Penetrating the obscuring mists of judicial precedent

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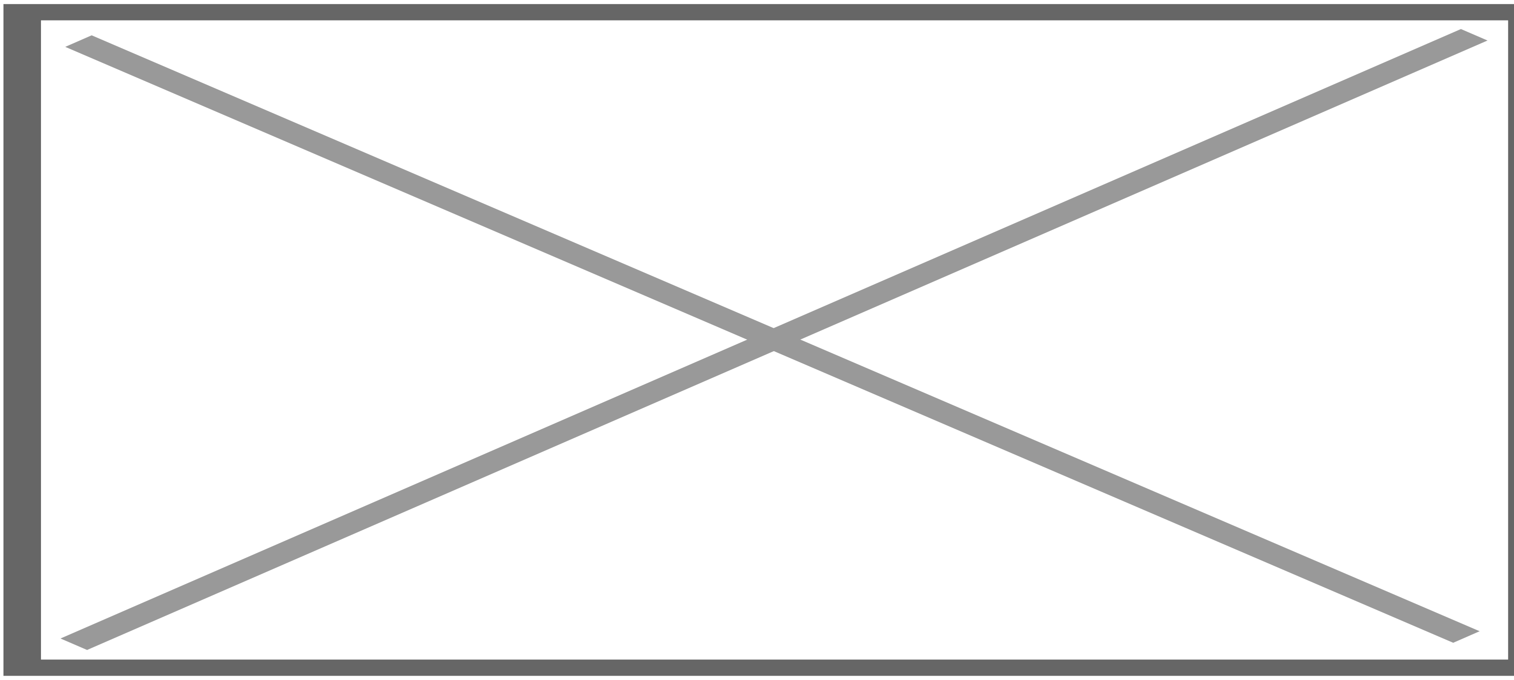

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In the case of *Drake v HMRC*, the First-tier Tribunal had to grapple with conflicting judicial precedents to decide a case concerning a lost deposit. We attempt to penetrate the obscuring mist.

Key Points

What is the issue?

Mr Drake, seeking to acquire a property under construction, paid the reservation fee and deposit but did not pay a later stage payment. When the contract was treated as repudiated, he claimed this as a capital loss, which HMRC found was not allowable.

What does it mean for me?

The judge was facing conflicting judicial precedents, which boiled down to a discussion of the ‘ratios’ of the various cases.

What can I take away?

For the time being, it must be assumed that tax relief will not be available on a lost deposit, even if the asset that was to be purchased would have become a chargeable asset in the purchaser’s hands.

In the December 2016 issue of *Tax Adviser*, my article 'Return of the naïve' looked at the Upper Tribunal case of *Hardy v HMRC* [2016] UKUT 332 (TCC). That case concerned Mr Hardy's aborted purchase of a property, which led to him losing the £72,000 deposit he had paid on first entering into the contract. The Upper Tribunal concluded that the loss did not give rise to an allowable loss, essentially because Mr Hardy had not disposed of a chargeable asset in the process.

As my previous article explained, the case was consistent with earlier decisions which suggested that, despite the broad meaning given to the word 'asset' in the capital gains tax code, not all assets fall within the scope of the tax. Therefore, whilst a contract to purchase land gives rise to some beneficial interest in the land, that beneficial interest is not converted into a chargeable asset until such time as the purchase is completed. Nevertheless, in my commentary, I expressed some discomfort with the *Hardy* decision, the result of which I described as 'unfair and counter-intuitive'.

In December 2019, a broadly similar case came to the First-tier Tribunal: the joint appeals of Lady and Lord Lloyd-Webber (*Lloyd-Webber v HMRC* [2019] UKFTT 717 (TC)). The Lloyd-Webbers had purchased two villas (as yet unbuilt) in Barbados but eventually abandoned the purchase following financing difficulties encountered during the construction process. The Lloyd-Webbers each lost over £3 million, which they sought to set against capital gains.

Superficially, the *Lloyd-Webber* and *Hardy* cases seemed similar and one would expect them to have been decided the same way. However, HMRC took the view that *Hardy* had been wrongly decided, on the basis that the Upper Tribunal had not been referred to the Court of Appeal's decision in *Underwood v HMRC* [2009] STC 239. Therefore, the First-tier Tribunal was free to decide the case without the baggage of the earlier judicial precedent.

Applying what it considered to be 'an objective approach and having regard to all the circumstances', the First-tier Tribunal duly allowed the Lloyd-Webbers' appeals, also remarking that its conclusion 'corresponded with the "real world" approach of Lord Wilberforce in *Aberdeen Construction* and *Ramsay*' and was 'also consistent with the wider scheme of the Taxation of Chargeable Gains Act 1992'.

It was with this background that the case of *Drake v HMRC* [2022] UKFTT 25 (TC) came to the First-tier Tribunal.

The facts of the case

In July 2014, Mr Drake sought to acquire a lease in respect of a property still under construction. The premium (i.e. purchase price) was said to be £2.2 million. However, Mr Drake was required to lay out:

- an immediate £5,000 as a reservation fee;
- a deposit (stated to be 20% of the premium less the reservation fee, but from the decision it appears to be that it was just 10% of the premium less the reservation fee); and
- a stage payment of 10% twelve months later.

Mr Drake duly paid the £5,000 and the remainder of the deposit (£215,000) but he did not pay the stage payment in 2015. The contract was treated as repudiated, leaving Mr Drake down by £220,000.

Mr Drake claimed this as a capital loss.

Contrary to its stance in the *Lloyd-Webber* case, HMRC no longer considered *Hardy* to have been wrongly decided. Or, to put it another way, it considered that *Lloyd-Webber* was wrongly decided. Accordingly, HMRC argued that the principles of judicial precedent meant that the *Hardy* case had to be followed.

The First-tier Tribunal's decision

The case came before Judge Zachary Citron.

The judge recognised that he was bound by the judicial precedent of the Upper Tribunal decision in *Hardy* unless, as decided in *Lloyd-Webber*, the Upper Tribunal had wrongly overlooked the *Underwood* case.

However, as *Lloyd-Webber* was a decision of the First-tier Tribunal, the judge was not obliged to follow it. Accordingly, the first thing that the judge had to consider was whether *Hardy* had indeed wrongly overlooked the case of *Underwood*.

This boiled down to a discussion of the 'ratios' of the various cases – the ratio, or *ratio decidendi*, representing the statements of legal rules or principles that were the essential basis for reaching the respective decisions.

In *Underwood*, the case concerned two contracts between A and B: one for the sale of land and the other for the reacquisition of the same land. Rather than both contracts being completed (with a conveyance to B and a reconveyance to A), they were settled simply by A paying B the excess of the repurchase price over the sale price. The Court of Appeal considered that in the absence of any actual disposal of the land, the initial sale to B could not be treated as giving rise to any capital loss. This was a marginally different point from that in the *Hardy* case. Accordingly, the judge considered that *Underwood* did not decide the principle at the heart of the *Hardy* case and, therefore, the *Hardy* case could not be considered to have been wrong, merely for ignoring Court of Appeal authority.

This conclusion meant that the judge in *Drake* could not simply follow the First-tier Tribunal's decision in *Lloyd-Webber*. Accordingly, the judge then had to consider whether he was bound by the superior authority of *Hardy*. Ordinarily, this would be the case, unless there was a material fact distinguishing the two cases.

The only potentially material factual distinction was that Mr Hardy was unable to assign the benefits of his purchase contract, whereas Mr Drake had such a right but failed to exercise it. However, the judge considered that in *Hardy*, the non-assignability of the contract was not a material factor in that decision; and therefore the factual distinction between the two cases could not justify the judge departing from the binding precedent of the *Hardy* decision.

As a result, Mr Drake's appeal was dismissed.

Commentary

The decision did not attempt to consider afresh the rights and wrongs of the *Hardy* decision. And given my own thoughts about the wrong turn that I believe has been taken in this area, as set out in my 2016 article, I will not repeat myself here. Like the judge's analysis in the *Drake* case, I have chosen to limit myself to the question of judicial precedent.

Indeed, one of the stated advantages of the doctrine of precedent is that the wheel does not need to be reinvented each time a similar case comes before the courts and tribunals: if a litigant is unhappy with the previously decided case, then it is generally necessary to pursue the case on appeal sufficiently far up the judicial hierarchy so as to get the principle reconsidered at an appropriate level of seniority. The approach generally leads to a saving of costs, as established legal principles do not need to be re?argued every time. However, such cases do highlight a potential drawback.

Furthermore, it should be noted that the judge has possibly given a hint as to his own thoughts about the way that the case law has gone when he said: ‘I am therefore regrettably unable to follow the FTT in [*Lloyd-Webber*].’ It remains to be seen whether Mr Drake has the stomach to take things further.

Finally, a question mark must hang over HMRC’s decision to back down from the *Hardy* approach in *Lloyd-Webber* only to return to it when it came to Mr Drake’s case. It is unusual for HMRC to throw away a winning card – even if they did not particularly believe in it.

My own theory is that HMRC realised that the case law was on shaky ground and that there was enough money at stake in the *Lloyd-Webber* case for the taxpayers to consider taking the matter all the way to the Supreme Court so that the matters could be reconsidered afresh. Accordingly, it is my suspicion that HMRC felt that a tactical retreat in that one case might be the best way forward, even if the *Hardy* precedent was to be deployed in successive cases. However, even this theory has its own flaws: in particular, why would HMRC let the *Lloyd-Webber* case go all the way to the tribunal? Whatever the truth and however prosaic it might prove to be, it is a further example of how unpredictable UK tax law is in relation to what is not an uncommon situation and this is something that does need addressing. In the meantime, it will remain one of life’s little ironies.

What to do next

No-one will plan to throw money away on a lost deposit. However, for the time being, it must be assumed that tax relief will not be available on the money that is lost, even if the asset that was to be purchased would have become a chargeable asset in the purchaser’s hands. Taxpayers must therefore consider whether or not they can take steps to ensure that they do acquire and dispose of a chargeable asset so as to cushion the blow.

However, an eye should be kept out for any further litigation of this case in the Upper Tribunal and beyond. If the case law does get a fresh analysis, this could prove to be widely welcomed.