The Personal Tax Planning Review

CAPITAL GAINS TAX AND PERSONAL INSOLVENCY

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Introduction

As the recession draws on, the number of bankruptcies and other personal insolvencies is increasing. Trustees in bankruptcy, and those who advise them, are encountering capital gains tax ("CGT") issues with greater frequency. CGT is of importance particularly to a trustee in bankruptcy because his function is to "get in, *realise* and distribute a bankrupt's estate".[2] This article attempts to deal with some of the CGT problems which are encountered in bankruptcy and other personal insolvencies.

Disposals of Assets by Trustees in Bankruptcy

The statutory provision, s.66(1) of the Taxation of Chargeable Gains Act 1992 ("TCGA 1992"), which deals with this area is badly drafted and ambiguous. It provides -

> "In relation to assets held by a person as trustee or assignee in bankruptcy or under a deed of arrangement this Act shall apply as if the assets were vested in, and the acts of the trustee or assignee in relation to the assets were the acts of, the bankrupt or the debtor (acquisitions from or disposals to him by the bankrupt or debtor being disregarded accordingly), and tax in respect of any chargeable gains which accrue to any such trustee or assignee shall be assessable on and recoverable from him."

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[2] Insolvency Act 1986, s.305(2).

It is unfortunate that the section declares that assets vested in the trustee will be treated for the purposes of the TCGA 1992 as vested in the bankrupt (in which case disposals will be treated as being made by the bankrupt and any gains will therefore be treated as accruing to the bankrupt[3]) and then speaks of gains which accrue to the trustee.

On one view this section should provide for a certain continuity of CGT treatment. It clearly provides that disposals to the trustee in bankruptcy from the bankrupt and *vice versa* are to be disregarded - which makes sense, given that all of the bankrupt's estate passes by operation of law to the trustee without the need for any conveyance.[4] Again, sensibly, the section provides that the trustee is assessable for CGT as he will be the person who holds the funds from any realisations of the bankrupt's estate. This interpretation relies upon reading the closing phrase of the section "which accrue to the trustee" as "which, notwithstanding the foregoing, in fact accrue to the trustee." On this view the gains in respect of any property will be taxed at the bankrupt's marginal rate of income tax, the annual exemption under s.3(2) TCGA 1992 and all and any of the bankrupt's allowable expenditure will be available upon the trustee's realisations of the bankrupt's estate. Any carried forward losses of the bankrupt[5] will be available for offset against gains. Reliefs, such as retirement relief under ss.163 and 164 TCGA 1992, and exemptions, such as the inter-spousal transfer exemption under s.58 TCGA 1992, may be also utilised.

However, there is a contrary view which suggests that because the trustee has been held to be the person upon whom the liability for capital gains tax falls in respect of the disposal of assets by him[6] such continuity of treatment is not available.[7] It is said that as a consequence of this, trustees in bankruptcy are not entitled to any part of the annual exemption under Schedule 1 TCGA 1992. On this view, it will also be the case that the only appropriate rate of capital gains tax chargeable in respect of disposals by trustees in bankruptcy is that which is equivalent to the basic rate of income tax because trustees in bankruptcy, like all trustees, are not "individuals".[8] Reliefs and exemptions would similarly not be available under this view.

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3 TCGA 1992, s.1(1) and s.2(1).

4 Insolvency Act 1986, s.306(1) and (2).

5 Including any trading losses arising in the 1991-92 and subsequent years of assessment: Finance Act 1991, s.72.

6 *Re McMeekin* (a bankrupt) [1974] STC 429 (QBD NI).

7 *Whiteman on Capital Gains Tax* 4th Edition (1988) para 25-41.

8 TCGA 1992, s.4(1) and (2).

The better view is probably the former. That interpretation provides consistency with other parts of the capital gains tax code[9] whereby disposals made by bare trustees and mortgagees are treated as if they were made by the beneficiary or mortgagor.[10] In the writer's opinion, this approach undoubtedly represents the intention of the section. Certainly, the bankrupt's estate is not "settled property"[11]; accordingly, Schedule 1 TCGA 1992 is not relevant in any event.

Sale by a Mortgagee of Charged Property

There is some further uncertainty in the case where a mortgagee of property mortgaged by a bankrupt exercises his power of sale of the property and realises a gain. Generally, for CGT purposes, a mortgagee is treated in the same way as a nominee of the mortgagor and the mortgagor is therefore the person who is chargeable and assessable to CGT.[12] The trustee in bankruptcy, however, will be the person who is assessable to capital gains tax in respect of a disposal when the mortgagor is an undischarged bankrupt.[13] If the mortgagee leaves the trustee with insufficient funds both to pay the capital gains tax bill and to discharge the mortgage, in such circumstances it appears that the capital gains tax liability must be satisfied first.[14] It seems that the mortgagee will have to prove, as an unsecured creditor, in respect of any funds accruing from the realisation which are taken to pay the capital gains tax liabilities.[15]

Payment of Capital Gains Tax

Capital gains tax due in respect of any disposals made by a trustee in bankruptcy is an expense of the bankruptcy which must be discharged before any of the bankruptcy debts, even the preferential debts.[16] The liability to pay capital gains

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9 Which *Whiteman* recognises: para 25-40.

10 TCGA 1992, s.60(1) and s.26(2) respectively.

11 *Ibid*, s.66(4).

12 *Ibid*, s.26(2).

13 *Ibid*, s.66(1).

14 *Re McMeekin* (a bankrupt) [1974] STC 429, 432, per Lowry C.J. And see Insolvency Rules 1986, r.6.224(1)(p) (discussed below).

15 *Re McMeekin supra* 433.

16 *Re Mesco Properties Ltd* [1979] STC 11 (HC) and 789 (CA), a pre-Insolvency Act 1986 case on the correct treatment of corporation tax on chargeable gains in a liquidation.

tax on chargeable gains accruing on the realisation of any asset in a post-29th December 1986 insolvency[17] is clearly an expense of the bankruptcy, and not a personal liability of the trustee.[18] This is because the trustee's remuneration, up to an amount not exceeding the sum payable to the official receiver, has priority over the capital gains tax liability in respect of any realisations made by the trustee.[19] This is so without regard to whether the realisation is effected by the trustee, a secured creditor or a receiver or manager appointed to deal with a security. For the purposes of the Insolvency Act 1986 "a security" includes, in England and Wales, any mortgage, charge, lien or other security.[20]

Other Forms of Insolvency Procedures

Any capital gains accruing to the trustee of a deed of arrangement made under the Deeds of Arrangement Act 1914 are treated in exactly the same way as gains accruing to a trustee in bankruptcy. The deed of arrangements procedure is seldom encountered.[21]

Instead, individual voluntary arrangements ("voluntary arrangements") are becoming increasingly popular. They differ from bankruptcy proceedings in that, generally, the debtor's assets do not become vested in the supervisor of the voluntary arrangement.[22] This is because the proposals for voluntary arrangements do not provide for the vesting of assets in the supervisor of the arrangement.[23] The debtor is therefore, as the person entitled to beneficial ownership, properly assessable to CGT on the disposal proceeds. It is for this reason that s.66(1) was not amended to include voluntary arrangements.

It will be usual for any arrangement to specify how CGT in respect of any chargeable gain should be dealt with. It is certainly right that the tax must be paid before the proceeds are applied to releasing any of the debtor's liabilities; and the Inland Revenue are most unlikely to agree to any arrangement which provides otherwise. Moreover, the supervisor must ensure that all funds realised from

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17 The date of the coming into force of the Insolvency Act and the Insolvency Rules 1986.

18 There was some uncertainty as to the position under the old law: see *Williams & Muir Hunter on Bankruptcy* 19th Edition (1979) pp.172-3.

19 Insolvency Rules 1986, r.6.224(1)(o) and (p).

20 Insolvency Act 1986, ss.248(b), 383(2) and 425(4).

21 Indeed its abolition and replacement was recommended by The Cork Report (Cmnd 8558) para 363-399.

22 Who does not necessarily procure the disposal of all the debtor's assets.

23 For an example, see: *Re Naeem* [1990] 1 WLR 48, 51 per Hoffman J.

disposals come into his hands so that he can be responsible for the payment of tax. This will often mean that the arrangement has to be left open for longer than might be envisaged because the payment date of capital gains tax in respect of any year of assessment is the 1st December following the end of the year of assessment in which the gain arose.[24]

Conclusion

The absence of a great volume of case law in this area indicates that the various rules work, notwithstanding the obscurity of s.66(1) TCGA 1992. It is more often than not a matter of a little detective work, as the answers in any particular case are frequently found in the Insolvency legislation, rather than the Tax legislation.

[24] TCGA 1992, s.7.