Party animals

KEVIN SLEVIN considers whether expenditure that enhances the value of a capital asset is always tax deductible.

Capital gains tax has been with us for nearly 50 years. There have been many changes since FA 1965 introduced it, but most of the basics have changed little. A good example of this is what is now TCGA 1992, s 38, which determines exactly what expenditure can be deducted when computing the amount of any capital gain.

In the vast majority of cases it is blindingly obvious what expenditure can be properly claimed, but throughout the life of this tax there has been uncertainty as to the correct treatment of a number of payments.

Although the facts may be unusual, the following example highlights some of the issues, particularly why costs – costs directly relating to a transaction – may not be properly deductible. Working out the amount of a capital gain can be loaded with difficulty for the adviser.

The background

Let's say that the shares in Party Animals Ltd were sold in 2011/12 for a total of £10m and one of the shareholders, Huey, wants to be sure that his share of the capital gain is correctly disclosed on his personal tax return. In particular, Huey wants specific confirmation that one substantial item of expenditure can be properly deducted in calculating the assessable gain.

Party Animals Ltd specialised in organising parties for the so-called "jet set" and all the shareholders had owned their shares since incorporation which was eight years prior to the sale. The shares were held by three individuals Huey, Dewey and Louie – but only Huey seeks advice. They each owned 300 ordinary £1 shares out of an issued share capital of 900 £1 shares.

KEY POINTS

- A shareholder agrees to pay an employee a proportion of any personal share sale proceeds.
- Is that payment deductible under TCGA 1992, s 38?
- Has the nature of the asset been changed by the payment?
- Other ramifications – is this employment income under ITEPA 2003, Part 7A?
- Is it time for a review of TCGA 1992, s 38?

Image Source/Getty Images

The three founder shareholders had seen the opportunity to invest in a business which largely revolved around Donald, who had a track record of being able to organise and run top-notch functions almost at the drop of a hat. His previous employment had come to an end through no fault of his own and our three shareholders saw the potential to set up a new company, Party Animals Ltd, to exploit Donald's talents and their financial acumen and cash resources.

Donald had no money of his own to invest in the new company but, having been offered share options in his previous (failed) employer company, was keen to have some form of participation in the equity in the event of the new company being successful.

Dewey and Louie were against any form of equity participation by Donald but, in order to bring him on board, Huey entered into an agreement with Donald that he would pay him 15% of any sale proceeds received in the event of a sale taking place while Donald was still employed by Party Animals Ltd. This was a purely commercial decision by Huey who had no family or other connection with Donald. Although this side deal was evidenced in writing, it was to be a confidential matter between Huey and Donald and has never been disclosed to any other person including the solicitors advising on the sale of Party Animals Ltd in January 2012.

In accordance with their agreement, a payment of £500,000 was made by Huey (out of his £3,333,333 share of the sale proceeds) to Donald in March 2012. Huey was content to benefit less from the sale than Dewey and Louie as his belief all along was that, without their confidential agreement, Donald would not have worked as hard for Party Animals Ltd as he did and, as a result, the company would not have been sold for £10m. Huey was content that he had effectively received net proceeds of £2,833,333 and was not concerned that his fellow shareholders had benefitted from the confidential agreement with Donald.

The issue

Although happy to have paid Donald £500,000, Huey did not wish to pay tax on a capital gain which was £500,000 greater than what he regarded as the true gain and therefore wanted advice on the question of how he could obtain tax relief on this amount. Being eligible to claim that the entrepreneurs' relief rate of 10% should apply to the whole gain, Huey realised that a successful claim would result in a tax saving of £50,000.

Huey sought advice from his tax adviser on whether he could simply exclude the £500,000 and declare the sale proceeds as the net amount. The adviser's initial response was to ask Huey to obtain an opinion from his solicitor as to whether or not the agreement was such that Donald had acquired (on entering into the arrangement) a beneficial interest in the shares disposed of. Alternatively, did Donald's interest, which was contingent upon a sale disposal taking place, amount to no more than an interest in the proceeds of sale (if and when such a sale occurred during his continued employment).

Huey's solicitor confirmed that Donald had no interest in the shares. Instead, his entitlement only arose as a chose in action once a sale had taken place. Accordingly, from a tax standpoint, Huey was required to disclose the gross proceeds before taking account of the payment to Donald.

So was the £500,000 payment to Donald an allowable deduction in computing Huey's capital gain given the restrictions to such deductions in TCGA 1992, s 38?

The s 38 restriction

It is always useful to look at the wording of the legislation. This is particularly so where the adviser feels confident that he or she already knows what the law is. Rereading a statute can often lead to a surprise point surfacing – of course, whether this is helpful or not in any given situation depends upon the facts.

The relevant legislation, ***TCGA 1992, s 38(1)*** – which has not materially changed since the introduction of capital gains tax in 1965 – is briefly summarised in HMRC's *Capital Gains Manual* (at CG15160) as covering consideration given by the taxpayer wholly and exclusively for:

(i) acquiring the asset;
(ii) creating the asset;
(iii) enhancing its value;
(iv) establishing, preserving or defending title to or rights over the asset;
(v) incidental costs of acquisition and disposal.

How is the payment to Donald to be treated?

Clearly, as regards (i) above, ie expenditure incurred acquiring the asset, although the arrangement under which the payment was made to Donald was entered into at the same time as Huey subscribed for his shares in Party Animals Ltd, there are no grounds for arguing that the payment related to the acquisition of his shareholding in Party Animals Ltd. There is no suggestion that (ii) above is applicable and so this takes us to (iii), ie whether the payment can properly be regarded as enhancement expenditure.

TCGA 1992, S 38(1)

"Except as otherwise expressly provided, the sums allowable as a deduction from the consideration in the computation of the gain … shall be restricted to:

(a) the amount or value of the consideration, in money or money's worth, given by him or on his behalf wholly and exclusively for the acquisition of the asset, together with the incidental costs to him of the acquisition or, if the asset was not acquired by him, any expenditure wholly and exclusively incurred by him in providing the asset;
(b) the amount of any expenditure wholly and exclusively incurred on the asset by him or on his behalf for the purpose of enhancing the value of the asset, being expenditure reflected in the state or nature of the asset at the time of the disposal, and any expenditure wholly and exclusively incurred by him in establishing, preserving or defending his title to, or to a right over, the asset;
(c) the incidental costs to him of making the disposal."

Enhancement expenditure

Paragraph CG15180 of HMRC's *Capital Gains Manual* focuses on the issue of enhancement expenditure and states that, in order to qualify as a deduction under this heading, the expenditure must:

- have been incurred *on* the asset;
- have been incurred for the purpose of enhancing the value of the asset; and
- be reflected in the state or nature of the asset at the date of disposal.

Paragraph CG15182 suggests that the words "on the asset" mean something more than simply being a payment in connection with the asset. The guidance states:

> "For example, a parent company may be required by the purchaser to secure the resignation of certain officers of a subsidiary company before completion of the sale of shares in that subsidiary. In order to achieve this, the parent company makes compensation payments to those officers. The shares are 'the asset' here. The compensation payments cannot be regarded as expenditure on the shares."

According to the above wording in the manual, the indications are that the expenditure is not allowable as enhancement expenditure.

Let us set aside HMRC's above approach for the moment and turn to the need to demonstrate that the payment to Donald has been incurred for the purpose of enhancing the value of the shares in the example of Party Animals Ltd. Donald was clearly a key executive of the company and his input obviously played a major part in building up the value of the goodwill of the business – which he will, let's say, continue to do as managing director reporting to the new owner for at least three years after

the founder shareholders have exited. One would therefore hope that HMRC would accept this as meeting the "enhancing the value" test.

However, while Huey's intention in entering into the arrangement was to motivate Donald (as the key "mover and shaker" in the business) thereby pushing up the value of the company in the event its sale, HMRC may try to argue that it cannot be said that the payment was incurred *on* the shares disposed of.

The nature of the asset

A seemingly more difficult issue in the example of Huey's gain is the need to show that, whatever the expenditure related to, it can be seen as being reflected in the state or nature of the asset – as distinct from merely enhancing the value thereof. The problem is that, when it comes to the disposal of shares, HMRC appears to take a very restrictive approach. Paragraph CG15184 states:

> "Where the asset is shares, [HMRC] would be looking for an alteration in, say, the rights attaching to those shares."

Although it can be said to be a logical interpretation on a first reading of the legislation, it seems more than a little harsh for HMRC to take such a stance in modern times. At the very least this approach seems to ignore the purposive approach to be adopted in interpreting tax statue. Alas, HMRC can find support for the decision of officials to take the literal approach in the judgment in *Aberdeen Construction Group Ltd v CIR* [1978] STC 127 where Lord Emslie commented on requirements of the legislation as follows:

> "...what [s 38(1)(b)] is looking for is, as the result of relevant expenditure, an identifiable change for the better in the state or nature of the asset, *and this must be a change distinct from the enhancement of value*."

Clearly, the payment to Donald described above cannot be said to have resulted in a change in the state or nature of the shares held by Huey and HMRC may well therefore seek to disallow the payment – especially coupled with their likely approach as regards the need to show the expenditure being incurred directly on the asset as discussed above (an approach which can be said to be dubious in the extreme). Facing the prospect of disallowance as a result of HMRC refusing to accept that the payment to Donald falls within s 38(1)(b), is there any scope for a claim within s 38(1)(c), namely incidental expenditure?

Incidental costs of disposal

While s 38(1)(c) allows a taxpayer to deduct incidental disposal-related expenditure in arriving at his gain, s 38(2) thereof removes any doubt about the deductibility of the sum paid to Donald as if it were an incidental cost of disposal by spelling out in no uncertain terms an exhaustive list of those items to be considered as incidental for this purpose. Paragraph CG15251 quite correctly states that allowable incidental costs are limited to:

- fees, commission or remuneration paid for the professional services of any surveyor, valuer or auctioneer, accountant or agent and legal adviser;
- the costs of transfer or conveyance (including stamp duty or stamp duty land tax);
- costs of advertising to find a buyer or seller; and
- costs reasonably incurred in making any valuation or apportionment required for the purposes of the capital gains tax computation.

The payment to Donald will therefore *not* be allowed as an incidental cost of disposal.

Non-allowable costs

On the face of things, while there is every commercial justification for Huey to take into account the £500,000 payment to Donald in calculating his 2011/12 capital gain, he will need to consider very carefully the likely approach to be adopted by HMRC and, should a claim be made, he will need to make such entries on the tax return white space so as to leave no doubt as to the stance taken in the computation and its variance from the approach reflected in HMRC's manuals. Some explanation will also be called for as to why any particular case can be differentiated from the *Aberdeen Construction Group Ltd* case referred to above.

Although the example in this article concerns a share disposal, many more uncertainties are encountered as regards transactions involving land sales. (See, for example, "Gift with claw-back" in this week's Readers' Forum, page 21.)

All manner of arrangements may be entered into with a view to structuring a transaction so as to meet the competing commercial needs of those involved. For example, what is the strict position where a number of adjoining landowners agree to effectively pool areas of the land they each own to make a single application to the planning authority?

Assuming the parties are not connected persons, the coming together of the land owners in question and the negotiated terms under which they will allocate the ultimate disposal proceeds will have been determined commercially, yet HMRC may try to argue against the deduction of equalisation payments made by one land owner to one or more of the others. It may be that the planning authority has particular aspirations as regards the need for green spaces, social housing, etc which can distort the value of one party's land when compared with the others, but his land may be essential to the overall plan because of, say, the need for good access or, indeed, it may be ideally suited as a location for the required social housing, thereby enhancing the value of the land owned by adjoining land owners. Whereas the recipient of a payment under an agreement to even out the value derived from the overall planning application will be taxed thereon, HMRC have been known to try and argue that the payment is not an allowable deduction in computing the payees' capital gain.

Time for a review

The above is clearly not good news for taxpayers, but the question which now needs to be addressed is whether, after nearly 50 years of operation, it is time to update s 38 so that:

(a) any capital expenditure incurred in relation to the acquisition or disposal of an asset;
(b) all capital expenditure incurred in relation to attempts to alter or improve or enhance the asset, whether or not this expenditure influences the final level of sale proceeds; and
(c) any expenditure incurred by the owner of an asset so as to facilitate the growth in its value or its disposal (which does not itself result in the acquisition of an asset by the taxpayer – whether chargeable or not);

should similarly be deductible to arrive at the true commercial capital gain to be assessed.

Those called upon to advise on the capital gains tax aspects of a particular transaction need to be alert to the other tax ramifications which might not be addressed. For example, in Donald's case, he is employed by Party Animals Ltd and there is no doubt that the £500,000 payment – although triggered by a disposal by Huey of his shares in Party Animals Ltd – does not relate to the sale of the shares by Donald. He has no interest in the shares and his entitlement arises only if the shares held by Huey are disposed of and only if it can then be shown that he is still employed by Party Animals Ltd. The payment made under the arrangement with Huey can only be said to be derived by Donald by reason of his employment and so, at first sight, there is nothing really controversial in saying that Donald is required to disclose the payment received as income on his personal tax return. However, could there be more to this than first meets the eye as a result of FA 2011, Sch 2 now to be found in the new ITEPA 2003, Part 7A?

Disguised remuneration

Although commonly referred to as "the disguised remuneration rules", Part 7A is in fact entitled "Employment income provided through third parties". As the title suggests, these anti-avoidance measures are aimed at employers, directors and employees who involve third parties to effect payments to one or more persons who are employees or officeholders.

Although the provisions are largely designed to counter tax avoidance carried on through the use (HMRC would say "abuse") of employee benefit trusts, the measures are structured in a way which can catch many varieties of arrangements. Arguably, one such arrangement is of the type under which Huey is liable to make a cash payment to Donald. While the arrangement in the example of Donald described above pre-dates 6 April 2011, ie the date from which FA 2011, Sch 2 came into operation (although see also the forestalling provisions covering the period from 9 December 2010 to 5 April 2011), these rules apply to all relevant steps (as defined) occurring on or after 6 April 2011.

Briefly summarised, it is possible to say that ITEPA 2003, s 554A has effect so that new rules operate where, among other things, an employee (referred to as "A" in the legislation) enters into a "relevant arrangement" which relates to A where it is reasonable to suppose that the arrangement in question is, in essence, wholly or partly a way of providing a reward in connection with A's employment with his employer (referred to as B in the legislation) and a "relevant step" is taken by a relevant third person, a step which it is reasonable to suppose is taken pursuant to the relevant arrangement. Suffice to say here that, subject to certain specific exclusions (see below), the making of the cash payment by Huey to Donald will be regarded as a relevant step and the value of it – £500,000 in the above example – may be:

(a) regarded as employment income for the tax year in which it is paid; and
(b) must be regarded as such by his employer for the purposes of operating PAYE and calculating National Insurance contributions. It is important to note here that the obligation to account for tax falls on the employer – whether not he is aware of the arrangement! Furthermore, if there is a liability under Part 7A which is settled by the employer company, unless the employee makes good this sum within 90 days, the sum paid in respect of income tax and employee NIC is assessable on the employee as a benefit in kind.

> ***"Those called upon to advise need to be alert to the other ramifications which might not be addressed."***

Overlap relief

The good news is that ITEPA 2003, s 554Z6 headed "Overlap with certain earnings", has effect so as to exclude from the operation of Part 7A an amount of earnings already falling to be taxable on Donald within ITEPA 2003, s 62. Clearly, the third-party payment to Donald falls within s 62 and, therefore, the need for Party Animals Ltd to concern itself regarding Part 7A ceases. This exclusion from the provisions would appear to be so regardless of whether Donald correctly declares the sum received as earnings liable to income tax or not. For example, if Donald fully disclosed all matters on his tax return, but mistakenly regarded the payment as being a capital receipt liable to capital gains tax, if the treatment adopted was not challenged as a result of an enquiry by HMRC and provided the level of disclosure was sufficient to prevent the application of TMA 1970, s 29 (the so-called "discovery provision") HMRC will not be in a position to opt to apply the Part 7A provisions.

Had the arrangement with Donald involved – whether wholly or in part – the provision of a benefit taxable under the normal benefit rules, the position would alter. This is because, unlike the case with cash payments described above, the Part 7A provisions take priority over the normal benefit in kind provisions. The value of the benefit as determined under Part 7A becomes liable to PAYE and NIC, with the liability falling on Party Animals Ltd – and in turn on Huey, Dewey and Louie under the terms of the share sale agreement. Best not to think about it. ■

Kevin Slevin provides technical tax advice and support to accountants in practice and he is also the author of *Entrepreneurs' Relief: A Guide for Accountants*.
Kevin can be contacted at kevin@slevinassociates.co.uk.