser in sub-sale transactions. Indeed, Counsel for Mr Underwood made this very point in the Court of Appeal. Neither Collins L.J. nor Lord Neuberger made more than a cursory examination of the implications of their decisions for these two very common forms of transactions.

Bed and breakfast transactions

Collins L.J. merely said in relation to bed and breakfast transactions:

> ''I do not consider that Mr Underwood is assisted by reliance on other types of transaction which are said to be similar. In ''bed and breakfast'' transactions the owner of the asset disposes of it and then re-acquires it: *MacNiven v Westmoreland Investments* [2001] UKHL 6, (1998) 73 TC 1, 48, affd [2003] 1 AC 311.''[16]

This comment simply begs the question. As I pointed out in my previous article, in the conventional form of bed and breakfast transaction, two contracts for the sale and purchase of securities are settled, just as the 1993 Contract and the Resale Contract were settled, by setting off against each other the equal and opposite obligations under the two Contacts to transfer the subject matter of the Contract and by setting off the obligations under the two Contracts to make payments with the result that no transfer of the subject matter of the Contracts is made and only a net sum is paid. These are the very characteristics that led

[14] *Jerome v Kelly (Inspector of Taxes)* [2004] UKHL 25; [2004] S.T.C. 887.
[15] *Lysaght v Edwards* (1875-76) L.R. 2 Ch. D. 499 Ch D.
[16] *Underwood v Revenue and Customs Commissioners* [2008] EWCA Civ 1423; [2009] S.T.C. 239 at [54].

the Special Commissioner, Collins L.J. and Lord Neuberger to conclude that no disposal had been made under the 1993 Contract. In distinguishing bed and breakfast transactions from Mr Underwood's transactions on the basis that in the former, ''the owner of the asset disposes of it'' Collins L.J. begs the very question which has to be answered.

Similarly, Lord Neuberger says:

> ''I should also mention Mr Soares's point that, if we dismiss this appeal, it would call into question the validity of the standard 'bed and breakfast' arrangements entered into by the holder of an asset (normally a parcel of shares) to crystallise a capital loss by selling, and immediately repurchasing, the asset. In such cases, there are two reciprocal transactions, under which the original holder of the asset can fairly be said to dispose of his interest in the asset, and immediately thereafter to re-acquire it.''[17]

This begs the question of why, in bed and breakfast transactions, ''the original holder of the assets can fairly be said to dispose of his interest in the asset''. What are the characteristics of a bed and breakfast transaction which are not found in Mr Underwood's transactions that allows one to come to that conclusion? It is clear that there are none. As I said in my previous article:

> ''It is difficult to see, however, why, if the arrangements for the settlement of the 1993 Contract and the Resale Contract in *Underwood* did not amount to performance of those contracts, the settlement of the bed and breakfast transactions by set-off of both the obligations to pay and the obligations to deliver securities should not also be insufficient to amount to performance. If the Special Commissioners' reasoning is restored, [as it has been by the Court of Appeal] it is clear that it must also apply to bed and breakfast transactions because in such transactions there is no point in time at which the institution can call for delivery of the shares from the taxpayer.''

Sub-sales

Again, Collins L.J.'s conclusions in relation to sub-sales are simply circular. He distinguishes sub-sales from Mr Underwood's transactions on the basis that in sub-sales there are two disposals.[18] Lord Neuberger's consideration of sub-sales is only slightly fuller:

[17] *Underwood v Revenue and Customs Commissioners* [2008] EWCA Civ 1423; [2009] S.T.C. 239 at [66].

[18] *Underwood v Revenue and Customs Commissioners* [2008] EWCA Civ 1423; [2009] S.T.C. 239 at [54].

> ''I also accept that, where an asset is the subject of an initial contract and a sub-contract, and, on completion of the two contracts, the buyer directs the seller to transfer direct to the sub-buyer, there are two disposals, one under each contract. However, that is because it can fairly be said that the asset is disposed of under each contract, albeit that the mechanics of the transaction involve an acceleration, or conflation, of the two disposals. The essential point is that, on completion, as between the buyer and seller, the asset is 'disposed of and acquired under the [initial] contract' (and, indeed, under the sub-contract) whereas that cannot be said about the Property under the 1993 contract (or, indeed, under the 1994 contract). An important difference between the sub-sale case and this case is that, here, the contractual arrangements between Mr Underwood and Rackham Ltd formed no part of the contractual chain, or what one might call the chain of equitable title, between the initial seller of the Property (Mr Underwood) and its ultimate buyer (Brickfields). Thus, Rackham Ltd, unlike the buyer/sub-seller in the sub-sale case, was not in a position to direct the sale of the Property to Brickfields (or, thus, to turn the Property to account).''[19]

So Lord Neuberger concludes that there are two disposals in a sub-sale ''one under each contract'' because ''. . . it can fairly be said that the asset is disposed of under each contract.'' That is obviously a circularity.

Lord Neuberger considers that the key question is whether there is an asset which is disposed of and acquired at the date of completion:

> ''[Counsel for the taxpayers] argument rests, indeed depends on, on an asset being disposed of and acquired at the date of completion as opposed to the date of contract.''[20]

In Lord Neuberger's view as in the view of the Special Commissioner, for there to be a disposal, completion of the contract must vest a beneficial interest in its subject matter in a person other than the disponer for at least a moment. In a typical sub-sale contract where contracts between A and B and between B and C for the sale of a property are completed by a transfer of the property from A to C and simultaneous payment of the consideration under the contracts partly by way of set-off, there will be no moment at which B can call for a transfer of the property from A. B, to adopt Lord Neuberger's words, is never in a position to direct the sale of the propety to C although he is in a position to enter into

[19] *Underwood v Revenue and Customs Commissioners* [2008] EWCA Civ 1423; [2009] S.T.C. 239 at [67].

[20] *Underwood v Revenue and Customs Commissioners* [2008] EWCA Civ 1423; [2009] S.T.C. 239 at [62].

a sales contract with C in respect of the property just as Rackham Ltd entered into a contract to sell the property back to Mr Underwood and might just as well have entered into a contract to sell the property to Brickfields. The important point is that B does not acquire at any time an interest in the property other than an interest under the doctrine of the Estate Contract because he does not have a right to call for the transfer of the property to him before the Contract is completed and, at the moment that the Contract is completed, it is completed by transferring the property direct to C in satisfaction of C's contractual right against B.

I have quoted above the Special Commissioner's explanation of why the effect of the 1993 Contract and the Resale Contract taken together was that Rackham Ltd did not acquire at any time a beneficial interest in the property. If one simply substitutes in that passage the parties under a typical sub-sale transaction one can see that the same reasoning leads to the conclusion that B does not make a disposal.

> ''. . . [T]here was no moment in time when the rights in the Property vested in [B] because the very event which constituted payment by [B] of the consideration under the [First] contract also constituted payment by [C] under the [Second] Contract. The payment being by set-off there was not and could not be a moment in time when [B] paid . . . [A] but [C] had not paid [B].''

Of course, the fact that, if one were to apply the ratio decidendi in *Underwood*, the most common forms of bed and breakfast and sub-sale transactions would have very different tax consequences from those which have been assumed to apply for the entire time that capital gains tax has existed, does not of itself have the result that the decision is incorrect.

A fog of uncertainty

At the very least, however, the implications of the decision for the coherence of CGT and of the taxation of these very common forms of transactions should have received more substantial consideration by the Court of Appeal.

Collins L.J.'s failure to recognise that the case depended upon a fundamental principle of CGT and the unlikelihood that the taxation of two common classes of transactions has been fundamentally misunderstood throughout the history of tax should surely have been sufficient for the House of Lords to grant leave to appeal. I understand, however, that leave to appeal to the House of Lords has not been granted. It is regrettable that it has refused this opportunity to resolve the conceptual incoherence caused by the Court of Appeal's decision. Those trying to ascertain how transactions under an executory contract providing for the transfer of the subject matter of the contract to the purchaser which, because

of its interaction with another contract, does not take place will now be subject to considerable uncertainty. Collins L.J.'s and Lord Neuberger's comments on sub-sale transactions will provide little comfort, begging, as they do, the essential question at issue in the case.

The dramatis personae

The dramatis personae in the case were Mr Underwood and two companies which he controlled, being Brickfields Estate Ltd (Brickfields) and Mac Estates Ltd (Mac Estates) and Mr Rackham and two companies which he controlled, being Anti-Waste Limited (Anti-Waste) and Rackham Ltd.

The facts

Mr Underwood's purchase of the property

On May 24, 1990 Anti-Waste sold a commercial property (the Property) to Mr Underwood for £1.4 million. His acquisition was partially financed with a £1 million mortgage from a bank (the Bank) secured on the Property.

The 1993 Contract

On the April 2, 1993 Mr Underwood entered into a contract (the 1993 Contract) with Rackham Ltd for the sale of the Property for £400,000 with a completion date of the December 31, 1993.

The Option

Also on the April 2, 1993 Rackham Ltd granted an option (the Option) to Mr Underwood under which he had the right to re-purchase the Property at any time before the December 31, 1995. The exercise price was to be £400,000 plus the cost of any capital improvements made by Rackham Ltd and 10 per cent of the difference between the value of the property at the date of the option agreement and its value at the date of exercise. Completion was to be 28 days after the date of exercise.

On April 28, 1993 the Property was valued at £400,000 on the open market and at £290,000 in the event of a forced sale.

The return for 1992/1993

In his tax return for the fiscal year 1992/1993 Mr Underwood claimed a loss on this transaction of £1,174,677.

Delayed completion of the 1993 Contract

The Bank would not permit the sale to Rackham Ltd to proceed until the loan was repaid and so Rackham Ltd and Mr Underwood agreed to extend the completion date of the 1993 Contract to December 31, 1994.

Negotiating a re-financing

It appears that Mr Underwood then negotiated a re-financing of his obligations. A Building Society (the First Building Society) agreed to loan £1.25 million to Mac Estates secured by a charge on a property owned by that company.
Another Building Society (the Second Building Society) agreed to grant a loan of £355,000 to Brickfields secured on the Property. It was a requirement of both loans that the Property should be sold to Brickfields and the loans were only to be released when that happened.

The Resale Contract

Mr Underwood determined to exercise the Option so as to be in a position to sell the Property to Brickfield.
Peculiarly, Mr Underwood did not give notice under the Option, but rather a new agreement (the Resale Contract) was made between Mr Underwood and Rackham Ltd dated November 29, 1994 under which Rackham Ltd agreed to sell the property to Mr Underwood for £420,000. This amount was calculated as being 10 per cent of the increase in the value of the property between the date of the option (£400,000) and the date of the Resale Contract (£600,000).

The Brickfields Contract

Also on November 29, 1994, the appellant entered into another contract (the Brickfields Contract) under which he agreed to sell the property to Brickfields for the sum of £600,000. At this stage the date of completion of the 1993 Contract was December 31, 1994 and of the Resale Contract and the Brickfields Contract was December 19, 1994.

The completion(s)?

On November 30, 1994 Mr Underwood executed a transfer of the Property directly to Brickfields in consideration of the sum of £600,000. On the same day Brickfields mortgaged the Property to the Second Building Society and received £353,000 from them. At ''about the same time'' Mac Estates mortgaged its property to the First Building Society and received a mortgage loan from it ''of which £250,000 was available to redeem the loan on the Property''. £640,000 was paid to the Bank with Mr Underwood finding the balance of £37,000 (£640,000 - £353,000 - £250,000) from his own resources. The Bank then released its charge on the Property. Mr Underwood did not pay the £20,000 to Rackham Ltd until December 4, 1996, Rackham Ltd's books showing a debtor for that amount in the meantime.

The 1993/1994 and 1994/1995 Returns

Mr Underwood made no chargeable gains in 1993/1994 and therefore carried forward the unrelieved 1993 losses to 1994/1995 when he set off the greater part of them against chargeable gains.

The assessments

The Revenue's position was that there was no disposal under the 1993 Contract but only under the Brickfields Contract. The result of that, presumably, was that Mr Underwood did not make a capital loss in 1992/1993 and in 1994/1995

Mr Underwood would have made a loss of £800,000 (£1.4 million - £600,000) plus an amount equal to the applicable indexation relief and the incidental costs of acquisition and disposal. This loss, however, was a loss on a disposal to a connected person and therefore, by virtue of the Taxation of Chargeable Gains Act 1992 s.18, was only off-settable against other disposals to Brickfields.