The capital gains tax treatment for lost deposits: three recent cases

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We examine three recent cases on the capital gains tax treatment of lost deposits – *Hardy*, *Lloyd-Webber* and *Drake* – which discuss the failure of the relevant capital gains tax legislation to reflect economic reality.

Key Points

What is the issue?

The capital gains tax system does not give tax relief for certain economic losses on capital transactions – and in some cases there is a mismatch with gains.

What does it mean for me?

It is clear that capital gains tax applies asymmetrically to a forfeited deposit transaction, providing no relief for the real economic loss suffered by the purchaser in being unable to recover the moneys he has paid by way of deposit.

What can I take away?

We need exhaustive and comprehensive statutory rules to determine what is an asset and when an asset is acquired for capital gains tax purposes, particularly in respect of completion contracts.

Contracts for the sale of interests in land commonly provide for completion by the payment by the purchaser of the outstanding consideration and the transfer by the vendor of the land interest to the purchaser. Commonly, such ‘completion contracts’ provide for the purchaser to make one or more advance payments (or deposits), forming part of the consideration given by the purchaser, which the vendor may keep if the contract fails to complete due to the purchaser’s fault.

Where the land interest is to be developed and the contract imposes an obligation on the vendor to transfer fully developed land on completion, the vendor is sometimes unable to fulfil this obligation and the transaction aborts. The vendor must then repay the deposit but may be unable to do so as a result of being insolvent. We call such transactions ‘insolvent vendor transactions’.

Sometimes such contracts do not complete because, at the completion date, the purchaser has insufficient funds to meet the completion payment forfeiting the deposit. We call such transactions ‘forfeited deposit transactions’.

An insolvent vendor transaction was considered in *Lloyd-Webber and another v HMRC* [2019] UKFTT 717 (TC). Forfeited deposit transactions were considered in *Hardy v HMRC* [2016] UKUT 332 (TCC) and *Drake v HMRC* [2022] UKFTT 25 (TC). All were concerned with whether an allowable capital gains tax loss arose to the purchasers and not with the capital gains tax treatment of the vendors.

In *Hardy*, the Upper Tribunal organised its decision by considering in turn three propositions put forward by HMRC’s Counsel, which we adopt.

The First Issue: Did the purchaser acquire an asset on making the contract?

In *Hardy*, the Upper Tribunal cited the comment of Warner J in *Zim Properties Ltd v Proctor* [1985] STC 90 that ‘not every right to a payment is an “asset” within the meaning of that term in the capital gains tax legislation. Perhaps the most obvious example of one that is not is the right of a seller of property to payment of its price. The relevant asset, then, is the property itself.’ The Upper Tribunal’s analysis concentrated on what it called the purchaser’s right ‘to obtain specific performance’, which allowed it to ask: ‘How then do the contractual rights upon which Mr Hardy now relies differ from his beneficial ownership of the property?’ Mr Hardy’s counsel ultimately accepted that there was no real distinction.

The answer to the tribunal’s question, however, ought to have been clear. Contractual rights are rights enforceable specifically against a specific person or group and cannot confer ‘beneficial ownership of the property’. The only equitable interest which the purchaser acquired on the contract being made is the very limited interest which arises to him under the doctrine of the estate contract (see *Jerome v Kelly* [2004] UKHL 25 paras 28 to 34).

Lloyd-Webber concerned an insolvent vendor transaction and was decided in favour of the taxpayer. It was accepted by the parties and the tribunal judge that the case of *Underwood v HMRC* [2008] EWCA Civ 1423 is authority for the proposition that an asset consisting of the rights under the contract is acquired by the purchaser when a completion contract is made. Therefore, the decision in *Hardy* on this issue was not binding on the First-tier Tribunal; and its decisions on the second and third issues (see below) were *obiter* and also not binding.

In *Drake*, the First-tier Tribunal decision in favour of HMRC was primarily based on its conclusion that the relevant statements in *Underwood* were expressed only in a very tentative fashion, and the tribunal was therefore bound by the judgment in *Hardy*.

Drawing the line

There are contractual rights which might fall within the literal definition in the Taxation of Chargeable Gains Act 1992 s 21(1) which, on a purposive reading, would clearly not be assets for capital gains tax purposes; if they were, capital gains tax would simply not work.

But where must the line be drawn? It is likely to be drawn by reference to the coherence of the capital gains tax scheme. This coherence would be underminde by regarding the completion contract as involving an acquisition of the purchaser's rights for capital gains tax purposes. If the purchaser acquires an asset both on the contract being made (the purchaser's rights) and also on completion (the land interest), how is the consideration given by the purchaser to be dealt with?

As was noted in *Hardy*, to be deductible in calculating the gain or loss arising on the disposal of either asset, that expenditure must have been given 'wholly and exclusively for the acquisition of the asset'. Expenditure with a dual purpose may be allowable only if its main purpose is allowable, and any other purpose is incidental and ancillary.

If the purchaser's consideration under the completion contract is given both to acquire the purchaser's rights and to acquire the land interest, this would seem to have a dual purpose – neither of which could be said to be merely incidental and ancillary. It would only be allowable if it could be allocated in some way between two purposes. That would be a most unrealistic exercise.

In *Lloyd-Webber*, the taxpayers' counsel attempted to deal with this difficulty by reference to the provisions of Taxation of Capital Gains Act 1992 s 43 ('Assets derived from other assets'). He argued that the consideration under the completion contract was given for the purchaser's rights alone; but that on completion, they merged with the land interest. The result was that the land interest derived its value from the purchaser's rights, so satisfying the conditions of s 43.

However, in completion contracts the land interest will normally have existed before the purchaser's rights came into existence, the purchaser acquires his rights before he acquires the land interest which are their subject and, when that interest is acquired, the purchaser's rights cease to exist. The value of the land interest cannot therefore be a result of its acquisition by the purchaser for the interest is unchanged by that acquisition. How can it be, therefore, that 'the value of' the land interest 'is derived from' the purchaser's rights as s 43 requires?

In *Lloyd-Webber*, the First-tier Tribunal simply ignored these difficulties.

What conclusion can be drawn on the First Issue?

Capital gains tax was introduced some 57 years ago. One might expect that the nature of its basic concepts would be absolutely clear by now. In fact, neither the deposit cases nor any preceding case law provide clear authority on the First Issue which is fundamental to the operation of capital gains tax.

On balance, the difficulties posed to the coherence of capital gains tax if the purchaser did acquire an asset consisting of the purchaser's rights for capital gains tax purposes suggest that he does not do so.

The First Issue and the vendor

The capital gains tax scheme could not operate coherently if it were the case that a vendor acquires an asset for capital gains tax purposes when the contract is made. The vendor's rights under the contract consist primarily of the right to receive the consideration from the purchaser.

If it were true that the vendor acquired a capital gains tax asset on the contract being made, he would also make a disposal of that asset when the right to the payment terminated when the completion payment was made. There is no authority for that proposition and, in practice, neither HMRC nor tax agents act on the basis that there is such a disposal.

The Second Issue: Assuming that an asset is acquired, is there a disposal of it?

If one assumes that the purchaser's rights are an asset for capital gains tax purposes, it is clear that when, under a forfeited deposit transaction, those rights cease to exist because they are forfeited, there will be a disposal of the asset.

The Taxation of Capital Gains Act 1992 s 144, however, provides comprehensive provisions relating to options, and in particular that the abandonment of most sorts of options is not a disposal by the purchaser of the option concerned.

If, on the contract being made, the purchaser acquires an asset (the purchaser's rights) for capital gains tax purposes and these rights are abandoned under a forfeited deposit transaction, then as the First-tier Tribunal accepted in *Hardy* and *Drake*, s 144(4) and (7) together prevent the forfeiture being a disposal of the purchaser's rights. In insolvent vendor transactions, the purchaser's rights will, in most circumstances, come to have a negligible value. If they are assets for capital gains tax purposes, the purchaser may therefore make a claim under the Taxation of Chargeable Gains Act 1992 s 24 for them be treated as the subject of a disposal. Section 147(7) will not apply to insolvent vendor transactions, because they do not involve a forfeited deposit and so will not prevent there being a disposal under s 24.

What conclusion can be drawn on the Second Issue?

In our view, the tribunals were correct in *Hardy* and *Drake* to decide that even if the purchaser's rights are an asset for capital gains tax purposes, s 144 prevents a forfeiture of the right to repayment of a deposit from being a disposal. We also consider that the First-tier Tribunal was correct to accept in *Lloyd-Webber* that s 144 has no application to insolvent vendor transactions.

The Second Issue and the vendor

Where a vendor becomes absolutely entitled to the deposit payment on the forfeit, a capital sum is derived from the vendor's rights, giving rise to a deemed disposal under Taxation of Chargeable Gains Act 1992 s 22.

In our view, the capital sum is derived from the land interest, although this does not appear to be accepted by HMRC. Therefore, when calculating any gain arising on the deemed disposal under s 22, you can deduct a portion of the vendor's expenditure on acquiring that interest.

The Third Issue: If the purchaser does acquire an asset and makes a disposal of it, does an allowable loss arise?

The UT concluded in *Hardy* that the deposit did not give rise to an allowable loss since it was not 'wholly and exclusively' incurred in acquiring the asset as required by the Taxation of Chargeable Gains Act 1992 s 38(1).

In *Lloyd-Webber*, the First-tier Tribunal disagreed with *Hardy*, finding that the consideration was given by the purchaser for his rights and subsequently merged with the land interest. We have already noted the difficulties which this view poses.

In *Drake*, the First-tier Tribunal followed the authority of *Underwood* in deciding for HMRC on all three issues.

What conclusion can be drawn on the Third Issue?

It is clear that the First and Third Issues are interdependent. In our view, a consideration of the coherence of the capital gains tax system results in the conclusion that, because the purchaser does not acquire an asset for capital gains tax purposes consisting of the purchaser's rights on a completion contract being made, no loss can arise on the termination of those rights under a forfeited deposit transaction – or, contrary to the decision in *Lloyd-Webber*, on their becoming of negligible value under an insolvent vendor transaction.

The Third Issue and the vendor

Whatever view one takes of the Third Issue, it is clear that in respect of forfeited deposit transactions the vendor receives a capital sum which, as we have said, derives from the land interest and gives rise to a deemed disposal under Taxation of Chargeable Gains 1992 s 22.

A need for legislative change?

Capital gains tax applies asymmetrically to a forfeited deposit transaction, providing no relief for the real economic loss suffered by the purchaser in being unable to recover the moneys he has paid by way of deposit. That is either because:

- as we consider most likely, the purchaser does not acquire an asset for capital gains tax purposes consisting of the purchaser's rights and therefore cannot make a disposal of them; or
- if he does, s 144(4) and (7) treat what would otherwise be a disposal as not being one.

In contrast, on the vendor becoming absolutely entitled to the moneys paid by way of deposit, he will be treated as making a disposal under s 22 and will be charged to capital gains tax on any resulting gain.

Plainly, the provisions of capital gains tax in respect of forfeited deposit transactions do not reflect economic reality and require amendment. More fundamentally, we need exhaustive and comprehensive statutory rules to determine what is an asset and when an asset is acquired for capital gains tax purposes, particularly in respect of completion contracts. Fifty seven years after the introduction of capital gains tax, that still feels like wishing for the moon.