ESC D33 is to be no more

Personal tax | Tax voice



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Gillian Banks summarises recent changes to this important ESC and HMRC's proposals to legislate it

Extra statutory concession D33 was published in 1988 following the judgment in *Zim Properties Ltd v Proctor* [58 TC 371]. Broadly the Court decided that the right to take court action for compensation or damages is an asset for capital gains tax purposes, often with little or no base cost, and the receipt of compensation is then a capital receipt that will be taxable.

Notwithstanding the wording in the concession HMRC considers that where there is an underlying asset, for example shares in a company or a building, the compensation is to be treated as derived from the asset, which is a purposive interpretation of the legislation rather than concessionary. This means that on receipt of compensation, there may be a part disposal of the asset (using part of the base cost), or for example if the receipt is used to repair or replace the property no gain or loss may arise.

The concession applies where there is no underlying chargeable asset – for example where losses have been incurred as a result of incorrect professional advice, private or domestic issues. In advance of the proposed consultation HMRC announced in January 2014 that in these cases the amount of compensation that would be exempt would be limited to £500,000. However, this is subject to HMRC review on a case by

case basis for larger amounts to ensure they remain within HMRC's collection and management powers. The clear implication was that relief on higher amounts would only be granted in exceptional cases. The CIOT and others responded to this unexpected announcement saying that the limit was arbitrary and could give rise to unfair results, two examples of which were included in response.

A formal consultation was published by HMRC in July 2014. It proposed that the concessionary elements of ESC D33 would be legislated, and that an increased limit of £1million should replace the £500,000 in the concession as it presently stands. A summary of the responses was published in November 2015, and it is noteworthy that all of the respondents disagreed with the proposal to limit the exemption to £1million, as such a limit was considered to be arbitrary. Several disagreed with the principle of taxing such compensation at all.

Compensation that would typically be affected by a limit would be for some kind of financial loss. In the absence of a tax charge the Courts will normally order compensation, or its amount will be negotiated between the parties, to put the claimant in the same financial position as they would have been but for the fault. It would be unusual for a claimant to end up in a better position, so it seems strange that the compensation, whatever its level, should be taxable.

Take the example where an individual transfers cash, of say £2million to their solicitor for the purchase of a property, and that money is misappropriated. If the individual were unable to obtain repayment, but sued the solicitor and was eventually compensated it would appear that £1million of the compensation would be taxable under the proposed new rules. The compensation simply restores the cash and there is no profit to the individual. The cash was not a chargeable asset so it would seem anomalous to tax it, which was presumably the purpose of ESC D33.

The Government is concerned that compensation which represents a profit or gain that an individual would have made but for the wrong, and which would have been taxable (or ought "reasonably" to be taxable) should still be taxable.

In practice it is likely that any compensation awarded or agreed would be grossed up (the *Gourley* principle) to cover the tax cost, so ultimately is will be the party at fault or their insurers who may have to bear this additional cost.

In their summary of responses the Government stated that before deciding on the next course of action the concerns raised would be discussed in more detail with the

respondents and this is progressing at present.

It is proposed that two further parts of the ESC are legislated and extended as follows.

Receipt of damages for wrong or injury suffered by an individual personally or in their profession or vocation are exempt under statute – section 51 TCGA 1992. The Government is proposing to extend this where the wrong or injury is to an individual in their trade or employment, and also where compensation is paid to relatives or personal representatives of a deceased person for distress or loss of financial support.

Finally, there is a proposal to extend section 49(1)(c) TCGA 1992, which deals with adjustments to capital gains computations where warranty payments are made, to include payments under indemnities. Whilst there is a legal difference between warranties and indemnities, their commercial impact (usually a repayment of proceeds) tends to be identical.

Both of these proposals received universal support and the Government will consider legislating them along with whatever is decided upon in relation to limiting the exempt amount once the consultation has been finalised.

It may be difficult to draft legislation that will deal with exempting compensation where there has been no gain or profit, whilst limiting the amount (or indeed perhaps taxing without limit) compensation that does represent profit. However, it is apparent that HMRC is keen to understand the issues clearly and it is to be hoped that the eventual legislation will be easily understood and result in a logical outcome.