Tax planning: the concept of ‘carelessness’

Management of taxes

20 November 2023

Three recent First-tier Tribunal cases have shed light upon the concept of ‘carelessness’, which governs historic assessments by HMRC and the penalties that can be applied.

Key Points

What is the issue?

Establishing that a taxpayer is careless is often the means by which HMRC opens enquiries into historic planning. HMRC will sometimes argue that carelessness arises when individuals fail to seek a second opinion.

What does it mean for me?

The legal landscape regarding what is required to satisfy the tribunal that a taxpayer has been careless has been the topic of discussion in three recent cases, involving failure to refresh, engage with, and act upon professional advice.

What can I take away?

Should taxpayers invest in a second opinion as added protection against assessments and penalties? The crucial factor is evaluating whether an alternative viewpoint can uncover unexplored insights or nuances.

The complicated world of tax planning is shaped not only by evolving legislation but evolving perceptions, creating challenges and opportunities for both taxpayer and agent alike. Central to these challenges is the concept of care which governs not only how far back HMRC can look into a taxpayer's affairs, but the level of penalties that can be applied.

'Careless' enquiries

Under Tax Management Act (TMA) 1970 s 9A, HMRC holds the right to make a formal 'enquiry' into every tax return submitted. The time limit for commencing an enquiry is 12 months after the day on which the return is carried out. If HMRC makes no enquiries within the period allowed, or if it has completed an enquiry, the return becomes final unless:

- the taxpayer is still within time to amend their return;
- the taxpayer has carelessly or deliberately caused a loss of tax; or
- HMRC discovers that the return was incorrect and the taxpayer had not disclosed enough information, meaning HMRC can then make a discovery assessment.

The legislation that gives the power to HMRC to make a discovery assessment is TMA 1970 s 29. HMRC cannot generally raise a discovery assessment if the taxpayer has filed a tax return unless HMRC has evidence to suggest that there is a loss of tax due to careless or deliberate errors (TMA 1970 s 29(4)). Therefore, establishing that a taxpayer is careless is often the means by which HMRC opens enquiries into historic planning.

In this context, HMRC may argue that carelessness arises when individuals fail to seek a second opinion. The legal landscape regarding what is required to satisfy the tribunal that a taxpayer has been careless has been the topic of discussion in three recent cases.

Strachan: failure to refresh professional advice

In *Strachan v HMRC* [2023] UKFTT 617 (TC), a case regarding domicile, Mr Strachan had not taken professional advice on his domicile situation since 1987. The First-tier Tribunal considered this to be careless, as the reasonable taxpayer would have refreshed the advice, especially given the significant changes to his position over the 25 year period.

It was argued on behalf of Mr Strachan that advice obtained in 2018 confirmed his domicile position; and that, had he taken similar advice prior to the submission of his 2011/2012 and 2012/2013 tax returns, it would have been the same. On that basis, the failure to obtain advice in the relevant years did not cause the loss of tax as the advice would have led to the same filing position.

The First-tier Tribunal disagreed on the basis that there was no evidence to support this position. However, it also noted that HMRC was unable to prove that the contrary was true and that the loss would have been avoided if advice had been taken.

HMRC asserted that once there had been a finding of carelessness, the burden of proof shifted to the taxpayer who then had to prove that the carelessness did not cause the loss of tax. Therefore, it was the lack of evidence presented by Mr Strachan that it should consider when making its decision.

The First-tier Tribunal disagreed, holding that the case law was clear that the burden rested with HMRC throughout, and that HMRC has been unable to establish a sufficient link between the carelessness and the loss. As a result, HMRC was out of time to raise assessments on the basis of carelessness and the taxpayer’s appeal was allowed.

Magic Carpets: failure to engage with professional advice or seek a second opinion

The case of *Magic Carpets (Commercial) Ltd v HMRC* [2023] UKFTT 700 provides a useful reminder that carelessness is not a given when dealing with tax planning arrangements which have lost favour with HMRC.

Magic Carpets (Commercial) Ltd (Magic Carpets) had entered into a tax planning arrangement which involved the use of an employee benefit trust. The First-tier Tribunal held that although Magic Carpets acted carelessly in implementing the employee benefit trust, HMRC had not satisfied the tribunal that this carelessness had brought about a loss of tax. There was no dispute that the employee benefit trust arrangement:

- was ineffective;
- did not achieve the tax savings anticipated; and
- led to a loss of tax.

In order to determine whether Magic Carpets' behaviour in entering into the arrangement was careless, the onus was on HMRC to establish, on the balance of probabilities, that when judged against the standard of the reasonable and prudent taxpayer in the same position, Magic Carpets failed to take care.

In deciding to enter into the arrangement, Magic Carpets took advice from an independent firm of accountants. The First-tier Tribunal accepted that it is reasonable for a taxpayer to rely on the advice of a professional advisor, especially where matters are complex and the taxpayer is not sophisticated. However, the tribunal was critical of the fact that the directors had not taken any steps to properly understand the detail of the arrangement and failed to engage with the documents – signing documents that referred to meetings that had not taken place.

The First-tier Tribunal also felt that given that the accountants whom Magic Carpets relied upon for advice were also using the arrangement, as well as the deficiencies in the documentation, Magic Carpets was careless in not seeking a second opinion.

Whilst HMRC was successful in establishing a lack of care, the First-tier Tribunal reminded HMRC that carelessness is a two-stage test. The second stage requires HMRC to prove that there was a causal link between the carelessness and the error/loss of tax. Whilst not expressly stated within the judgment, the tribunal here approached causation in a similar manner as one would when looking at a claim in tort.

Causation in tort looks at the relationship between an act and the consequences it produces. Factual causation is often assessed by reference to the 'but for' test, which in this instance required the tribunal to ask whether the loss would have occurred but for Magic Carpets' carelessness (namely, its failure to seek a second opinion). If the answer to that question is no, then there is a causal link between the carelessness and the loss. As recognised by the First-tier Tribunal at paragraph 92 of its judgment:

> 'That point is, if anything, clearer under the legislation in Finance Act 2007 Schedule 24. The definition of "carelessness" in paragraph 3 Schedule 24 requires the inaccuracy in the return to be "due to" a failure to take reasonable care.'

This approach therefore required the tribunal to consider what the substance of any second opinion would have been.

The lead case in respect of employee benefit trusts arrangements is *RFC 2012 Plc (in liquidation) (formerly the Rangers Football Club Plc) v Advocate General for Scotland* [2017] UKSC 45. In this case, the Supreme Court held that payments made by a company to an employee benefit trust for the purpose of providing remuneration in the form of loans to employees should be treated as earnings of the relevant employees, such that PAYE income tax and NICs became due immediately.

However, before that decision, the position was not clear cut and different courts and tribunals (and indeed even HMRC) had differing opinions on the status of employee benefit trust arrangements.

The First-tier Tribunal concluded that based upon the case law and the prevailing market conditions at the time at which the arrangement was entered into, it was likely that any advice obtained from a second opinion would have been the same; i.e. that the amounts would not attract PAYE income tax. Accordingly, there was no link between Magic Carpets' carelessness in not seeking a second opinion and the loss.

The upshot of the First-tier Tribunal's ruling on this point meant that the determinations were out of time, as HMRC could not rely upon the six-year carelessness time limit and it was not correct to impose penalties on the basis of careless behaviour.

HMRC's alternative argument (which relied on the accountants as agent being careless on similar grounds) was also rejected.

Delphi Derivatives: failure to act upon professional advice

In the case of *Delphi Derivatives Ltd v HMRC* [2023] UKFTT 722 (TC), which involved a similar employee benefit trust arrangement to that in *Magic Carpets*, the company was held not to have taken reasonable care as they failed to act upon the advice of their accountants (who had expressed concerns about the arrangement).

Causation was again an issue. However, the First-tier Tribunal on this occasion held at paragraph 166 that:

> 'In our judgment, "due to" in para 3(1) of Sch 24 does not equate to the kind of nexus of causation apposite to tort liability.'

The First-tier Tribunal thereby posed a different question; namely, can the inaccuracy in question be explained by a failure to take care?

The taxpayer tried to argue that the second opinion would not have differed from that provided by the scheme promoters. However, causation is a question of fact and there was no information before the First-tier Tribunal that would have allowed them to make such a finding – especially given that the arrangements in that case departed from the standard employee benefit trust arrangement.

Conclusion

Should taxpayers invest in a second opinion as added protection against assessments and penalties? Like all good tax questions, the answer is it depends.

If the planning is perceived as legitimate at the time, seeking an identical second opinion may yield little benefit. The crucial factor is evaluating whether an alternative viewpoint can uncover unexplored insights or nuances in the ever-evolving tax landscape.

All the judgments discussed in this piece are First-tier Tribunal decisions and so not binding. It will be interesting to see if (or when) the issue of causation reaches the Upper Tribunal.

Until then, there is a glimmer of hope for taxpayers within a changing tax landscape who can evidence that a second opinion would have no impact on the filing position, particularly in cases of once seemingly legitimate tax planning.