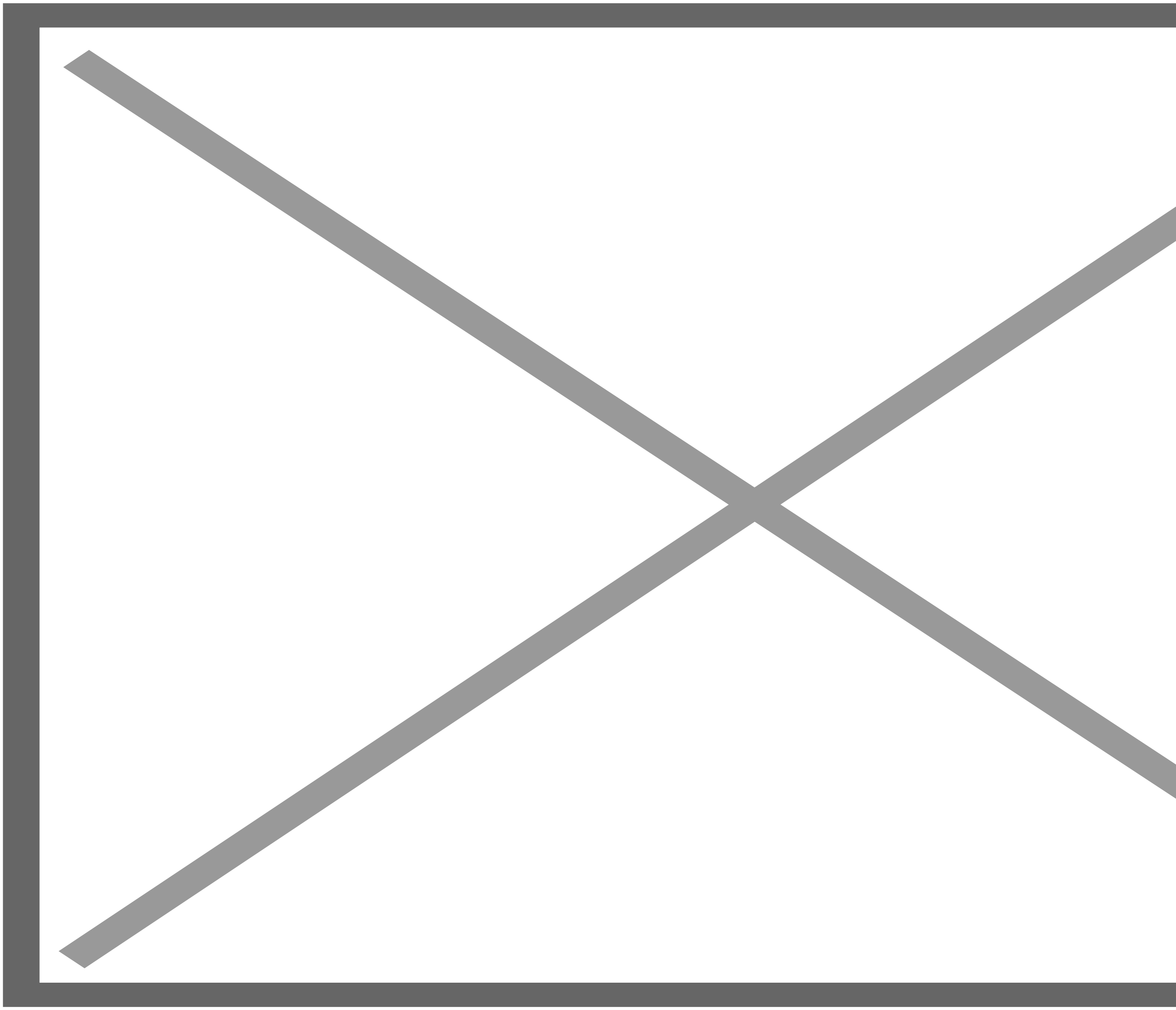
Return of the naïve

Management of taxes Personal tax



01 December 2016

Keith Gordon considers the Upper Tribunal's decision in *Hardy v HMRC* [2016] UKUT 332 (TCC) which concerns the loss incurred on a rescinded contract

Key Points

What is the issue?

The taxpayer sought to offset capital gains with a £72,000 loss suffered on the forfeit of a deposit

What does it mean to me?

The case confirms that an interest in land becomes a chargeable asset only if the purchase contract is subsequently completed.

What can I take away?

The case raises a concern that real losses are not relievable in circumstances where any corresponding gain would potentially be subject to the tax.

The facts of the case

In May 2008, the taxpayer ('Mr Hardy') entered into a contract to purchase a leasehold property, with a view to renting it out. The agreed purchase price was £720,000, with a 10% deposit payable on entering into the contract.

The contract stipulated that Mr Hardy could not assign the benefit of the contract. Thus, should he have changed his mind, he would be forced to forgo the deposit paid.

Under the terms of the contract, completion was due to take place in May 2009. At the time, Mr Hardy was able to raise a mortgage for 75%, leading to a shortfall of £108,000. He attempted to sell two other rental properties that he owned, but was unable to do so in time for the scheduled completion. He duly notified the seller that he was unable to complete and the seller subsequently exercised its right to rescind the contract and to keep the deposit.

Mr Hardy was subsequently able to sell his other two rental properties which gave rise to capital gains. He sought to offset these gains with the £72,000 loss suffered on the forfeit of the deposit.

HMRC considered that the capital loss had been incorrectly claimed and the matter proceeded to the FTT, which disallowed the appeal.

His principal argument in the FTT had been that he had acquired beneficial interest in the property which he lost when he rescinded the contract. The FTT considered that the argument could be disposed of by reference to the decision of the House of Lords in *Jerome v Kelly* [2004] UKHL 25 (which was the subject of my article 'Give and let die' in the August 2004 issue of Tax Adviser). As the FTT held, Mr Hardy did not acquire any relevant interest in the property because the intended transaction simply did not take place. Therefore, the rescission of the contract (and the loss of the £72,000) could not relate to the disposal of any asset and, therefore, failed to qualify for loss relief.

Mr Hardy appealed against the decision and the case was subsequently heard by the Upper Tribunal. In the course of this further appeal, Mr Hardy was permitted to raise a new argument being that the contractual rights acquired by Mr Hardy in May 2008 (rather than the interest in the property itself) amounted to an asset which, when subsequently abandoned, gave rise to an allowable loss.

The Tribunal’s decision

The case came before Mr Justice Arnold and Judge Greg Sinfield.

They prefaced their reasoning with a couple of overriding principles:

1. As put forward by Counsel for Mr Hardy, capital gains tax cases should be guided by normal business principles.
2. However, as countered by Counsel for HMRC, it is not sufficient to point to what is indisputably a commercial loss; instead, one has to ascertain whether the legislative conditions for loss relief are satisfied.

The Tribunal’s subsequent reasoning then turned on three questions, each of which needed to be answered in the affirmative for Mr Hardy to be entitled to his loss relief.

Did Mr Hardy acquire an asset?

The Tribunal noted that the term ‘asset’ is widely defined and can include contractual rights (*O’Brien (Inspector of Taxes) v Benson’s Hosiery (Holdings) Ltd* [1980] AC 562). On the other hand, not every right to payment constitutes an asset within the capital gains tax legislation (*Zim Properties Ltd v Proctor* [1985] STC 90). Indeed, as Warner J held in Zim Properties, a right to a payment of a property’s selling price is not an asset – the relevant asset in that case is the property itself.

In the present case, Mr Hardy obtained the contingent right to have that property conveyed to him subject to satisfaction by him of his own obligations under the contract. However, the Tribunal made it clear that this right (whilst a valuable one) did not constitute an asset for the purposes of capital gains tax. In particular, the Tribunal continued by equating this right to an actual beneficial interest in the property, saying that the two were no more than different sides of the same coin. In other words, the new argument raised by Mr Hardy was ultimately the same as the argument that had previously failed in the First-tier.

One might initially consider that a conclusion that Mr Hardy had acquired a beneficial interest in the property should answer the first question in Mr Hardy’s favour. However, as the Tribunal explained, the question that needs to be addressed is whether or not that beneficial interest constitutes an asset within the capital gains tax legislation.

The fatal blow (so far as Mr Hardy is concerned) is a key part of the speech of Lord Walker of Gestingthorpe in *Jerome v Kelly*. As his Lordship held at [32], the beneficial ownership of a property in such cases is ‘in a sense split between the seller and buyer’ – thereby confirming the view expressed by the Upper Tribunal that Mr Hardy had indeed acquired some beneficial interest in the property. However, in the next sentence of his speech, Lord Walker made it clear that this ‘split’ was based on certain assumptions which could be retrospectively ‘falsified by events, such as rescission of the contract’.

In other words, to use a more modern analogy, any acquisition is merely ‘virtual’ until it is realised by the actual subsequent completion of the contract.

Consequently, the Tribunal answered the first question in the negative, thereby leading to the Tribunal dismissing Mr Hardy’s appeal.

Did Mr Hardy dispose of an asset?

In view of the Tribunal's answer to the first question, this did not need to be addressed. However, the Tribunal dealt with it briefly

In short, the Tribunal held that the Taxation of Chargeable Gains Act 1992 ('TCGA'), section 144 precluded there from being any disposal. Section 144 is better known for dealing with options and for identifying acquisitions with the underlying asset as acquired upon the exercise of the option. However, section 144(7) extends the scope of the provision to deposits such as that paid by Mr Hardy. With this extension in mind, the Tribunal referred to the closing words of section 144(4) which provides that the abandonment of most options shall not be treated as a disposal of an asset. Consequently, the forfeiture of the deposit (even if the payment of the deposit constituted the acquisition of an asset) is not a disposal for the purposes of TCGA.

Did Mr Hardy incur an allowable loss?

Similarly, the third question did not need to be addressed but was again considered briefly by the Tribunal. The Tribunal accepted HMRC's argument that the deposit had not been paid wholly or mainly for the purposes of acquiring contractual rights, but as part-payment towards the intended acquisition of the property. Consequently, the £72,000 paid did not qualify as allowable expenditure for the purposes of TCGA, section 38(1).

Commentary

Having watched the *Jerome v Kelly* case being argued in the House of Lords early in my legal training, I have long been fascinated by its consequences and those of other cases which are fundamental to the operation of the tax, now in its 52nd year, such as *Zim Properties*.

As was said very early on in the life of the tax (*Aberdeen Construction Group Ltd v Inland Revenue* [1978] AC 885), capital gains tax operates in the real world by reference to gains as opposed to mere arithmetical differences. These words came shortly before the advent of what has since been known as the *Ramsay*-doctrine/approach and, certainly with hindsight, can be seen to herald the era of focusing on the substance of transactions rather than any individual component of them.

Thus it should be of some concern that real losses are not relievable in circumstances where any corresponding gain would potentially be subject to the tax. Of course, this anomaly could be easily addressed by Parliament by removing this 'tax nothing' (and perhaps many other tax nothings that blight the tax system). However, I wish to focus on the wider principles. I also wish (for the purposes of simplicity) to avoid any discussion of TCGA, section 28 (which deals with unconditional contracts and which was the focus of the House of Lords' consideration in *Jerome v Kelly*).

It is not surprising that taxpayers and their advisers get confused when told that:

1. interests in land constitute chargeable assets for capital gains tax purposes and
2. that a purchaser of land (when entering into the contract) acquires an interest in the land (or, to use Lord Walker's terminology, some share of the beneficial interest in that land), yet
3. that undeniable interest in the land becomes a chargeable asset only if the purchase contract is subsequently completed.

The key to the difficulty is that tax law operates in the context of the real world which itself is subject to legal principles which have a long history, especially where the law of property is concerned. Tax statutes will usually be presumed to conform with such established principles except where to do so would put an unbearable strain on the tax legislation. However, this can give rise to unexpected results (or at least results that seem unfair and counter-intuitive, as this case demonstrates).

Furthermore, *Zim Properties* tells us that a property owner's right to sue a solicitor in negligence was a chargeable asset, separate from the property itself, yet HMRC have always been happy to ignore this decision and operate a concessionary approach (Extra-statutory concession D33). Given the fact that HMRC have undertaken to codify all ESCs which are not in fact in accordance with the law, the fact that this remains uncodified suggests that perhaps HMRC are not convinced that *Zim Properties* was correctly decided.

In short, I believe that the entire interaction of the capital gains code with the rest of the legal system would merit some very detailed analysis. Such analysis should go back to first principles including the question as to whether or not it should continue to be reconciled with the land law issues or, instead, operate as an entirely artificial code which simply straddles the law of property. Such an analysis will of course have to recognise that the UK tax code has to accommodate (currently) three separate legal jurisdictions where the law of property differs – indeed, that fact could justify the view that the capital gains tax code was not intended to be interpreted entirely in conformity with the law of property of one such jurisdiction.

Or perhaps I am just being naïve.

Update on a previous case analysis

In the February 2014 issue, I wrote an article concerning the complaint made by *Ingenious Media Holdings plc* following unauthorised disclosures to the press made by the then Permanent Secretary for Tax. In its recent judgment, the Supreme Court has since decided that the decision of the High Court was wrong.