

## Current position with discovery assessments

### (Lecture P1151 – 19.29 minutes)

When assisting clients with HMRC enquiries it is easy to get absorbed by technical arguments and to overlook the procedural aspects of the case. It doesn't matter how right HMRC are about a technical argument, they can only assess additional tax if they have the power to do so. This is not an issue for HMRC where they have an open enquiry but if not, they have to be able to make a 'discovery' assessment. These notes will seek to consider the relevant points and considers some recent case law showing the limitations on their powers.

The legislation relating to the discovery provisions is at s29 TMA 1970 for individuals with equivalent provisions existing for other taxpayers. All comments below are equally relevant for all the relevant legislation.

There are two basic ingredients for a discovery assessment to be valid:

- HMRC must show they have 'discovered' that there is an underpayment of tax;
- The underpayment must be attributable to the careless or deliberate actions of the taxpayer unless the information on the tax return would not have been sufficient to alert a hypothetical tax officer to a potential underpayment of tax.

The nature of the behaviour then determines the length of time HMRC have to make an assessment from the end of the tax year:

- Discovery but behaviour not careless or deliberate – 4 years
- Careless – 6 years
- Deliberate – 20 years

With HMRC taking much longer to finalise enquiries under the current regime, it is not unusual to find HMRC missing the 6-year deadline and then having to argue deliberate behaviour in order to justify the discovery assessment.

#### *The discovery*

There are again two stages to the question of whether a discovery has been made. Firstly, what do we mean by saying that HMRC have 'discovered' that there has been an underassessment of tax? Secondly, have they acted on this before it has become stale?

In *HMRC v Charlton (and others)* [2012] UKUT 770 the following comment was made:

'All that is required is that it has newly appeared to an officer, acting honestly and reasonably, that there is an insufficiency in an assessment. That can be for any reason, including a change of view, change of opinion, or correction of an oversight.'

This seems to cover every possible situation but 'discover' for tax purposes means more than to just find something or become aware of something as it must fall within one of three categories:

1. That any income which ought to have been assessed to income tax or chargeable gains which ought to have been assessed to capital gains tax, have not been assessed; or
2. That an assessment to tax is or has become insufficient; or
3. That any relief that has been given is or has become excessive.

This leads to some anomalies as, for example, the High Income Child Benefit Charge and the tax charge for unauthorised members pension payments do not fall within these provisions for technical reasons about the way the charges are levied.

Returning to the general point though, it is easy to see this in a situation where an HMRC officer finds evidence that income has been diverted or where they make a decision that a tax avoidance scheme does not work (even though that might need to be confirmed by the Courts). However, a mere suspicion would not be sufficient to meet this test and should be challenged. From HMRC's perspective, they may want to issue an assessment in order to meet a deadline and may not have concrete evidence but they do need to make that discovery so the assessment is valid. HMRC will often use the phrase 'protective assessment' but this concept is not recognised in law and such assessments, whilst reasonable from an operational perspective, may not actually be valid.

When there is no firm evidence of wrongdoing, then HMRC might look at ways of inferring that there has been a loss of tax. These might include capital statements or business economics exercises. In the case of *Jonas v Bamford* [1973] 51TC1, the Inland Revenue prepared capital statements for a taxpayer who appeared to have insufficient income to support his lifestyle. It was held:

'There can be no doubt at all that the Inspector of Taxes discovered that Mr Jonas was the possessor of resources which could not be explained by reference to known sources of capital and income. This is virtually the classic case of discovery.'

The Courts have, however, been less willing to accept business economics exercises as being acceptable in proving discovery. They may identify areas of risk but that is not enough to show that tax has been underpaid. This was reinforced in the case of *Scott v Anor (t/a Farthings Steak House) v McDonald* [1996] SpC91 which was a disaster for HMRC:

'The Inland Revenue have failed to find any unaccounted for bankings or unaccounted for expenditure or any unaccounted for capital accretions. Their efforts have thus been devoted to the preparation of several business economics exercises, several of which have been shown to be inaccurate or just plain wrong. In any event in my judgement business economic exercises alone can rarely if ever justify the sort of attack mounted by the Inland Revenue in these appeals.'

There is a presumption of continuity. This means that if they find an underpayment of tax in one year then the actions that have led to that are presumed to have happened in other years unless the circumstances are clearly different. This was demonstrated recently in the case of *Stirling Jewellers (Dudley) Ltd v HMRC* [2019] UKFTT TC06940 where a business whose turnover had increased dramatically due to a change in business model and whose accounting methods had not kept up with those changes was found not to have underpaid tax for earlier years because the presumption of continuity was successfully challenged.

Finally, there is the question of whether the actions of others can be indicative of the actions of a taxpayer. This is controversial. In *Anderson v HMRC* [2018] UKUT 159, a discovery assessment was upheld on the basis that other participants in the tax avoidance scheme clearly spent insufficient time working to be entitled to loss relief and it could be inferred that the same applied to the appellant. If the tax avoidance scheme had failed for more generic reasons, then that might be relevant but this does seem like a harsh judgement.

The second point is then when the discovery is made and how quickly it should be acted on. A discovery has to have a quality of 'newness' for the assessment to be valid. This was explored in the recent case of *Beagles v HMRC* [2018] UKUT 380. Mr Beagles had entered into a marketed tax avoidance scheme that had been correctly disclosed but HMRC overlooked the reporting and did not open an enquiry into the relevant return, which would have needed to be done by 31 January 2004. They realised this in June 2004 but did not act. It was decided that the scheme should be challenged in August 2005 and they pursued a case involving another participant which was found in HMRC's favour in August 2007. HMRC issued a discovery assessment on Mr Beagles in January 2008 but the Courts found that the discovery had been made in August 2005 and so it was 'stale' by the time the assessment was issued in 2008. No time limit has been placed on how long it takes for a discovery to lose its newness but here 2½ years was too long.

Another very recent case shows how HMRC's own internal procedures can often fail them. The case of *Kothari and others* [2019] TC 07238 related to an SDLT mitigation scheme that had been used by six individuals. HMRC had undertaken a huge review of the scheme, which had been utilised by thousands of individuals, with a team of officers delegated to make and issue discovery assessments when HMRC decided it did not work. The assessments were issued in batches close to the assessing window closing but the appellants in this case did not receive their assessments until three years later when they received a 'nudge' letter and were then issued with a copy of the assessment. HMRC argued it was the point at which the assessment was made which was relevant and not when they were delivered, having accepted they were not delivered at the time they were made. The judge accepted they had been made in February 2013 but did not accept that they could then be delivered at HMRC's convenience. This was therefore not an enforceable assessment.

Another issue that is relevant here is the question of whether one officer reaching a conclusion which has previously been reached by other officers looking at similar cases would qualify as discovery. In *HMRC v Charlton (and others)* [2012] UKUT 770, it was found this was a discovery as it was a fresh decision in relation to the particular taxpayers. However, it has been recognised, correctly, that simply passing the file to a new officer who makes the same decision again, would not be sufficient to refresh an otherwise stale discovery.

One final point to note - A discovery does not become stale just because it takes a long time for the officer dealing with the case to notice that something is wrong. In *Sanderson v HMRC* [2013] UKUT 0623 the officer only belatedly realised that tax had not been correctly assessed even though he had had the relevant information for some time. This was still a discovery – albeit one that he should have made sooner! This does mean that you can still make a discovery even where a matter has obviously been overlooked although it becomes more difficult for HMRC to justify this if it has been explicitly agreed and they cannot do this if a matter has been concluded under s54 TMA 1970 (although this is quite rare under self-assessment).

### *The culpability*

As noted above, the time limit that HMRC has to work to depends on the behaviour of the taxpayer.

If there is not careless or deliberate behaviour, then HMRC has to be able to prove that they could not have known about the potential understatement of tax at the time that the enquiry window closed. Cases on this point have tended to favour HMRC as the Courts have not needed them to look very hard to identify the issue. However, if a full disclosure has been made on the return and the potential technical issue clearly identified then it is possible to argue that any reasonable competent officer would have known there was something to look at.

This point has been addressed in a recent case which commented on the taxpayer's capacity versus that of HMRC.

In *Cooke* [2018] TC06239 HMRC argued that the taxpayer's accountant was careless in not identifying that a DTR claim was excessive, but at the same time argued that an HMRC officer could not have been expected to pick the point up. On the other side the taxpayer argued that the accountant was not careless but an HMRC officer should have been able to spot the problem. The FTT agreed with the taxpayer as HMRC's officers should be tax specialists whereas the general practice accountant was not a tax specialist. The discovery assessment was not valid.

If we are looking at proving some culpability, which HMRC will want to do as those arguments seem easier for them, then it is important to realise that the loss of tax has to be brought about carelessly or deliberately. Filing a return late, for example, might be seen as careless but can HMRC show that the mere filing of the return late is the action that led to the under-assessment of tax? That one would be difficult.

The discovery provisions talk about careless or deliberate conduct by the taxpayer or someone acting on their behalf. This is important and distinguishes the discovery provisions from the penalty provisions (since penalties can only be levied where it is the taxpayer who has behaved in this way). This also means that the taxpayer could be entirely unaware of conduct by another person affecting their tax position but still be vulnerable to a discovery assessment. 'Acting on his behalf' does have limitations because someone passively providing information (such as a bank providing an incorrect interest certificate) would not be acting on behalf of a taxpayer even if they might be providing information for the return.

Carelessness is 'exercising a lack of reasonable care'. This can take many forms. Failing to take necessary advice when you are aware that there is a complication in your tax affairs would fall within this definition, as would having inadequate accounting records to be able to prepare accurate accounts. HMRC tend to take the view that most offences are, at the very least, down to careless behaviour but this is not always the case. However, we are all allowed to make mistakes and if you make a mistake despite trying to get things right, this is not careless.

In Bubb [2016] TC04922 the taxpayer understated income on his return but had encountered problems submitting returns online from France as the computer did not recognise his French address and appeared to random change the figures he was entering. It was found his behaviour was not careless. In the recent case of Negka [2019] TC06966, the FTT allowed an appeal against a discovery assessment relating to expenses claimed relating to repairs on a property since the taxpayer had repeatedly been given incorrect advice by HMRC. Conversely, in Atherton v R&C Commrs [2019] BTC507 it was found that the taxpayer had acted carelessly as neither he nor his advisor had taken advice as to how to correctly complete the tax return in a situation where there were complex issues to address. The moral of this is probably that you need to keep an audit trail of everything you do (within reason!) to try and get your tax return correct.

This neatly brings us back to the question of relying on a third party and how this impacts on a carelessness argument. If the accountant is careless then this can be treated as if the taxpayer has been careless. In the case of Rotberg [2014] TC03780, the accountant had omitted gains on shares on the mistaken belief that rollover relief was due. Although this had been confirmed in a brief conversation with an HMRC advisor, the Tribunal still found that the advisor had been careless and therefore so had the taxpayer. Contrast this with the case of Anderson [2016] TC05092 where the market value of shares used by the taxpayer was found to be lower than the figure arrived at by Shares and Assets Valuation team in HMRC. However, the taxpayer had taken advice from a leading firm of accountants and so was found not to have acted carelessly.

How useful are white-space disclosures? This is a matter of great debate. It is probably true to say that a white-space disclosure highlighting an area of doubt and explaining why a particular view has been taken is probably an indication of having taken reasonable care. However, not having disclosed something is not an automatic indication of lack of reasonable care. The thing that has caused the underpayment of tax is not the writing of something in the return; it is the underlying transaction. This view is not necessarily accepted by HMRC who will argue that not bringing something to their attention can be careless but what about a situation where you have, say, Counsel's opinion that something is not taxable? Note, of course, that there are specific provisions now where such opinion is 'tainted' i.e. because the Counsel is promoting a particular scheme.

Deliberate behaviour is submitting a return that you know to be incorrect or where it is suspected that it is incorrect (and you deliberately do not check). It is actually a more straightforward argument in most cases than careless because there will normally be evidence which demonstrates the point.

The point was neatly summed up in the case of *Contractors 4 U Ltd v HMRC* [2016] UKFTT17:

‘the term deliberate should be interpreted as being an action taken consciously where there was an appreciation that there was a choice’

Although this has been expanded now as there probably has to be dishonest intent.

It is not always straightforward. In *Scott v HMRC* [2016] UKFTT599 HMRC argued that the actions of the taxpayers must have been deliberate because the discrepancy between the returned income and the actual income was so significant that they must have realised. However, the Tribunal stated:

‘Our overall impression was that Mr and Mrs Scott had a somewhat disorganised approach to their personal finances, as witnessed by the complete lack of underlying records as regards cash receipts and banking. We therefore consider it quite possible that any under declaration was caused by carelessness rather than by deliberate default. Using the same logic for the uncertainty surrounding the tax assessments we therefore find that HMRC have failed to discharge the burden of proof on them to demonstrate under declaration of income by Mrs Scott’.

An important point: the burden of proof is on HMRC to prove deliberate conduct.

However, in the recent case of *HMRC and Raymond Tooth* [20019] EWCA Civ826, there was some worrying commentary on this point. The Court of Appeal actually found that no discovery had been made but Mr Tooth had put employment losses on the partnership page of his return due to a technical issue meaning he could not put them in the right place. Although not relevant, two of the judges stated that including the losses in the wrong place meant the return was inaccurate and that inaccuracy would have been deliberate, as it was known by the taxpayer. This is very unhelpful to the overall discussion in this area.

*The conclusion?*

In the end, it is not always an easy area to address but it is important not to assume that HMRC are correct when they issue assessment and their actions should always be scrutinised in order to determine if there are any grounds for appealing against these on procedural grounds.

*Contributed by Ros Martin*