The loss-carry back rules following an increase in earlier profits

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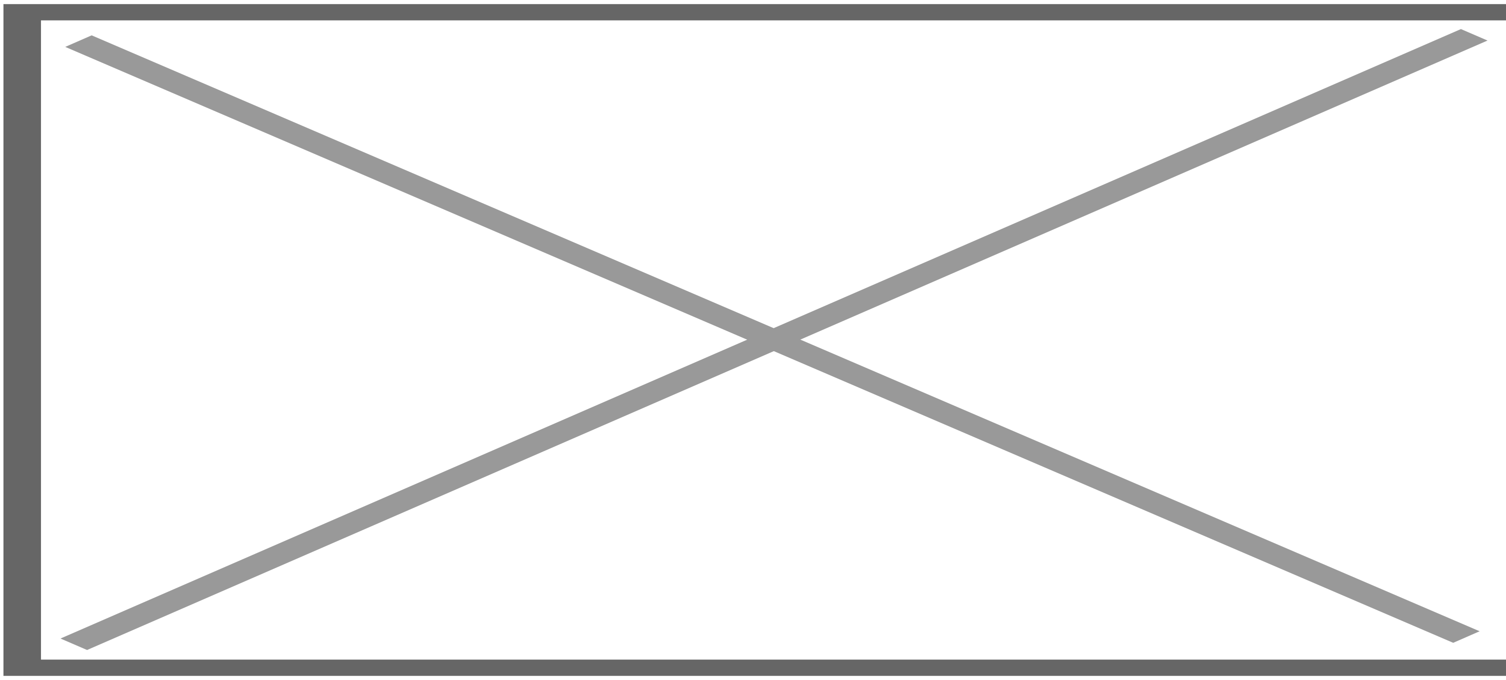

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The Upper Tribunal’s recent analysis in *Peter Lowe and Civic Environmental Systems Ltd v HMRC* considers the loss carry-back rules when the profits of the earlier year are subsequently increased.

Key Points

What is the issue?

The case of *Peter Lowe and Civic Environmental Systems Ltd v HMRC* considers the consequences of a corporation tax carry-back claim when the profits of the earlier year are subsequently increased.

What does it mean for me?

The Upper Tribunal agreed with HMRC that the administrative provisions in Taxes Management Act 1970 Sch 1A provided a comprehensive procedural code in relation to claims that are made outside a tax return.

What can I take away?

It might be prudent when quantifying carry-back to qualify the amounts by adding ‘or, in the event of the earlier year’s profits or the later year’s loss being amended, such different amount as required by s 37 of CTA 2010’.

The combined cases of *Peter Lowe and Civic Environmental Systems Ltd v HMRC* [2022] UKUT 84 (TCC) addressed three very distinct issues, including Mr Lowe's entitlement to obtain relief for certain expenditure when calculating the capital gains tax payable following the disposal of a property and the amount of a penalty payable by Mr Lowe in relation to an underassessment on two of his tax returns.

However, this article concerns the third issue, being the consequences of a loss carry-back claim when the profits of the earlier year (i.e. those which are being relieved by the later year's losses) are subsequently increased.

The facts of the case

In its corporation tax returns, Civic Environment Systems Ltd (CES) declared the following results:

- for the year ended 30 April 2007, a profit of £142,039; and
- for the year ended 30 April 2008, a loss of £444,748.

When submitting its 2008 return, CES sought to carry back the loss under what was then the Income and Corporation Taxes Act (ICTA) 1988 s 393A(1) (now the Corporation Tax Act 2010 s 37). It was common ground that the carry-back rules operate on an all-or-nothing basis, so that the amount carried back is necessarily equal to the lower of:

- the profits of the earlier year; and
- the loss incurred in the later year.

Accordingly, in the present case, the loss carried back was £142,039, leaving unrelieved losses of £302,709 to be carried forward and set against future profits arising from the company's trade.

However, it appears that HMRC opened an enquiry into at least one of those two tax years, with appeals against the closure notice(s) referred to the First-tier Tribunal. I say 'appears' because the precise procedures followed are not immediately apparent from the Upper Tribunal's decision. However, the net effect of the First-tier Tribunal's determination of the appeal or appeals before it was that the 2007 profit was amended to £682,039 (i.e. an increase of £540,000), without any change to the 2008 loss figure.

CES considered that £307,709 of this increased profit should be covered by the loss relief claim already made (because the claim has to be made on that all-or-nothing basis). In other words, the loss should all have been used up in relation to 2007, leaving no losses to be carried forward. However, HMRC argued that the company was too late to modify the carry-back claim. The First-tier Tribunal agreed with HMRC.

CES appealed against the decision to the Upper Tribunal.

The Upper Tribunal's decision

The case came before Mr Justice Marcus Smith and Upper Tribunal Judge Jonathan Richards.

The Upper Tribunal looked at the wording of s 393A(1) and took particular note of the statutory words that ensure that, if a claim is made under the section, the profits of the earlier year are mandatorily 'treated as reduced by the amount of the loss'. Indeed, the Upper Tribunal accepted that if one focused on s 393A alone, CES would have 'a powerful case'.

However, the Upper Tribunal felt that it was necessary to consider the Corporation Tax Self Assessment (CTSA) administrative provisions, as well as the substantive provisions in ICTA 1988. In particular, the Upper Tribunal referred to the Finance Act 1998 Sch 18 para 58. Paragraph 58 deals with situations where a claim involves two different accounting periods (a loss carry-back claim being a very common example of such a claim).

Paragraph 58(2) provides that (in such cases) where the earlier year’s tax return has already been submitted and where the claim can be given effect by an amendment to the return, then the claim shall be treated as an amendment to that earlier year’s return. However, given that it was too late to amend the earlier year’s return when the loss relief claim was first made, it was common ground that para 58(2) did not apply. That meant (by virtue of para 58(3)) that the provisions in the Taxes Management Act 1970 Sch 1A (claims made outside a tax return) applied instead.

HMRC argued that Schedule 1A para 3 was critical. This is a provision that governs the amendment of claims. In the same way as there is a period in which a tax return (and claims made within a tax return) may be amended within a 12 month period, the parallel code in Sch 1A ensures that taxpayers have a year in which to amend claims that are made outside a tax return.

HMRC pointed out that the increased 2007 profits were not identified until well after that 12 month period had expired, and said that fact precluded the additional 2007 profits from being relieved by the 2008 loss.

The Upper Tribunal agreed with HMRC. In short, it considered that the administrative provisions in Sch 1A (as invoked by Sch 18) provided a comprehensive procedural code in relation to claims that are made outside a tax return. Accordingly, even if anomalies arose, the Upper Tribunal could not ignore the clear time limits found in para 3.

CES’s appeal was therefore dismissed.

Commentary

My instinctive response when reading this case was that the Upper Tribunal had probably reached the wrong answer in this case. Having considered the matter more carefully a few days later, I formed the view that the Upper Tribunal had definitely reached the wrong answer.

First of all, this is not a case where the carry-back claim itself had to be amended. Accordingly, it was wrong to put too much emphasis on the time limits in para 3. A claim had been made under s 393A and no-one has sought to change that fact. All that has changed is the quantification of the loss that is being carried back *as a result* of the 2007 profits having been increased.

Furthermore, the increase in the 2008 loss carry-back should have been an automatic consequence of the increase to the 2007 profits: as was common ground, s 393A does not permit companies to make partial carry-back claims (except to the extent that there are insufficient profits in the earlier year). Indeed, the Upper Tribunal’s decision could lead to some unscrupulous companies from manipulating the all-or-nothing aspect of s 393A by understating the profits of the earlier year, so as to artificially increase the losses relieved in other ways.

Accordingly, when HMRC amended the 2007 return as part of the closure notice process, thereby increasing the trading profits, they had no compunction in making the consequential amendments to increase the tax payable (so as to reflect the additional profits). However, the return should have been further amended so as to reflect all those consequences of the increased profits – including the additional losses now able to be carried back from later years. Furthermore, para 34(2A) of Sch 18 ensures that any further consequential amendments to other tax returns of the company can be made when a closure notice is issued. As a result, following the fact that more losses need to be absorbed in an earlier year, HMRC can (and should) effect the withdrawal of losses previously carried forward by amending the later years' returns.

Furthermore, the Upper Tribunal's decision should also be seen in the light of the provisions that follow those paragraphs specifically referred to in its decision but which were apparently not considered. Paragraphs 61 to 65 of Schedule 18 deal with the situations where certain assessments or amendments are made: subject to certain restrictions in cases involving careless or deliberate conduct, consequential claims may be made out of time or, if previously made, may be varied.

Under para 61(1)(a), one of those situations covered by those provisions is a consequential amendment of a company's tax return for one accounting period following a closure notice issued to the company in relation to another accounting period (i.e. under para 34(2A). In other words, Parliament has expressly stated that the following could happen in a suitable case:

- HMRC issues closure notice in relation to accounting period 1.
- That gives rise to a consequential amendment to the tax return for accounting period 2 under para 34(2A).
- The company can then, consequential to that consequential amendment, make or amend a claim in relation to that second accounting period.

I fully accept that the absence of any similar provision in relation to accounting period 1 could be interpreted as saying that Parliament is permitting consequential claims to be made 'late' only in certain limited cases. However, that would be to attribute to Parliament a rather capricious attitude.

The alternative argument is that Parliament said nothing about accounting period 1 simply because the consequential amendments follow automatically. Indeed, given the 'all-or-nothing' nature of the carry-back claim (which itself has not been amended), as provided for by s 393A, then all profits should automatically be relieved, to the extent that losses were made in the second accounting period.

Secondly, I do wonder what would have happened had the 2007 losses been reduced rather than increased. The logical conclusion of the Upper Tribunal's decision is that this too would not have led to any amendment to the loss carry-back claim, meaning that the remaining losses carried forward would not be amended. The consequence of this is that some losses would inevitably be stranded and unable to be relieved in later accounting periods. The alternative is that those newly released losses would suddenly become available several years down the line (i.e. only for accounting periods in respect of which a timely claim may be made) – again creating the possibility for manipulating what is otherwise a prescriptive scheme. Neither is a desirable outcome.

Finally, I consider that the Upper Tribunal was wrong to suggest that the 'powerful' argument it identified (if one focuses on s 393A alone) should be undermined by the subsequent introduction of CTSA. The Upper Tribunal has implicitly accepted that CES's arguments would have prevailed before CTSA came into being because the Upper Tribunal refers to 'the statutory provisions relating to carry back of losses [being] materially overhauled following the introduction of self-assessment'.

That statement is only partially correct because what was undoubtedly overhauled was the entire mechanism for dealing with claims (and not merely loss carry-backs). However, it strikes me as somewhat surprising that the *effect* of loss carry-backs would have been so fundamentally changed as an unannounced by-product of the introduction of CTSA.

What to do next

I sincerely hope that the case will proceed to the Court of Appeal and/or the legislation is overhauled so as to remove all anomalies that arise in connection with consequential claims.

In the meantime, it might be prudent, when quantifying carry-back, to qualify the amounts with the following rider: ‘or, in the event of the earlier year’s profits or the later year’s loss being amended, such different amount as required by s 37 of CTA 2010’. Such a rider might not be sufficient to overcome the effect of this case. However, it would give the company a further argument to deploy.

Of course, if the company does not wish to disturb those residual losses as brought forward, then the *CES* case (in its current state) will be of considerable use. That is, if HMRC maintains a consistent stance as to how these provisions operate...