



TC01648

Appeal number: TC/2010/05915

Income tax – underdeclaration of takings by takeaway restaurant – amendment of partnership returns for the enquiry year and five other years – imposition of penalties for inaccuracies in the original returns – whether the returns were inaccurate – yes – whether HMRC’s amendments to them were correct – no, though the basic methodology followed had been reasonable – amendments to be altered to correct excessive amounts – whether penalties correctly imposed – yes, subject to adjustment in line with amended partnership return figures – appeal allowed in part

FIRST-TIER TRIBUNAL

TAX

**THE RED STAR (a partnership comprising Mr L C Yau Appellants
(deceased), Mrs P W Yau and Mr P Y Yau)**

-and-

**THE COMMISSIONERS FOR HER MAJESTY’S Respondents
REVENUE AND CUSTOMS (Income tax and NIC)**

**TRIBUNAL: KEVIN POOLE (TRIBUNAL JUDGE)
TERENCE BAYLISS FFA**

Sitting in public in Birmingham on 27 January, 28 March and 3 August 2011 (with subsequent written submissions)

Annabelle Poon of Grandway Trading Limited for the Appellants

Cheryl Payne-Dwyer, Senior Officer of HMRC for the Respondents

DECISION

Introduction

1. This appeal concerns an alleged suppression of sales and profit at a Chinese
5 takeaway restaurant in St Just, Cornwall. The Appellants appeal against amendments
to the partnership returns (and the consequent amendments to their respective
personal self-assessment tax returns) over a six year period. They also appeal against
the imposition of penalties in respect of the alleged under-declarations of profit over
the same period.

10 2. The business of the restaurant was, at all material times, carried on by a
partnership comprising Mr L C Yau, his wife Mrs P W Yau and their son, Mr P Y
Yau. The partnership name was “The Red Star”. It commenced on 22 November
1998. Mr Yau senior unfortunately died in January 2009, after HMRC’s enquiry
commenced.

15 3. Mr Yau junior (to whom we will refer in this decision as simply “Mr Yau”)
worked in the restaurant with his father. He gave evidence before us. Mrs Yau did
not give evidence, on the basis that she was unwell; from the absence of any written
statement from her, we infer also that she had not been sufficiently involved in the
business for her evidence to be relevant.

20 The facts

The enquiry

4. Red Star submitted its partnership tax return for the year ended 5 April 2006
on time. The basis period for the computation of the partnership profits was the
accounting period from 1 December 2004 to 30 November 2005. The accounts for
25 that period showed net profit for the year of £39,314 on a turnover of £114,065. After
adjustment for tax purposes (mostly by replacing depreciation with capital
allowances), the figures transposed into the partnership return resulted in a taxable
profit of £40,753 for the tax year 2005-06, shared equally between the three partners.

5. HMRC selected the return for enquiry. By letters dated 25 April 2007, they
30 wrote to the late Mr Yau (who was the representative partner) to inform him that they
intended to enquire into the return. They also wrote to the individual partners on the
same day, telling them that their personal tax returns for the same year should be
regarded as also under enquiry, pending the outcome of the enquiry into the
partnership return.

35 6. The inspector dealing with the matter at HMRC, Mr Laity, wrote on the same
day to the Appellants’ accountants, requesting various documents and information to
assist in the enquiry. This was supplied on 25 May 2007.

7. Mr Laity absorbed the information supplied and had some concerns with it.
He asked for a meeting to discuss the position, and the meeting was arranged for 10
40 July 2007 at the accountant’s offices. Mr Yau attended that meeting on behalf of all

the partners. It was explained that the running of the business had become more and more his responsibility over recent times, rather than his father's. His accountant was also present.

5 8. Mr Laity produced various charts at the meeting which he had prepared from the records which had been supplied to him. He highlighted some areas where the charts demonstrated what he regarded as matters of concern.

10 9. He was concerned that the value of sale per customer seemed to fluctuate in a way which he regarded as unexpected over the course of the year, and various reported purchases of the business did not appear to follow the profile of the reported sales in the way he would have expected. The purchases included containers, vegetable oil, chips, beansprouts and rice.

15 10. He focused particularly on the rice purchases. Mr Yau informed him that a normal weekly usage would be two to three bags, each containing 20kg of rice. This appeared to be consistent with the records of certain purchases of rice identified over the winter period (in December and February). Mr Yau agreed that the usage would be higher in the summer. Doing some quick arithmetic, Mr Laity suggested (and Mr Yau did not disagree) that a reasonable estimate of the annual requirement for rice would be in the region of 2,500 to 3,000 kg. He stated that the purchase records provided to him showed purchases of just 1,600 kg during the year, and Mr Yau
20 "agreed that this was nowhere near enough to meet the requirements". (In fact, Mr Laity had been working on the basis of incorrect information. He accepted immediately following the meeting that the true figure of recorded rice purchases during the year was 1,940 kg, and it was agreed at the hearing of the appeal that the true figure was in fact 2,020 kg.)

25 11. Mr Laity also expressed concerns about certain surprising features of the order tickets that had been supplied to him which suggested to him that there was perhaps more than one order pad in use at any one time and sales had been concealed by slimming down the order tickets into one apparent series. There were apparent discrepancies in the times written down on the numbered tickets; a distinctive stain
30 which appeared on two tickets but not on the tickets in between; and most crucially, one bundle of tickets for 6 October 2005 contained two tickets numbered 94 which clearly came from different pads – the takings of both tickets having been included in the records as takings for that day, and there being no missing ticket of that number in any of the other days' tickets. (In fact, the latter assertion was incorrect – there was a
35 missing ticket 94 from the tickets used on 9 May 2005. Nothing turns on this error, however, because neither of the ticket 94's from 6 October 2005 matched the other tickets from 9 May 2005 in terms of exact size or location of staple holes.)

12. In response to Mr Laity's observations, Mr Yau had said he could not comment further until he had spoken to his father.

40 13. Following this meeting, the Appellants withdrew their instructions from their accountants and instructed Octopower 2000 Limited, another company (like Grandway Trading Limited, the Appellants' representative since 18 May 2010)

represented by Mr Simon Poon. Four days after the meeting, the Appellants ceased to trade at the business premises, the business apparently being transferred to a limited company for which Mr Yau acted as an employed manager in carrying on the business as before.

5 14. There was much correspondence but no material progress in the enquiry over
the following two years or so and in September 2009 Mr Laity issued what he referred
to as his “pre-decision” letter dated 25 September 2009. In it, he indicated that he
proposed to amend the partnership return by recalculating its turnover on the basis of
10 Mr Yau’s estimate of the purchases of rice given at the meeting, with a corresponding
uplift in the cost of purchases. This would increase the turnover from £114,065 to
£150,000 and the taxable profit from £40,853 (in fact the correct figure was £40,753)
to £65,000. He also proposed to adjust the reported profits from earlier and later
years to the same £65,000 figure (adjusted for inflation).

15 15. This letter was followed up by a letter dated 19 January 2010, which was sent
to the Appellants with a second letter dated 25 January 2010. In the first of these
letters, HMRC gave a formal closure notice in respect of the enquiry in relation to the
partnership return for 2005-06. In the second letter, they explained their reasoning in
some detail and also notified the Appellants that they were “adjusting the profits of
the business (and therefore the shares attributable to each partner) for the years
20 2002/03 to 2007/08 inclusive”, “in accordance with section 40 Taxes Management
Act 1970” (“TMA”). Detailed schedules were subsequently provided setting out the
amendments being made to the partnership returns for all the years in question and
setting out the amended personal self-assessments of each of the partners.

16. It is these amendments which are the main subject of the present appeal.

25 17. In addition, HMRC imposed penalties on Mr Yau and his mother in relation to
what they considered to be the negligent delivery of incorrect returns for the years in
question. A Penalty Determination dated 25 January 2010 accompanied the letter,
setting out the penalties, which HMRC say are calculated on the basis of 40% of the
underpaid tax and NICs for all the years in question. HMRC say that this penalty
30 determination purports to levy penalties only on Mr Yau and Mrs Yau (no penalties
being imposed on the estates of deceased taxpayers). These penalties were also the
subject of the present appeal.

35 18. After the second day of the hearing of this appeal, HMRC noticed that the
original penalty notice was invalid, and withdrew it. In its place, they issued on 8
July 2011 separate penalty notices addressed to Mr Yau and his mother, imposing on
each of them a penalty of 40% of the tax and NICs which HMRC calculated as having
been underdeclared by them respectively. The parties agreed that this appeal could be
regarded as extending to the revised penalty notices, without the need for a new
appeal to be formally raised.

HMRC's method of calculation

19. Having reached the conclusion that the sales were being underdeclared, Mr Laity tried various arithmetical methods of calculating what he considered should be the correct level of sales. There were no records of the takings of the business (which were primarily in cash) apart from a manuscript daily note in a diary and a bundle of order tickets. After considering various alternatives, he elected to work from Mr Yau's estimate (given at the meeting in July 2007) of the quantities of rice used in the business.

20. He took the 1,940 kg of rice purchases which he believed to have been recorded, and compared that to what he regarded as a "correct" figure of 2,600 kg, based on Mr Yau's statement at the meeting about using "2-3 bags per week", and interpreting that as 2½ bags (50 kg) per week. He reasoned that if the purchases were suppressed by the ratio 1,940:2,600, it would be reasonable to assume that the sales would be suppressed by the same ratio (thus maintaining the reported gross profit rate, which fell within industry norms). This led him to a sales figure of £152,870, which he rounded down to £150,000. He then applied the reported gross profit rate to the uplifted turnover, resulting in a gross profit figure of £99,885. After deducting the other expenses claimed in the original accounts, as adjusted for tax purposes (£34,147), he reached a figure for net taxable profit of £65,738, which he rounded down to £65,000.

21. Applying a presumption of continuity, he then adjusted the profits for all the other tax years from 2002-03 to 2007-08 to the same figure, subject only to some rounding down, an adjustment for inflation by reference to the Retail Prices Index and a time apportionment for the final period of trading reflected in the 2007-08 period (which was less than a year).

Extraneous facts

22. There was a great deal of evidence put before us and submissions made to us as to:

- (1) The nature of the St Just area and its population;
- (2) Weather problems experienced in Cornwall over various years;
- (3) Local competition in the takeaway food sector in St Just;
- (4) Travel distances and times between St Just and various other locations;
- (5) The existence of mortgage financing related to Mr Yau's parents' acquisition of a property in Torquay in 2001;
- (6) Purchase and use of various types of containers by the Appellants;
- (7) Purchase and use of order pads;
- (8) Purchase patterns of various other raw materials used in the business, especially when compared to patterns of reported sales;

(9) Likely wastage of frozen chips upon cooking;

(10) Expected total sales per bag of rice

(11) The reliability of the Appellants' main supplier (and accordingly the reliability of the records of purchases from it).

5 23. None of this evidence went to the key issue of establishing what, if any, underdeclaration of sales had been made by the Appellants. Some of it was potentially peripherally significant in supporting the proposition that some level of underdeclaration had taken place, but we were satisfied on that point by other evidence (see below).

10 *Findings of fact on significant disputed or unagreed matters and calculation of profits*

24. We find that Mr Yau had worked in the takeaway restaurant on the counter (taking orders) since approximately 1998. He worked there right up to the time when the Appellants ceased to carry on the business in 2007. He carried on working there subsequently as manager for the new owner.

15 25. Mr Yau senior was the main driving force behind the business, and was generally present at the business premises throughout the years under appeal. He dealt with the ordering of supplies and with the administration. Apart from writing the daily takings total in the diary (which Mr Yau did on his instruction), he compiled the business records, including those which have been put before us in the context of
20 this appeal. He also dealt with all the ordering of food and other supplies. He continued in this role until around July 2006, when he stepped back from the business after suffering a mild stroke and having been unwell. He then moved away from the area to a house he owned jointly with his wife in Torquay. From then on, Mr Yau ran the business of the partnership until it ceased in July 2007.

25 26. From the order tickets that were put in evidence, we were satisfied that some level of underdeclaration of sales was taking place during the period 1 December 2004 to 30 November 2005. We can see no legitimate explanation for the existence of two tickets bearing the same number in a situation where Mr Yau is adamant that he only ever used one order pad at a time. We have also been referred to a number of
30 other original order tickets where supposedly sequential tickets clearly do not come from the same pad. There are unexplained mismatches in the location of staple holes and colour of paper between tickets which are supposed to come from the same pad. Overall, it is clear to us that someone (and it could only have been Mr Yau senior or Mr Yau) has very carefully put together an entirely artificial "record" of the orders
35 actually taken and the resulting takings. We accept that it was Mr Yau senior who was doing this and not Mr Yau. We also accept that Mr Yau did not have any direct knowledge of what his father was doing.

40 27. Given this evidence that the sales were underdeclared, and given that the gross profit percentage reported in the accounts was within the normal range for such businesses, we consider it was appropriate for Mr Laity to consider the question of whether the purchases might also have been underdeclared, and whether some

evidence of the amount of that underdeclaration might provide some means of calculating the amount of the underdeclaration of sales.

28. He had one piece of specific evidence that purchases had been underdeclared, namely Mr Yau's statement in the July 2007 meeting that he normally used two or
5 three bags of rice per week. This was not comprehensive and detailed evidence, but it was the best evidence available to Mr Laity. He had also carried out other analysis work on the various purchase and sales patterns of the business which quite reasonably reinforced his impression that "something was wrong". We also accept his evidence that if he had tried to estimate the true turnover and cost of sales of the
10 business from that other information, the results would have been less reliable and also would have resulted in much greater adjustments than those he actually made.

29. We also note that the Appellants advisers did not engage constructively with HMRC to provide further information which might have led the enquiry down some other, more constructive, route. If they had spent as much time and energy on doing
15 so as they did on making repeated ill-founded complaints about Mr Laity's conduct, the enquiry may have had a very different outcome.

30. We do feel, however, that by taking an average of 2½ bags per week of rice throughout the year as being the true measure of purchases, Mr Laity has gone further than the evidence warrants. We take Mr Yau's statement of "a normal weekly usage "
20 of two to three bags as meaning that, for most weeks, two bags would be enough and for busy weeks, three bags would be required. Our assessment is that a more accurate measure of the rice usage would be that on average, for the 10 weeks of the year when reported sales were more than 10% above the annual weekly sales average, the weekly use would be three bags; for the remaining 42 weeks it would, on average, be
25 two bags.

31. We therefore find that the true usage of rice was 2,280 kgs.

32. Mr Yau's reported use was 2,020 kgs. We consider that this figure includes any small amount of rice given to him by his sister when she closed down her own
30 takeaway restaurant as she gave no evidence as to the amount of rice which she actually gave to him and it was clearly not significant.

33. Applying Mr Laity's methodology, therefore, we would arrive at a true turnover figure for the year to 30 November 2005 of £128,746 (excluding VAT) – an increase of £14,681. Applying the reported gross profit percentage of 66.59%, this
35 results in an adjusted gross profit of £85,731. After deducting the expenses claimed (of £36,647), this results in a net accounting profit of £49,084. After then making the same tax adjustment to that accounting profit as is shown in the partnership return (a net increase of £1,439) the final taxable profit comes to £50,523 (an increase of £9,770 over the reported taxable profit of £40,753).

34. We note that Mr Laity based his amendment to the partnership return for
40 2005-06 solely on an adjustment to the turnover figure by uplifting it in proportion to what he considered to be the undeclared purchases of rice. Given the level of

obstruction, delay and general non-cooperation he was faced with from the Appellants' advisers, we consider he had no better option available to him and he took a fundamentally reasonable approach. We have found that a slight variation of the "undeclared rice purchases uplift" method is required (as above) but we agree with the basic approach.

35. The question then arises as to what adjustments, if any, should be made to the partnership returns for the other years which are the subject of this appeal.

36. On that matter, we are not satisfied that the presumption of continuity (see below) applies in the way HMRC have sought to apply it.

37. Mr Yau gave evidence that Mr Yau senior had been very much in charge of the business during the year ended 30 November 2005, as he had been for many years before that time. We are satisfied therefore that a presumption of continuity is appropriate for the years 2002-03 up to 2005-06. However, the correct presumption is not (as Mr Laity has assumed) that the net profits continued the same throughout all the years (subject only to inflation); the correct presumption is that Mr Yau senior continued to underdeclare both sales and purchases at a similar rate throughout the period. We consider that on a correct application of the presumption of continuity, HMRC should therefore have amended the partnership profits not by simply substituting an inflation-adjusted figure carried back from 2005-06, but by applying the same methodology as was used to arrive at the 2005-06 figure, and assuming the same degree of underdeclaration of both sales and purchases.

38. So far as the presumption of continuity for 2006-07 and 2007-08 is concerned, there was clearly something of a hiatus at the business when Mr Yau senior retired in the summer of 2006 as a result of his illness. If proper returns had been made for these last two years, we consider that would have been sufficient to displace the presumption of continuity. However, the partnership returns made for the tax years 2006-07 and 2007-08 (covering the accounting periods 1 December 2005 to 30 November 2006 and 1 December 2006 to cessation in July 2007 respectively) are estimated returns. As such, we consider it is appropriate to assume that profits carried on being earned at the same rate as in the previous year (subject only to inflation). We therefore find that the profits for the years 2006-07 and 2007-08 are to be amended to £52,480 and £32,853 respectively. These are based on the revised 2005-06 figure, adjusted for inflation and, in relation to the latter period, time apportioned up to the cessation of the business on the basis of 7.33 months' trading during the year.

39. We had some figures for turnover, cost of sales and expenses in the evidence before us for the accounting period ended 30 November 2004, but only by reference to the prior year figures in the 30 November 2005 accounts. We had no such figures for earlier years. Our calculation of the corrected taxable profit for the year ended 30 November 2004 (to be included in the amended partnership return for 2004-05) is as follows:

Reported sales:	£105,043
Adjust for suppression at same assumed rate as 2005-06 (x 2280 ÷ 2020):	£118,563
Resulting gross profit at reported GP rate of 67.22%:	£79,698
Less £34,129 expenses claimed, gives revised net profit (before adjustment for tax purposes):	£45,569
Add tax adjustment as made for purposes of 2004-05 return (addition of £3,025, calculated as the difference between the 2004 net accounting profit and the original taxable profit shown in HMRC's amendment to the 2004 return):	£48,594

40. The figures were not before us in evidence to enable us to carry out the same calculation for the earlier years. However, we find that this is the calculation that needs to be done to arrive at the true taxable profits for those years.

5 The law

41. Mrs Payne-Dwyer submitted that we have power under section 50(6) TMA to reduce the amount of the amended partnership self-assessment if we decide that any amounts in it are excessive. She pointed out that the burden of proof lies on the Appellants to show that this is the case – see *Jonas v Bamford* [1973] STC 519. On the basis of *Hurley v Taylor* [1998] STC 1, she pointed out that we are required to dismiss the appeal and uphold the amended [self]-assessment if we are uncertain where the truth lies, or if we are unable to decide whether the Appellants' explanation is true or false. She also pointed out that once an irregularity has been established, there is a presumption of continuity that the irregularity will have continued “until there is some change in the situation”; on this basis, she argued, it was appropriate to make the adjustments that Mr Laity had made to the other years, in addition to the enquiry year.

42. We agree in principle with the submissions made by Mrs Payne-Dwyer as to the basis upon which we must proceed in determining the appeal.

43. Miss Poon did not disagree in any significant way with the legal position, though of course she took a very different view as to how it should apply in the present appeal.

44. She does however criticise HMRC for failing to use their information gathering powers to obtain more information to help in their assessment of the Appellants' case. This in our view misses the point. Once HMRC have made out a prima facie case, it is for the Appellants to provide information to displace it. They cannot sit on the sidelines and complain that HMRC have not done their work for them.

45. Miss Poon also argues that HMRC have changed the basis of their arguments following the issue of the closure notice, and she submits that on the authority of *Tower McCashback v HMRC* [2008] EWHC 2387, this should not be permitted. We disagree with this submission. It was clear from the original decision letter issued by
5 HMRC that they were recalculating the profits on the basis of underdeclared sales, quantified by reference to underdeclared purchases of rice. That position has not changed. The other evidence HMRC adduced in relation to the issue of order pads and tickets merely goes to support HMRC's assertion that the record of sales is unreliable, it does not go to the quantification of the shortfall. In any event, we do
10 not consider that the *Tower McCashback* case is authority for the proposition that only matters mentioned at the time of the closure notice may be taken into account when considering the validity of an amendment made by the closure notice to a document such as a partnership return.

46. As to the penalties, there does not appear to be any dispute that these are
15 governed by section 95A TMA, under which, broadly, the fraudulent or negligent delivery of an incorrect partnership return renders each partner liable to a penalty up to the amount of the reduction in his or her income tax liability which arises from the inaccuracy. In this case HMRC have imposed a penalty on each of Mr Yau and his mother at the rate of 40% of the respective differences. We have the power, under
20 section 100B TMA, to confirm, reduce or increase the penalties.

Decision

47. We find that the original partnership return of the Appellants for each of the years 2002-03 to 2007-08 is incorrect.

48. We find that the inaccuracy is, in each case, attributable to the fraud or
25 negligence of Mr Yau senior (see [26]).

49. We find that HMRC's amendments to the various partnership returns result in the amounts in each of them being excessive (see [33], [37] to [40]).

50. We find that the proper amounts to be included in the 2002-03 and the 2003-
30 04 partnership returns in respect of the taxable profits of the Appellants (and to be allocated equally between them) is to be calculated by adjusting the accounting profits upon which the original returns were based in line with our calculation set out at [39] above.

51. We find that the proper amount to be included in the 2004-05 partnership
35 return in respect of the taxable profits of the Appellants is £48,594, divided equally between them (see [39]).

52. We find that the proper amount to be included in the 2005-06 partnership return in respect of the taxable profits of the Appellants is £50,523, divided equally between them (see [33]).

53. We find that the proper amount to be included in the 2006-07 partnership return in respect of the taxable profits of the Appellants is £52,480, divided equally between them (see [38]).

54. We find that the proper amount to be included in the 2007-08 partnership return in respect of the taxable profits of the Appellants is £32,853, divided equally between them (see [38]).

55. We find no basis to interfere with the penalty loading of 40% applied by HMRC in calculating the penalties previously notified to the Mr Yau and Mrs Yau. We are satisfied that the inaccuracies in the various returns arose deliberately and the level of cooperation given by the Appellants once they had appointed new advisers was extremely poor.

56. Once the final figures for the revised tax liabilities of Mr Yau and Mrs Yau for each of the above years have been ascertained, we will be in a position to issue a final decision on the penalties actually payable, should it be necessary.

57. Should there be any disagreement about the calculation of the final amendments made by HMRC to the 2002-03 or 2003-04 partnership returns, about the calculation of the Appellants' final tax liabilities for all six years under appeal, or about the calculation of the amended penalties, either party will be at liberty to apply for a final determination of the outstanding disagreement. We will not hesitate to use our power to award costs if we consider either party or their representatives to have acted unreasonably in connection with that application.

58. This document contains full findings of fact and reasons for the 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.



KEVIN POOLE
TRIBUNAL JUDGE
RELEASE DATE: 12 DECEMBER 2011