Fair administration?

Simon McKie explains HMRC's restriction to relief given by ESC D33 for gains arising on the disposal of rights to take court action

KEY POINTS

- **What is the issue?**
ESC D33 is to be restricted so that capital gains in excess of £500,000 in respect of disposals of certain rights of action will not be exempt
- **What does it mean to me?**
Clients who have received no real economic benefit from disposals of rights of action, who, indeed, may have suffered a real economic loss, will be taxed on a purely notional gain
- **What can I take away?**
That you should respond to the consultation document when it is issued, saying that the change should be reversed

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

A right to take court action for compensation or damages (a 'right') is an asset for CGT purposes (*Zim Properties Ltd v Procter (Inspector of Taxes); Procter (Inspector of Taxes) v Zim Properties Ltd* ChD [1985] STC 90). When the compensation or damages are received, or there is a payment made to give up the right, as there will be when the claim is compromised by the potential defendant making an agreed payment in settlement, there is a disposal of that right, either under general principles or under TCGA 1992 ss 22 and 24.

Computation

Consideration for the disposal

If the disposal arises by reference to an award of damages by the court, TCGA 1992 s 17 will apply because the disposal will be 'otherwise than by way of a bargain made at arm's length …' When the disposal arises by reference to a compromise agreement under which the right is given up in consideration for a payment, s 17 will not normally apply.

Normally no actual consideration will have been given for the right and, in respect of an asset which was acquired after 9 March 1981, 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.'(s 17(2).)

The result of that is that there will often be no acquisition expenditure which is deductible under TCGA 1992 s 38(1)(a). 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.

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.'

HMRC, over-generously, regard this exemption as extending to actions for damages for 'distress, embarrassment, loss of reputation or dignity' and for 'unfair or unlawful discrimination and libel, slander or defamation'(Capital Gains Manual paragraph CG13030).

A restrictive class of chargeable disposals

Because of TCGA 1992 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 sub-section. Below are two examples of disposals of rights which are chargeable to CGT.

Extra statutory concession D33

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 in which he would have been had he not been wronged. There is no question of a person being advantaged by a successful action. The damage he has suffered is repaired to the extent that it is possible for the court to do so.

It is surely obvious that it is unfair to impose tax on a sum which merely compensates the recipient for a loss he has suffered through the fault of another person. Fortunately, even HMRC appeared to recognise that. Extra statutory concession D33 for many years gave relief by concession providing one form of concessionary treatment for rights relating to property and, in addition, providing that:

> '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.

HMRC's 27 January 2014 notice

The announcement

On 27 January, HMRC issued a notice announcing that:

> '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.'

PROFILE

Name Simon McKie
Position Chairman
Company McKie & Co (Advisory Services) LLP
Tel 01373 830956
Email simon@mckieandco.com
Profile Simon McKie MA(Oxon), Barrister, FCA, CTA(Fellow), APFS, TEP is a designated member of McKie & Co (Advisory Services) LLP, the consultancy specialising in providing taxation advice to advisers of private clients.

Commentary to the revisions

The grotesque unfairness of this charge 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 a 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 [sic] 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. *Zim Properties* was heard in 1984, 30 years ago. Surely even HMRC cannot have taken 30 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

EXAMPLE 1

Brenda Broxwood, who was 11 years old at the time and academically outstanding, was knocked down by a drunk 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 a liability of £935,000. It would also lead to decennial charges (IHTA 1984 s 65) and exit charges (IHTA 1984 s 64) 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 TCGA 1992 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.

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 all the way to the Supreme Court, although it was finally unsuccessful in doing so, 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, he 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% – the amount which under the revised ESC D33 will still be exempt).

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 ...'

Zim here is a typographical error. The case of *R (on the application of Wilkinson) v Inland Revenue Commissioners* HL [2006] STC 270 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, explained that HMRC's care and management powers give them a discretion which:

> '... 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 but on whether the tax anomalies themselves are minor or transitory, the cases concerned are marginal cases of hardship or a statutory allow for cases of hardship would be difficult to formulate or would 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'. HMRC's announcement made it clear that people in this position will normally 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.

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 of action. 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.

FURTHER INFORMATION

This article is based on a longer article in the *Rudge Revenue Review*: www.tinyurl.com/ESCD33

East Midlands Branch

Celebrating 25 years of the ATT

Thursday 11 September 2014

Autumn Residential Tax Update Conference

12-14 September 2014

University of Warwick