The threshold certainty

Personal tax

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Jon Claypole and Jonathan Levy consider the conclusion of a long running battle on the issue of follower notices, and what this could mean for their future

Key Points

What is the issue?

Following a final judicial ruling, the threshold that HMRC must apply to issue a follower notice must be greater than merely ‘likely’ that the principles or reasoning in that case apply. The statutory test of ‘would’ apply is a higher threshold.

What does it mean to me?

The follower notice regime differs from the accelerated payment notice regime because it requires the client to close the HMRC enquiry or risk up to a 50% penalty for the right to challenge the substantive point, so the issues carry very substantial financial implications.

What can I take away?

Any client that participated in the ‘Round the World’ tax planning arrangements and received a follower notice should consider challenging the validity of the notice.

On 2 July 2021, the Supreme Court released its decision in the long running case of R (oao Haworth) v HMRC [2021] UKSC 25 (see bit.ly/3flKImV).

This is the first case taken all the way to the Supreme Court challenging the ability of HMRC to issue a follower notice. The judges unanimously concluded that HMRC had unlawfully issued a follower notice and consequently an accelerated payment notice to Mr Haworth.

The decision brings finality on what has been a long running battle with HMRC and demonstrates that judicial review remains an option open to challenge HMRC’s actions, albeit not one to be taken lightly as the taxpayer will need to be resolute to see it through.

The background

The authors discussed the decision of the High Court in the July 2018 edition of Tax Adviser and the factual background can be referenced from that article.

In summary, Mr Haworth listed his successful software business on the UK Stock Exchange in the summer of 2000, at the height of the technology bubble when company valuations were irrationally high (albeit the bubble burst shortly afterwards). He held shares personally but also through a longstanding offshore family trust settled in 1981.

On advice from leading tax counsel the trust was migrated to Mauritius and the UK in the same tax year with the objective of taking advantage of the UK/Mauritius double tax treaty. This tax planning was colloquially called ‘Round the World’ and was implemented by somewhere between 50 and 100 taxpayers.

It should be noted that this planning could not rely on standardised documents, which were identified by HMRC as a characteristic of mass marketed schemes and used as justification for introducing the follower notices legislation in 2014. In the Haworth case, whether the listing on the UK Stock Exchange proceeded remained

uncertain up to the day before the placing happened and all the documentation was unique to the Haworth case.

The statute

The follower notices regime was introduced in the Finance Act 2014 and gave HMRC further powers to tackle historic tax avoidance. At the time, the introduction of the legislation was controversial because once issued, the taxpayer had no statutory right of appeal and the notice required the taxpayer to close HMRC's enquiry into the tax avoidance that the taxpayer had participated in – by paying the tax saved plus interest – or risk a 50% penalty. The size of the maximum penalty has recently been subject to a consultation process by HMRC, which has accepted that the maximum penalty of 50% is too high. As a consequence, the maximum penalty is being reduced to 30% in the Finance Act 2021.

On receipt of a follower notice, the taxpayer effectively had the option to 'throw in the towel' or risk the financial penalty if, at the eventual outcome of the enquiry into the tax avoidance, it was found to be unsuccessful.

At the time, the tax and legal profession expressed grave concerns that the proposed legislation could in practice deny clients access to justice because of the penalty risk, and also that the decision whether to issue a follower notice rested solely with HMRC. The inability to appeal the notice meant that HMRC would be acting as judge and jury in the decision making process.

In response, HMRC committed to put in place 'strict internal governance and safeguards so that follower notices can only be issued following approval at senior level within the organisation, and will be scrutinised by staff other than those who have been working on the detail of the case'.

However, the only legal remedy open to a taxpayer on receipt of a follower notice is judicial review – which is expensive and, being litigation, carries uncertainty.

The key parts of the legislation in point in the Haworth case were:

- Under Finance Act 2014 s 204(1), HMRC may give a follower notice to a person if Conditions A to D are met.
- Under s 204(3), Condition B is that the return, claim or appeal is made on the basis that a particular tax advantage ('the asserted advantage') results from

particular tax arrangements ('the chosen arrangements').

- Under s 203(4), Condition C is that HMRC is of the opinion that there is a judicial ruling which is relevant to the chosen arrangements.
- Under s 205(3), a judicial ruling is 'relevant' to the chosen arrangements if:
  a) it relates to tax arrangements;
  b) the principles laid down, or reasoning given, in the ruling would [our emphasis], if applied to the chosen arrangements, deny the asserted advantage or a part of that advantage; and
  c) it is a final ruling.

One of the key battlegrounds in the Haworth case, which became the threshold test, was the practical application of the meaning of the word 'would' under s 205(3).

The Smallwood decision

In Smallwood v HMRC [2010] EWCA Civ 778, one of the issues in point was where the place of effective management (POEM) of a trust would be found.

The Special Commissioners decided that this was in the UK.

However, in the Court of Appeal, Hughes LJ (with Ward LJ concurring) held that the Special Commissioners' conclusion on the issue of POEM was one of fact. Applying Edwards v Bairstow [1956] AC 14 principles the court decided that, on the particular facts found by the Special Commissioners, their conclusion did not indicate any error of law.

Advice from HMRC Solicitor's Office

Through the judicial review process, HMRC's internal documents and submissions were obtained and these proved pivotal in the case and decision.

They demonstrated there was at least one opinion within HMRC that it could not issue a follower notice on the back of the Smallwood decision – but clearly the opposite view ultimately prevailed. When it came to the submissions to the HMRC panel responsible for issuing the follower notice to Mr Haworth, the panel was told that in another case the tax tribunal was likely [our emphasis] to conclude that the POEM was in the UK, having regard to seven factors, identified by Hughes LJ that were called by HMRC the 'Smallwood pointers', 'Smallwood hallmarks' or 'Smallwood criteria'.

The follower notice issued to Mr Haworth referenced the ‘Smallwood pointers’ as justification for its issue, adding that these pointers inevitably led to the conclusion that the POEM of the Haworth trust was in the UK, rather than Mauritius.

Another important point arose in the Haworth case. The documents obtained from HMRC demonstrate that it could not unequivocally show that all the documents presented by Mr Haworth’s advisors to HMRC in support of his case were fully reviewed before the submission to the internal governance panel which decided to issue the follower notice.

The courts below

The High Court ruled that HMRC had lawfully issued the follower notice; however, the Court of Appeal unanimously upheld Mr Haworth’s appeal.

In the Supreme Court

There were four grounds to HMRC’s appeal.

Ground 1

HMRC accepted that it had taken the view that it was only ‘likely’ that the application of the Smallwood ruling would deny that advantage to Mr Haworth, but argued that this still satisfied Condition C. The court did not agree. The key issue was what was meant by ‘would’ in s 205(3)(b): how certain must it be, that the Smallwood decision provides the answer in Mr Haworth’s case?

Lady Rose, giving the leading judgment of the Supreme Court, agreed with Mr Haworth’s counsel that the statutory test of ‘would’ is a higher threshold than HMRC had adopted of ‘likely’.

Given the severe consequences for the taxpayer of the giving of a notice, HMRC must form the opinion that there was no scope for a reasonable person to disagree that the earlier ruling denied the taxpayer the advantage. Only then can they be said to have formed the opinion that the relevant ruling ‘would’ deny the advantage. An opinion merely that was ‘likely’ to do so was not sufficient.

Grounds 2 and 3

These grounds concerned whether HMRC misdirected itself about what was actually decided in Smallwood by overstating the conclusions reached by the Court of Appeal in that case. The submission to the panel that decided to issue the follower notice stated that Hughes LJ had held that the UK POEM of the trust was the inevitable consequence of the tax scheme, because the decisions of the trust whilst resident in Mauritius were orchestrated from the UK.

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Lady Rose rejected HMRC's view, saying: 'That does overstate the conclusion of the court in Smallwood. Hughes LJ did not decide that it was an inevitable consequence of a scheme which shared the Smallwood pointers that its POEM would be the UK and not Mauritius.' Instead, Hughes LJ simply said the special commissioners were entitled to reach the conclusion they did.

Ground 4

Ground 4 concerned whether the follower notice failed to give an adequate explanation as required by s 206(b) and whether that failure invalidated the notice. The Supreme Court (as did the Court of Appeal) said that although HMRC should not send 'voluminous notices' to taxpayers, some more explanation as to why the corresponding reasoning applied to his arrangements should have been set out. In the Haworth case, the court concluded that the lack of explanation was not enough to invalidate the follower notice per se, but one wonders, given that the appeal failed on the other grounds, whether the judges chose not to exercise their minds on this point too much.

Conclusions

The authors hope that, following the Haworth decision, HMRC will reconsider the circumstances when it will issue future follower notices.

Those clients who participated in the 'Round the World' tax planning might wish to consider the validity of the follower notices if they received one. They are likely to have incurred professional fees in considering their options and many will have closed the substantive enquiry on receipt of the follower notice – and paid the

tax (plus interest) as a consequence.

Those clients may also want to have their substantive enquiry reopened and have their appeal heard by the tax tribunal. This is a complex area and advice should be taken as to whether this is an option open to them. However, the authors would encourage a realistic evaluation of the merits of their substantive case before proceeding, as the appeal process itself is expensive both in terms of professional fees and emotional energy!

Following the Haworth decision, HMRC quickly made the following announcement:

‘On 2 July, the Supreme Court handed down its judgment in the case of R (oao Haworth) v HMRC. The case related to a follower notice issued to Mr Haworth, and the accelerated payment notice which accompanied it. HMRC may issue follower notices to users of avoidance schemes which, in the opinion of HMRC, have been shown to fail in another person’s litigation. Accelerated payment notices can be issued with follower notices and require the recipient to pay the disputed tax to HMRC pending resolution of the dispute.

‘This was the first challenge to the follower notice legislation to be considered by the Supreme Court. HMRC lost the case on all grounds.

‘The court provided a useful clarification of the test HMRC must apply when deciding whether to issue follower notices. HMRC are considering the judgment carefully and the extent to which any customers who have received follower notices might be affected. There is no need for customers to contact us about this case, we will contact any customers we think will be affected by the judgment as soon as possible.’

It remains to be seen how HMRC reacts to the Haworth decision, and whether, and if so to what extent, it agrees with the analysis – not just that of the authors, but of other commentators from within the tax and legal professions.