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Case Note: Underwood v HMRC: Mysterium sub Silua—Part 1

LT Beneficial ownership; Capital gains tax; Completion; Contracts for sale of land; Disposals; Sale of land

In the first of two articles on the High Court decision in Underwood v HMRC*, Simon McKie examines the nature of a disposal for capital gains tax purposes.*

Capital gains tax was introduced some 43 years ago. It is, and has been since its introduction, chargeable on capital gains ''accruing to a person on the disposal of assets''[1]. One might have thought, therefore, that the nature of a disposal for capital gains tax would, by now, be absolutely clear. In fact there is no general definition of a disposal to be found in the legislation, although particular provisions extend the meaning of the word to various transactions and other situations which would, or might, not be disposals within the general definition.[2] Nor is a coherent treatment to be found in case law. The nature of a disposal is discussed only obliquely in the decided cases.[3]

The recent decisions by the Special Commissioners and by Briggs J. in the High Court in the case of *Underwood v HMRC* bring sharply to the fore the question of what exactly is a disposal for capital gains tax purposes.[4]

[1] Taxation of Chargeable Gains Act 1992 s.1(1). All references in this article are to the Taxation of Chargeable Gains Act 1992 unless otherwise stated.

[2] TCGA 1992 ss.21–27.

[3] The standard practitioners' text are also disappointing in their treatments of the subject. The most substantial discussion is to be found in *Whiteman on Capital Gains Tax*, 4th edn (Sweet & Maxwell, 2007).

[4] *Underwood v HMRC* [2008] EWHC 108 (Ch) (The Special Commissioners' reference was [2007] S.T.C. (S.C.D.) 659. In the article that follows the High Court decision is referred to simply as the ''High Court Decision'' and, similarly, the Special Commissioners' decision is referred to as the ''Special Commissioners' Decision''.

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 Ltd (Anti-Waste) and Rackham Ltd. Although the terms on which Mr Underwood on the one hand and Mr Rackham and his companies on the other dealt with one another were sometimes not such as one would expect between persons with a purely business connection, the Special Commissioner's decision does not record that there was any other form of connection between them.

The facts

Mr Underwood's purchase of the Property

On May 24, 1990 Mr Rackham purchased a commercial property (the Property) for £950,000 and on July 16, 1990 he sold this property to Anti-Waste for £1.4 million. On the same day, Mr Underwood purchased it from Anti-Waste. His acquisition was partially financed with a £1m mortgage from a bank (the Bank) secured on the Property. It seems that the same solicitor, a Mr Cunningham, acted for all parties on all transactions considered in the case.

The 1993 Contract

The property market worsened and the Bank began moves to call in its loan. On 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 December 31, 1993. The purpose of this transaction is not recorded, but it was accepted by the Special Commissioners that it was not undertaken for tax planning purposes, although its timing might have been affected by tax considerations.

The Option

Also on April 2, 1993 Rackham Ltd entered into an option agreement (the Option) with Mr Underwood granting Mr Underwood a call option to re-purchase the Property at any time before December 31, 1995. Mr Underwood gave one pound for this option. 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. In the High Court Briggs J. commented:

> ''[T]he decision affords no explanation why Rackham was prepared, by the combination of the 1993 contract and the option, to incur all the risks of a fall in value of the property, while at least potentially limiting itself to only a 10% share of any increase in value. Nonetheless, and after a full enquiry by HMRC, it was common ground that the 1993 contract and the option were to be treated as arms length commercial transactions.''[5]

The tax return for 1992/93

In his tax return for the fiscal year 1992/93 Mr Underwood claimed a loss on this transaction of £1,174,677 (£1,400,000 - £400,000 less indexation relief and ''other deductions'' which were presumably the incidental costs of acquisition and disposal). Against this loss he set a gain of £659,095 and carried forward the balance.

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 in the following way.

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 having obtained a formal valution of the property on September 28, 1994, valuing it at £750,000 on an open market valuation and at £600,000 on a forced sale basis. 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.

With unpaid interest Mr Underwood's liability to the Bank had mounted to £1,160,000. On November 23, 1994 the Bank agreed to accept the sum of £640,000 from Mr Underwood in full discharge of this liability. As an aside, therefore, Mr Underwood had achieved a write off of his liability of £520,000, a benefit which was, presumably, tax free.

[5] High Court Decision at 1149.

The Re-Sale Contract

In order to achieve his re-financing, Mr Underwood had to be able to sell the property to Brickfields, but he had already contracted under the 1993 Contract to sell it to Rackham Ltd for £400,000 with completion to take place on December 31, 1994.

So Mr Cunningham determined to exercise the Option in order to be in a position to sell the Property to Brickfield. The documentation for dealing with the 1993 Contract, the Option and the sale to Brickfield was all dealt with by Mr Cunningham and it is to be assumed that he also dealt with the redemption of the bank's mortgage and the loan on mortgage by the two building societies.

Peculiarly, Mr Underwood did not give notice under the Option, but rather a new agreement (the Re-Sale 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 Re-Sale Contract (£600,000). The oddity that the forced sale value should have been used rather than the open market value was not commented upon either by the Special Commissioners or by Briggs J. in the High Court. It was accepted by both parties to the appeal that the contract was in effect the exercise of the option and this seems also to have been accepted by the Special Commissioners.[6] No completion date was given in the Re-Sale Contract, but the Standard Conditions of Sale applied so that completion was to be 20 working days after the date of the contract; that was December 19, 1994.

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. Again, because the date of completion was left blank, the Standard Conditions of Sale applied so that completion was to be on December 19, 1994. So at this stage the date of completion of the 1993 Contract was December 31, 1994 and the date of the Re-Sale Contract and the Brickfields Contract was December 19, 1994.

The completion(s)?

It was decided that in order to avoid stamp duty there would be only one transfer of the Property from Mr Underwood to Brickfields and that the obligations to make payments arising under the 1993 Contract and the Re-Sale Contract would

[6] Special Commissioners' Decision at para.664.

be netted off so that Mr Underwood would pay £20,000 (£420,000 - £400,000) to Rackham Ltd.

On November 30, 1994 Mr Underwood executed a transfer of the Property 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 1993/94 and 1994/95 returns

Mr Underwood made no chargeable gains in 1993/1994 and therefore claimed to carry forward the unrelieved 1993 losses to 1994/1995. In that year his return showed a gain on the disposal to Brickfields of £176,962 (£600,000 - £420,000 less, presumably, the incidental costs of disposal and acquisition). He set the brought forward 1993 loss against this gain and against other gains arising in the year of £327,428. This appears to have left a small amount of the brought forward 1993 loss to be carried forward to future years.

The assessments

An oddity of the case is that the assessments against which Mr Underwood appealed were estimated assessments which bore no relation to the amounts which would be assessable under the Revenue's view of the transactions. The Revenue had assessed tax of £1,680 on chargeable gains of £10,000 in respect of the tax year 1992/1993 and tax of £237,608 on an amount of chargeable gains which is not specified in the Special Commissioner's decision in respect of the tax year 1994/1995. The Revenue's position, accepted by both the Special Commissioners and the High Court, although on different grounds, 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 1992/93 and was therefore assessable on the gains he had realised in that year of £659,095. In 1994/1995, on the Revenue's position, 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. Therefore, Mr Underwood would have been assessable on the other gains realised in the year of £176,962.

What is a disposal?

The Special Commissioners' decision

The Special Commissioners' decision was a decision in principle with the actual assessable amount to be agreed between the parties within one month or, failing agreement, by the Special Commissioners.

Although the Special Commissioners accepted that full payment had been made under the 1993 Contract and under the Re-Sale Contract of the sale considerations of £400,000 and £420,000 respectively provided for by those contracts, in their view there had been no disposal by Mr Underwood and no acquisition by Rackham Ltd under the 1993 Contract and, by implication of that decision, no disposal by Rackham Ltd under the Re-Sale Contract and no acquisition under that contract by Mr Underwood.

They reached this view on the basis that the question at issue was whether Rackham Ltd had ever acquired the Property as beneficial owner. The Special Commissioners concluded that it had not because:

> ". . . [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 [Re-Sale] 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."[7]

The Special Commissioners did not specifically say that a disposal constituted a transfer of beneficial ownership in an asset from one person to another, but that is plainly their assumption.

Transfer of beneficial ownership in an asset

Briggs J. in the High Court made that assumption explicit and adopted it:

> " . . . [T]he capital gains tax legislation does not define what is meant by a disposal, but s.60 of the 1992 Act does have the effect of directing attention away from the transfer of bare legal title to an asset and towards the transfer of beneficial ownership. In the words of Lord

[7] Special Commissioners' Decision at 668.

Nicholls in *Kirby (Inspector of Taxes) v Thorn EMI Plc* [1987] STC 621 at 625, [1988] 1 WLR 445 at 450:

> ' . . . the basic structure of the tax is of a charge on gains accruing to a person on disposal of an asset by him. There is no statutory definition of disposal but, having regard to the context, what is envisaged by that expression is a transfer of an asset (i.e. of ownership of an asset), as widely defined, by one person to another . . . '
>
> This therefore means the beneficial ownership rather than bare legal title.''[8]

Berry v Warnett

In delivering the leading speech in the House of Lords judgment in *Berry v Warnett (Inspector of Taxes)*[9], Lord Wilberforce said that:

> '' . . . [Capital Gains] tax is levied on chargeable gains accruing on the disposal of assets . . . there is no limitation on the generality of the word 'disposal', which must be taken to bear its normal meaning.''

It might be thought that Briggs J.'s understanding of the nature of a disposal does not do justice to Lord Wilberforce's emphasis on the width of the word or on its not being a technical usage. It is quite clear, however, that ''disposal'' is used in a narrower sense in the capital gains tax legislation than in general usage. The second edition of the Compact Oxford English Dictionary defines ''disposal'' as the ''action or process of disposing'' and gives as the primary meanings of ''dispose'':

> ''(1) get rid of, (2) arrange in a particular position, (3) give, sell or transfer (money or assets), (4) incline (someone) towards a particular activity or frame of mind.''

It is clear that (3) and (4) form no part of the definition of a ''disposal'' for capital gains tax purposes and (2) encompasses concepts which have been given a technical meaning in the law whilst (1) will surely cover many situations which have never been thought to be capital gains tax disposals.

Taxation of Chargeable Gains Act 1992 s.60

If Briggs J. is correct and a disposal is a transfer of the beneficial ownership of an asset, one might wonder what is the function of the Taxation of Chargeable Gains

[8] High Court Decision at 1150 & 1151.
[9] *Berry v Warnett (Inspector of Taxes)* [1982] S.T.C. 396 at p.399.

Act 1992 s.60 which treats property held on bare trusts as if the property were vested in, and the acts of the nominee or trustee in relation to the assets were the acts of, the person or persons for whom he is a nominee or trustee (acquisitions from or disposals to him by that person or persons being disregarded accordingly). On reflection one realises that the rule is necessary to deal not with disposals but with other matters, for example, with acquisition costs; so, for example, even if one defines a disposal as being a transfer of a beneficial interest one still has to determine what costs have been given by the disponer for the acquisition of the asset within s.38(1)(a).

Taxation of Chargeable Gains Act 1992 s.70

Briggs J.'s views are also consistent with the treatment of transfers into settlement under the Taxation of Chargeable Gains Act 1992 s.70 which provides that such a transfer is a disposal of the entire property thereby becoming settled property, notwithstanding that the transferor has some interest as a beneficiary under the settlement and notwithstanding that he is a trustee, or the sole trustee, of the settlement. That provision is only necessary if disposals are transfers of beneficial interests rather than transfers of legal interests.

Promissory contracts

More difficult issues are raised by disposals under a promissory contract, that is, a contract which is to be executed at a time after the contract is made.

The doctrine of the estate contract

It is clear from nineteenth-century authorities[10] that under the Doctrine of the Estate Contract a contract for the sale of land vests an equitable interest in that land in the purchaser before completion and divests the vendor of at least some part of his equitable interest in that land. In *Underwood*, the Special Commissioners specifically stated that:

> ''The fact that Rackham Ltd acquired an equitable interest in the contract prior to performance did not constitute a disposal or a part disposal, see *Jerome v Kelly (Inspector of Taxes)* [2004] STC 887 at [32] and [45].''[11]

Briggs J. in the High Court did not explicitly say that the disposal under a promissory contract which is subsequently performed is constituted by the

[10] *Paine v Meller* [1801] 6 V.E.S. 349; *Broome v Monck* [1805] 10 V.E.S. 597; *Wall v Bright* [1820] 37 E.R. 456; and *Lysaght v Edwards* (1875-76) L.R. 2 Ch. D. 499.

[11] Special Commissioners' Decision at 668.

transfer on completion and not at all by the formation of the contract but he did quote Lord Hoffman's words in *Jerome v Kelly* in relation to the Taxation of Chargeable Gains Act 1992 s.28(1) in which Lord Hoffman unequivocally accepted that the contract does not itself "count as a disposal":

> " . . . [W]hatever may be the explanation, it seems to me clear that the paragraph was intended to deal only with the question of fixing the time of disposal and not with the substantive liability to tax. It does not deem the contract to have been the disposal as the 1962 Act had done. For that reason, it includes no provisions dealing with what happens if the contract goes off. In such a case, there will be no disposal and nothing to deem to have happened at the time of the contract. The time of the contract is deemed to be the time of disposal only if there actually is a disposal. This assumes that the contract will not in itself count as a disposal and so deals with the academic arguments about the effect of the equitable interest which arises at the time of the contract . . . ".[12]

Why, if a disposal for capital gains tax purposes is a transfer of the beneficial interest, did the House of Lords conclude in *Jerome v Kelly* that a contract is not itself a disposal? Lord Hoffman seems to deduce that principle from the form of the Taxation of Chargeable Gains Act 1992 s.28.[13] In his leading speech in that case, however, Lord Walker seems to base his conclusion on the limited and provisional nature of the interest vested in the purchaser by the formation of a contract:

> "[T]here is a useful summary [of the relevant case law on the doctrine of the estate contract] in the judgment of Mason J in *Chang v Registrar of Titles* [1976] 137 CLR 177 at 184:
>
> 'It has long been established that a vendor of real estate under a valid contract of sale is a trustee of the property sold for the purchaser. However, there has been controversy as to the time when the trust relationship arises and as to the character of that relationship. Lord Eldon considered that a trust arose on execution of the contract (*Paine v Meller* (1801) 6 Ves 349, 31 ER 1088; *Broome v Monck* (1805) 10 Ves 597, 32 ER 976). Plumer MR thought that until it is known whether the agreement will be performed the vendor "is not even in the situation of a constructive trustee; he is only a trustee sub modo, and providing nothing happens to prevent it. It may turn out that the title is not good, or the purchaser may be unable to pay" (*Wall v Bright* (1820) 1 Jac & W 494 at 501, 37 ER 456 at 459). Lord Hatherley said that the vendor

[12] High Court Decision at 1150.
[13] *Jerome v Kelly* [2004] S.T.C. 887 at 891.

> becomes a trustee for the purchaser when the contract is completed, as by payment of the purchase money (*Shaw v Foster* (1872) LR 5 HL 321). Jessel MR held that a trust sub modo arises on execution of the contract but that the constructive trust comes into existence when title is made out by the vendor or is accepted by the purchaser (*Lysaght's* case). Sir George Jessel's view was accepted by the Court of Appeal in *Rayner v Preston* (1881) 18 Ch D 1). It is accepted that the availability of the remedy of specific performance is essential to the existence of the constructive trust which arises from a contract of sale.'
>
> See also the judgment of Jacobs J (at 189-190), concluding that—
>
> '[w]here there are rights outstanding on both sides, the description of the vendor as a trustee tends to conceal the essentially contractual relationship which, rather than the relationship of trustee and beneficiary, governs the rights and duties of the respective parties.'
>
> It would therefore be wrong to treat an uncompleted contract for the sale of land as equivalent to an immediate, irrevocable declaration of trust (or assignment of beneficial interest) in the land. Neither the seller nor the buyer has unqualified beneficial ownership. Beneficial ownership of the land is in a sense split between the seller and buyer on the provisional assumptions that specific performance is available and that the contract will in due course be completed, if necessary by the court ordering specific performance. In the meantime, the seller is entitled to enjoyment of the land or its rental income. The provisional assumptions may be falsified by events, such as rescission of the contract (either under a contractual term or on breach). If the contract proceeds to completion the equitable interest can be viewed as passing to the buyer in stages, as title is made and accepted and as the purchase price is paid in full.''[14]

If Lord Walker simply meant that an uncompleted contract for sale does not irrevocably vest an absolute interest in the land in the purchaser then he was obviously correct. But if he meant to say that a contract does not create an immediate equitable interest in the land for the purchaser, albeit limited and subject to contingencies, it is difficult to reconcile his view with the decision in *Lysaght v Edwards* in which Jessel M.R. held that if a valid contract is cancelled for non-payment of the purchase money after the death of the vendor, his property will still in equity be treated as having been converted into personalty at the time of his death, because the contract was valid at his death with the result that it would devolve under bequests of personalty. It seems clear, therefore, that a contract vests an equitable interest in the purchaser, albeit a limited one and

[14] *Jerome v Kelly* [2004] S.T.C. 887 at 896 & 897.

one which will be terminated if the purchaser does not fulfil his obligation to pay the purchase money or repudiates the contract.

Understanding Jerome v Kelly

How then does one understand the House of Lords' decision in *Jerome v Kelly*? It seems to the author that the grounds for Lord Walker's view are to be found in his discussion of the effect of provisions now found in s.28 which were formerly in s.27 of the Capital Gains Tax Act 1979:

> ''[S]ection 27(1) appears to be directed to a single limited issue, that is the timing of a disposal. It does not say that the contract is the disposal, but that a disposal effected by contract and later completion is to be treated, for timing purposes, as made at the date of the contract. Its language is not so clear and compelling as to lead to the conclusion that Parliament must have intended to introduce a further statutory fiction as to the parties to a disposal. The differences between Park J and the Court of Appeal are more complex than that and cannot be resolved by a single knock-down argument.''[15]

Here Lord Walker does not say that a disposal is not effected by a contract, but rather that it is effected by the contract and its later completion. If that is the case, the disposal takes place in a two-stage process (or perhaps a three-stage process—contract, acceptance of title, completion) which is deemed by s.27 to take place at the time of contract.

It may be this view of the decision in *Jerome v Kelly* which is reflected in Briggs J.'s observation that:

> ''[I]t is precisely because s.28(1) of the 1992 Act deems the disposal of the land to have occurred at the date of the contract for its sale that, as Lord Hoffman observed in the passage which I have already quoted, refined analysis of the stages by which the beneficial interest passes from vendor to purchaser in a contract which has completed is unnecessary for capital gains tax purposes.''[16]

That view may be helpful in reconciling the decision in *Jerome v Kelly* with Briggs J.'s view of the nature of disposal and with the long established doctrine of the estate contract, but it does not explain either why in *Jerome v Kelly* the parties to the disposal were identified by reference only to the beneficial interests in the asset which was the subject of the disposal subsisting immediately before completion or why, in the event that there is no completion, there is no disposal.

[15] *Jerome v Kelly* [2004] S.T.C. 887 at 895.
[16] High Court Decision at p.1151.

Judge made law?

Perhaps *Jerome v Kelly* should be seen, not as resting on an explication of the legal principles governing disposals for capital gains tax, but rather as creating a judge-made rule specifically modifying those principles that a disposal of the beneficial interest in an asset which is actually made in a staged process between contract and completion, should be deemed to take place only in the event of completion; a rule which was created for reasons of practical convenience rather than intellectual coherence.

One can only hope that, either on an appeal in *Underwood* or in another case, the House of Lords will take an opportunity to provide a coherent account of the nature of a disposal.

Did beneficial ownership pass?

Both the Special Commissioners and Briggs J. having proceeded on the basis that a disposal for capital gains tax purposes involves a transfer of beneficial ownership and that the formation of a contract cannot itself constitute a disposal, the question became whether the transactions which took place on November 30, 1994 resulted in the beneficial ownership in the Property passing to Rackham Ltd. Their answers to that question and the implications of those answers for ''Bed and Breakfast'' and sub-sale transactions will be examined in Part 2 of this article.[17]

[17] To be published in [2008] P.C.B. Issue 6.

 [2008] P.C.B., Issue 5 © 2008 Thomson Reuters (Legal) Limited and contributors