TC01318

Income Tax - Costs application by Appellant in a discovery assessment where the Respondents had withdrawn their assessment shortly before the date of the hearing - whether the assessment was likely to have been sustained had the appeal proceeded

FIRST-TIER TRIBUNAL **Reference no: TC/2010/06395**

TAX

THE EXECUTORS OF DAVID ATKINS Deceased

Applicants

-and-

THE COMMISSIONERS FOR HER MAJESTY'S REVENUE AND CUSTOMS

Respondents

Tribunal: HOWARD M. NOWLAN (Tribunal Judge)

Sitting in public at 45 Bedford Square, London on 21 June 2011 on an Application by the Appellants for Costs

Michael Stubbs of Ingenhaag LLP, accountants, on behalf of the Appellant

The Respondents had indicated in advance that they would not be represented but had submitted written representations

DECISION ON AN APPLICATION FOR COSTS

1. This was a slightly unusual application. Although HMRC had withdrawn its discovery assessment for approximately £13,000, at a very late stage in the period before the Appeal was due to be heard, the Appellant nevertheless pursued an application for costs, and indeed the costs application required me to consider some of the circumstances in relation to the appeal itself.

2. This was a case where I could only award costs, if I thought it was appropriate to do so, where the facts indicated that HMRC had "acted unreasonably in bringing, defending or conducting the proceedings".

3. Whilst the Respondents furnished me with a summary of why they considered that their discovery assessment had been justified, and whilst they then apologised for having been very late in eventually withdrawing their assessment, the facts that the Appellants' accountant gave to me put a rather different complexion on matters. In the absence of any response from the Respondents, and because the Appellants' accountant's account seemed to be entirely credible, I was very much influenced by this account which I now summarise.

4. The deceased, Mr. Atkins, had until his death been a Lloyd's "name". In accordance with the proper basis of accounting, and of producing his tax return for the final year prior to his death, his accountant revealed that the deceased had had a loss in respect of his Lloyd's activity, albeit that £29,878.14 was held in a Special Reserve Account, presumably by the manager of the deceased's syndicate, as a reserve to meet then anticipated claims.

5. Mr. Stubbs explained to me that at the date of death, it was actually expected that the entire amount of that reserve would be required to meet claims, and that indeed there was a possibility that even more would be required to meet claims for the final relevant year. In any event, it was clearly the accepted practice that amounts required to be held and reserved in the Special Reserve Account were deductible from what would otherwise have been the profits of particular years, albeit of course that if and when such reserves were later released, those releases would be subjected to tax.

6. Mr. Stubbs then explained the statutory provisions to me that dealt with the situation where a Lloyd's name might have secured a tax deduction for an underwriting year (very possibly at the 40% rate of tax), when following the death of the name, the executors might later receive funds on the release, or partial release, of those funds held in reserve. I was told that the relevant provisions, contained in paragraph 11 of Schedule 20 to the Finance Act 1993, and various Regulations ensured that the release of the provision in the later years would still attract tax at the rate of 40%, notwithstanding that it would actually accrue to the executors and would ordinarily be taxed at 20% in the hands of the executors. This was achieved by providing that the release would in fact be added back to the income of the deceased in the last full tax year of his life, so as to be taxed at whatever rate was then applicable. Albeit that that was the result for the purposes of ensuring that there would not be the asymmetry in rate between the deceased having secured a deduction at the 40% rate, whilst the release would be taxed at only 20%, I was also told that for the purposes of ascertaining when the tax was actually due, and when interest should run etc., the release was treated as being received in the later year when it was actually received.

7. Mr. Stubbs also explained to me the very understandably way in which HMRC had observed that this legislative result did not tie in appropriately with the provisions for self-assessment, enquires into such returns, and closure of such enquiries. For if no enquiry was opened into the final return, which might have been entirely correct, then that return would be final at the end of the one year window for opening enquiries, and it would be impossible (at least, discovery apart), to re-open that year should the reserves later be released. The practical way promoted thus by HMRC to enable the correct results to be achieved was for the initial return for the last year prior to death to be dealt with in the ordinary way (with therefore deductions being given for amounts held in the Special Reserve Account), but for HMRC then invariably to "open an enquiry" into those returns, deliberately leaving that enquiry open until the ultimate fate of the amounts held in reserve had been resolved.

8. I was given a copy of the Guidelines issued by HMRC to Executors for how to deal with Special Reserve Fund valuations, and I confirm that it indeed indicated how enquiries would be opened into returns, in order to keep matters open, and facilitate the later adjustments to the return for the last period preceding death, as required by Schedule 20 mentioned above.

9. I have no reason to doubt Mr. Stubbs' account, not least because HMRC declined to attend the Costs Hearing, and Mr. Stubbs then told me that he had prepared the tax returns in exactly the manner required. HMRC had failed to open any enquiry. Mr. Stubbs suggested that on account of some adjustment to the return, the enquiry window closed not as HMRC suggested on 31 January 2008, but on 30 April 2008. There is no great significance to whether this was right or not, save that on 24 April 2008, Mr. Stubbs sent HMRC a letter reminding them to open an enquiry. He did not specifically refer to the fact that this was the very course recommended in the Guidelines referred to in the previous paragraph, albeit that it was. Again no enquiry was opened. The material fact remains that whether that letter preceded the closure of the enquiry window, as Mr. Stubbs believed, or whether in fact the enquiry window had already closed on 31 January 2008, it was on account of HMRC's failure to open such an enquiry that when there was later a full release of the entire provision, HMRC would only be able to assess that amount, were they able to sustain a discovery assessment.

10. In March 2010 the whole of the Special Reserve Fund, together with accrued interest, was released to the Executors and this was almost immediately disclosed to HMRC.

11. In due course HMRC sought to make and sustain a discovery assessment, and considerable work was undertaken by Mr. Stubbs in preparing for the Appellants' appeal against that assessment. I understand that the Appellants themselves had sought to cap their liability to Mr. Stubbs for his professional services in seeking to appeal against the discovery assessment at a figure of £2,750, plus VAT, and that Mr. Stubbs has undertaken work that would ordinarily have resulted in a higher charge but for the agreed capping. Mr. Stubbs appeared content to undertake the further services, it seems, partially because he considered that as a matter of principle, when he had made the returns exactly as required, and when the difficulty in recovering the tax properly due resulted only from ignorance and errors on the part of HMRC, he deserved to be vindicated.

12. HMRC prepared a very full Statement of Case as to why they considered that, had they proceeded with their case, the discovery assessment would have been

sustained. The case revolved principally around the test contained in section 29(5) TMA 70. It did make reference to the saving provision in section 29(2) TMA 70 but suggested that this would not have been available to the Appellants, and also suggested rightly that the Appellants' accountant had not relied on the defence under section 29(2).

13. It is inappropriate to consider in detail, in hearing an Application simply for Costs, whether the substantive Appeal would have succeeded or not, had HMRC not withdrawn their assessments. There is some relevance to this issue, however, in that if there is every likelihood that the Appeal would have been dismissed, then the feature that HMRC would be seen to have voluntarily abandoned a good claim for tax of approximately £13,000 might need to be taken into account when deciding whether to award the Appellant their costs. Should there have been a good chance that the Appellants' appeal would have been allowed, and should the case have been one where it might also be award the Appellants their costs under Rule 10(1)(b) of The Tribunal Procedure (First-tier Tribunal) (Tax Chamber) Rules 2009, it might then remain appropriate in this Application that we give the Appellants their requested order for costs.

14. There are two grounds on which one might very easily expect the Appellants to have succeeded in their Appeal against the discovery assessments though neither is free from doubt.

15. The first is that for a discovery assessment to be sustained, or indeed even made under sub-section 29(1) TMA, it is almost always expected that for there to have been some under-statement in the taxpayer's tax return, it would have to have followed that the return itself would have been wrong in some way. In this case, on the information that we have, we believe that the return itself was not only made in accordance with correct practice and in conformity with the Guidelines summarised at paragraph 8 above, but the return was indeed absolutely correct.

16. Somewhat strangely, however, this appears not to furnish the Appellants with a defence to the discovery assessment. It certainly later emerges that there has been an under-assessment in the return for the relevant year, and notwithstanding that this has nothing whatever to do with there having been an error or under-statement in the return, it nevertheless appears that the feature that the return was correct does not undermine the discovery assessment.

17. There is, however, another yet more extraordinary feature in this case, which is that common sense directs that the Appellants should have been able to rely on the defence provided by sub-section 29(2) TMA 70. That provides that:

> *"Where:*
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> *(a) the taxpayer has made and delivered a return under section 8 or 8A of this Act in respect of the relevant year of assessment, and*
> *(b) the situation mentioned in subsection (1) above* (i.e. the under-assessment for the period in question) *is attributable to an error or mistake in the return as to the basis of which his liability ought to have been computed,*

the taxpayer shall not be assessed under that subsection in respect of the year of assessment there mentioned if the return was in fact made on the basis or in accordance with the practice generally prevailing at the time when it was made".

18. It seems to me that the return in this case was made precisely in accordance with the Guidelines published by HMRC as to how executors should prepare the last relevant return for the deceased "name" at Lloyds. The problem in this case results entirely from the way in which HMRC have themselves failed to act in accordance with their own Guidelines in failing to open an enquiry into the relevant return. This was perceived to be the way in which the return would be kept open in order to be adjusted when any amounts might later be released from the Special Reserve Fund.

19. The only defence that I can see to the feature that in their Appeal, the executors might legitimately have contended that they were able to rely on the "sub-section (2) defence" is the quite extraordinary point that the executors fail to satisfy one feature of the sub-section (2) requirement, namely that their return was in fact correct in the first place, and the under-assessment was not due to any error or mistake in the return. The under-assessment was entirely due to HMRC's error in not following their own Guidelines, not opening and enquiry, and not in that way being able to make a late adjustment to the earlier return.

20. I consider that the respect in which the sub-section (2) defence might technically be said to have been applicable is so ridiculous and unjustified that I still consider it appropriate to award the Appellants their costs. That is the decision on this Application.

21. The reasons for this Decision are that:

- the initial failure to open an enquiry and to follow the procedures in HMRC's own Guidelines appears entirely to have been the fault of HMRC;
- the Appellants' return appears to have been made entirely correctly;
- HMRC has forced the Appellants to prepare for a tax appeal that has involved considerable costs;
- in the light of the point made in paragraph 20 above that appeal had no deserved merit, even if on the ridiculous ground mentioned in paragraph 18 above the sub-section (2) defence might have been disputed; and
- at no time, or even in their letter summarising the background to this case, have HMRC even alluded to the failure to open an enquiry into the return, and their failure to proceed in the only way considered workable in relation to the precise situation that has arisen in this case. HMRC have, in other words been very unforthcoming to either the Appellant or to me in admitting their fundamental errors, and they have not appeared at the hearing to advance any argument as to why this conclusion may be unfounded.

21. I accordingly award the Appellants their costs in the figure referred to in paragraph 11 above.

22. This document contains full findings of fact and the reasons for my decision. Any party dissatisfied with this decision has a right to apply for permission to appeal against it pursuant to Rule 39 of the Tribunal Procedure (First-tier Tribunal) Tax Chamber Rules 2009. The application must be received by this Tribunal not later than 56 days after this decision is sent to that party. The parties are referred to "Guidance to accompany a Decision from the First-tier Tribunal (Tax Chamber)" which accompanies and forms part of this decision notice.

HOWARD M. NOWLAN (Tribunal Judge)

Released: 13 July 2011