Are you going to be, Revenue, fair?

Management of taxes

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Keith Gordon discusses the High Court's decision on legitimate expectation in *Hely-Hutchinson*

Key Points

What is the issue?

HMRC has a duty to treat taxpayers fairly and not to discriminate between them. The *Hely-Hutchinson* case considers HMRC's revised guidance in 2009 that prevented relief for *Mansworth v Jelley* losses in a few cases

What does it mean to me?

Tax professionals had raised the question as to whether HMRC's 2009 change of position defeated taxpayer's legitimate expectation, given that the 2003 guidance was 'clear, unambiguous and devoid of relevant qualification'

What can I take away?

The judge concluded that there were several factors that should have been taken into account by HMRC when reaching its decision. The judge duly quashed the closure notices, requiring the Revenue to remake its decision

On 12 December 2002, the Court of Appeal handed down its decision in the case of *Mansworth (HM Inspector of Taxes) v Jelley* [2002] EWCA Civ 1829. The court's decision was not in itself controversial: it unanimously upheld the decision of the High Court, which in turn had upheld the decision of a special commissioner who allowed Mr Jelley's appeal. Even the Inland Revenue were eventually reconciled to the court's decision. As a result, the decision would most likely have been soon forgotten by most tax advisers, except perhaps those who are aficionados of the taxation of employee share options. However, in fact, it set in motion one of the most remarkable series of events that, 13 years later, is still not fully resolved. The High Court's decision in the case of *R (oao) Hely-Hutchinson v HMR*C [2015] EWHC 3261 (Admin) is the latest episode in that series.

The Revenue's response to *Mansworth v Jelley*

The Inland Revenue's initial response was to publish a technical note on 8 January 2003, acknowledging that they would not seek to appeal against the court's decision. However, and critically, they went further.

They stated that the effect of the decision was to increase the capital gains acquisition cost over that previously thought to be the case. In particular, employees who had exercised unapproved share options would be treated as having incurred allowable expenditure equal to the sum of:

- the shares' market value at the date of the exercise; and

- the amount charged to income tax on that exercise.

In most cases of employee share options, the employee disposes of the shares immediately after exercising the option, such disposal taking place at market value. It will be seen, therefore, that the Inland Revenue’s technical note amounted to saying that in such a situation most employees would realise a capital loss equal to the amount charged to income tax on the exercise of the option. Thus, while the income tax rules sought to apply a tax charge in relation to the ‘benefit’ enjoyed by the employee, the capital gains tax rules would relax the effect of this.

Taxpayers were invited to revise their returns if they were still open or make standalone claims for capital losses in relation to earlier years – welcome news for many taxpayers after Christmas. Unsurprisingly, the invitation was eagerly accepted.

Of course, the Exchequer could not allow this situation to continue for ever and the 2003 Budget announced the introduction of s 144ZA to TCGA 1992 which would put the law back to a more sensible position.

In the meantime, the professional press was awash with articles suggesting that the Revenue’s post-Yuletide munificence was not justified by the legislation and went much further than necessary in order to implement the Court of Appeal’s decision. Most notably was the article in *Taxation* on 23 January 2003 written by Michael Sherry, who had been Mr Jelley’s counsel. He described the Revenue’s technical analysis as ‘incomplete and seriously muddled’ and explained how the specific facts of Mr Jelley’s case were relatively unusual. Despite this criticism, the Revenue remained steadfast to its view, supplementing its January technical note with further guidance later in the year.

The obvious consequence was that many taxpayers obtained a windfall courtesy of the Exchequer, or at least they did if they had or could realise capital gains against which the newly calculated losses could be set off.

The facts of the case

There appears, however, to be one group of taxpayers whose entitlement to the *Mansworth v Jelley* losses (as they quickly became known) has not been so smooth. They appear to be individuals who were employed by various investment banks in the late 1990s and whose employment share option awards were part of a perceived avoidance scheme used by the employers as part of a 'tax-efficient' remuneration strategy. The taxpayer in the present case, Mr Hely-Hutchinson, is one such individual.

Soon after the capital losses were claimed, the Revenue wrote to Mr Hely-Hutchinson to open an enquiry into the claim. It was explained that this enquiry was on the back of the Revenue's investigations into his employer's share option scheme, but added that 'for this scheme' it was the Revenue's view that the *Mansworth v Jelley* losses were not due. Mr Hely-Hutchinson wrote to protest that he was seemingly being treated differently from other taxpayers in a similar position, a reference to those for whom the Revenue was abiding by the 2003 guidance. He also noted that the enquiry into the loss claims ought to be separate from the investigation into the employer – yet it appears that a formal closure notice was not sought and HMRC left the enquiry open, although not actively pursued so far as Mr Hely-Hutchinson was concerned.

In the meantime, Mr Hely-Hutchinson realised capital gains but offset these with the losses brought forward from the earlier years. HMRC opened protective enquiries into the tax returns for the later years.

Then, in March 2009, HMRC suddenly announced that it had now received legal advice that the views expressed in 2003 were incorrect. On the basis of this new view of the law, HMRC would cease to give effect to any *Mansworth v Jelley* losses in cases that remained open. Those cases are thought to be limited to employees of the banks.

Consequences of the 2009 guidance

Unsurprisingly, tax professionals raised the question as to whether HMRC's 2009 change of position defeated the taxpayer's legitimate expectation, given that the 2003 guidance was 'clear, unambiguous and devoid of relevant qualification' as was the test in *R v IR Commrs, ex parte MFK Underwriting Agencies Ltd* [1989] STC 873. In further guidance, HMRC noted its 'primary responsibility to apply the law correctly' but recognised that it can sometimes be so unfair for them to do so that that would amount to an abuse of power. The guidance acknowledged that, in those circumstances, the taxpayer can be taxed in accordance with HMRC's previous view of the law, even if that was no longer thought to be correct. As the guidance concluded, this would normally occur if the taxpayer could demonstrate that he or she 'reasonably acted in reliance on the previous guidance and would suffer detriment from the correct application of the statute'.

The tax profession argued in return that someone claiming that a legitimate expectation had been breached was not required to prove detrimental reliance, which was one route to a successful legitimate expectation claim. However, over the subsequent years, HMRC has refused to accept this argument. In my own experience, even those taxpayers who have advanced reasons to show that they had indeed relied on HMRC's 2003 guidance to their detriment have generally found the department to be unsympathetic.

Mr Hely-Hutchinson's case progressed slowly in the meantime until closure notices were issued in relation to the various enquiries in April 2014. They amended Mr Hely-Hutchinson's loss claims (and the subsequent tax returns) to deny him the *Mansworth v Jelley* losses. Mr Hely-Hutchinson challenged HMRC's decision to do so by judicial review.

The court's decision

Although the taxpayer raised four grounds of challenge, they ultimately boiled down to the question of fairness. The judge, Mrs Justice Whipple, held as follows:

1. HMRC has a duty to treat taxpayers fairly and not to discriminate between them.
2. Conversely, not every example of inconsistent treatment amounts to an abuse of HRMC's powers. For example, giving one taxpayer the benefit of an incorrect view of the law does not compel HMRC to give all other taxpayers the same benefit.
3. Overall, it is a balancing exercise – for a taxpayer to succeed, it must be shown that HMRC's treatment 'is so conspicuously unfair as to amount to an abuse of [HMRC's] powers'.
4. As a general principle, HMRC should be 'held to their published statements'. But, she added, there are plainly circumstances when they can retreat from such statements. This is subject to the doctrine of legitimate expectation.

5. HMRC’s argument that their primary duty to collect the tax due was often put forward as if it were a trump card that prevailed over other considerations. However, in fact, it is ‘a broad duty, exercised by means of a wide managerial discretion, within which is embedded the duty to treat taxpayers fairly’.
6. The categories of unfairness are not closed. Thus, cases in which HMRC should forgive tax otherwise due can travel beyond cases of detrimental reliance.
7. Specifically, HMRC can be required to continue to apply the wrong tax treatment to ensure consistency of treatment, where the alternative would be conspicuously unfair and an abuse of power. This requires a high degree of unfairness.
8. In the context of a legitimate expectation claim, a statement formally published by HMRC or one of its predecessor departments may be safely regarded as binding in any case falling clearly within its terms. The statement should also be clear, unambiguous and devoid of relevant qualification.
9. On the other hand, a legitimate expectation may properly be frustrated if there is an overriding public interest in imposing a different treatment.

On the facts of the case, Whipple J made these findings:

1. Contrary to HMRC’s arguments, the 2003 guidance did constitute guidance on which a taxpayer might base a legitimate expectation claim. Not only would it be wrong to suggest that the 2003 guidance was of a lesser (less binding) status, but it went further and invited taxpayers to make claims based on the Revenue’s view of the law then.
2. The guidance was a statement formally published by the Revenue and was also clear, unambiguous and devoid of relevant qualification. Mr Hely-Hutchinson clearly fell within its terms and relied on it when submitting his loss claims.
3. He thus had a legitimate expectation that he would be able to obtain relief for his *Mansworth v Jelley* losses.
4. That legitimate expectation was no lesser or different because HMRC later came to a different view of the law.
5. The delay in closing the enquiries was not part of a deliberate ploy by HMRC so that it could revoke the 2003 guidance.
6. The publication of the revised guidance in 2009 was as much a valid exercise of HMRC’s powers as the 2003 guidance had been.
7. HMRC could not simply withdraw the 2003 guidance – it had to consider the wider position and determine what was fair in all the circumstances.

8. Such fairness requires consideration of the circumstances in which the 2003 guidance was issued, a taxpayer's legitimate expectation as well as the public interest in collecting the tax due under the statute.
9. The 2009 guidance gave no indication on the extent to which fairness had been considered and suggested that HMRC considered itself bound to withdraw the treatment set out in 2003. To the extent that the 2009 guidance suggested that a taxpayer could claim legitimate expectation only if detrimental reliance could be shown, that was incorrect.
10. Similarly, HMRC's internal guidance, which was applied when the closure notices were issued, was wrong because it pointed to 'the necessity for the taxpayer to show detrimental reliance'.
11. Instead, detrimental reliance is just one factor to take into account in the balancing exercise.
12. Although – as HMRC had argued – the taxpayers who had been refused *Mansworth v Jelley* losses were being treated identically (they were the group of taxpayers who had open enquiries in 2009), there is still intrinsic unfairness when compared with the wider group of taxpayers who, in 2003, were invited to claim these losses.
13. This comparative unfairness should have been considered by HMRC in its internal guidance.
14. Although not necessarily carrying much weight in the present case, consideration should have been given to the fact that Mr Hely-Hutchinson was in the position he was because of a mistake made by the Inland Revenue in 2003.
15. Similarly, some weight should be given to the fact that it took HMRC so long to recognise and rectify its mistake.

As is the constitutionally correct approach in judicial review cases, the judge declined to carry out the balancing exercise herself. Instead, she concluded that there were various factors that should have been taken into account by HMRC but were not when reaching its decision. She duly quashed the closure notices, requiring the Revenue to remake its decision.

Of course, HMRC can always consider all the factors listed by Whipple J and ultimately conclude that fairness still permits it to deny Mr Hely-Hutchinson the benefit of the *Mansworth v Jelley* losses. However, it is noteworthy that Whipple J did tentatively offer her own 'instinctive response': that the approach set out by HMRC in its guidance was ‘very unfair’. It is perhaps for this reason that – at least according to comments on Twitter – HMRC has sought to appeal against Whipple J’s decision to the Court of Appeal.

Commentary

The leading case concerning HMRC’s duty to act fairly is the Court of Appeal’s decision in *R v IR Commrs, ex parte Unilever plc* [1996] STC 681 and one I refer to regularly. In my experience, it is a duty that has been often overlooked as HMRC officers become focused on applying the tax statutes in a mechanical fashion. Indeed, the *Hely-Hutchinson* case typifies the error of that approach – since the gist of HMRC’s argument was that taxpayers with open enquiries in 2009 had to be taxed in accordance with the Revenue’s revised view of the law in all but the most exceptional cases.

For tax practitioners, there is sometimes some discomfort about reverting to nebulous subjects such as fairness when tax is so steeped in statute and the precision that is meant to result from that. Nevertheless, as *Unilever* itself makes clear, HMRC’s duty to act fairly is itself based on statute in the Taxes Management Act 1970 and the Commissioners for Revenue & Customs Act 2005 (CRCA 2005). It is regrettable that this duty is statutorily worded as imposing a responsibility for ‘the *collection* and management’ of taxes because this focuses officers’ attention on revenue-raising. However, as a matter of law, that phrase is statutorily defined as meaning ‘*care* and management’ (s 51(3), CRCA 2005).

Given that Whipple J’s judgment simply applies existing case law, which should not be controversial, it is surprising that HMRC consideres that it has grounds to appeal. Thus, the uncertainty will continue for Mr Hely-Hutchinson and other taxpayers whose entitlement to *Mansworth v Jelley* losses is still being challenged. One might have thought that HMRC would consider it appropriate to throw in the towel now and not string things out further in the hope that more taxpayers will give up their claims due to the professional costs of standing up to the Revenue. However, whoever said that HMRC acted fairly?

Finally, it should be noted that Mr Hely-Hutchinson was represented by counsel (Rory Mullan and Harriet Brown) acting pro bono – they should be commended for having taken this case on that basis and to such good effect.