The Personal Tax Planning Review

LIABILITY OF "DONEES" FOR CAPITAL GAINS TAX ON GIFTS[1]

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1 Introduction

It is a paradox of our capital gains tax legislation that although a donor of an asset has given away the entire value of the asset and received nothing in return, yet he is deemed in general to have received a market value consideration and is thus liable to capital gains tax on a fictional gain. By contrast, the donee who is in receipt and enjoyment of the gain is not primarily liable for the tax.

As between donor and donee, that is the unjust position. Donors who wish to part with only an asset and do not wish to have to pay in addition the capital gains tax on the gift must make appropriate arrangements in advance with their donees. The inheritance tax gifts with reservation of benefit provisions and, in the case of an income-producing asset, the income tax settlement provisions, must be kept clearly in mind.

2 The Right of Recovery of Tax from Donee

As between the donee and the Revenue, however, the position is not so simple. The purpose of Taxation of Chargeable Gains Act section 282 is no doubt to ensure that in any case where a donor fails to pay capital gains tax referable to a gift, then the Revenue may, in the alternative, collect the tax from the donee. In my view, the draughtsman has failed fully to achieve this purpose.

3 The Statute

Taxation of Chargeable Gains Act 1992 section 282(1) provides:

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1 This article is based on part of Chapter 11A of my *Non-Resident Trusts* Sixth Edition published by Key Haven Publications PLC autumn 1995, in which I deal with this and related problems in the specific context of trustees of settlements who receive gifts from settlors and beneficiaries who become absolutely entitled as against trustees to settled property.

> "If any year of assessment a chargeable gain accrues to any person on the disposal of an asset by way of gift and any amount of capital gains tax assessed on that person for that year of assessment is not paid within 12 months from the date when the tax becomes payable, the donee may, by an assessment made not later than 2 years from the date when the tax became payable, be assessed and charged (in the name of the donor) to capital gains tax on an amount not exceeding the amount of that chargeable gain so accruing, and not exceeding the grossed up amount of the capital gains tax unpaid at the time when he is so assessed, grossing up at the marginal rate of tax, that is to say, taking capital gains tax on a chargeable gain at the amount which would not have been chargeable but for that chargeable gain."

4 "By way of Gift"

The section applies only if one can identify the disposal of an asset by way of gift. A normal gift in settlement would certainly be caught. It would be a gift because the donor would have gratuitous intent. It would be no defence of the trustees to say that they were not the object of the donor's bounty. It would be irrelevant that the settlor was also the principal beneficiary.

Where there is a sale at a deliberate undervalue, then, in my opinion, there is a disposal by way of gift. In the context of the inheritance tax gift with reservation of benefit provisions, the contrary view has been taken by some practitioners.

Where the transferor has no gratuitous intent but, while intending to sell an asset at market value to the transferee, he in fact sells it at less than its market value, then, as a matter of ordinary language, there is no disposal of the asset by way of gift. This will particularly be the case where "market value" is ascertained on an artificially high basis, as, for example, where Taxation of Chargeable Gains Act 1992 section 19 applies.[2]

Section 282(4) provides, however:

> "In this section references to a gift include references to any transaction otherwise than by way of a bargain made at arm's length so far as money or money's worth passes under the transaction without full consideration in money or money's worth, and "donor" and "donee" shall be construed accordingly ..."

If a transaction occurs otherwise than by way of bargain made at arm's length, it will often be a "gift" as a matter of ordinary English, but not always. Where, for

2 Assets disposed of in a series of transactions.

example, a beneficiary becomes absolutely entitled as against the trustees of a settlement to settled property, that is not, as a matter of English, a gift from the trustees to the beneficiary but would clearly be a disposal[3] otherwise than by way of bargain at arm's length and thus a gift for the purposes of section 282, the trustees being the donor and the beneficiary the donee. Similarly, where an asset is distributed *in specie* by a company to its members.

It will be recalled that a disposal from a person to a person who is connected[4] with him is deemed to be otherwise than by way of bargain at arm's length: Taxation of Chargeable Gains Act 1992 section 18(2). Thus, if a person disposes of an asset to a person connected with him then, although he may have had no gratuitous intent, the disposal is *prima facie* a "gift" for the purposes of the section.

Why were there added the words "so far as money or money's worth passes under the transaction without full consideration in money or money's worth"? In my view, it was precisely to take out of the definition of "gift" transactions for full value which are deemed to made otherwise than by way of a bargain made at arm's length simply because the parties are connected with each other.[5] Where, however, a person disposing of an asset unintentionally makes a bad bargain with a person connected with him, the transaction is still a "gift" for the purposes of the section.

Where the "donee" has given some consideration, it would be inequitable if he were liable to pay the whole of the capital gains tax on the disposal. The greater the value of the consideration he has given, the greater the inequity. In an extreme case he could, for example, give the "donor" 95% of the value of the asset and still be assessed to, say, capital gains tax equal to 39% of that value! If the donor were insolvent, he could finish up paying more than the full value of the asset! A court would no doubt be sympathetic in such circumstances. It *might* just be possible to tease out of the words in section 282(4) "so far as"[6] an argument that he is liable to pay only an amount of tax proportionate to the undervalue he has given for the asset.

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[3] See Taxation of Chargeable Gains Act 1992 section 71(1).

[4] The relevant test is that contained in Taxation of Chargeable Gains Act 1992 section 286.

[5] See Taxation of Chargeable Gains Act 1992 section 18(2).

[6] Money or money's worth passes without full consideration.

5 Prior Assessment of Donor

It is a pre-condition of the liability of the donee, that the donor shall have been assessed to capital gains tax for the relevant year of assessment. It would appear to be irrelevant whether the assessment in terms refers to the gift or, indeed, whether the Inspector who made the assessment knew anything about the gift at the time he made it. It is clearly irrelevant that the donor died between the making of the gift and the making of the assessment on his personal representatives.[7]

Normally, an assessment can be made at any time within six years of the end of the year of assessment in which the gift occurred. Even disregarding exceptional cases where the Revenue may be able to raise an assessment out of time, the requirement that the tax should have been unpaid by the donor for 12 months, thus, potentially, taking one up to the end of the eighth year of assessment, counting the year of gift as the first year, means that the donee may not be safe from assessment until the end of the tenth year of assessment.[8]

6 Indemnity for Tax and Interest

As the donee will be assessed and charged in the name of the donor, it would follow in any event that he would be entitled, on normal restitutionary principles, to recover the tax from the donor. Section 282(2) likewise in terms provides that "A person paying any amount of tax in pursuance of this section shall be entitled to recover a sum of that amount from the donor."

It is arguable to what extent the donee may be charged to interest outstanding at the time that he is assessed and/or to interest on the unpaid amount on which he himself is assessed, from the time of that assessment. Section 282 is silent both as to the liability of the donee for interest and as to any right of indemnity he may have against the donor. In my view, if and to the extent that the donee is liable for interest, he will have the right[9] to recover it from the donor.

It must be borne in mind that the indemnity, whether that given by statute or by normal restitutionary principles, is in respect of a fiscal liability. It is therefore

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7 See section 282(3).

8 Again, assuming that the Revenue are not able to assess the donor out of time. If the donor appealed against the assessment, the time when the tax became payable would normally be deferred even further.

9 The right is based on normal restitutionary principles and technically takes the form of an action for money had and received on the grounds that the plaintiff has been compelled to pay the defendant's debt. See generally *Woolwich Equitable Building Society v IRC* [1992] STC 657 (HL).

highly arguable that courts outside the United Kingdom would not, in the absence of some relevant convention, enforce the right of indemnity of the donee against the donor any more than they would directly enforce a claim by the Revenue for tax brought directly against the donor.[10]

7 Limitations on Liability

7.1 The Limitations

There are two express and, in my view, one implied limitation on the liability of the donee. It is far from clear what the second limitation means or how it is intended to interact with the first. The first limitation is in respect of the amount of capital gains tax *payable* by the donor in respect of the gift in settlement, taking it at an average rate. The second limitation, however, affects only the amount of capital gains tax *unpaid* at the time when the donee is assessed. There must also be a third, implied, limitation on the liability of the donee, namely that it shall not in any case exceed at any time, whether before or after the assessment is made, the outstanding liability of the donor at that time.

7.2 The First Limitation

The first limitation is "to capital gains tax on an amount not exceeding the amount of the chargeable gain so accruing". What is meant by this? Now capital gains tax is charged "on the total amount of chargeable gains accruing to a person chargeable in the year of assessment, after deducting ... allowable losses accruing to the person in that year of assessment":[11] see Taxation of Chargeable Gains Act 1992 section 2(2). This is subject to section 3, which confers the annual exemption. While sections 2 and 3 between them determine the amount of chargeable gains in respect of which a person shall be assessable for the year, the rate depends on section 4. Broadly speaking, it will be the marginal rate at which the taxable chargeable gains would have been liable to income tax had they constituted taxable income additional to the taxpayer's actual taxable income. The result is that all chargeable gains realised by a taxpayer in a year are to be charged at the same rate, without distinction, which rate will depend upon the extent of utilisable allowable losses, the annual exemption for which the taxpayer qualifies, the amount of his income liable to income tax for that year, the aggregate amounts of the chargeable gain and the rates of income tax. It is thus possible that the rate at which the taxpayer is in fact charged to tax on chargeable gains for a year may vary between zero and 40%. In my opinion, the expression in section 282(1)

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10 See *Government of India v Taylor* [1955] AC 491.

11 Or in previous years, insofar as they have not been otherwise utilised.

"capital gains tax on an amount not exceeding the amount of the chargeable gain so accruing" must mean capital gains tax at this rate for the year.

7.3 The Second Limitation

There then follows what appears at first blush to be a second limitation: "capital gains tax on an amount ... not exceeding the grossed up amount of that capital gains tax unpaid at the time when he is so assessed, grossing up at the marginal rate of tax, that is to say, taking capital gains tax on a chargeable gain at the amount which would not have been chargeable but for that chargeable gain." What on earth does all this gobbledegook mean?

Suppose, for example, that the donor has realised £100,000 worth of chargeable gains in the year of assessment, that he is liable to capital gains tax of £20,000 and that the (average) rate at which he is so liable is thus 20%. Suppose further that the gain arising on the disposal to the trustees was £10,000 and that, but for that gain, the donor would have realised gains of £90,000 in the year and been liable to pay tax of £16,000.

Now the first limitation is the amount of capital gains tax on the amount of the chargeable gain accruing on the gift, i.e., £2,000, being 20% (the rate for the year) of £10,000 (the amount of the gain).

What, then, is the second limitation? It refers to the grossed up amount of "that" capital gains tax unpaid at the time when the donee is assessed. To what does "that" refer? It could mean simply "all the capital gains tax unpaid at the date the donee is assessed". Or it could, with some forcing of the English, mean "the capital gains tax attributable to that gift". In my view, it can mean only the latter. Let us consider each possibility in turn.

Before doing so, we must consider at what rate one grosses up. The marginal rate. How does one ascertain the marginal rate? In the usual way, that is, by ascertaining the tax which would not have been payable but for the gain. In this case that amount of tax is £4,000 (£20,000 minus £16,000) so that the marginal rate is 40% (£4,000 divided by £20,000). Now the fact that reference is made to a marginal rate at all, rather than to the rate for the year, suggests that the draughtsman is directing his attention to only part of the chargeable gains included in the assessment for the year and in particular to the chargeable gain accruing on the gift in question. This consideration already militates strongly against the first construction of "that" capital gains tax, i.e., all the capital gains tax unpaid at the time of the assessment of the donee.

Now suppose that prior to the assessment of the donee, the donor has paid £18,000 of the tax, so that only £2,000 remains unpaid. If one grosses up the whole of this £2,000 at 40%, then the grossed up amount is £5,000, i.e., £2,000 represents capital gains tax at the rate of 40% on a gain of £5,000. The ceiling is not the

£5,000 but capital gains tax on that amount. But at what rate? It cannot be the marginal rate, because that would cancel out the grossing-up calculation and one would always finish up with the amount of capital gains tax on the gift which was unpaid. While this result would be extremely sensible, one cannot simply ignore thirty-six words of the subsection as redundant! It must therefore mean the actual rate of tax on the gift, i.e., 20%. Now if all of the capital gains tax is unpaid, the first ceiling will be £2,000, but the second ceiling only £1,000 (20% of £5,000), which is ridiculous. In fact, given that the real rate is one-half of the marginal rate, the maximum amount of tax which will be exigible from the donee will be one-half of the unpaid tax at the time of the assessment.

In the example, the amount of tax outstanding is exactly equal to the amount of tax on the gift, calculated at the average rate for the year. Supposing that the amount of tax outstanding is lower than tax on the gift, then it is clear that the second ceiling will still be lower than the first ceiling. Supposing that the amount of tax outstanding is greater than tax on the gift, then it is clear that the second ceiling would be higher because of the completely fortuitous circumstance that the donor had not paid capital gains tax in respect of other disposals made in the year. If the second ceiling is lower than the first ceiling, it will still be unduly advantageous to the donee. If it is higher, it will be of no account.

Secondly, suppose "that capital gains tax" refers to the capital gains tax attributable to the gift made to the donee. Reverting to the example where £2,000 is outstanding, we need to ascertain the capital gains tax unpaid at the time when the donee is assessed. How is that to be done? Do the normal rules as to appropriation of payments made in satisfaction of debts apply? If so, when the debtor (in this case the donor) makes a payment and appropriates it to one debt (in this case, say, capital gains tax on the gift to the donee), the creditor (in this case the Revenue) is bound by that appropriation. If the debtor makes no appropriation, however, the creditor has the right to make an appropriation. On balance, my view is that these rules have no application here, as an assessment for capital gains tax for a year of assessment creates one indivisible debt. I shall therefore assume that any tax paid by the donor is to be treated as paid *pro rata* in respect of all gains on which he has been assessed for the year.[12]

Capital gains tax unpaid and referable to the gift is thus £2,000 multiplied by the fraction which the unpaid tax of £2,000 bears to the total tax bill of £20,000, i.e., by one-tenth, resulting in a figure of £200. In equity, one would expect this to be the effective ceiling. In fact, the ceiling is capital gains tax on an amount not exceeding the grossed up amount of tax of £200. Now the grossed up amount is

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[12] The situation would arguably be very different where other donees had already been assessed under section 282 for tax unpaid in respect of gifts to them made in the same year of assessment and had made payments on account of their (representative) liability.

£500 and tax on that is, at 20%, only £100! This is indeed a startling conclusion. Moreover, it renders the first limitation entirely redundant. Take the extreme case where no tax at all has been paid when the donee is assessed. The first limitation results in an, equitable, ceiling of £2,000. But the second limitation results in a ceiling of £1,000! It is only where the actual rate of tax payable on the gift is the same as the marginal rate that the second ceiling will ever be as high as the first.[13] It can never be higher.

8 Conclusion

Something has gone seriously wrong with the drafting of section 282. I prefer the second construction of the second limitation, as involving less problems and producing at least a uniformly anomalous result. On that view, while the draughtsman may have been intending to treat tax on the gift as payable at the highest rate, he has in fact achieved the result of imposing a ceiling which is below the average rate! Even on the other view, there will be many cases where the ceiling is less than one would expect and this lower ceiling will depend on extraneous and arbitrary factors. The subsection needs wholesale revision if justice is to be done.

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[13] This can never in fact happen, on account of the annual exemption. The average rate will reach the marginal rate only on infinitely high gains.