Loss carry back rules: the case of Civic Environmental Systems

Large Corporate OMB

22 August 2023

We look at a recent case which considers how the loss carry back rules operate when the earlier year's profits are increased following an enquiry

Key Points

What is the issue?

The case of *Civic Environmental Systems Ltd v HMRC* [2023] EWCA Civ 722 highlights the fact that some of the ramifications of the self assessment regimes (as introduced in the 1990s) are still to be fully understood.

What does it mean to me?

It seems counterintuitive for the allocation of losses to be so dependent on the status of returns for periods other than that for which the original claim or election is being made.

What can I take away?

If the Court of Appeal's decision is correct, then a surprising outcome is that a company could manipulate the use of its losses by careful timing of its carry back claim.

When writing this article, I was reminded of my article 'What a carry back' in the January 2020 issue of *Tax Adviser*. That article noted how it is taking decades for some of the ramifications of the self assessment regimes (as introduced in the 1990s) to be fully understood.

The case of *Civic Environmental Systems Ltd v HMRC* [2023] EWCA Civ 722 will only reinforce that concern.

The facts of the case

Civic Environmental Systems Ltd (CES) prepared its accounts each year to 30 April. In the period to 30 April 2007, its corporation tax return showed a trading profit of (using rounded figures) £142,000. The return was submitted on time (in March 2008).

In May 2009, CES then submitted a return for the year to 30 April 2008. Again using rounded figures, the return reported a trading loss of £444,000. The company elected to carry back losses to offset the profits realised in the previous year. As those profits were £142,000, that left losses of £302,000 which were duly carried forward.The corporation tax paid in respect of the 2007 period was duly repaid.

In the meantime, HMRC opened an enquiry into CES's 2007 return. That was subsequently closed with HMRC concluding that the taxable profits should be increased from £142,000 to £450,000. HMRC's conclusion was subsequently upheld by the First-tier Tribunal on the company's appeal.

The parties' respective arguments

The company further argued that those additional profits could be relieved by the carry back claim made in respect of the 2008 losses. The logic is that loss carry back claims are made on an all-or-nothing basis: it is not possible to specify how much of a company's losses may be carried back and how much is carried forward. Instead, the carry back claim must exhaust the profits of the earlier year, leaving only the excess to be carried forward.

CES argued, therefore, that the loss carry back rules mandated a revision to the claim so as to ensure that the entire loss from 2008 (£444,000) would be set against the revised profits figure, meaning that corporation tax was payable on only the balance of £6,000. (CES accepted that this would lead to a removal of the losses previously carried forward to 2009.)

It was common ground that (if one were carrying out the exercise purely on paper) the 2008 loss would be fully set against the revised profits for 2007, leaving just £6,000 taxable profits in 2007 and no losses able to be carried forward.

HMRC argued, however, that the loss carry back claim was limited to £142,000 (being the relievable losses at the date of the claim). In the absence of any enquiry into the carry back claim itself, it was not possible to revise those figures, notwithstanding the subsequent increase in the profits in the earlier period.

HMRC's position was upheld by both the First-tier and Upper Tribunals. CES appealed against the decision to the Court of Appeal.

The Court of Appeal's decision

The case came before Lady Justices Asplin and Simler and Lord Justice Nugee. Lord Justice Nugee gave the only reasoned judgment, with the two Lady Justices concurring.

The court dismissed the company's appeal.

The principal argument put forward by the company (and rejected by the court) was that the carry back rules (then in section 393A of the Income and Corporation Taxes Act 1988) mandated the full use of losses whenever a claim was made under the section (up to the amount of relievable profits, if lower).

As the Upper Tribunal had done, the Court of Appeal said that argument, focusing on section 393A, ('if [that] were the only relevant provision') would give the company 'a powerful case'. However, the Court of Appeal was persuaded that the theoretical analysis relied upon by the company was 'materially overhauled following the introduction of self assessment for both individuals and companies'.

As a result, the court focused on the procedural provisions found in the Finance Act 1998 Schedule 18 governing corporation tax self assessment (CTSA). In particular, the court looked at paragraph 58, which refers to cases where claims and elections affect more than one accounting period. Paragraph 58(2) provides that where the claim or election affects a period for which a return has been submitted but where it is still permissible to amend that return (because the ordinary 12 month time for amending the return has not expired), then the claim or election should be treated as if it actually made the required amendment.

The court concluded that this meant that one had to consider the timing of the 2008 carry back claim. It was common ground that it could have been made at a time when it was still possible to amend the 2007 return. Had that been the case, the 2007 return would automatically have been amended so as to take into account the carry back claim. It would therefore have been that amended return that would have been the subject of HMRC's enquiry. As a result, any increase in the profits arising from the enquiry would then be subject to potential additional relief from the carry back claim.

However, the court said that a different analysis should apply if the carry back claim was made at a time when it was too late to amend the 2007 return. In such a situation, the claim is subject to the provisions of paragraph 58(3) which, in turn, provides that the provisions of Schedule 1A to the Taxes Management Act 1970 apply. Schedule 1A effectively provides a code for dealing with claims outside tax returns – this code broadly matches the self assessment provisions that govern returns but operates in parallel.

The court concluded that, in such a scenario, any enquiry into the 2007 return has to be into the return as unamended by any carry back claim. As a result, it is not permissible, when concluding that enquiry (or in any consequential tribunal proceedings), to somehow give any revised effect to the 2008 carry back claim. That claim stands alone. As the court said, that result gives finality to the 2008 carry back claim (and, presumably, the subsequent years which might or might not have been given relief for any surplus losses brought forward) – such finality being a key tenet of the self assessment regimes.

Commentary

When reading the earlier Upper Tribunal's decision in this case, I considered that the outcome was odd and probably wrong. With respect, I feel no differently having read the Court of Appeal's decision. It seems counterintuitive for the allocation of losses to be so dependent on the status of returns for periods other than that for which the original claim or election is being made.

However, I recognise, as the court itself said, that any regime which has time limits could lead to different outcomes in what are otherwise broadly similar scenarios. Furthermore, such oddities that remain do not mean that the court's decision is wrong. It all turns on what the legislation says.

That said, I still do not believe that the court has read the legislation correctly.

Underlying the court's decision is the assumption that the CTSA rules were intended to change the procedural landscape and it should therefore be unsurprising if there are now different possible outcomes of a carry back claim. Furthermore, the court recognised that these changes were made in the interests of enhancing the finality of returns, etc. (such finality being given after a year, except where an enquiry is opened).

However, it remains my view that that assumption was wrong and thus led the court to reaching the wrong conclusion. Ultimately, this is one of the cases where one can justifiably look at the same coin from two different perspectives and reach fundamentally different conclusions. As a result, it is necessary to look at other legislative clues to better discern Parliament's intent. In this case, I believe that there is a provision which (although referred to) was not in my view given sufficient emphasis by the court. That provision is paragraph 34(2A) of Schedule 18.

That is a provision that ensures that, when an enquiry comes to an end, it is not only the return under enquiry that can be amended but also any other return by the company if necessary 'to give effect to the conclusions stated in the … closure notice'.

I recognise that that subparagraph was introduced some ten years after the CTSA code was first enacted. However, the original provisions (paragraph 34(1)(b) and (2)(b)) had a similar effect.

That provision tells us that the finality granted to a tax return is not absolute, even outside the enquiry window. Indeed, an enquiry into year 1’s return can have a knock-on effect on many other years, without an enquiry into those other years returns being necessary.

In those circumstances, I would say that this provides a valuable clue to suggest the court’s underlying assumption is wrong. Therefore, in my view, CES’s powerful case remains as valid as it would have been pre-CTSA.

What to do next

If the Court of Appeal’s decision is correct, then a surprising outcome is that a company could manipulate the use of its losses by careful timing of its carry back claim.

For example, suppose the company made trading profits of £100,000 in year 1, a trading loss of £400,000 in year 2 and trading profits of £300,000 in year 3. Suppose further that the tax rates were such that the company would be paying higher corporation tax rates in year 3 than it would in year 1 (and so the company is quite happy to be carrying forward much of the year 2 losses to year 3). The conventional wisdom is that the company should make a carry back loss, wiping out year 1’s profits leaving the remaining losses available to wipe out year 3’s profits. However, now suppose that the company was concerned that HMRC might consider there to be additional profits of (say) £300,000 in year 1 and that an enquiry was underway or at least imminent.

On CES’s approach, that would simply be a risk that the company would have to face. However, the Court of Appeal’s decision tells us that, provided that the carry back claim is delayed until after the period for amending the year 1 return passes, then the £300,000 losses carried forward to year 3 remain intact. Therefore, even if the company ends up with additional profits in year 1, the company has successfully preserved the relief in year 3.

It will also be noted that this strategy turns on the company tactically delaying its carry back claim (albeit still within its own time limit). It is my view that Parliament is unlikely to have introduced a provision that positively encourages such behaviour.