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Changes to the taxation of compensation (ESC D33)

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Scope of capital gains tax

Capital gains tax was introduced in 1965. In many ways it is a reserve form of income tax. Under TCGA 1992, s 37(1) a sum that is charged to income tax is excluded from the consideration used in calculating a capital gain. '*Capital sum*' is defined in s 22(3) as any money or money's worth which is not excluded from the consideration taken into account in calculating a capital gain.

Every gain arising from the disposal of assets which is not liable to income tax is liable to capital gains tax. All assets are chargeable assets for capital gains tax purposes unless they are exempt assets. The concept of 'chargeable asset' is very broad: *O'Brien v Benson's Hosiery (Holdings) Ltd* 53 TC 241; *Marren v Ingles* 54 TC 76. Section 21(1)(a) says that *'all forms of property shall be assets for the purposes of this Act including ... incorporeal property generally'.* Section 22(1) says that a receipt from 'a *capital sum … derived from assets'* is to be treated as a disposal for capital gains tax purposes, '*notwithstanding that no asset is acquired by the person paying the capital sum and this subsection applies in particular to (a) capital sums received by way of compensation for any kind of damage ...'.* , if the asset in question is a '*chargeable asset'* within s 21(1)(a).

Thus damages received by way of compensation are in principle a taxable receipt, liable to capital gains tax, if not liable to income tax, but subject to wide-ranging exemptions.

Compensation and damages

Compensation and damages become payable in a wide range of situations, so there is no uniform tax treatment. Compensation may at one end of the spectrum considered to be capital in nature and at the other end to be a trading receipt.

In *Able (UK) Ltd v R & C Comrs* [2007] STC 1738 the company was paid compensation of £2.185m for temporary loss of use of land which it owned, which was used for landfill. While the land was subject to a compulsory purchase order (later withdrawn) the company was unable to make profitable use of the land. The company argued that the compensation was a capital receipt. The key question was that identified by the court at [18]: '*When the issue is as to the classification of a compensation payment in the hands of a recipient, the question is: for what was the compensation paid?* At [48] the court set out the general principles which were applicable.

Tax treatment of compensation and damages

The principles are familiar.

(1) Compensation for loss of trading profits is a trading receipt: *London & Thames Haven Oil Wharves Ltd v Attwool* 43 TC 491 at 515. Where additional costs are incurred by reason of breach of duty, the compensation will be taxable income: *Donald Fisher (Ealing) Ltd v Spencer* [1987] STC 423. If compensation is paid for loss of revenue, the compensation itself is likely to be a revenue receipt, liable to income tax or corporation tax.

(2) In other cases, it is likely to be a capital receipt. As such it may be a taxable or non-taxable capital receipt, and a loss may be relievable or a tax nothing: *Beauchamp v Woolworth plc* [1989] STC 510

(3) In *IRC v John Lewis Properties plc* [2003] STC 117 at [80]-[87] Dyson LJ set out five indicia of a capital receipt as follows:

(i) duration: if what is disposed of is long-lasting;

(ii) value of the asset assigned;

(iii) the disposal causes the value of the disponor's interest in the asset to be diminished;

(iv) whether the payment is of a single lump sum;

(v) whether the disposal of the asset is accompanied by a transfer of risk in relation to it.

(4) Section 51(2) says that sums obtained by way of compensation or damages for any injury or injury suffered by an individual in his person or in his profession or vocation are not chargeable gains. This applies to damages for personal injuries, slander, sexual or racial discrimination.

(5) Section 23 limits the scope of section 22. If the asset is not wholly lost or destroyed, insurance proceeds or compensation applied in restoring the asset are not treated as sums involved in the disposal of the asset: s 23. In other words there is a form of rollover relief.

(6) Several cases involving compensation distinguish statutory payments from the disposal of assets. In *Davis v Powell* 53 TC 241 it was held that a sum paid by way of compensation under Agricultural Holdings Act 1948, s 34(1) was not derived from the tenancy. It was simply sum which Parliament required to be paid after the lease had gone. A similar approach was taken in *Drummond v Brown* 58 TC 67. The Court of Appeal rejected a claim that compensation under the Landlord and Tenant Act 1954 was a capital sum derived from the lease. The Court concluded that this was a right given by Parliament and could be taken away by Parliament. It could not be described as an 'incident' of the lease. As Fox LJ put it at 85:

'The statute simply created an entitlement where none would otherwise have existed ... We do not think that the sum can be said to be derived from any asset.'

The Special Commissioners adopted the same approach in cases concerning agricultural tenancies: *David v Henderson* [1995] STC (SCD) 308; *Pritchard v Purves* [1995] STC (SCD) 316.

The reverse-*Gourley* problem

Tax is a key factor in determining the net amount available to the recipient and the true cost to the payer. Indeed, until the tax treatment is known, it is impossible to determine the level of compensation which should be paid or accepted. If damages are tax free, and the loss in respect of which the damages are paid would have been subject to tax, taxation is taken into effect by reducing the damages: *British Transport Commission v Gourley* [1956] AC 185.

In an employment context, the court will reduce the damages by a sum representing the tax which would have been payable, had the damages been received as employment income rather than damages. This sum is the 'notional tax'. The *Gourley*-deduction rule applies to damages for breach of contract: *Stewart v Glentaggart Ltd* [1964] 1 QB 95. Hence the *Gourley* principle applies to reduce an award of damages where:

(a) the damages represent compensation for loss of income otherwise taxable, and

(b) the award of damages itself is not subject to tax:

See: *Deeny v Gooda Walker* [1996] STC 299 at 304. Thus *Gourley* gives the benefit of saving of tax to the person paying the damages, to avoid over-compensation of the claimant.

It follows that, if damages are moved from a tax exempt to a taxable category as regards the recipient, the amount paid as compensation will have to be grossed up as regards the payer. This is known as the reverse-*Gourley* problem.

Zim Properties Ltd

The reverse-*Gourley* problem arose from the decision in *Zim Properties Ltd v Proctor* 58 TC 371. At 390 Warner J held that the right to sue for compensation was itself an asset for capital gains tax purposes, which would be disposed of in return for the compensation:

> *'Either way it would in my view be inconsistent with the decision in O'Brien v Benson's Hosiery (Holdings) Ltd to hold that a right to bring an action to seek to enforce a claim that was not frivolous or vexatious, which right could be turned to account by negotiating a compromise yielding a substantial capital sum, could not be an "asset" within the meaning of that term in the capital gains tax legislation.'*

The right to bring an action to enforce a claim is an asset if it can be turned to account by a negotiated settlement. It is a chose in action. In Zim Properties the payment of agreed compensation by the claimant's solicitors for a loss arising from professional negligence was held to be derived from the right to sue the solicitors. That right was an asset of the claimant company, which was acquired when the cause of action arose. Thus the Court held that a right of action is a chargeable asset in its own right for capital gains tax purposes, regardless of whether or not the right of action arises in relation to something which is an asset for capital gains tax purposes, and even in the absence of any underlying asset.

Problems of *Zim*

This was an inconvenient decision for a number of reasons. However, neither side had an interest in appealing it.

The first problem was that a right of action generally has no base cost. Hence the whole amount received in compensation would be liable to capital gains tax. That would in turn lead to the need to gross up the compensation to take account of the tax position of the recipient.

The second problem was identifying the source of the compensation where there is an underlying asset. What is being disposed of for the compensation? The underlying asset or the right of action?

The third problem is that the underlying asset may be exempt but the right of action will always be a chargeable asset.

ESC D33

ESC D33 was introduced on 19 December 1988. It is central to the capital gains tax treatment of damages. ESC D33 solved all three of these problems:

Problem 1 (nil base cost) was solved by providing that where there is no underlying asset, the whole receipt will be exempt from capital gains tax.

This in effect suspended the operation of TCGA s 17(2)(a) and/or added a new category of exempt disposals to the legislation.

Problems 2 (source of payment) and 3 (mismatch between underlying asset and right of action) were solved by saying that where there is an underlying asset whose disposal or deemed disposal gives rise to the damages payment, the payment is regarded as arising from the underlying asset. This in effect overruled *Zim Properties*.

ESC D33 para 11 says that if a right of action is acquired 'in connection with some matter which does not involve a form of property which is an asset for capital gains tax purposes', then in such a case 'any gain accruing on the disposal of the right of action will be exempt from capital gains tax'. ESC D33, para 11 states:

> '11. 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. ...

> 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 … any gain accruing on the disposal of the right of action will be exempt from capital gains tax'.

Accordingly, where there is no underlying asset, the disposal of the cause of action would in any case be exempted by concession.

In practice, ESC D33 has worked very well for 27 years.

Changes to ESC D33

ESC D33 was revised with effect from 27 January 2014. The principal change was to limit the automatic para 11 exemption from tax for capital sums where there is no underlying asset to £500,000. Any amounts for amounts of compensation above this threshold to be exempt have to be made in writing to HMRC.

Consultation Document – July 2014

HMRC take the view that the scope of ESC D33 exceeds their discretionary power. They also regard the exemption for compensation where there is no underlying asset (e.g. cases of professional negligence) as over-generous. On 31 July 2014 HMRC published a Consultation Document proposing its supersession and incorporation into legislation.

The main change proposed is that the exemption for compensation where there is no underlying asset and no other asset should be restricted to £1m.

The proposed changes were not mentioned in the Budget Statement. However, they are likely to be included in Finance Bill No 1 of 2015.

Conclusions

As Lord Wilberforce commented in *Aberdeen Construction* 52 TC 281 at 296

> *'[A] guiding principle must underlie any interpretation of the Act, namely, that its purpose is to tax capital gains and to make allowances for capital losses, each of which ought to be arrived at upon normal business principles. No doubt anomalies may occur, but in straightforward situations … the courts should hesitate before accepting results which are paradoxical and contrary to business sense.'*

The aim of damages is not to enrich the recipient, but to place him in the same position as he would have been in, had no breach of duty occurred. Neither compensation or restitution involve making a person better off. If a person is not better off, he has not made a capital gain. That is what Lord Wilberforce said in *Aberdeen.*

If damages are taxable, tin effect this imposes an additional tax charge on the payer, i.e. the insurance company has to pay both the compensation and an extra tax charge for having paid it.

The solution is to make all compensation tax free, giving the benefit of tax-free status to the payer.

The law took a wrong turn in *Zim Properties.* It should be consigned to the dustbin of history, rather than have its status raised and life prolonged though legislation.

Instead of seeking to preserve the existing anomalies, while at the same time introduce a backdoor new tax charge at the expense of insurers, it would be better to adopt a new scheme.