McKie&Co

RUDGE REVENUE REVIEW

ISSUE XVII

7th May 2014

INDEX

ENSURING THE FAIR ADMINISTRATION OF THE TAX SYSTEM

HMRC has restricted the relief given by ESC D33 for gains arising on the disposal of rights to take Court action in order, it claims, 'to make sure the tax system is administered fairly'.

RIGHTS OF ACTION – A CGT ASSET

Zim Properties Ltd v Procter (Inspector of Taxes)[1] is authority for the proposition that a right to take court action for compensation or damages (a 'Right') is an asset for CGT purposes. When the compensation or damages are received, or there is a payment made to give up the Right,[2] there is a disposal of that Right either under general principles, under s.22[3] (disposal where capital sums derived from assets) or under s.24.

Under s.24:-

> 'The occasion of the entire … extinction of an asset shall, for the purposes of [CGT] constitute a disposal of the asset ...'

COMPUTATION

Consideration for the Disposal

The Right will cease to exist when the Right is satisfied by payment or the Right is given up in consideration of a payment.

It is implicit in the scheme of CGT that the gain on a disposal of an asset is computed by deducting from the consideration for the disposal the sums allowed under s.38.[4] Section 17(1) deems a person's acquisition or disposal of an asset to be for a consideration equal to its market value, *inter alia*:-

> 'where he acquires or, as the case may be, disposes of the asset otherwise than by way of a bargain made at arm's length …'

In respect of the disposal of the Right, if the disposal arises by reference to an award of damages by the Court, s.17 will apply because the disposal will be 'otherwise than by way of a bargain made at arm's length ...'. A litigant does not make a bargain with the Court. When the disposal arises by reference to a compromise agreement, s.17 will not normally apply unless the agreement is made with a person connected with the disponer,[5] in which case s.18 will have the result that the disposal will be treated as 'a transaction otherwise than by way of a bargain made at arm's length'.

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1 *Zim Properties Ltd v Procter (Inspector of Taxes); Procter (Inspector of Taxes) v Zim Properties Ltd* ChD [1985] STC 90

2 As there will be when the claim is compromised by the potential defendant making an agreed payment in settlement

3 All statutory references in this review are to the Taxation of Chargeable Gains Act 1992 unless otherwise stated

4 This emerges from TCGA 1992 s.15 and ss.17 – 20 and ss.22 – 24

5 TCGA 1992 s.18

If s.17 applies, the Right will be deemed to have been disposed of for its market value. There are interesting questions as to at what point in time one determines the Right's market value (on or immediately before the disposal?) and when the disposal takes place (which may vary according to whether the disposal takes place under general principles, s.22 or s.24) but we shall not pursue those questions here. In practice it is accepted that the market value to be used will not vary materially from the amount of the actual payment received.

Amounts Deductible Under s.38

What sums are deductible under s. 38 on the disposal of the Right?

One may deduct under s.38(1) the consideration given for the acquisition of the asset. In fact no actual consideration will have been given for the Right – it is, by its nature, a right arising from a wrongful act. If consideration were given for that wrongful act it would not be wrongful.

In respect of the acquisition of a Right, it is difficult to imagine circumstances in which the conditions of s.17(1) would not be satisfied because where there is a cause of action it will, inevitably, come into existence by virtue of acts which are unilateral rather than the result of a bargain.

In respect of an asset which was acquired after 9th March 1981, however, it is provided that s.17(1) does not apply to the acquisition of an asset if:-

> '(a) there is no corresponding disposal of it, and
> (b) there is no consideration in money or money's worth or the consideration is of an amount or value lower than the market value of the asset.'[6]

The Right comes into existence and is acquired when the damage caused by a wrongful act crystallises. In relation to a claim in respect of negligent advice, for example, that will be when the claimant, in reliance on the negligent advice, acts to his detriment.[7] There will be, therefore, no corresponding disposal of the right when the claimant acquires it and the claimant certainly will not give consideration for the wrongful act or for the damage to which it gives rise.

The result of that is that there will be no acquisition expenditure which is deductible under s.38(1). The costs of establishing the claim and of the Court action itself, if the Right is extinguished by the Court either rejecting the claim or making an award of damages which is satisfied by payment, will be deductible under s.38(1)(b) and the costs of negotiating a compromise of the claim should be deductible under s.38(1)(c). Because there will be no deductible acquisition cost under s.38(1)(a), however, it will often be the case that the gain will be equal to the whole, or to substantially the whole, of the compensation received.

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6 Section 17(2)

7 *Forster v Outred & Co* [1982] 1 WLR 86 at page 98 and *Zim Properties Ltd v Procter* ChD [1985] STC 90 at page 111

Where the Right was held at 31st March 1982[8] or where the Right has been acquired on a death under a Will or Intestacy,[9] it will be deemed to have been acquired at its market value at that time. Of course, the market value of the Right may vary wildly according to the behaviour of the other parties and the process of negotiations.

SECTION 51(2) – EXEMPTION

Section 51(2) provides that:-

> 'It is hereby declared that sums obtained by way of compensation or damages for any wrong or injury suffered by an individual in his person or in his profession or vocation are not chargeable gains.'

That is a rather peculiar formulation as of course sums of money are never in themselves chargeable gains. Chargeable gains are the results of computations in which the consideration received, or treated as received, for a disposal is taken into account. Nonetheless, in practice it is accepted that this section operates to exempt a disposal arising by virtue of the receipt of damages of the specified types from charge to CGT.

'...suffered by an individual in his person ...'

HMRC says the following in respect of 'any wrong or injury suffered by an individual in his person':-

> 'The words "in his person" should be read in distinction to "in his finances" but they should be read as including distress, embarrassment, loss of reputation or dignity in addition to physical injury. Compensation or damages for unfair or unlawful discrimination suffered in the "person" and for libel or slander (in Scotland defamation) are also included.'[10]

The first sentence is a generously, arguably an over-generously, wide construction. There has been no case law on the construction of s.51(2) but it is difficult to see how, for example, damage to one's reputation caused by a libel can be 'an injury suffered by an individual in his person'. It might be an injury suffered personally but the phrase 'in his person' surely denotes a physical injury. Citing uses of the word 'person' with the possessive pronoun, the SOED defines a 'person used with a specifying word' as:-

> 'The living body of an individual, regarded either together with its clothing and adornments or simply as the physical form or figure.'

The second sentence of HMRC's statement, by its inclusion of the phrase 'in the "person"', begs the very question which it is purporting to answer.

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8 Section 35
9 Section 62(1)
10 CGT Manual para CG13030

'... suffered by an individual ... in his profession ...'

In respect of 'damages for any wrong … suffered by an individual … in his profession or vocation' HMRC says:-

> 'The words "in his profession or vocation" refer to compensation or damages suffered by an individual in a professional capacity such as unfair discrimination, libel or slander (in Scotland, defamation) as distinct from "in his finances"'.

A Restrictive Class of Chargeable Disposals

Because of s.51(2) there will be only a restricted class of circumstances in which there will be a disposal of a Right which is chargeable to CGT, particularly if one applies HMRC's over-generous construction of that subsection. Two examples are given below of circumstances in which a disposal chargeable to CGT arises on the receipt of a sum of money on the extinction of a Right.

THE SCHEME OF THE AWARD AND TAXATION OF DAMAGES

Actions for damages, of course, provide a remedy for damage suffered due to another person's wrongful act. The Court seeks to put the person wronged back into the position he would have been had he not been wronged. The damage he has suffered is repaired to the extent that it is possible for the Court to do so. There is, therefore, no question of a person being advantaged in suffering a wrong in respect of which he is awarded damages by the Court.

Where the receipt is not a trading receipt[11] or earnings from employment it will not normally be subject to Income Tax.[12] Various periodical payments and annual payments made in respect of personal injury damages are exempt from Income Tax[13] and most lump sum awards or compromise payments will be capital receipts.

This general position that awards by the Court of damages and amounts received in compromise agreements for giving up a Right are not taxable forms a rational system when one considers the way in which the Court assesses damages.

Taking Account of Taxation in Awards of Damages

Because the principle of damages awards is that the amount awarded should put the injured party into the same position in which he would have been had he not sustained the damage caused by the wrongful act, in assessing financial loss the Court takes into account the tax which would have been suffered by the claimant in respect of the

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[11] Cases concerning receipts which were held to be income receipts of a trade include: *Shove (Inspector of Taxes) v Dura Manufacturing Co Ltd* KB 1941, 23 TC 779, *Kelsall Parsons & Co v CIR* CS 1938, 21 TC 608*; Bush, Beach & Gent Ltd v Road (Inspector of Taxes)* KB 1939, 22 TC 519; *Shadbolt (Inspector of Taxes) v Salmon Estate (Kingsbury) Ltd* KB 1943, 25 TC 52; *Creed (Inspector of Taxes) v H&M Levinson Ltd* ChD, [1981] STC 486 and *Donald Fisher (Ealing) Ltd v Spencer (Inspector of Taxes)* CA [1989] STC 256

[12] HMRC argue that payments by a tenant in respect of dilapidations of buildings are income receipts on the basis of the Privy Council's decision in *Raja's Commercial College v Gian Singh & Co Ltd* PC [1976] STC 282 which concerned Singaporean taxation

[13] ITTOIA 2005 s.731

matters by reference to which the sum is quantified. Thus if the amount is quantified by reference to sums which the claimant would have received had the wrongful act been committed and on which, had he received it, he would have borne Income Tax, the sum awarded is reduced by an amount to take account of that tax.[14] Where the amounts in reference to which the sum is calculated bears tax and the sum obtained in damages will also be taxed, the calculation of the award becomes more complicated. In *Stewart v Glentaggart Ltd*[15] damages were awarded for wrongful dismissal and were expected to be taxable in part. The Court found that the calculation of the deduction from the total damages for notional tax must be made in two stages:-

(a) first by estimating the tax which would have been payable on the overall salary lost; and then
(b) by grossing up the resulting net amount by adding the tax which the recipient would have to pay on the damages.

The Courts have not always followed this method of calculation[16] so that the correct method remains unclear.

EXTRA STATUTORY CONCESSION D33

Fortunately dealing with these complexities has never been necessary in respect of capital sums. Even HMRC has recognised the unfairness of imposing a tax on a sum which merely compensates the recipient for a loss he has suffered through the fault of another person. Extra Statutory Concession D33 has for many years provided relief by concession in two ways. First:-

> 'Where the right of action arises by reason of the total or partial loss or destruction of or damage to a form of property which is an asset for capital gains purposes, or because the claimant suffered some loss or disadvantage in connection with such a form of property, any gain or loss on the disposal of the right of action may by concession be computed as if the compensation derived from that asset, and not from the right of action.'

Secondly:-

> 'A right of action may be acquired by a claimant in connection with some matter which does not involve a form of property which is an asset for capital gains purposes … In these circumstances any gain accruing on the disposal of the right of action will be exempt from capital gains tax.'

That achieved a just result although it is always unsatisfactory for the application of a defective law to be modified by administrative discretion rather than for the defect in the law being corrected by statute. As Mr Justice Walton said, in *Vestey v IRC*, in

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[14] *British Transport Commission v Gourley* HL [1955] 3 All ER 796
[15] *Stewart v Glentaggart Ltd* CS 1963 SC 300
[16] It was not followed in *Bold v Brough, Nicholson & Hall Ltd* QBD [1963] 3 All ER 849 but it was followed in *Shove v Downs Surgical plc* [1984] 1 All ER 7

words which have been cited many times since, 'one should be taxed by law, and not be untaxed by concession'.[17]

HMRC'S NOTICE OF 27TH JANUARY 2014

The Announcement

On 27th January of this year, however, HMRC issued a notice announcing that:-

> 'With effect from 27 January 2014, HMRC has amended ESC D33 to introduce a maximum limit of £500,000 on the amount of a payment of compensation which will be exempt from CGT in cases where this compensation is not linked to an underlying asset (for example where a professional adviser gives misleading advice, or fails to claim a tax relief in time). Where compensation is linked to an asset chargeable to CGT, the exemption remains unlimited.'

Contradictory Detail

Actually this is an inaccurate summary of the change for later in the same notice it says:-

> 'From 27 January 2014 –
>
> - only the first £500,000 of this kind of capital compensation will be exempt
> - HMRC will not normally provide relief above that amount, but
> - anyone who receives compensation of more than that amount and thinks it should not be chargeable to CGT can make a claim in writing to HMRC. There is no guarantee that a claim will be upheld but HMRC will consider whether further relief can be given.'

Revisions to the Concession

Later in the notice the actual revision to the text of the concession is given:-

> 'From today, the text at paragraph 11 is changing.
> **11 No underlying asset**
> A right of action may be acquired by a claimant in connection with some matter which does not involve a form of property which is an asset for capital gains tax purposes. This may be the case where professional advisers are said to have given misleading advice in a tax or other financial matter, or to have failed to claim a tax relief within proper time. Actions may be brought in relation to private or domestic matters. Where the action does not concern loss of or damage to or loss in connection with a form of property which is an asset for capital gains tax purposes, the approach in paragraph 9 above of treating the compensation as deriving from the asset itself is not appropriate. In these circumstances any gain accruing on the disposal of the right of action will be exempt from capital gains

[17] *Vestey v IRC* [1977] ChD STC 414 at page 439

tax up to a limit of £500,000 for any compensation awarded in a single set of legal proceedings.

Any awards of compensation above this threshold will need to be reviewed on a case-by-case basis to ensure that they remain within the Commissioners' collection and management powers. Therefore such claims will need to be notified to HM Revenue and Customs in writing.'

COMMENTARY ON THE REVISIONS

The first thing to say about this change, is that it is of course grotesquely unfair. The unfairness is illustrated by the two examples below. Indeed, it is difficult to imagine any circumstances in which it would be fair to tax somebody on a sum which he has been awarded by a court to remedy the damage he has suffered from another person's wrongful act.

HMRC's Justification of the Change

The notice under the heading '*WHY ARE YOU MAKING THE CHANGES?*' says:-

'The change reflects a clarification of the scope of the concession taking into account the limits of the Commissioners of Revenue and Customs collection and management powers in this area following the High Court case of *Zim Properties v Proctor*.

HMRC wants to make sure the tax system is administered fairly so we think it is right that anyone in receipt of compensation of more than £500,000 should be asked to make a claim in writing to HMRC if they believe more than just the first £500,000 should be exempt from CGT.'

The first paragraph is odd.

First, how can a change clarify 'the scope of the concession'? It does not clarify its scope. It changes it.

Secondly, *Zim Properties* was heard in 1984, thirty years ago. Surely even HMRC cannot have taken thirty years to digest its implications. What is more, *Zim Properties* had absolutely nothing to do with the limits of the Commissioners of Revenue & Customs collection and management powers. Indeed the Commissioners of Revenue & Customs didn't exist at the time that the case was heard. Perhaps the reference to *Zim* here is a typographical error. The case of *R (on the application of Wilkinson) v IRC*[18] did concern the Revenue's power of care and management and the extent to which that power allows it to make Extra Statutory Concessions. Although the leading speeches were concerned primarily with issues other than the extent of that power, Lord Hoffman, in a speech with which the other Lord Justices of Appeal agreed, did say:-

[18] *R (on the application of Wilkinson) v IRC* HL [2006] STC 270

'The commissioners[19] are not "the Crown", owners of the consolidated fund and able to deal with its property like any other owner (see *Re West End Networks Ltd (in liq)*, *Secretary of State for Trade and Industry v Frid* [2004] UKHL 214 at [27], [2004] 2 AC 506 at [27]). In that respect, this case is different from *Hooper's* case. The commissioners are a statutory body created by the Inland Revenue Regulation Act 1890. They are charged by s 13(1) of that Act to "collect and cause to be collected every part of inland revenue". Section 1 of the 1970 Act gives them what Lord Diplock described in *IRC v National Federation of Self-Employed and Small Businesses Ltd* [1981] STC 260 at 269, [1982] AC 617 at 636, as:

> "…a wide managerial discretion as to the best means of obtaining for the national exchequer from the taxes committed to their charge the highest net return that is practicable having regard to the staff available to them and the cost of collection."

This discretion enables the commissioners to formulate policy in the interstices of the tax legislation, dealing pragmatically with minor or transitory anomalies, cases of hardship at the margins or cases in which a statutory rule is difficult to formulate or its enactment would take up a disproportionate amount of parliamentary time.'

This passage does not suggest that where HMRC has the power to exempt from taxation a class of transactions which are taxable under the law, that power is limited to transactions below a maximum monetary amount except, possibly, if the maximum limit were set at a very small amount. The focus of Lord Hoffman's comment is surely not on the size of the transactions. It is on whether the tax anomalies themselves are minor or transitory, the cases concerned are marginal cases of hardship or a statutory provision to remove the anomaly, or to allow for cases of hardship, would be difficult to formulate or take a disproportionate amount of parliamentary time to enact. Injustice, as our examples show, can cause hardship in large transactions as in small.

As to the second paragraph of HMRC's explanation of the rationale of the change to ESC D33, HMRC gives no indication at all as to why it would be fair to extract tax from somebody in respect of the receipt of a capital amount which does not represent a real economic gain but, rather, merely repairs the damage which he has suffered from another's wrong.

The Claim for Special Relief

Nor is it true to say that under this revision of ESC D33 those who receive more than £500,000 in compensation are merely being 'asked to make a claim in writing to HMRC'. The concession makes clear that most people in this position will be denied relief.

It is also unclear how a person asking HMRC for relief is to justify his request as the notice gives no clue as to the principles which HMRC will apply in identifying the minority of cases in which they will grant relief.

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[19] At this time, the Commissioners of Inland Revenue under Inland Revenue Regulation Act 1890 s.39 and TMA 1970 s.1

The phrase '… HMRC will consider whether further relief can be given' is also puzzling. One can see that they will consider whether they will grant relief but here they say that they will consider whether they have the power ('can') of granting relief. This, coupled with the final paragraph of the revised paragraph 11 of the concession, seems to suggest that HMRC's view is that there is something in its care and management powers which gives it the power to grant relief in some cases but not to grant relief in others according to the size of the transaction concerned rather than that it has a discretion to grant relief in all cases concerning disposals of Rights. If that is what the phrase means, it surely requires explanation and justification.

Why Now?

Finally, one is puzzled as to why the amendment has been made at this time. Since the decision in *Wilkinson* was published, HMRC has been engaged in the process of reviewing its Extra Statutory Concessions. Where it decides that a concession which it has given in the past is, in the light of *Wilkinson*, *ultra vires*, it will either withdraw the concession or propose the enactment of equivalent provisions in a statutory form. The notice announces that:-

> 'We will [sic] be issuing a consultation document later in 2014 seeking views on what should be included in legislation to replace D33.'

If HMRC is to consult on enacting this concession why has it been necessary to restrict it in this grotesquely unfair manner in the meantime? The consultation will surely provide the appropriate opportunity for HMRC to explain properly why it considers that a restriction is required, as a result, one presumes, of its revised understanding of the scope of its care and management powers, and for the correctness of that view to be tested in the consultation.

A Crude Attempt to Raise Revenue?

One might suspect that this is simply a crude attempt to raise additional tax revenue. Can HMRC really expect, however, that sufficient payments of compensation above £500,000 in respect of this limited class of rights of action will be made in the period between the issue of the notice and the enactment of a statutory form of relief as will give rise to a sum of tax sufficient to justify the precipitate introduction of the change without consultation? One cannot tell. The notice contains no estimate of future yield.

AN OBJECT LESSON?

All in all, the Revenue's notice of this revision of the concession is an object lesson in the poor formulation and execution of tax policy and of its inadequate communication to the public.

EXAMPLES

Example I

Brenda Broxwood, who was eleven years old at the time and academically outstanding, was knocked down by a drunken driver and suffered serious brain injuries. She was awarded damages of £5 million reflecting the discounted costs of the 24-hour lifetime care which she now needed and the loss of her future earning capacity. Acting as his daughter's receiver under the Mental Health Act, Mr Broxwood, on the advice of his solicitor, settled these moneys on discretionary trusts. Although the solicitor did not realise it at the time, the transfer was immediately chargeable to Inheritance Tax resulting in an immediate liability of £935,000. It would also lead to decennial charges[20] and exit charges[21] in the future. These charges would not have arisen if the settlement had met the conditions of IHTA 1984 s.89 (Trusts for disabled persons) and if it had, there would have been no disadvantage to Brenda from the difference in its terms.

The Court declined to exercise its discretion to set this settlement aside under the doctrine of mistake because of the presence of equitable bars to doing so. Mr Broxwood began an action for negligence against the solicitor on Brenda's behalf and a compromise was reached under which the solicitor agreed to pay £1,000,000 being £950,000 in respect of unnecessary tax charges and £50,000 for costs.

This sum was received in consideration of the extinction of the right of action and was therefore a disposal of that right. It was not excepted from charge to CGT by s.51(2) because it was in respect of a claim for financial damage arising from the solicitor's negligence and not for damages for any wrong or injuries suffered in Brenda's person. Brenda made a gain of £950,000 (because only the costs of pursuing the action against the solicitors and of negotiating the compromise agreement were deductible under s.38). Of this sum only £500,000 was exempt under ESC D33 and so Brenda was charged to CGT of £126,000 ((£950,000-£500,000) @ 28%) on her award.[22]

[20] IHTA 1984 s.64

[21] IHTA 1984 s.65

[22] The keen-eyed reader will see that these facts are an adaptation of those in *Pitt and others v HMRC* [2013] UKSC 26. Of course the Example assumes that HMRC did not use their discretion under the revised concession to grant relief but is it reasonable to expect that a department that decided to pursue the unfortunate Pitt family, although it was finally unsuccessful in doing so, all the way to the Supreme Court would grant relief to Brenda whose circumstances were essentially similar?

Example 2

David Dabinett had developed an idea for a new trading venture. He arranged in principle with his bank for the bank to make a loan, which it called a 'business loan', to be used to purchase and equip business premises, to buy stock and to fund working capital. The loan was to be secured on the business property and to be guaranteed by a close friend.

At the last moment, due to the negligence of his solicitor, the bank refused to make the advance, Mr Dabinett was unable to complete on the purchase of the business premises and he was sued by the vendor. He was sued by the builders and decorators whom he had engaged to refurbish and alter the business premises. He was unable to pay his suppliers who also sued him and he was unable to start his trade. By the time he had paid or made arrangements with his many creditors and found a new source of finance, market conditions had changed and starting the trade at that time was no longer a viable business proposition.

He began proceedings against his solicitors for negligence. His actual losses amounted to £2 million and he paid £500,000 in costs but he accepted an offer of £2 million to settle the matter in order to avoid the uncertainties of litigation. This was a disposal of his right of action. For CGT purposes he had made a gain of £1,500,000 (£2 million - £500,000). He had not made an allowable trading loss because he had not begun to trade. He had not made a capital loss because he had not acquired any capital asset other than his right of action. In economic reality he had lost £500,000 (£2,000,000 + £500,000 - £2,000,000). Nonetheless he paid CGT of £280,000 (£1,500,000 - £500,000 x 28%).

He was, of course, happy to do so because HMRC had informed him, along with the rest of the public, that the change in ESC D33 was:-

> '... to make sure [that] the tax system [was] administered fairly …'