

For In-House Counsel: News and views for in-house legal teams

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Earlier this year, HMRC made a little known amendment to the way in which it taxes compensatory damages, with potentially significant results for both claimants and defendants in professional indemnity actions.

The amendment concerns HMRC's so-called 'Extra Statutory Concession' (ESC D33). This provided that where damages were paid following judgment or settlement which should be treated as capital, rather than income, in the hands of the successful claimant:

- Where the damages in question were not linked to an asset chargeable to CGT, the whole of that compensation was automatically exempt from CGT (non-asset based damages);
- Where the damages could be linked to an asset chargeable to CGT, the damages would be taxed as a capital gain on that asset rather than being taxed in its entirety.

The first of these rules has now changed. From 27 January 2014, only the first £500,000 of non-asset based damages are automatically exempt. The consequences of this unheralded (and seemingly largely un-consulted) change are potentially extremely significant. Any compensation paid above £500,000 does not now normally attract any relief - in other words, claimants may have to pay tax on damages above the £500,000 limit.

For example, if a claimant recovered £1m in "capital" non-asset based damages as a result of a negligence claim, the claimant would now ordinarily have to pay 28% CGT (or 18% corporation tax if a company) to HMRC on the £500,000 above the £500,000 limit i.e. it would face a tax liability of £140,000 (or £90,000 if paid by way of corporation tax) - the claimant would receive substantially less damages; alternatively (if the claimant is live to the issue) the defendant might be ordered to pay substantially more damages.

Parties' approaches to settlement should change in view of this amendment. Claimants are bound to factor potential corporation tax/CGT liabilities into their settlement considerations; equally, defendants should expect claimants to ask them to pay any such liability.

This is certainly one to watch. Following a consultation in July of this year, HMRC are now proposing to make a further amendment: an absolute limit of £1m on non-asset based related "capital" compensatory relief. If implemented, this change will mean that any claimant recovering more than £1m on these cases will have to account to HMRC for corporation tax or CGT on any amount above the new limit. The impact of this potential change on all inhabitants of the litigation world - parties, insurers and their lawyers - could be significant and will require an understanding of the nature of the damages in the hands of the claimant

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