

TAXATION OF DAMAGES, COSTS AND INTEREST (3)¹

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In this paper, I consider three aspects of this matter. First, the decision in *Deeny v. Gooda Walker*; second, issues of capital gains tax and damages (*Zim Properties* and Concession D33); and third, the question of joining the Inland Revenue in private litigation.

*Deeny v. Gooda Walker*²

The issue in this case was whether damages awarded to Lloyd's Names as compensation for losses caused by negligent conduct of their underwriting businesses by their underwriting agents are taxable receipts of the Names' underwriting businesses. The Courts at every stage held that they were, but the agents obtained a dissent in the Court of Appeal from Savile LJ (and leave from the Court of Appeal to appeal to the House of Lords). The agents' case that the damages were *not* taxable receipts of the Names' businesses – and so ought to be computed on a net-of-tax basis following *Gourley* – was that the Names' underwriting businesses consisted of underwriting risks at Lloyd's and were to be distinguished from the apparatus which enabled the Names to carry on their businesses – and the relationships of the Names and their agents was part of that apparatus. Thus damages arising from breach of duty by the agents would not compensate for lost profits of the business (although it would be computed in that way), but would instead be damages for the negligent

conduct of that apparatus underlying the underwriting business.

This distinction between the underwriting business and the apparatus underlying it was unanimously rejected by the House of Lords, and the arrangements between the Names and their agents were held to be part of their underwriting business for tax purposes, so as to make the damages taxable as receipts of the trade – albeit receipts received in unusual circumstances. Thus, the actual decision of the House of Lords was that the damages were taxable because they arose from a contract made in the course of the Names’ underwriting business.

However, an interesting – at least to me – aspect of the case was that the Names (for whom I appeared, led by Geoffrey Vos QC) put forward an additional argument based on first principles, on the nature of receipts of a trade. We said that whether or not the agreement between the Names and the agents was a contract made in the course of the Names’ underwriting business – *ie.* even assuming it was *external* to the business, as the agents argued – the damages would still be taxable as trading receipts because they compensated the Names for trading receipts which had not been received – or trading losses which had been incurred – because of the agents’ negligence. This was called the “wider” argument, and it was based on Diplock LJ’s well-known formulation in *London and Thames Haven Oil Wharves Ltd. v. Attwooll* [1967] Ch. 712, 815, which we said was a correct exposition of the law. That formulation is as follows:-

Where, pursuant to a legal right, a trader receives from another person compensation for the trader's failure to receive a sum of money which, if it had been received, would have been credited to the amount of profits (if any) arising in any year from the trade carried on by him at the time when the compensation is so received, the compensation is to be treated for income tax purposes in the same way as that sum of money would have been treated if it had been received, instead of the compensation.

The principle applies also to compensation received for a trader's liability to pay a sum of money which was a deductible revenue expense (*Donald Fisher (Ealing) Ltd v. Spencer* [1989] STC 256).

We argued that this compensation principle dealt with all cases – and did not simply show how an income receipt was to be distinguished from a capital receipt, because we thought that if a receipt arose *from* a trade it must *necessarily* be of an income rather than a capital nature. It seemed to us to be illogical to suppose that a capital receipt could arise from a trade, because a trade is itself a capital asset which can produce only income profits. If a capital profit arose, it could not be *from* the trade; it could only be from a disposal or part disposal of the trade itself or a capital asset employed in the trade. Lord Hoffmann accepted this argument and Lord Goff expressed no opinion on it – but it was rejected by the other three law lords, who evidently thought that a receipt of a trade could be of a capital or an income nature, so that in order to test the taxability of damages you do not simply apply Diplock LJ's formulation, but you have to ask two questions: (1) was the receipt a

receipt of the trade? and, if so, (2) was it of a revenue or capital nature?

Capital gains tax and damages: *Zim Properties* and Concession D33

Zim Properties v. Procter [1985] STC 90; 58 TC 371 is an extraordinary case. It took 20 months for the Commissioners to state a Case for the High Court, and a further 2½ years after the Case had been stated to get to a High Court hearing. It established (as the Revenue had argued) that rights to take court action are an asset for capital gains tax (CGT) purposes, such that the compensation, or damages – including settlement proceeds – can attract CGT as a capital sum derived from that asset.

Having won *Zim*, the Revenue (four years later – at the end of 1988) issued what is now Extra-Statutory Concession (ESC) D33 on CGT on compensation and damages, promulgating a practice that almost entirely nullifies the effect of the *Zim* decision. The taxpayer in *Zim* had unsuccessfully argued that the settlement proceeds in issue related not to a separate asset, being the right to sue, but were instead proceeds of a part disposal of the underlying asset about which the negligent advice had been given and the original proceedings brought. The Court's decision that this was wrong affected the base cost which could be deducted from the compensation figure, and also the availability of reliefs to shelter the resultant gain – e.g. indexation relief (now taper relief for an individual), rollover relief, etc.

The ESC, however, while setting out the strict position as established in *Zim*, goes on to give relief by concession, which can be summed up as follows. Where the right of action relates to an *underlying asset* – for example, a property in the case of an action against an estate agent for negligent advice on sale – the compensation can be treated as proceeds on a disposal, or more likely a part disposal, of the underlying asset – i.e. the property, with the allocation of base cost and availability of reliefs and exemptions appropriate to such a disposal or part disposal. On the other hand, where there is *no underlying asset* – no asset in relation to which the right of action arises (for example a claim against advisers for negligent financial, including tax, advice), the Revenue grant exemption from CGT for any gain arising on the disposal of the right of action.

Sometimes it is not easy to establish whether there is an underlying asset, and if there is one, what it is. I had a case recently concerning a partnership of surveyors, who carried on a normal professional surveying business, but also looked for investment opportunities. When two partners found an investment opportunity, but did not invite the other partners to participate in it on terms reflecting their profit sharing ratios, the other partners sued for breach of the partnership agreement (which was not in writing) and claimed that the two defendant partners were constructive trustees of the property concerned for the firm. The defendants denied that they were constructive trustees, and the action was settled on the basis of substantial compensation paid to the claimant partners

and an agreement that the two defendant partners were not and had never been constructive trustees of the property. In these circumstances, what, if anything, was the underlying asset relative to the compensation received? I thought it was arguably the partnership goodwill, and that the compensation should be treated under the ESC as proceeds of a part-disposal of the goodwill.

The thinking behind the underlying asset approach in the ESC also confirms (as is recognized in the ESC) that any compensation received in respect of a right of action for personal injury or defamation, or unfair or unlawful discrimination suffered in the person, is exempt from CGT, because of the specific provision (s.51(2) TCGA 1992) that sums obtained by way of compensation or damages for any wrong or injury suffered by an individual in his person or in his profession or vocation are not chargeable to CGT.

Joining the Inland Revenue in private litigation

By RSC Ord. 77, rule 8A (Schedule 1 to the Civil Procedure Rules 1998 SI 1998/3132) reads -

Nothing in CPR rule 19.3 shall be construed as enabling the Commissioners of Inland Revenue to be added as a party to any proceedings except with their consent signified in writing or in such manner as may be authorised.

The Commissioners may, however, themselves apply to be joined as a party. In practice, therefore, it is up to the

Revenue, whether they decide to be joined, and their decision seems to be taken on a case-by case basis.

In my own recent experience, the Revenue consented to be joined in two cases, *Lloyds UDT v. Standard Chartered Finance Trust Holdings plc and Others*³, and *Toronto-Dominion Bank v. Oberoi and Another*⁴. They also, of course, consented to be joined in *Deeny v. Gooda Walker*. The first case (*Lloyds UDT*) was in reality about the proper construction of a tax provision – s.35(2) CAA 1990 and one can immediately see the Revenue's interest in being there. This was also the position in *Deeny*, where the tax consequences of an award of damages to a trader was in issue. But the second case, *Toronto-Dominion Bank*, was a rectification action, which had tax consequences because the Bank sought rectification of a lease, which was in terms a lease for an upfront payment of rent, saying that it should be rectified to show the payment as a premium, and not rent. This had Schedule E implications because the lease was a lease of accommodation provided for the Bank's employee. The Revenue unsuccessfully opposed the grant of rectification. The Revenue's decision to be joined in this action was more unexpected. They had not sought to be joined in the last reported tax-related rectification action (where rectification was refused, despite their not being there) – *Racal Group Services Limited v. Ashmore* (1995) 68 TC 86. I am inclined to see a change in policy over the period since 1995, and suggest that the Revenue are more likely than they were previously to want to be joined in private litigation which raises a tax point.

Against this, I notice that in *Abacus Trust Co (Isle of Man) Ltd v. NSPCC*⁵, a case heard in July 2001, where Patten J applied the principle in *Re Hastings-Bass*⁶ to declare void *ab initio* a trustees' appointment which had been made in disregard of tax advice and which had calamitous tax consequences, the Revenue refused either to be joined in the proceedings or to be bound by the Court's decision – reached, inevitably, in their absence. In these circumstances, the judge expressly stated that he was satisfied that Counsel had put before the Court all matters relevant and necessary for a proper decision in the case.

Where the actual tax consequences of a transaction could not be affected by the result of the case, there will usually be no occasion to join the Revenue, even where the proper construction of a tax provision is in issue. A recent example is *Grimm v. Newman*⁷, a negligence action concerned with the proper application of the remittance basis. The Revenue were not there, even though this was apparently a matter of regret to the Court of Appeal, because on the facts Mr. Grimm's case had been settled with the Revenue and he was suing his accountant in the light of that settlement. Where, on the other hand, the tax consequences of a transaction are in issue, the Court will usually suggest that the Revenue are given the opportunity to consent to be joined, if the parties have not approached them themselves, and even if they object to doing so. Where the Revenue are joined, they may propose that they bear their own costs in any event and are not liable for any other party's costs in any event. This was the position in *Lloyds UDT*.

There was no such proposal in *Toronto-Dominion Bank*, with the result that the Revenue ended up with a liability for the other party's costs.

¹ From a paper contributed by the author to a seminar of the Chancery Bar Association chaired by Park J, on 24th February 2003.

² [1996] STC 299 (HL).

³ [2001] STC 1652 (Ch D); [2002] STC 956 (CA).

⁴ Digested in [2003] STI 171.

⁵ [2001] STC 1344.

⁶ [1974] STC 211; [1975] Ch 25.

⁷ [2002] STC 84 (Ch D); [2002] STC 1388 (CA).