Untangling the Gordion Knot

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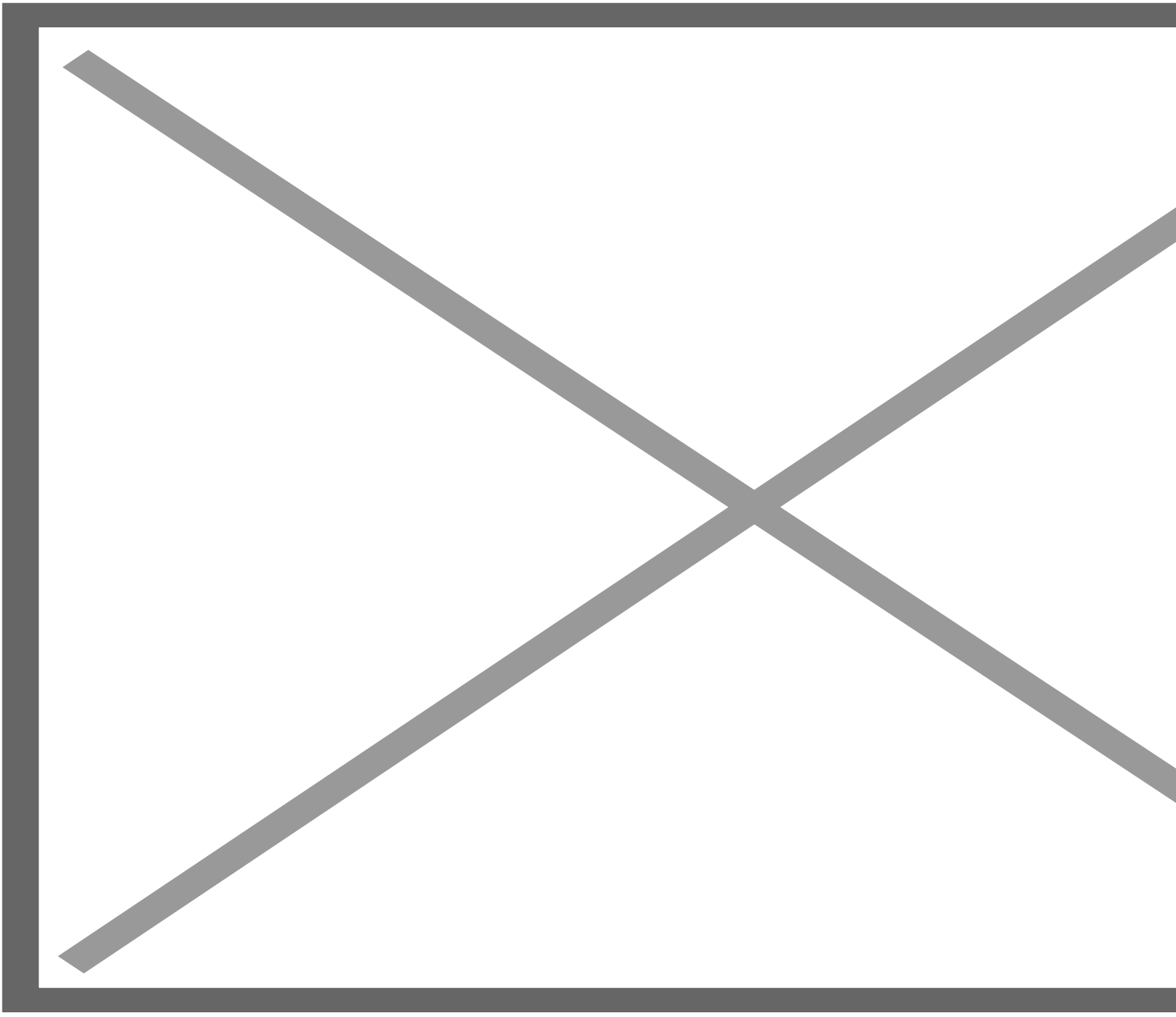

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Michael Avient and *Heather Williams* explain the significance of the *De Silva* case regarding finality under self-assessment

Key Points

What is the issue?

In finding that a carry back claim should be included in the self-assessment return the Court of Appeal created as many problems as it solved

What does it mean to me?

Those advising clients with historic enquiries into carry back claims will need to consider whether, as a result of the decision, HMRC will have lost the right to recover ‘freestanding credits’

What can I take away?

Following the decision in De Silva many issues remain unclear and with the importance of enquiries in determining the validity of APNs it is to hoped the Supreme Court will recognise the public importance for hearing the appeal

The decision in *The Queen on the Application of Mr De Silva and Anr v The Commissioners for Her Majesty’s Revenue and Customs* has received very little professional comment. This may be because it is seen as either another tax avoidance case, its facts are particularly complicated and specific or perhaps it is a very specific regulatory dispute with little general application? Regardless of the reason, this article would hope to untangle the specific facts which complicate and cloud the core issues and uncover how this case raises some significant matters regarding finality under self-assessment and the potential exposure of the exchequer to tax loss.

Getting tax avoidance out of the way

Firstly, it is important to remove the question of tax avoidance from the discussion. Significant detail was given in the Court of Appeal decision regarding the nature of the original partnerships that led to the tax claims made by the individual partners. It is a matter of undisputed fact that the losses originally reported by the partnerships were excessive as were the resulting tax claims and this has been accepted by the partnerships.

HMRC therefore sought to amend both the self-assessments and claims made by the individual partners. In respect of the latter, the partners claimed that although HMRC could amend the self-assessment it was time barred to amend the claims especially where these related to carry-back claims to offset the loss against earlier years’ income.

It is clear the potential loss of tax to HMRC solely related to this case played heavily on the minds of the Court of Appeal as in paragraph two Gloster LJ stated ‘The Appellants’ case in essence is that the Revenue had one lawful and early opportunity to challenge the Appellants’ assertion of entitlement to relief…’ However, it is suggested that such considerations are not appropriate when considering matters of administrative provisions. The point at issue is simply the procedure set out in the legislation and how this is applied to all cases.

If the issue of tax avoidance and the perceived mischief in this particular case is removed and the legislation is considered objectively it is suggested that the decision of the Court of Appeal creates as many issues as it solves. In the alternative, if the submissions of the taxpayer so roundly rejected by the court had been accepted then all of the procedural issues would have been resolved.

Putting the settlement agreement and the deemed enquiries to one side

The case also considered whether the terms of the settlement agreements signed by the partnerships were binding on the individual partners. This issue is separate to the issue considered here being the appropriate legislative treatment of carry-back claims and the correct legislative bases for enquiring into those claims. It will therefore not be considered further although others may feel is worthy of separate consideration.

The case also had to consider the issue of the deeming provisions relating to enquiries into partnership returns and individual partners self-assessment returns. In this regard it is sufficient to accept that the parties agreed that as a result of the enquiry into the partnership returns there was a deemed TMA 1970, s 9 enquiry into the individual's self-assessment tax return for the year in which the partnership loss was reported. For all material purposes this is the same treatment as if HMRC had opened a s 9A enquiry direct into the individual partners self-assessment returns.

The core issue

Having stripped out the above elements, what is left should be a relatively simple procedural question of how should HMRC enquire into the claims made by the individual partners. In the current case, HMRC had not opened separate enquiries into the claims and therefore needed to rely on the deemed s 9A enquiries.

In respect of claims to offset the loss against income in the year in which it arose, it was accepted that valid enquiries had been issued. The issue was whether the same could be applied to claims to carry back the loss to earlier years.

HMRC had successfully contended in the Upper Tribunal that the claims were included in the return reporting the loss arising from the partnership. As such there were valid enquiries into the claims.

The taxpayer on the other hand argued that this ignored the clear and distinct procedural regimes which existed for claims included in the return and those not included in the return; the former being dealt with under s 9A and the latter Schedule 1A. In respect of Schedule 1A detailed, separate and different provisions were made for such claims including the form of the claim, how to give effect to such claim, how to enquire into such claims etc. From a procedural perspective this should be the preferred interpretation as it dealt effectively with all the possible permutations relating to claims whether included in or outside of the return.

The view of the Court of Appeal

The decision of the Court of Appeal mirrored that of the Upper Tribunal in many respects and did not really constitute a full reconsideration of the issues.

Its conclusion was that Schedule 1B para 2(3) which provides 'The claim shall relate to the later year' meant that carry-back claims had to be included in the individual partners' tax return in which the loss was reported.

The court found further support for this view in what Sales J in the Upper Tribunal had characterised as an 'inchoate' claim. The mischief perceived here was that the claims in the current instance had been made before the actual partnership loss had been reported to HMRC. To remedy this the court stated that the correct approach was to either make the claim in '...in the return for the loss-making year in question… or to make an earlier (or indeed later) Schedule 1A standalone claim, which is then, subsequently, nonetheless required to be included in the return for the later year'. Effectively the claim only became 'final' once it was included in

the return.

The court then went further than Sales J's view and stated that not only were HMRC not restricted to enquiring into carryback (standalone claims) under Schedule 1A para 5(1) but could in fact choose the enquiry route whether that be either s 9A or Schedule 1A. However, if HMRC utilised Schedule 1A they would then be precluded from also enquiring under s 9A.

Looking at the point in isolation and specific to the facts of the case, the decision of the court appears to address the appropriate procedural issues and neatly ensure HMRC did not have to raise an enquiry when the correct quantum of the claim could not be ascertained. Further, it ensured that in the current instance HMRC were not time barred and a significant loss of tax to exchequer was avoided.

Issues arising from the Court of Appeal decision

It is suggested that the decision in the Court of Appeal, although tempting given the specific facts, actually exemplifies the issues specifically identified by the taxpayer, namely gaps in the legislation that could lead to a loss to the exchequer.

If the taxpayer's straightforward approach is abandoned, the interaction of s 9A and Schedule 1A becomes very complex. The court's view that a carry back claim could not be relieved against the income of the earlier was not disputed. However, the core of the reasoning was that the claim would 'affect the tax chargeable and payable in the later year' and as such it was required to be included in the particular return reporting the loss.

The reasoning behind this appeared to be the mischief that if the sole basis for an enquiry into a carry back claim was Schedule 1A the time limits for opening an enquiry may have expired before the quantum of the loss was reported. The court rejected the contentions of the taxpayer that this mischief simply did not exist as the purpose of Schedule 1B para 2(3) was to make clear that the time limits for making a claim and opening an enquiry ran from the later and not the earlier year.

However, the court appears to have not given consideration to the wider implications of its decision. It neatly resolved the issue of ensuring that there was a valid enquiry and HMRC were not time barred. But, the decision, it is suggested, ignored the fact that a carry-back claim cannot affect the amounts chargeable to tax or the amount payable in the later year of assessment.

The basis for this assertion is that the claim is one for relief involving two or more years and therefore falls within Schedule 1B para 2(1). Effect for the claim may therefore be given by repayment or setoff. What it does not do, as made clear in HMRC's claims manual is '… affect the self-assessment of the later year.' In effect what the claim does is give rise, in HMRC own terms, to a 'freestanding credit', a concept recognised in *Inspector of Taxes v Keeling*.

If the claim does not affect the self-assessment should the claim still be treated as included in the return as it affects the amount payable by the taxpayer for any year of assessment? It is well understood that the self-assessment is different to the actual amount payable, as it does not include tax that may already have been paid. The method of determining the amount payable can be found in s 59B(1) which states it is the difference between the self-assessment and the payments on account for the year.

This could ultimately have significant implications for the right of HMRC to recover tax at the completion of an enquiry into a carry back claim under Schedule 1A. The powers provided under s 28A and s 28B at the conclusion of such an enquiry only allow the amendment of the self-assessment. As has been seen HMRC accept

that carry back claims do not affect the self-assessment. If the court's view is correct the other provisions for amending the claim found in Schedule 1A para 7 and 8 are unavailable as these apply only to claims not included in the return. The potential result is that HMRC and the exchequer will have lost the right to amend the claim.

The decision is also difficult to reconcile with Schedule 1A para 4(1) which requires HMRC to give effect to the claim promptly unless an enquiry is opened. If the court's view is correct once the claim is made and no Schedule 1A enquiry is opened then HMRC would have a duty to give effect to the claim and give a free standing credit. There is no power to suspend this duty on HMRC until an enquiry is opened under s 9A. As a result if this analysis is correct, the claim must be given effect to and any subsequent conclusion of a s 9A enquiry would not have the power to recover any tax relief obtained.

The difficulties arising from the court's decision can further be demonstrated by the following example. The taxpayer suffers a loss in 2016/17 but makes an early carry-back claim as permitted in his 20015/16 tax return. HMRC having concerns about the claim, issue a notice of enquiry under Schedule 1A and use the power given to them not to give effect to the claim. On the basis of the decision in the Court of Appeal as an 'inchoate claim' the claim must be included in the return for the year in which the loss is reported, as it is only at that time that it becomes 'final'.

HMRC finally conclude the whole of the loss should be disallowed. However, the loss itself is not chargeable and does not in itself give rise to relief. Therefore, although the loss may be reduced to nil it has no impact on the self-assessment or the tax payable. It is the claim that entitles the taxpayer to relief. However, the claim also does not affect the self-assessment or the tax payable. Provision is made for the recovery of freestanding credits in Schedule 1A para 8(a) but this is restricted to claims not included in a return. As the Court of Appeal decision clearly decides, in this instance, the claim is included in the return. To find otherwise would preclude HMRC from having the choice to issue a s 9A enquiry.

Policy considerations

As mentioned above it is clear the court was very minded that if they found for the taxpayer, then HMRC would be time barred from amending the claims and recovering the freestanding credit. It is almost certain that the court would also have been concerned that this was not an isolated incident and there may well be many other similar cases awaiting the decision.

The court may also have been minded to consider the implications for how the decision might flow through to other legislation. For example, in order to issue a valid accelerated payment notice there must either be a valid enquiry or appeal and the quantum of such must be correct. If the court found that there was a possibility that HMRC had not raised a valid enquiry then this condition would not have been met due to a similar circumstance to those considered in the case. Similarly, if there was no valid enquiry HMRC would have lost the right to recover the freestanding credit. As such the quantum of the accelerated payment would have to be zero, a point specifically raised in *Rowe*.

Conclusion

The Court of Appeal roundly dismissed the taxpayers' arguments as having a sense of unreality. However, it is submitted that this is simply not the case and in seeking to dismiss the appeal the court had its sights firmly set on the perceived significant loss to the exchequer not on the application of the procedural provisions.

The taxpayers' argument was simple, there were two regimes one for current year claims and one for carry-back claims. Once the category into which a claim fell was determined, each regime was complete and self-contained as to how claims should be made, dealt with, and enquired into. Effectively, any permeation of facts could be dealt with within one of the prescribed regimes.

In seeking to take a different approach the Court of Appeal has not looked at the wider implications of its decision and how, unlike the taxpayers approach, it leaves gaps in the powers of HMRC. In stating that the court was required to look at the facts as 'a matter of substance' the court has allowed the 'purposive' approach to drift into the area of complex tax administrative law where it is suggested it has no place.

The fundamental cornerstone of the self-assessment is certainty. HMRC are given extensive powers of enquiry and discovery but if these powers are not actioned in time then the taxpayer has the right to rely upon the administrative provisions requiring finality. The result may sometimes be arbitrary but that is the nature of provisions which require a longstop.

It is understood that an application for permission to appeal to the Supreme court has been made and for the reasons stated above it is hoped that the appeal will be allowed.