Tax update

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Any comments or queries?

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About this update

The Tax update is published on the first Thursday of every month, and is written by members of RPC's Tax Disputes team.

We also publish a general VAT update on the final Thursday of every month, and a weekly blog, RPC Tax Take.

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News

Follower Notices and APNs – new Guidance issued by HMRC

HMRC has republished its Guidance on Follower Notices and APNs, with changes made to deal with companies with disputed losses claims.

HMRC defines the term "asserted surrenderable amount", as an amount of a surrenderable loss which an HMRC officer believes will not be available for surrender if the relevant planning proves ultimately to be unsuccessful. After receiving an APN, a company must withdraw its consent to surrender a loss and notify the claimant company of the same. The claimant company must then amend its returns and pay corporation tax which then falls due.

The Guidance indicates that if the planning is later found to work, a new group relief claim can be submitted within 30 days of the decision confirming the same.

The Guidance can be read here.

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Direct recovery of debts: "Safeguards"

HMRC has published a Briefing setting out the "safeguards" it will implement when seeking to access taxpayers' bank accounts to recover outstanding tax, or tax credit debts. These are derived from the draft legislation contained in Finance (No. 2) Bill 2015 and associated draft regulations.

The intended safeguards will include not issuing a hold notice until an HMRC officer has had a meeting with the taxpayer. At that meeting HMRC will confirm the identity of the taxpayer and discuss "time-to-pay" options. HMRC also states that it will check that the recovery action will not cause "undue hardship".

Direct recovery will apply only to those who owe more that £1,000 and will be left with £5,000 in their bank account after collection. HMRC says that it will offer support to people it identifies as being vulnerable.

Briefing notes do not have the force of law. This draft legislation, if enacted as drafted, will provide HMRC with a significant new power. Many of the concerns of the professional bodies which have responded to consultations on this legislation appear to have been ignored and it remains to be seen how frequently HMRC will utilise this power and against whom.

The Briefing can be read here.

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POTAS and DOTAS shake up

HMRC has released new Guidance on the disclosure of tax avoidance schemes (DOTAS) and promoters of tax avoidance schemes (POTAS), regimes.

The new, revised, Guidance explains changes to the regimes since 2014.

In relation to the issue of Conduct Notices, whereas previously the Guidance confirmed that HMRC would meet with a promoter who it considered had met a "threshold condition" before deciding whether to issue that notice. In the updated version, this section is omitted, suggesting that HMRC no longer feels the need to consult with a promoter before exercising its discretion to issue a notice.

HMRC may be seeking to broaden the scope of the POTAS regime as the Guidance states that HMRC may consider as significant what would otherwise be non-significant breaches of threshold conditions if it is of the view that multiple non-significant breaches are part of a "pattern".

Any promoters subject to Conduct Notices, or threatened Conduct Notices, should seek legal advice as a matter of urgency.

The Guidance can be read here for POTAS and here for DOTAS.

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Cases

Tribunal criticises HMRC over treatment of vulnerable taxpayer in special relief case

In *John Clark v HMRC*[1], the First-tier Tribunal (FTT) has found that special relief, under paragraph 3A, Schedule 1AB, Taxes Management Act 1970 (paragraph 3A), ought to have been granted to a taxpayer who suffered from serious learning difficulties.

Background

The taxpayer was registered with HMRC for self-assessment in 2003 by his wife. Having failed to file returns, HMRC issued determinations for 2002/03 and the five subsequent years in the total sum of £17,779.94. The taxpayer claimed that it would be "unconscionable", for the purposes of paragraph 3A, for HMRC to seek payment of the tax sought in the circumstances of his case. Paragraph 3A(3), provides:

"(3) ... the Commissioners are not liable to give effect to a claim made in reliance on this paragraph unless conditions A, B and C are met.

(4) Condition A is that in the opinion of the Commissioners it would be unconscionable for the Commissioners to seek to recover the amount ...".

HMRC rejected the taxpayer's claim and he appealed to the FTT.

The taxpayer suffers from severe learning difficulties. In a report prepared for the appeal by a chartered educational psychologist, it was concluded that the taxpayer has "an intellectual level of a primary school child". The taxpayer suffers from dyslexia, and other learning difficulties which affects his ability to read, write and spell.

At the end of 2003, the taxpayer separated from his wife and he became solely responsible for the care of their daughter who was, at that time, of school age. Following separation from his wife, the taxpayer suffered from depression. It was around this time that he stopped working and during the period between then and 2013, he worked only periodically, earning very little income, all of which was accounted for through PAYE.

In his evidence (given with the assistance of a third party), the taxpayer informed the FTT that he did not recall receiving tax returns or demands for payment. He indicated that he would not have appreciated the implications of such documents if he had received them.

He admitted that he had received what he described as a "charge" from HMRC in February 2010, however, he did not understand its significance.

A hand written letter, prepared by his daughter, was sent to HMRC in 2011. The letter was returned by HMRC who did not act upon it. It merely advised that it had been sent to the wrong department.

The taxpayer later attended HMRC's offices on three separate occasions. Unfortunately, he was unable to communicate with the staff as they did not appreciate that he had learning difficulties.

1. [2015] UKFTT 324 (TC).

The FTT's decision

HMRC did not provide any witnesses. HMRC's representative at the appeal hearing argued that the determinations had been made to the department's "best judgement". Since no written records had been retained by the taxpayer it had made estimates as to the turnover of his "business" and profit.

In HMRC's opinion, the test contained in paragraph 3A was not met. It argued that the test should be applied at the date of the determinations and that if returns had been submitted on time the determinations would have been set aside. It argued that the taxpayer had had three years in which to do this but he had failed to do so. The determinations had therefore been correctly raised.

HMRC also argued that dyslexia was a condition of "varying degree" and that it did not absolve a sufferer from his tax obligations. It maintained that HMRC had acted properly in this case and that special relief was not intended to benefit those who chose not to engage with HMRC.

The taxpayer was pressed, in cross-examination, about the apparent selectiveness with which he had sought the help of his daughter and younger son in respect of other matters, such as the payment of child benefit, the taxpayer indicated that he felt embarrassed by his literacy problems and that he had sought to keep from his children the extent of the problems he suffered.

The FTT found the appellant to be "an entirely credible witness", "frank, candid and utterly lacking in guile".

The FTT applied and expanded on the definition of "unconscionable", contained in *William Maxwell*[2], defining it as "completely unreasonable, unreasonably excessive, or (we would add) inordinate, or outrageous". The FTT said that this test had to be applied at the time and in the context in which the recovery of the tax contained in the determinations was being contemplated.

HMRC's decision that the recovery of the determinations was not unconscionable was found wanting. The FTT commented that HMRC's reasoning was "too narrow, inadequate, and lacking in consideration of the appellant's peculiar vulnerability". In the FTT's view, HMRC ignored the taxpayer's inability to engage with the tax authorities and made no attempt to recognise, or make concession for, his vulnerability.

HMRC's response to the taxpayer's letter in June 2011 and attendance at HMRC's offices was "inadequate and unsatisfactory". The FTT contrasted HMRC's behaviour with that of officials dealing with child benefit payments made to the taxpayer who "seem to have been more supportive". In the circumstances of the case, the FTT found HMRC's refusal of the claim unreasonable and allowed the taxpayer's appeal.

Comment

The obvious question which arises following a case such as this is: why did HMRC pursue a person with severe learning difficulties and force him to give evidence before the FTT, where he was subjected to cross-examination by HMRC's representative?

2. *William Maxwell v HMRC* [2013] UKFTT 459 (TC).

The lack of empathy shown by HMRC towards such a vulnerable member of society stands as a damning indictment upon the organisation. HMRC is quick to issue press releases when it has succeed before the FTT, but it is unlikely that it will be seeking publicity for this decision.

The decision can be read here.

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Taxpayer succeeds in research and development claim

In *Monitor Audio Ltd v HMRC*[3], the FTT has allowed the taxpayer's appeal, concluding that research and development (R&D) tax deductions were available to it under section 1044, Corporation Tax Act 2009 (CTA 2009).

Background

Monitor Audio Limited (Monitor) is a designer and distributer of loudspeakers. It claimed R&D deductions, at the rate of 75% available to small and medium-sized enterprises, for the accounting periods ending 30 September 2010 and 30 September 2011, amounting respectively to £430,097 and £755,284.

As a result of a management buy-out in 2007, West Register (Investments) Limited (West Register), which was a 100% subsidiary of Royal Bank of Scotland (RBS), held 43.75% of the ordinary shares and 26.22% of the voting rights in Monitor. The buy-out was funded by £8.7m in secured credit facilities from RBS, and £2.6m in equity from Total Capital Finance Limited (Total Capital), a company within the RBS group. When Monitor ran into financial difficulties in 2008 and was unable to finance its debts, a debt for equity swap was agreed between Monitor and RBS. The shares that RBS and Total Capital obtained as a consequence of this agreement were subsequently transferred to West Register.

Monitor's corporation tax computations for the relevant periods included a 75% deduction for R&D expenditure available to small and medium-sized enterprises, under section 1044, CTA 2009. It noted RBS's shareholding in it, but suggested that it was an "institutional investor" under EU Recommendation 2003/361.

HMRC opened enquiries and subsequently issued closure notices refusing the claim on the basis that Monitor was not entitled to the R&D deductions claimed as it was not a small or medium-sized enterprise. An internal review upheld HMRC's decision to deny relief and Monitor appealed to the FTT.

The FTT's decision

The question for the FTT to consider was whether, with the considerable shareholding of RBS, Monitor was a small and medium-sized enterprise.

Section 1119(1), CTA 2009, defines a small or medium-sized company as a "micro, small or medium-sized enterprise as defined in Commission Recommendation (EC) No 2003/361 ...". Most pertinent is Article 3 of the Recommendation, which provides a definition of a "partner enterprise" to include an upstream enterprise which holds more than 25% of the capital or voting rights of another enterprise. However, an entity will not be treated as a partner enterprise if the upstream enterprise is a "venture capital company" or an "institutional investor". Due to limited evidence provided about the activities, strategies and risk appetite for the relevant periods, the FTT agreed with HMRC and concluded that West Register was not to be treated as a venture capital company.

3. [2015] UKFTT 357 (TC).

The FTT then considered whether West Register was an institutional investor, for the purposes of Article 3. It considered the definition of an institutional investor provided in Article 3 of the Commission Recommendation (EC) No2003/361: "an investment organisation which aggregates investments from a number of, or on behalf of, small investors". The essential test is whether the investor, through its involvement in the company, was putting the business in a stronger market position. In the present case, the evidence demonstrated that West Register and RBS had little involvement in the management of Monitor. The FTT therefore concluded that both West Register and RBS satisfied the definition of an institutional investor, for the purposes of Article 3. As West Register and RBS satisfied the definition of institutional investor, Monitor was to be treated as a small and medium-sized enterprise and was entitled to claim R&D relief. The appeal was therefore allowed.

Comment

The FTT has provided some helpful guidance on the meaning of institutional investor in this context. In the view of the FTT, the essential test is whether the investor, through its involvement in the company, is putting the business in a stronger market position. In the present case, the evidence established that West Register and RBS had very little involvement in the management of Monitor.

The decision can be read here.

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The Crown has a duty to make full disclosure to the court when applying for search warrants

In *Chatwani*[4], the Divisional Court has confirmed that state agencies applying for search warrants have a duty to make full disclosure to the court and the court should take an inquisitive approach when considering any such application.

Background

The Chatwani brothers were under investigation by the National Crime Agency (NCA) for suspected money laundering. In the course of its investigation, the NCA devised a plan to capture "unequivocal evidence" of the suspected wrongdoing in order to enhance any future prosecution of the claimants. The plan was to arrest the claimants in a "deliberately boisterous way" in order (1) to remove them from premises which the NCA intended to search and (2) enable covert recording devices to be installed at the premises to capture self-incriminating comments which it was hoped would be made by the claimants following their release.

In order to obtain the search warrants, the NCA was obliged to make an application to a magistrates' court, pursuant to the requirements contained in Part 2 of the Police and Criminal Evidence Act 1984. In formulating its plan, the NCA had formed the view that it was critical that as few people as possible knew its details. Consequently, the applications for the warrants failed to include any detailed information on the investigation and simply asserted that the statutory test had been met.

Notwithstanding obvious failings, the magistrates granted the applications and issued the search warrants.

4. *The Queen (on the Application of Chatwani & Ors) v The National Crime Agency & Anor* [2015] EWHC 1283 (Admin).

The judicial review application

The claimants commenced judicial review proceedings in the High Court to challenge both the arrests and the search warrants.

In the judicial review hearing, counsel for the NCA accepted that the approach taken by the officers showed a "fundamental misconception as to the role of the court" in applications for warrants and accepted that the search warrants were therefore unlawful. Nevertheless, as the NCA intended to apply for an order, pursuant to section 59 of the Criminal Justice and Police Act 2001 (CJPA), to retain the seized material, it asked the High Court for permission to retain the material pending such an application (under section 59(6) CJPA, a Crown Court judge may permit retention of material seized pursuant to an unlawful warrant, thereby allowing investigatory agencies a "second chance").

The Court's decision

Mr Justice Hickinbottom was of the view that the claimants' position had considerable force and that it was difficult to believe that an organisation such as the NCA would suffer from such "systemic ignorance" of the rules. On the evidence, however, the court was not satisfied that bad faith had been demonstrated, rather, there had been a "fundamentally misconceived approach to [the] warrants".

The court accepted that there existed grounds for the officers to believe that indictable offences had been committed, such that the issue of warrants may have been appropriate, but any such evidence had not been provided to the magistrates. It was the task of the magistrate (or in complex cases a circuit judge) to determine whether the requirements of the statutory test had been met. The NCA appeared to have, in the court's words, "abrogated that role to itself".

The court emphasised that the magistrate is not there simply to review the reasonableness of a decision of an officer that the statutory criteria are met. It is critical that the court itself is satisfied that the test is met. This will involve "detailed, anxious and intense scrutiny" by the court. The duty is on the state agency to place all relevant material before the court in order that this analysis can be carried out. This goes beyond the ordinary civil disclosure standard, and involves a duty of candour.

The failures in the instant case rendered the warrants unlawful. The court concluded that the conduct of the NCA was such that it would not be permitted to retain the benefit of the unlawful searches. Although the court did not conclude that the officers had acted in bad faith it considered that the NCA had acted with "patent and egregious disregard" or "indifference to the constitutional safeguards" in relation to the warrants. In the view of the court, the errors were grave and "went to the very root of the statutory scheme". Accordingly, the court compelled the NCA to return the seized material and deliver or destroy any copies, schedules or other work product derived from the seized material.

Comment

In his summer budget, the Chancellor of the Exchequer announced that HMRC is to be provided with £800m of extra funding over the next five years to combat tax evasion and non-compliance. HMRC hopes to treble prosecutions for tax evasion by the end of the current parliament. As raids on premises are often essential in order for HMRC to gather the necessary evidence it will need in a criminal prosecution, it is likely that it will be applying to the courts for ever increasing numbers of search warrants. In making such applications, HMRC must comply

with its duty to make full and proper disclosure to the court which is tasked with deciding the application. Failure to comply with this obligation will leave the legality of any warrants subsequently issued open to challenge by way of judicial review.

This case also acts as a timely reminder that the second chance provided by section 59 CJPA, will be denied to state agencies in circumstances where its failings are sufficiently egregious.

It is important that anyone who is the subject of a search warrant executed by HMRC obtains urgent advice from a lawyer with the appropriate expertise in this area.

The decision can be read here.

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