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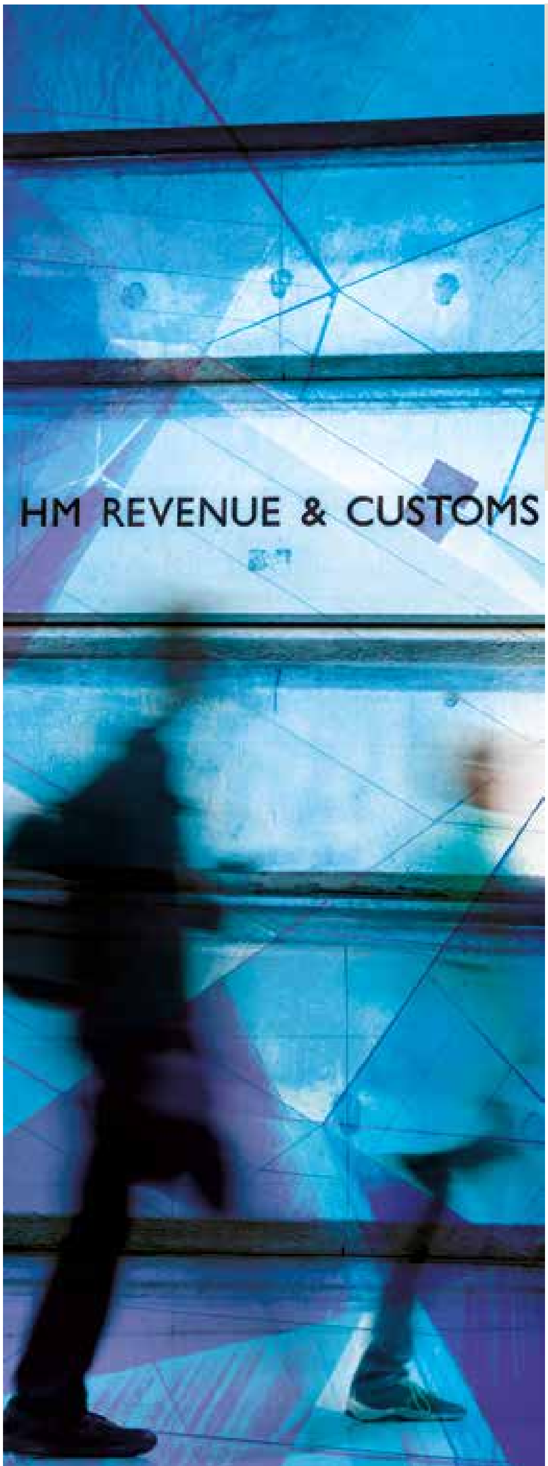

Early stage disputes

A practical guide


Sophie Lloyd & Rob Smith | Travers Smith

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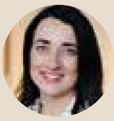
Early stage tax disputes: a practical guide

Speed read

A growing number of taxpayers can expect to be involved in ‘early stage’ (i.e. pre-tribunal) tax disputes over the coming years. Whilst every dispute turns on its own facts, there are some practical points of general application. Central to each of these is the importance of the taxpayer taking a careful, considered approach throughout the early stages – both in fulfilling its own obligations and ensuring that HMRC does not step beyond the limits of its authority. Failing to take care early in the process can risk unnecessarily prolonging disputes or storing up problems for later down the line.



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February is an opportune time to reflect on some of the practical aspects of early stage disputes with HMRC. For many UK tax advisers, February is associated with a long exhale after reaching the tax return season finish line. But as one tax return is filed, a corresponding enquiry window opens. As enquiry windows commonly close on an anniversary of their opening, the months preceding February also tend to see HMRC issuing a flurry of enquiry notices ahead of the statutory deadline, with March then bringing HMRC’s practice of issuing ‘protective’ discovery assessments. We therefore find ourselves slap bang in the middle of HMRC’s peak activity in the early stage disputes lifecycle.

It is also an interesting time in the development of HMRC’s compliance function. Following a suspension of most compliance work in 2020 amid the disruption of the pandemic and pressing demands on HMRC’s resources to deliver covid support measures, HMRC is very much focused again on compliance and the government expects it to deliver some big tax revenue figures in the years ahead. An additional £180m of investment in HMRC’s technical and personnel compliance functions was announced at Spring Budget 2021 and whilst some of this investment is to be allocated to new digital systems that should ease the collection of tax, increased compliance work carried on by HMRC officers appears to be a key component of this investment. This involves recruiting new compliance staff (presumably trained specifically in compliance matters) and, in turn, more enquiries being raised and more discovery assessments being made. It was also noted at the Spring Budget 2021 that the investment would enable HMRC to continue to fund compliance work in well-trodden areas of non-compliance: the loan charge, historic disguised remuneration cases and early intervention to encourage individuals to exit tax avoidance schemes.

Against that backdrop, this article serves as a reminder of some practical points to bear in mind in the conduct of an early stage dispute with HMRC. We have interpreted ‘early stage’ to mean the dealings with HMRC after a tax return has been submitted which do not involve an independent third party in the settlement process. This article does not, therefore, cover any aspect of the tribunal process or alternative dispute resolution mechanisms.

Opening stages

HMRC may begin the process by contacting the taxpayer (directly or via an agent) with informal questions regarding a tax return prior to opening a formal enquiry. The tone of the questions may be casual, but the taxpayer should not take them lightly and should take professional advice. Voluntary disclosures made at any stage during the process, even before a formal enquiry notice has been issued, can have significant consequences in the course of the dispute. This was seen in *JJ Management Consulting LLP* [2020] EWCA Civ 784 where the Court of Appeal held that it is within HMRC’s powers to assess tax on the basis of voluntary disclosures made outside the formal enquiry process. Taxpayers should keep a careful record of the internal decisions that were made regarding the parameters of any disclosure process, even when performed on a voluntary basis.

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Unless HMRC is satisfied that there is no insufficiency of tax on the basis of the information voluntarily disclosed, or has enough information to assess the taxpayer without taking further steps, it will open a formal enquiry. Of course, the informal questions stage may be skipped altogether, and the first a taxpayer may know about an investigation is the notice of formal enquiry.

The notice of enquiry will typically include an informal request for information and a date by which it should be produced. The deadline provided (which depends on the circumstances, but is usually a minimum of 30 days) is not statutory, and therefore not hard-and-fast. If there is a reason why it cannot be complied with, it is a good idea to simply explain this to the HMRC officer. This also has the benefit of setting a tone of open communication and cooperation from the outset of the process. It is worth noting that generally HMRC should provide more generous deadlines if the enquiry notice is issued in December or January (as is common given the enquiry window deadline), as HMRC's internal manual recognises that these are extremely busy months for tax agents.

The first check a tax adviser should perform upon receipt of an enquiry notice is a review of whether the enquiry notice is valid, for example, if the enquiry window (usually 12 months from the date a tax return was filed) has elapsed then the enquiry will be invalid. This check should be carried out first as if a taxpayer treats the notice as valid, even if it technically it is not, it may not be possible for it to successfully contest the validity later on down the line. This was seen in the recent Supreme Court judgment in *Tinkler* [2021] UKSC 39 where it was held that, on the facts, estoppel by convention applied to prevent the taxpayer successfully arguing that an enquiry was not properly opened, despite the enquiry notice having been invalid. In that case the notice had been sent to the wrong address, but the taxpayer had proceeded on the basis that it was valid and had not sought to argue otherwise until the dispute had been in progress for several years.

Although historically there may have been a degree of squeamishness around closing down disputes 'on a technicality', the statutory limitations imposed on HMRC were intended by Parliament to protect taxpayers and ensure due process during the course of a dispute. Taxpayers are fully entitled to police those boundaries, ensuring that HMRC does not step beyond the limits of its authority. It is important to raise any procedural points as soon as possible in ongoing correspondence, especially where these may help bring the dispute to a conclusion.

Ongoing correspondence with HMRC

Throughout the early stages of a tax dispute, taxpayers may find themselves exchanging a number of letters with HMRC. This ongoing correspondence may be a function of a complex factual background or difficult technical points, or simply because HMRC do not set out their position in full until several rounds of correspondence have already been exchanged.

When exchanging correspondence, it is important not to lose sight of the wider picture. What outcome is the taxpayer hoping to achieve? Taxpayers should work with their advisers to 'war game' possible outcomes. Whilst a drawn out process will rarely be attractive for a taxpayer, in respect of technical disputes in particular there may be a disadvantage in a taxpayer setting out its technical arguments in full before HMRC has done so.

Taxpayer correspondence should be submitted in a timely fashion, without running the risk of HMRC considering the taxpayer to be uncooperative (which may affect HMRC's outlook at a later stage when considering penalties). Whilst there are no statutory time limits in relation to ongoing correspondence, HMRC will typically suggest a deadline. As we have already noted, it is good practice to request an extension where this deadline cannot be met.

Written correspondence may lead to a proposed conference call or meeting with HMRC. HMRC likes to offer this and has trained its compliance staff in interview techniques. There is no statutory obligation to attend such a meeting and taxpayers should consider carefully whether it is in their best interests to do so. However, if a meeting is considered not to be in the taxpayer's best interests, HMRC should be informed that it is not considered necessary or the best approach at that particular time. If the taxpayer does agree to a meeting, HMRC should be asked in advance for a detailed agenda (HMRC guidance states that an agenda should always be provided) and to explain why a meeting is considered necessary. Tax advisers should carefully consider who should attend the meeting, including whether it is in the best interests of the taxpayer for the adviser itself to be present. At any meetings, detailed notes should be taken and, if HMRC produce their own notes, these should be reviewed carefully (although the taxpayer is not under any obligation to confirm its approval of HMRC's own notes).

Requests for information and documents

It is likely that a central part of any enquiry process will be requests from HMRC for information and documents. Generally, such requests will first be made on an informal basis through correspondence. Such informal requests leave taxpayers with a balance to strike. It is generally prudent to cooperate with informal requests, with a view to bringing the enquiry to a swift conclusion and avoiding the issue of a notice under FA 2008 Sch 36 (see below). However, taxpayers should be aware of providing documents which have limited relevance, especially where HMRC appear to be engaging in a fishing expedition. Providing information and documents which HMRC do not strictly need in order to conclude their enquiry may simply prolong the process by prompting tangential or irrelevant lines of investigation.

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There may also be more immediate reasons a document cannot be provided, such as confidentiality restrictions, legal professional privilege or data protection legislation. These factors should all be given careful consideration to ensure that taxpayers do not provide documents to HMRC in breach of obligations owed to other parties or so that privilege is lost. In some cases, it may be appropriate to proactively suggest to HMRC that a Sch 36 notice is issued in order to create a legal obligation which overrides a confidentiality clause or data protection concern. However, in such circumstances HMRC should be asked to acknowledge that the issue of a Sch 36 notice is not due to a lack of cooperation from the taxpayer. This can be helpful from a penalty mitigation perspective later down the line.

The Sch 36 notice is a powerful tool available to HMRC where information or documents cannot be obtained informally. There are several forms of Sch 36 notice, including taxpayer notices which require the production of information or documents within the taxpayer's possession or power (but only where 'reasonably required' in connection with the enquiry).

A detailed examination of the statutory framework governing taxpayer notices (and other forms of Sch 36 notice, such as third party notices) is beyond the scope of this article. However, taxpayers should be aware of some practical considerations:

- It is important to check that the notice has been validly served, i.e. issued to the correct entity/person within the requisite time periods.
- The form and terms of the notice should always be reviewed carefully. It must be expressed in clear terms so that taxpayers can have certainty that they have complied with the notice.
- Taxpayers should consider whether the 'reasonably required' standard has been met before offering up information or documents. As we have already noted, providing documents with only limited relevance can risk HMRC opening irrelevant new lines of investigation, prolonging the enquiry process.
- Where compiling the documents requested by HMRC will be an onerous task, consideration should be given to agreeing a process with HMRC – for example, agreed search terms to be applied to electronic records.
- Taxpayers should ensure they have a clear process for identifying any documents which may be subject to legal professional privilege, as HMRC cannot require a taxpayer to produce privileged documents. Privilege is a complex area and legal advice should always be sought if there is any doubt as to whether a document is privileged. Taxpayers should also think very carefully before opting to waive privilege in relation to a document in order to provide it to HMRC as such a waiver may have wider ramifications.

Discovery assessments

Discovery assessments are not relevant where HMRC has an open enquiry in relation to a tax year. Once an enquiry has been opened into a particular tax year, HMRC is not subject to any statutory time restrictions within which to issue a closure notice in order to assess additional tax. The purpose of a discovery assessment is to allow HMRC, if the relevant conditions are met, to override the finality of the tax return where an enquiry window has expired in relation to a particular tax year. The taxpayer must then choose whether to pay the tax or appeal against the assessment.

Discovery assessments therefore represent HMRC stating their view that additional tax is due and asserting their intention to collect that tax through their statutory powers. Accordingly, there are a number of taxpayer protections in the form of the statutory conditions that must be met by HMRC to validly issue a discovery assessment. As with enquiry and Sch 36 notices, the first step upon receiving a discovery assessment should be to check its validity by testing the relevant conditions set out at TMA 1970 s 29 (for companies, the equivalent rules are in FA 1998 Sch 18, but this article will only refer to the TMA 1970 statutory references for ease). To the extent that these conditions are not met, the appeal against a discovery assessment should be made on the grounds that, as a procedural matter, the assessment is invalid. This could either be the sole grounds of appeal or in addition to grounds that HMRC is incorrect on the substantive tax issue.

Firstly, HMRC must have made a 'discovery'. The courts have interpreted the word 'discovery' broadly. No new information is required for a discovery. It simply means that it has newly appeared to an HMRC officer that there is an insufficiency in an assessment, and the HMRC officer does not even need to be certain beyond doubt in that conclusion. However, HMRC has the burden of showing that a discovery has been made and that the statutory conditions for it to be valid have been met. The burden of proof then shifts to the taxpayer to show that the assessment is incorrect.

TMA 1970 s 29 provides that HMRC is not able to issue a discovery assessment if the tax return that is the subject of the assessment was made in accordance with the 'practice generally prevailing' at the time. 'Practice generally prevailing' broadly means that the tax return's preparation was in accordance with long-established principles that were accepted by both HMRC and taxpayers. An example of this is practice that is published in HMRC guidance or a memorandum of understanding. Tax advisers are likely to be aware of whether this condition is relevant or not from their analysis of the underlying substantive technical tax issues and the advice provided to the taxpayer at the time of filing the return.

> The statutory limitations imposed on HMRC were intended by Parliament to protect taxpayers and ensure due process during the course of a dispute. Taxpayers are fully entitled to police those boundaries

Unless the taxpayer's behaviour leading to an insufficiency of tax has been careless or deliberate, HMRC are also not able to issue a discovery assessment where it could have been reasonably aware of the potential loss of tax based on the information available to it at the time that the enquiry window was open. Most importantly, this includes information contained in the tax return. The relevant tax return should be revisited and reviewed in order to consider whether the hypothetical officer referred to in the statute should have been reasonably aware of the insufficiency based on the disclosures made in the return. This can be a difficult area, as the hypothetical HMRC officer is assumed to have reasonable knowledge and understanding of tax law. However, the level of specialist knowledge that the hypothetical HMRC officer should have, as well as what constitutes a sufficient disclosure, are not settled and the case law discussing these concepts tend to be extremely fact specific. This is therefore an area ripe for dispute between HMRC and the taxpayer, but this should not cause taxpayers to hesitate in including it as a ground for appeal where a disclosure was made in the relevant tax return.

It is worth noting that in the absence of a tax return having been filed by the taxpayer, the conditions set out in the preceding two paragraphs do not apply, and only the applicable time limitations restrict HMRC's powers to issue an assessment after making a discovery.

The applicable time limitations are set out at TMA 1970 ss 34 and 36. The relevant deadlines often depend upon the behaviour of the taxpayer (or someone acting on their behalf), with the basic deadline of four years from the end of the relevant year of assessment (or accounting period) being extended to six years where there has been carelessness and twenty years where there has been deliberate behaviour. The basic deadline can also be extended in certain other situations, such as, for income tax and capital gains tax, to twelve years where the assessment which relates to 'offshore matters' (a consequence of which is that HMRC has plenty of time to analyse the data it is receiving as a result of the common reporting standard).

HMRC is known to sometimes issue what it describes as a 'protective' discovery assessment, which are issued shortly before an applicable time limit expires (and therefore most commonly issued in March). There is no statutory concept of a 'protective' discovery assessment, but they are referenced expressly in HMRC guidance, which provides that protective assessments are 'intended to protect HMRC's position by keeping the matter open until enquiries are completed'. It is important to remember that HMRC may not raise a discovery assessment purely because it is close to the statutory deadline. The other statutory conditions must be met, and HMRC must have made a discovery. Taxpayers should challenge HMRC's burden of proof to show that any protective assessment is not only motivated by an upcoming time restriction.

Taxpayers must appeal any discovery assessment within 30 days. It is important to also apply for the postponement of payment of the tax assessed under TMA 1970 s 55. There is no harm in adopting a full and thorough approach in listing the taxpayer's grounds of appeal.

Closing stages and settlement

Assuming that HMRC is not satisfied by information provided or arguments put forward by the taxpayer, there are only two outcomes to an early stage tax dispute: settlement or progression to tribunal. However, in relation to discovery assessments there is an interim step on the journey towards tribunal: the internal HMRC review. An internal review is a means by which HMRC or the taxpayer can unlock a discovery assessment appeal. A taxpayer may opt to go straight to tribunal without an internal review, but HMRC is required to offer one as a first step (although the taxpayer may refuse the offer and proceed straight to tribunal if it wishes).

Whether requested by the taxpayer or offered by HMRC, the first stage in the review process is for HMRC to 'state its view of the matter', i.e. put forward its case in its totality. The review itself is then carried out in a 45 day window by a different HMRC officer, independent of the officer dealing with the taxpayer, following which HMRC will restate its position (which may be unchanged). Whilst on technical matters, the likelihood of HMRC reversing its position as a result of an internal review is low, the process may nevertheless be useful in flushing out its technical arguments. For disputes over factual or evidential matters, it is perhaps more likely that a fresh pair of eyes may result in a different interpretation.

Assuming an unsatisfactory conclusion to the HMRC internal review, if the matter is not to proceed to tribunal, then the only alternative for the taxpayer is settlement. Reaching a settlement with HMRC is a markedly different process to settling a dispute between two commercial parties, where a counterparty might be confident of the merits of its case but nevertheless willing to settle for a lesser amount to avoid time-consuming and expensive litigation. HMRC's litigation and settlement strategy means that it cannot operate with such freedom. Where a case is 'all or nothing' (i.e. the tax disputed is either payable in full, or not at all), HMRC will concede if it thinks it is unlikely to win at tribunal, but otherwise will proceed provided it is cost effective to do so. Where there are a range of possible figures for the amount of tax due, HMRC will not settle for less than it could reasonably be expected to obtain from litigation.

Once a settlement is agreed, it must be given effect. Taking an example where there is both an enquiry to close and an appeal of a discovery assessment to resolve – the former is achieved through the issue of a closure notice by HMRC and amendment to the taxpayer's return, the latter through an agreement in writing which has statutory effect under TMA 1970 s 54 as if it were a tribunal decision (subject to a 30 day cooling off period for the taxpayer). Acknowledging that this may be a cumbersome process where there are several open enquiries and/or discovery assessments in relation to the same matter, HMRC will also agree to conclude a dispute using a single, overarching settlement (which HMRC calls a 'contract settlement'). Under a contract settlement, HMRC gives up its right to proceed formally in exchange for payment of the agreed amount of tax owed. HMRC takes the view (albeit without a clear statutory basis) that a contract settlement of this nature dispenses with the need for closures notices to be issued in relation to any open enquiries.

Taxpayers should challenge HMRC's burden of proof to show that any protective assessment is not only motivated by an upcoming time restriction

Closing remarks

Early stage tax disputes are expected to become relevant to a growing number of taxpayers over the coming years as public finances tighten and significant new investment is made into HMRC's compliance function. No two disputes are the same: each case must be taken on its own merits. The best approach for the taxpayer will be highly sensitive to the underlying facts and the tactics employed by the HMRC officer dealing with the case.

However, as this article has illustrated, there are practical points of general application. Central to each of these is the importance of the taxpayer taking a careful, considered approach throughout the early stages of the process – both in fulfilling its own obligations and ensuring that HMRC operates within its statutory boundaries. Without such care, taxpayers may inadvertently prolong disputes or create previously unforeseen difficulties later down the line in the process. ■

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