Innocent entanglements

Sharon McKie and Simon McKie explain how HMRC's claims of deliberate omissions of income from a taxpayer's self-assessment returns were rebutted.

Taxpayers caught, by reason of their innocent errors, in the toils of an HMRC investigation often assume, at first, that their honesty and goodwill will protect them, that HMRC will conduct its investigation with due regard to the evidence produced, and that it will not make demands that are disproportionate to the culpability of their errors or to the tax at issue.

The first job of any adviser advising such clients is to disabuse them of such notions and to prepare them for an investigation conducted purely with a view to raising money without regard to whether the burden placed on the taxpayer is proportionate. This article considers an example based upon a real-life situation. The names of the persons involved have been changed and much detail omitted, but the circumstances given are those which occurred. It is a cautionary tale.

The Infortunatus Group

A businessman, Mr Infortunatus, came to us for advice. He ran a successful trading group (the 'Infortunatus Group') of which all the members were UK incorporated and resident. Its trading activities were strongly regulated and its major customers were local authorities so that the reputation of both the business and its directors for probity were essential to its continued success.

Key points

- A UK resident, but non-domiciled taxpayer purchases business properties.
- An offshore trust and company structure was standard tax planning for non-domiciliaries.
- The arrangements entered into gave rise to income tax disadvantages.
- Professional advisers omitted to mention the income tax charges.
- An HMRC enquiry asserted strongly that there had been a deliberate omission.
- The issue of unnecessary information notices under FA 2008, Sch 36.
- A successful review under TMA 1970, s 49A.

The Infortunatus Group conducted its trade in various properties. Some 15 years ago, Mr Infortunatus had been considering the acquisition of further properties to be financed primarily with bank borrowing when he met a partner in Account LLP, a firm of chartered accountants and chartered tax advisers.

Mr Infortunatus was not domiciled in the UK, although he had been resident here since 1982. In April 2004, on the advice of Account LLP, he put in place the following arrangements (the 'arrangements'). He settled assets (the 'settlement') on a corporate trustee (the 'trustee') which was incorporated and tax resident in Guernsey. The assets would be held on trusts under which he had a life interest. The trustee had flexible powers over capital and income which could be exercised in favour of a wider beneficial class consisting of Mr Infortunatus, his issue and their spouses.

In turn, the trustee acquired the entire share capital of a company (OffCo), which was incorporated and resident in the British Virgin Islands.

The trustee borrowed money at interest and lent, also at interest, those moneys to OffCo. With them, and with the proceeds of further bank loans secured on the UK properties, OffCo purchased various UK properties. The properties were let to a member of the Infortunatus Group, Infortunatus Ltd, which used them in its trade.

The arrangements had various tax advantages and disadvantages.

Property purchase

Infortunatus Ltd might have bought five properties for £10m to use in its trade, borrowing £10m from its bankers at an annual interest rate of 5%. It would then have received a corporation tax deduction for the annual interest of £500,000.

Instead, the trustee borrowed £5m at 5% a year and lent it to OffCo. OffCo borrowed a further £5m from the bank at 5% interest and purchased the properties for £10m. OffCo let the properties to Infortunatus Ltd for an annual rent of £500,000.

All these transactions took place on market terms.

The income and corporation tax effects of these transactions were as follows.

	Income assessed on Mr Infortunatus under ITTOIA 2005, s 619 £	Income assessed on Mr Infortunatus under ITA 2007, s 720 £	Taken into account in the corporation tax computations of Infortunatus Ltd £	Aggregate effect £
Payment of rent to OffCo	-	500,000	(500,000)	0
Payment of interest by OffCo to bank	-	(250,000)	-	(250,000)
Payment of interest by OffCo to the trustees	250,000	(250,000)	-	0
Bank interest paid by trustee not deductible	-	-	-	0
Net (credit/debit) to tax computation	250,000	0	(500,000)	(250,000)

Inheritance tax

At the time, an offshore trust and company structure of this sort was absolutely standard tax planning for non-domiciliaries. To those who had not long been resident in the UK, they offered both inheritance tax and capital gains tax advantages.

Mr Infortunatus had been resident for 17 or more of the 20 years up to and including the year the settlement was made and was therefore treated as domiciled in the UK for inheritance tax purposes. For such taxpayers, the arrangements offered no inheritance tax advantages but they did offer a considerable capital gains tax advantage.

Capital gains tax

Had a company in the Infortunatus Group or Mr Infortunatus himself acquired the properties, any gain arising on a later disposal would have been fully charged to corporation tax or capital gains tax. However, neither the trustee nor OffCo would be subject to capital gains tax on gains arising on such disposals.

The settlor charge, under TCGA 1992, s 86, would not apply to the settlement, although the capital payments charge under TCGA 1992, s 87 would apply to it. If trust gains (including gains realised by OffCo and attributed to the trustee) were matched, under the charge with capital payments made to a non-UK domiciliary (who might, of course, be the settlor), although gains would be treated as accruing to the non-domiciliary thus reducing the unmatched trust gains of the trust, the non-domiciliary would not be chargeable to capital gains tax on those gains.

With careful management, therefore, the arrangements offered Mr Infortunatus complete freedom from capital gains tax on the profit arising on any future disposals of the properties.

Income tax

However, the arrangements also created an income tax disadvantage. Had a member of the Infortunatus Group acquired the properties funded by interest-bearing bank loans, that interest would have been deductible in arriving at the company's assessable profits.

In contrast, the income tax effect of the arrangements was as follows.

- Under ITTOIA 2005, s 624, the income of the settlement was to be treated as the income of Mr Infortunatus alone and income tax was chargeable on it under s 619.
- Under ITA 2007, s 721, an amount of income was treated as arising to Mr Infortunatus which was calculated by reference to the income of OffCo. Income tax was chargeable on that amount (under s 720).
- Under the arrangements, the rent paid by Infortunatus Ltd was deductible in its accounts and formed the gross income of OffCo. In calculating the profits of the UK property business of OffCo, by reference to which the income treated as arising to Mr Infortunatus under ITA 2007, s 731 was calculated, a deduction was to be made for the interest OffCo paid on its loans from the trustee and the bank. In calculating, however, the income of the trustee, which was treated as that of Mr Infortunatus under ITTOIA 2005, s 624, the bank interest paid by the trustee was not to be deducted. ***Property Purchase*** illustrates the income tax disadvantage which arose from the arrangements as a consequence of this by reference to some simple figures.

The net effect of the arrangements was, therefore, to deny a deduction for the interest on the bank loans made to the trustee. The arrangements result in the aggregate amount deductible for tax purposes being £250,000 less than if Infortunatus Ltd had purchased the properties.

The previous advice

Unfortunately, Account LLP did not advise Mr Infortunatus that he would be assessable under ITA 2007, s 720 on income calculated by reference to that of OffCo or that he would be assessable under ITTOIA 2005, s 619 as if the income of the settlement were his.

He assumed that the arrangements did not offer an income tax advantage because he had not been told by Account LLP that they did. Nor did it occur to him, however, that they would create a disadvantage or that he would be taxed on merely hypothetical income, being income that arose to the trustee (assessable under ITTOIA 2005, s 619) and income that did not exist in reality at all (the income assessed under ITA 2007, s 720). He assumed that the profits of the UK property business would be charged to tax on OffCo as UK source income and that, as the life tenant of the settlement, he would be charged to income tax on any income of the settlement net of interest paid.

> “In November 2015, HMRC raised an enquiry into Mr Infortunatus’ 2013-14 return asking questions on some routine matters which did not concern the arrangements.”

He, and OffCo, submitted self-assessment returns on this basis from 2004-05 to 2012-13. In fact, the settlement never had a surplus of interest received over interest paid and so no entries were made in respect of the trust on his tax returns. For every year, OffCo made a net profit on its UK property business and submitted self-assessment returns accurately reflecting that profit.

In 2008, having become aware that there were to be significant changes to the taxation of trusts, Mr Infortunatus took taxation advice on the arrangements from an expert firm of solicitors, Law Co. They explained the inheritance tax and capital gains tax effects of the proposed changes on the arrangements but did not mention income tax.

In 2014, prompted by a standard circularisation letter from the trustee in respect of exchange of information arrangements, Mr Infortunatus asked his taxation agent, a high street firm of chartered accountants (High Street Co) whether he had to report any income in respect of the settlement on his self-assessment return. High Street Co advised that he would be assessable only on the net income of the settlement and, as it had always had a net deficit on its income account, nothing needed to be included on his return.

The first hint…

So, by the end of 2014, Mr Infortunatus had taken advice from three separate professional firms on the arrangements, two of whom had a considerable degree of specialist expertise in respect of the areas of the taxation relevant to them, and none had mentioned that he had a liability to tax under both ITTOIA 2005, s 619 and ITA 2007, s 720.

In April 2015, Mr Infortunatus received a marketing approach from one (Big Four Co) of the big four firms of chartered accountants. The approach was primarily an attempt to sell the firm’s auditing and corporation tax services to the Infortunatus Group, but this brought with it the first indication that income might have been incorrectly omitted. In one meeting it was mentioned that Mr Infortunatus might have a liability to income tax in respect of the income of OffCo, although the nature of the putative charge was incorrectly described.

Mr Infortunatus did not take up Big Four Co’s offer of its services but he determined that, when his returns were to be prepared, he would obtain further advice on the arrangements.

The enquiry

Before he did so, in November 2015, HMRC raised an enquiry into Mr Infortunatus’ 2013-14 return asking questions on some routine matters which did not concern the arrangements.

This prompted him to engage our advice in respect of the arrangements. We immediately advised that it appeared likely that assessable income had been omitted from his previous returns. On our advice, in January 2016 Mr Infortunatus alerted HMRC to this possibility and informed the department that he had engaged us to investigate the matter. Obtaining all the relevant factual information took some time, as did our analysis of the relevant legislation, but in August 2016 we submitted a lengthy report to HMRC setting out all the relevant factual information. This included a full account of the advice Mr Infortunatus had received, as well as a comprehensive analysis of the application of the relevant law, including a consideration of all relevant issues of construction if there was any significant uncertainty.

At this stage, HMRC had been put in possession of every relevant fact and alerted to every relevant technical issue that subsequently proved to be of any significance in the matter. Our report concluded that income had been omitted from his returns. This should have been included in every fiscal year from 2004-05, when the arrangements were first put in place, to 2013-14.

We also concluded, however, that the loss of income tax brought about by this omission had not been brought about by Mr Infortunatus either deliberately or carelessly and so the conditions of TMA 1970, s 36 were not satisfied in respect of the omissions. The result of this was that the omitted income could be assessed only for 2012-13 and following years.

Our client was not primarily concerned at the prospect of having to pay tax on the omitted income, but at the prospect of having a penalty imposed on him which would enable HMRC to place him on the tax defaulters’ register which might affect his reputation for probity. To a lesser extent he was also concerned at the possibility that substantial penalties might be imposed.

Deliberate behaviour?

Four months later, HMRC opened an enquiry into 2014-15 and informed our client that enquiries for 2013-14 and 2014-15 were to be conducted under Code of Practice 8. This governs HMRC investigations if the department suspects that the taxpayer concerned has ‘deliberately … [tried] … to pay less than the correct amount or take advantage of a scheme or device to reduce a tax liability.'

HMRC requested specific further information that turned out to have no relevance to the matter but which we supplied in January. At the end of February, HMRC raised further assessments for 2010-11 and 2012-13. We appealed against the 2010-11 assessment on the basis that it was out of time and against the 2012-13 assessment because it had been raised in an incorrect amount. At the same time, we gave notice under TMA 1970, s 49A that we required HMRC to review the assessment. However, we subsequently agreed that the deadline for the review might be postponed while we attempted to agree the matter with the Revenue.

In early correspondence, HMRC asserted that our client must have omitted the income from his returns deliberately and that, therefore, it could assess all the years from which omissions had been made from the first such year, 2004-05. In doing so, it did not ground its assertions on the words of the legislation but on the much less precise wording of its manuals, referring repeatedly to 'deliberate behaviour', a phrase which does not form part of the statutory wording.

A foregone conclusion?

We carefully and patiently demonstrated, as we had done in our report, that far from our client's omissions being deliberate it was quite clear that they had not even been careless because our client had taken every effort to obtain appropriate advice. Having done so, he had not been advised that the omitted income was assessable. Further, that when he had become aware that he might have omitted income from his returns which should have been included, he informed HMRC of the fact and had expended large amounts of money and time to determine his correct liability.

During a telephone conference between us, the tax officer and his line manager, the reason for HMRC's intransigence became apparent. It was clear that the manager had not bothered to acquaint himself with the facts of the case but had simply assumed that, because income had been omitted from the returns, this omission must have been deliberate. Having taken up that position, however, he was not willing to resile from it whatever facts and arguments were put forward on the taxpayer's behalf. From then on no progress could be made towards an agreement with HMRC. Wholly unnecessary information notices under FA 2008, Sch 36 para 3 were issued to Account LLP and Law Co which only elicited information entirely consistent with the information we had supplied. Exchanges of correspondence took place in which HMRC simply reiterated the same points it had made before without taking any account of the further arguments and responses submitted to it.

Planning point

An omission of income or gains from a tax return must have been made deliberately or carelessly if the conditions of TMA 1970, s 36 are to be satisfied such that an assessment can be made by HMRC up to six years after the end of the year of assessment to which the loss of tax relates. Otherwise the four-year time limit in TMA 1970, s 34A will apply.

The review under TMA 1970, s 49A

In view of the above, we requested that the review under TMA 1970, s 49A(2)(a) should proceed. We submitted representations under TMA 1970, s 49E, and further representations in response to a submission made by the HMRC officer. This again simply repeated HMRC's original assertions taking little account of the subsequent material we had submitted. Our representations included a careful point-by-point refutation of each and every assertion made by HMRC and were accompanied by an opinion given by the distinguished Queen's Counsel, Ms Hui-Ling McCarthy.

In late November 2017 the reviewer issued his conclusion. It was that Mr Infortunatus' omissions had been made neither deliberately nor carelessly, that the assessment for 2010-11 was, therefore, out of time and that the assessment for 2012-13 should be reduced to the correct amount we had originally calculated. Even so, we had to correct certain ambiguities in the conclusion and agree those corrections with HMRC with the result that the relevant amendments of the assessments were not issued until January 2018. Even after that, HMRC subsequently raised erroneous penalty notices which required further work from us to ensure they were withdrawn.

The result

Our client had been subject to the stresses of an investigation for more than two years, had expended enormous amounts of time in searching for information that was up to 12 years old and in reviewing our draft letters and submissions to HMRC and his costs in the matter were approximately equal to the amount of tax at stake in respect of the years which proved to be out of time for assessment. Nonetheless, it had been worthwhile for him to bear those stresses, burdens and costs because the potential penalties were very significant and because, by ensuring that penalties were not exigible, we also ensured that our client's name would not be placed on the tax defaulters' register. The time and costs he would have expended had he, and we, not taken an active role in determining his omissions and alerting HMRC to them would have been enormously greater.

It was as good a result as one could have hoped for, but what a sorry tale it is of the operation of our tax system on a client who had taken every possible step to determine his tax liabilities and to account for them properly to HMRC.

Author details

Simon and **Sharon McKie** are partners in McKie & Co (Advisory Services) LLP, a taxation consultancy firm providing expert advice on all areas of UK direct taxation relevant to the private client. They can be contacted by email at: administrator@mckieandco.com.

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