THOUGHTS ON *DRUMMOND*[1] AND THE JUDICIAL APPROACH TO TAX AVOIDANCE

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On the surface this case was simply concerned with whether an avoidance scheme, based on the surrender of second-hand life insurance policies, produced the tax results envisaged by the taxpayer. However the case also has broader relevance in relation to the interaction between capital gains tax ("CGT") and income tax, and gives an indication of the current attitude of the Courts towards tax avoidance.

In outline the facts were as follows. London & Oxford Capital Markets ("London & Oxford") was a small investment company which operated as a market maker in second hand life assurance policies. It created a stock of such policies by arranging for an interest free loan to be made to one of its employees, Ms Sedgley, and the latter used the loan to effect life insurance policies with the American Life Insurance Company ("AIG") on 23 February 2001. The policies were real ones and the rights of the policyholder were of an arm's length nature. On 26 March 2001 Ms Sedgley assigned the policies to London & Oxford for a small profit. The latter charged the policies as security for an overdraft on 28 March 2001 and on 30 March 2001 it drew down on the overdraft facility and used the funds to pay substantial additional premiums on the AIG policies. Of course from Mr Drummond's point of view the background is largely irrelevant. His concern was to buy and then surrender second-hand life policies: given that the policies were genuine, their provenance was immaterial. Mr Drummond agreed to purchase five of the policies from London & Oxford for £1.962 million. The five policies had a surrender value of £1.751 million (equivalent to the premiums paid). On 05 April 2001 the Appellant surrendered the 5 policies to AIG. The entire process had cost Mr Drummond approximately £210,000 and the object had been to create an allowable CGT loss of £1.962 million.

The surrender of the 5 policies triggered a charge to CGT and income tax. The dispute with HMRC ("the Revenue") concerned the amounts which could be excluded from the disposal consideration for CGT purposes ("the section 37 issue") and the sums which could be deducted as allowable expenditure ("the section 38 issue"). The taxpayer's position was that the disposal consideration should be reduced to nil, whilst there should be allowable expenditure of £1.962 million, thus creating an allowable loss in the latter amount.

The Scheme of the Legislation

The surrender of an insurance policy resulted in an income tax charge under Chapter II of the Income and Corporation Taxes Act 1988 ("ICTA 1988"). Section 539 of that Chapter provided that it had effect "for the purposes of imposing…charges to tax…in respect of gains to be treated…as arising in connection with policies of life insurance…". In turn s.540(1)(a)(iii) identified the surrender of the whole of the rights conferred by a non-qualifying policy as a "chargeable event". Section 541(1)(b) then provided that:

> "On the happening of a chargeable event…there shall be treated as a gain arising in connection with the policy… (b) if the event is… the surrender in whole of the rights, thereby conferred, the excess (if any) of the amount or value of the sum payable plus the amount or value of any relevant capital payments arising by reason of the event…over the sum of the following (i) the total amount previously paid under the policy by way of premiums; and (ii) the total amount treated as a gain…on the previous happening of chargeable events."

The effect of the above section was to produce a deemed gain ("the chargeable event gain") of £1,351 which was the difference between the surrender value and the premiums paid. An income tax charge was imposed on this deemed gain by s.547(1)(a) which treated the gain as "…part of the individual's total income for the year in which the event happened…".

However in addition to the income tax charge the surrender also triggered CGT consequences. Section 210(3) of the Taxation of Chargeable Gains Act 1992 ("TCGA 1992") provides that subject to subsection (2) "…the occasion of the surrender of a policy of assurance, shall be the occasion of a disposal of the rights under the policy of assurance". Subsection (2) of that section stated that a chargeable gain would only accrue where the disponer was not the original beneficial owner of the policy and acquired the rights for a consideration in money or money's worth. As such the surrender of the 5 policies by the taxpayer was a chargeable event for CGT purposes.

Clearly the application of both taxes created the scope for double taxation. This was addressed by ss.37 and 38 TCGA 1992, and it was over the operation of these sections that the dispute arose as follows.

The Section 37 Issue

Section 37 TCGA 1992 provides that:

> "(1) There shall be excluded from the consideration for a disposal of assets taken into account in the computation of the gain any money or money's worth charged to income tax as income of *("the First Limb")*, or taken into account as a receipt in computing income or profits or gains or losses of, *("the Second Limb")* the person making the disposal for the purposes of the Income Tax Acts." [limb references added]

Prima facie the disposal consideration for CGT consisted of £1.751 million (i.e. the surrender proceeds), and the dispute concerned the amount, if any, to be excluded from this. The Revenue argued that the chargeable event gain fell under the First Limb of s.37, such that only £1,351 fell to be excluded. By contrast Mr Drummond contended that the entire surrender proceeds should be excluded under the Second Limb, on the basis that it was taken into account under section 541(1)(b) ICTA 1988 in calculating the deemed gain. The effect would be to reduce the disposal consideration to nil, and in turn the effect of any allowable expenditure under s.38 would be to produce a loss: this, of course, was the object of the scheme.

Patrick Way, counsel for the taxpayer, made a number of arguments in support of this contention. In outline his main submissions were as follows:-

(i) The chargeable event gain was not "money" or "money's worth" and as such could not fall under the First Limb. Although it was calculated by deducting one sum of money from another this did not mean it was money: on the contrary it was simply the product of an arithmetical calculation. Even though money was the unit of measurement, nonetheless the chargeable event gain was not actually money, e.g. it could not be spent in a shop. Further the phrase "money's worth" meant something of value which could be converted into money, but this was not the case with a chargeable event gain.

(ii) Treating the chargeable event gain as money satisfying the First Limb meant that both parts of s.37 would be satisfied without the section making clear which Limb would take priority. The Second Limb was satisfied because the surrender proceeds were money and they were taken into account in computing the gains (i.e. the chargeable event gains) of the taxpayer for income tax purposes. Mr Drummond's construction, whereby the First Limb was not satisfied, would avoid any overlap between the two Limbs.

(iii) More generally, the First Limb was not applicable because the structure of s.37 showed that the two Limbs were mutually exclusive. The First Limb was concerned with "pure income profits", i.e. sums in relation to which no computation was necessary to determine the amount subject to income tax, for example interest from a building society or a dividend. By contrast, the Second Limb was aimed at amounts which were not themselves subject to income tax but were taken into account in the computation of amounts so charged. The chargeable event gain was not a pure income profit and thus did not satisfy the First Limb, but the surrender proceeds did satisfy the Second Limb.

(iv) The taxpayer's approach was consistent with purposive interpretation. Admittedly, the aim of s.37 was to prevent double taxation and not to allow the creation of artificial losses for tax purposes. However, in adopting highly detailed legislation Parliament's purpose had been to achieve certainty, and it had accepted the risk of anomaly as part of this overall purpose. Indeed HMRC itself had recognised this anomaly since on 09 April 2003 it issued a Budget Note[3] in which it recognised that a taxpayer could create a tax loss where there was no economic loss and it was to correct this "defect" that the legislation was amended by the Finance Act 2003.

The Special Commissioner rejected the taxpayer's argument and held that the First Limb applied. In essence his reasoning was that the surrender proceeds were not monies taken into account in computing Mr Drummond's income, profits or gains for income tax purposes, and instead the only amount so taken into account was the actual chargeable event gain of £1,351.

Similarly Norris J found in favour of the Revenue. His view was that the chargeable gain was "money", since it was the difference between two other sums of money, and thus the First Limb was satisfied. In turn it was not necessary to consider if there was some other sum of money (i.e. the surrender proceeds) which also satisfied s.37. Further and in any event the judge held that the Second Limb was inapplicable because the policy proceeds were not brought directly into the computation of Mr Drummond's total income; on the contrary they simply provided the starting point for the statutory calculation.

The taxpayer appealed against the judge's decision, and in addition to the main arguments above Mr Drummond's counsel also made the following submissions:-

(i) The surrender proceeds were taken into account in computing Mr Drummond's gains, i.e. chargeable event gains. The judge had relied on *Hirsch v Crowthers Cloth Ltd*[4] ("*Hirsch*") in which Vinelott J held that "taken into account" meant being brought "directly" into a computation, but in the present case the judge considered that this had not happened. However a comparison with what Vinelott J regarded as sufficiently direct in *Hirsch* showed that the surrender proceeds did satisfy the Second Limb.

(ii) Norris J introduced a hierarchy into s.37 by saying that once the First Limb was satisfied it was not necessary to see if there was any other money which fell within the section. As such the First Limb took priority over the Second Limb: not only was this not warranted by the wording of the section but in addition would lead to double taxation, as illustrated by the following example.

Assume X Ltd. carried on the business of constructing and selling large retail developments, making up its accounts to the 31st December each year. In the year ended 31 December 2001 it made only one disposal (of a shopping centre) for £100 million. It had acquired the site for £10 million and spent £30 million on development. As such its trading computation for the year would result in a taxable profit of £60 million.

Under the judge's interpretation of s.37 the disposal consideration (which was *prima facie* £100 million) would be reduced by £60 million; the latter would be treated as money since it resulted from the difference between sums of money. £100 million would not be excluded under the Second Limb since the latter would not be considered – instead the First Limb would take priority but this would only allow an exclusion of £60 million.

However, X Ltd's allowable expenditure would still be reduced by £40 million as a result of s.39 TCGA 1992. This would mean that X Ltd would have a chargeable gain of £40 million and be subject to income tax on £60 million – in total the taxable amount would be £100 million although the economic profit was only £60 million.

(iii) The taxpayer's approach was supported by *Revenue & Customs Commissioners v Smallwood*[5] ("*Smallwood*"). In that case the Court of Appeal considered the interaction between ss.38-9 TCGA 1992. Section 39 excluded certain items *prima facie* allowable as deductions under s.38, and the Court held that the word "excluded" was designed to ensure that s.39 could only exclude things which would otherwise be included under s.38. The same reasoning could be applied to s.37, which also contained the word "excluded". Based on *Smallwood* the only sums that could be excluded from the disposal consideration were those which formed part of it in the first place – the chargeable event gain never did so.

The Court of Appeal unanimously found in favour of the Revenue and a single judgment was given by Rimer LJ. In outline the Court's reasoning was as follows:

(i) Interpretation requires more than black letter literalism. The purpose of ss.37-39 was to prevent double taxation, not to "enable the creation of an imaginary loss", and this must be borne in mind when construing s.37.

(ii) This was a case falling within the First Limb. The chargeable event gain was "money" chargeable to income tax, and was a figure which would feature in the taxpayer's tax return like dividends or interest.

(iii) By contrast this was not a Second Limb case. The surrender proceeds were not "taken into account as a receipt in computing income" since they did not feature in the taxpayer's tax return or in accounts he might have to prepare for the purpose of their completion. The Second Limb was aimed more naturally at the case of traders, i.e. it would catch trading receipts and in turn trading expenses would be excluded from deduction by s.39.

The taxpayer's argument that the judgments below were "driven by a desired result rather than by an objective analysis of the language of section 37(1)" was rejected by the Court as unjustified. The Court of Appeal's judgment may leave the reader with a similar feeling. Undoubtedly the result achieved would accord with most people's sense of fairness: it is a "sensible" result, but nonetheless it does not sit easily with the wording of the legislation and in particular the way in which it is applied in other contexts. A number of arguments made by the taxpayer were not addressed, and some of the reasons given by the Court are open to challenge. Some of the key problems are as follows:

(i) It is true that the surrender proceeds do not feature on a tax return, but nor do individual trading receipts, yet the Court accepted that the latter satisfy the Second Limb. Trading receipts do of course feature in accounts, whereas surrender proceeds may not, but in any event it is not clear why a figure must appear in a tax return or accounts for the Second Limb to be satisfied. All that is required is that a receipt be taken into account in a

computation, and the surrender proceeds were. Indeed it is noteworthy that the Court said the policy proceeds were not taken into account in computing "income", but the First Limb also refers to the computation of "gains" – the latter should include chargeable event gains.

(ii) The Court of Appeal's conclusion that the chargeable event gain was "money" within the meaning of the legislation is defensible. However the taxpayer's more fundamental point was that the First Limb was concerned with "pure income profits", i.e. amounts which are subject to income tax without any prior calculations, and chargeable event gains do not fall within this category. The problem is that if chargeable event gains, which are the product of a calculation, can fall within the First Limb then there is no reason why net trading income cannot also. However, the Court recognised that individual trading receipts satisfy the Second Limb, and therefore there would be overlap between the two Limbs and scope for double taxation as indicated by the taxpayer. Unfortunately the judgment does not address the point. The Court may have been comforted by the knowledge that the Revenue is unlikely to apply the legislation to traders in "ordinary" cases in a way that leads to double taxation, but it is questionable whether this should prevent the legislation being applied in a way which is internally coherent. On the one hand it achieves what might be called a "common-sense result", but on the other, the decision if examined closely does violence to the provisions.

(iii) The Court did not explore in depth the underlying cause of the anomalous result contended for by the taxpayer. In an "ordinary" case if a person is subject to both income tax and CGT it is the same figures which are used for both. In turn ss.37 and 39 exclude from the CGT computations the amounts taken into account for income tax purposes. Since they are the same figures the CGT amounts are reduced to nil, such that there is only an income tax charge. This can be illustrated by an example.

Assume a trader bought a widget for £2 and sold it for £10. For income tax purposes he will have a trading receipt of £10 and an expense of £2, leading to a taxable profit of £8. Similarly for CGT his disposal consideration will *prima facie* have been £10 and his allowable expenditure under s.38 £2, producing a chargeable gain of £8. However the effect of ss.37 and 39 would be reduce both by the amounts taken into account in the income tax computation, such that both would be become nil and there would be no chargeable gain.

The mismatch in relation to second-hand life insurance policies flows from the fact that for income tax purposes the chargeable event gain is calculated by deducting from £1.751 million the premiums paid by other persons. However, for CGT purposes the

gain is *prima facie* calculated by deducting from £1.751 million the price paid for the policy by the taxpayer himself. Thus whilst s.37 reduces the disposal consideration to nil, because the same figure was taken into account for income tax purposes, s.39 does not reduce the allowable expenditure to nil because that sum was not used in the income tax computation. This mismatch creates the artificial loss. An appreciation of this might have made the taxpayer's contentions more acceptable notwithstanding the anomalous result.

The Section 38 Issue

The allowable expenditure for CGT was governed by s.38 TCGA 1992 which allows the consideration given wholly and exclusively for the acquisition of an asset to be deducted from the disposal consideration in calculating a gain/loss. The taxpayer argued that the entire £1.962 million paid should have been allowable as a deduction: if he was correct on the s.37 issue, such that the disposal consideration was reduced to nil, the effect would be to create a net loss of £1.962 million for tax purposes. By contrast the Revenue argued that none of the expenditure should have been deductible since Mr Drummond's purpose in acquiring the insurance policies was simply to create a loss for CGT purposes.

The Special Commissioner found in favour of the Revenue, whereas Norris J took a "middle ground". Bizarrely, had the Special Commissioner's decision been upheld Mr Drummond would have made a chargeable gain of £1.75 million. However, Norris J held that expenditure could be allowed under s.38, as a general proposition, because there was no purpose test for CGT (unlike the test that applied pursuant to s.74 ICTA 1988). However only £1.751 million was allowable; the difference of approximately £210,000 represented scheme costs (e.g. London & Oxford's profit, an introductory commission, a contribution to a fighting fund etc.) and as such was not spent wholly and exclusively on acquiring the policies, with the result that it was not allowable.

Mr Drummond appealed on the basis that the various benefits and services acquired in addition to the policies were an integral part of the acquisition, such that their cost should be allowable. Alternatively, the figure of £210,000 was not necessarily correct. The appropriate course was to value the various services and benefits, and in turn the balance would be attributable to the acquisition of the policies: it was wrong to assume that the amount spent on acquiring the policies was limited to their market value of £1.751 million since sometimes a person is willing to pay a greater amount.

The Court of Appeal rejected the taxpayer's arguments. It seems the Court was correct to reject the primary argument that the entire £1.962 million should be deductible; it was clear that some of the expenditure was on scheme costs and this should not have been allowable. The contention that the exact amount attributable to the scheme costs may not have been £210,000 had greater merit, but the Special Commissioner had found that this was the amount as a fact and his decision does not seem to have been so unreasonable that no reasonable tribunal could reach it.

Conclusion

The Court of Appeal's rejection of the taxpayer's s.38 arguments should not create much controversy, but its approach to s37 is noteworthy as a reminder of the judicial distaste for tax avoidance schemes. The Court's conclusion was sensible in terms of the fiscal result, but it was at the expense of an in depth analysis of the provisions and the consequences which could potentially flow from the decision. Of course it is a comfort that the Revenue is unlikely to interpret the judgment so as to allow it to impose double taxation in "ordinary" cases.

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[1] *Drummond v Revenue & Customs Commissioners* [2009] EWCA Civ 609

[2] The author was involved in the case as a pupil of the taxpayer's counsel. The views expressed here are his own.

[3] REV BN 30 Capital Gains: Second Hand Life Insurance Policies

[4] 62 TC 759

[5] [2007] STC 1237