

# RECENT TRENDS IN TAX LITIGATION

by Michael Thomas

## Introduction

The purpose of this article<sup>1</sup> is to try and identify, with reference to some recent cases, the key themes of current UK direct tax litigation. It is hoped that the patterns which emerge can then be applied to help enable taxpayers to obtain favourable outcomes in disputes with HMRC. The best possible result, of course, is to avoid a dispute entirely, but this is not always possible. The article is in three parts. First, I shall look, in a very broad way, at how our tax system has been developing recently and consider the impact of this on tax litigation. The second part involves a more detailed look at some important direct tax cases from the last year which are relevant to small and medium sized enterprises (SMEs). Some of the cases also deal with points of substantive interest as well as illustrating the patterns of tax litigation. The final section attempts to pull the themes which have been identified together and suggests where future attacks from HMRC are likely to come and how they might successfully be avoided or, if necessary, defeated.

## Recent Developments in the UK Tax System and Their Impact on Litigation

The key development in our tax system in recent years has been the exponential increase in the amount of legislation. The motivation for any tax reform is to raise more money. Most of the legislation is designed to close what the Government perceives as loopholes and thereby increase revenues. The up-front cost to the Government from legislation is minimal and it avoids the need to litigate grey areas. HMRC's recent more aggressive stance towards schemes and the introduction of the disclosure rules in 2004 have seen the legislative process accelerated so that HMRC will change the law first and litigate afterwards (if they consider it worth their while). Hence in the last few years there has been a large amount of anti-avoidance legislation, including very specific amendments, and whole new regimes such as that dealing with "Pre-owned Assets", "Targetted Anti-Avoidance Rules" for capital gains tax and even a mini "General Anti-Avoidance Rule" for SDLT - the notorious s.75A. In addition the legislative rewrites have achieved little other than making the statute book even fatter and rendering textbooks out of date.

However, legislation comes at a cost. First, there is the price of complexity. The more complex the law is the, the more time and resources both taxpayers and HMRC have to spend ensuring that taxpayers have complied properly with their obligations. HMRC's general line is that complex anti-avoidance legislation is necessary to combat the ingenuity of tax planners and those who are not doing aggressive planning can safely ignore large swathes of the tax code. There is some truth in this, but many of the ordinary charging provisions, such as Schedule 22 ITEPA, are very complex and wide-ranging. Other regimes, notably the SDLT Schedules dealing with leases and partnerships, are disproportionately complex relative to the tax at stake. This gives rise to the danger that issues are overlooked, which should be a serious concern for both taxpayers and HMRC. In turn, this increases the likelihood of increased tax-based fraud and negligence cases, which is not the kind of litigation any of us wants to be involved in. Finally, and ironically, complex technical legislation aimed at preventing tax planning tends to provide fertile ground for developing exactly the

kind of tax schemes it is meant to prevent. That this last point is not lost on HMRC is demonstrated by the more innovative kinds of anti-avoidance legislation which have appeared recently.

Secondly, because law is an interpretive practice, every last statutory provision is open to dispute. Human activity is infinitely varied and no code can apply with absolute clarity to every situation. Increasing the amount of legislation thus actually increases the scope for litigation rather than the opposite. Frederick the Great famously discovered this when enacting the Prussian Civil Code. He had the enlightened idea that a suitably comprehensive code could prescribe an answer in every situation and thereby do away with the need for disputes and lawyers. Of course the idea failed, and the lawyers argued over the correct interpretation of the code! The lessons of history have not prevented those responsible for our tax code from repeating the pattern. Nor is legislation the answer to everything even for HMRC. UK legislation must comply with EU law. The Government cannot simply change the law when the relevant tax is VAT, and this, as well as the culture of the former HM Customs & Excise, has driven the high volume of VAT litigation in recent years. The recent direct tax challenges based on the incompatibility of UK law with EU law, such as *Cadbury Schweppes*<sup>2</sup> on CFCs, have been brought precisely because the Government cannot achieve the result it wants by enacting UK law which breaches EU Law.

Finally, it is no use having anti-avoidance legislation as a deterrent if HMRC is not prepared to back it up by litigation. The reason for this is that it is (almost) always possible to find some kind of technical argument that aggressive planning works, and if it appears that HMRC is not likely to litigate then some clients will take a commercial decision to run the risk and attempt the planning. This is a legitimate course, provided that the taxpayer's self-assessment obligations are complied with, which will very likely mean making additional disclosures to HMRC. Accordingly, it is important, if HMRC wants to stop what it considers unacceptable tax planning, that it actually litigates the cases. Hence the statements made to this effect especially by Dave Hartnett at the 2005 Latimer Conference and the challenges to aggressive schemes which HMRC is now bringing through the courts. It should be noted, however, that by no means have all the schemes which were blocked by legislation in recent years been challenged.

### **Review of Direct Tax Cases Relevant to SMEs**

A general distinction can be drawn between two kinds of tax case. One kind is where there has been what might (neutrally) be labelled as an "aggressive self-assessment", and this might raise a point of fundamental importance, depending on how common the situation is and the significance of the relevant statutory provision. The other is where HMRC challenges a scheme. There are other kinds of cases which fill up the reports, but these are outside the scope of this article. VAT litigation and direct tax challenges based on EU law have been referred to above. One species of case which deserves a mention in passing is those based on HMRC's information powers. When HMRC seeks information from taxpayer then it almost invariably wins any contested hearing. It will therefore generally be detrimental to try and withhold information because to do so will only heighten their curiosity and merely delay the inevitable at the cost of antagonising and arousing the suspicions of HMRC.

I now want to consider some important recent tax cases, mostly from the last year. For present purposes, I am chiefly concerned with what the cases tell us about the challenges which HMRC brings and how the courts dispose of them. It is important to remember that both HMRC and the judges, by which term I include the Special Commissioners, are human beings. The judge's job is to try and find the right result by applying the law, with due regard to its purpose, to the facts. In the words of Ribeiro PJ<sup>3</sup> the "ultimate question is whether the relevant statutory provisions, construed purposively, were intended to apply to the transaction, viewed realistically." Judges do not approach the case in blinkers. It therefore greatly assists a litigant to be able to demonstrate that he has merit on his side.

### **Challenges to Schemes**

In contrast, when a judge decides that the participants in a tax saving scheme are "acting out a charade", as Sir Stephen Oliver did in the recent case of *Drummond v. HMRC*<sup>4</sup>, then there is only likely to be one result. In *Drummond*, the taxpayer entered into a scheme designed to create a £2m allowable loss for CGT purposes. The taxpayer bought 5 second-hand 'non qualifying' life assurance policies for £2 million. The next day the policies were surrendered for £1.75 million. He then claimed a loss of £1.96 million. The key provision (and note that the scheme has since been countered by statute) was s.37(1) TCGA 1992. It provides that there is excluded from the CGT computation "money ... taken into account as a receipt in computing income or profits or gains ... or, the person making the disposal." The taxpayer's case was that the entire surrender proceeds of the policy was taken account of in computing the "chargeable event gain" in Ch.II Part XIII ICTA, which was taxable as income, notwithstanding that in performing that calculation the total of the premiums paid was subtracted to leave only £1,351 actually chargeable. Sir Stephen Oliver found against the taxpayer and concluded that only the actual chargeable event gain of £1,357.35 was taken into account so as to be ignored under s.37(1). Having decided against the taxpayer on the s.37(1) issue Sir Stephen Oliver considered whether the £1.96 million was deductible in the CGT computation to give the taxpayer a £210,000 loss (which is the economic loss he had suffered). He found against the taxpayer on this point also. Sir Stephen's decision on this point may have been coloured by his view of the scheme. The taxpayer and the promoter were quite frank in admitting that this was a tax avoidance scheme which sought to take advantage of an apparent statutory mismatch. This did not gain them much judicial sympathy. It is also noteworthy that the entire history of the strategy and its promotion is set out in the decision. For example, a letter from the promoter to the client outlining the strategy is reproduced in full.

*Astall and Edwards v. HMRC*<sup>5</sup> is a slightly different kind of case from *Drummond*. *Astall* concerned a scheme involving relevant discounted securities. The taxpayers settled small sums into a trust in which they had a life interest. The settlor then lent money to the trust in return for a security. The security provided that if a condition relating to the dollar-pound exchange rate, which was designed to have an 85% chance of being satisfied, was met within one month, and a notice to transfer the security was given, the purchaser could redeem it at 5% of the issue price on 7 days' notice, but otherwise the security became redeemable only after 65 years. The exchange rate condition was duly satisfied. The taxpayer then sold the security to a bank at a large loss, and the bank redeemed it at 5% of the redemption price. The

taxpayer unsuccessfully tried to claim the loss on the difference between the issue price and the price received from the bank as a loss on a relevant discounted security under Sch.13 FA 96. *Scottish Provident* and *Barclays Mercantile* were applied so that a purposive construction was given to the definition of relevant discounted security, and the facts considered with regard to the real possibilities of redemption. It was a practical certainty that the security would be redeemed at a loss of 94%. Accordingly, the security was not a relevant discounted security. This conclusion illustrates that the courts are prepared to construe purposively even technical legal concepts such as “relevant discounted security.” It is noteworthy that again the Special Commissioner (Dr. J Avery Jones) went through the history of the scheme and the documentation which was issued. Having done so he found that the exchange condition and the fact that KPMG delayed seeking a purchaser until after the issue of the securities were inserted purely as anti-*Ramsay* devices.

The *Drummond* and *Astall* cases are only two of several in the last year where HMRC has successfully challenged schemes. Nevertheless, they amply demonstrate the crucial point that litigating against the state is always tough, and that trying to uphold an aggressive tax saving scheme is always going to be even tougher. It is no surprise whatsoever that HMRC has tended to succeed in its recent challenges against schemes. The key point is that, in the eyes of the judiciary, the taxpayers lacked merit. Taxpayers cannot expect judicial sympathy for clever technical arguments which produce loopholes, when there is a respectable alternative analysis which denies the loophole. It should also be borne in mind that the presence of a tax scheme means that, even if the arrangement achieves its immediate aim, the courts will be more receptive to an attack from HMRC on a separate point.<sup>6</sup>

The moral of the story seems to be clear: if a taxpayer does a scheme based on a loophole, then if at all possible it is much better to make sure it is a good one rather than one which is just technically arguable. It might perhaps be asked, what is a good scheme? Perhaps the best answer is that it is one where the loophole is not just technically arguable, but so clear that, even with the aid of *Ramsay*, HMRC cannot convince a judge that the statute is not flawed. An example of such a case is *HMRC v. Darcy*<sup>7</sup>. In *Darcy* the taxpayer entered into a series of transactions in gilts with the aim of obtaining a deduction for manufactured interest. It was common ground that the deduction was available. HMRC then tried unsuccessfully to argue that the deduction was matched by a charge under the accrued income scheme. Henderson J concluded by reflecting that in a tax system as complex as the UK's, there would inevitably be some gaps of which taxpayers would be able to take advantage<sup>8</sup>.

The courts' usual approach to schemes can be contrasted with the case of *Jones v. Garnett* (aka ‘*Arctic Systems*'). This – as is well known - concerned a scheme to save tax and NICs, whereby a husband and wife established a company and owned the shares equally. The company provided the services of the husband as IT consultant to agencies. The wife undertook administrative tasks for 4 to 5 hours per week. The husband was paid only a nominal salary, and the remainder of the profits were distributed equally. HMRC contended that the settlements legislation, contained (at the material times) in Chapter 1A Part X ICTA 1988, applied, so that income gifted to the wife was treated as that of the husband for tax purposes. The House of Lords agreed with HMRC that the arrangement did involve an “element of bounty”, so that the settlements legislation was in point; however, the arrangement constituted

an “outright gift” between spouses, so that the exception in s.660A(6) applied. My own view is that *Jones* was wrongly decided, at least as a matter of technical law. Mr. Jones did not make an “outright gift” of his income to his wife: rather he made a continuing gift by failing to demand a market salary for the work which he did. On a normal reading of the statute, HMRC should clearly have won. However, the House of Lords was alive to the perceived merits of the case and took account of the fact that HMRC had used wide-ranging anti-avoidance powers aimed at trusts to challenge a long-established and apparently accepted kind of planning, the ultimate result of which was to share the benefit of lower tax rates between spouses. Their Lordships were therefore happy to take a rather strained view of both the law and the facts to achieve what they considered to be the just result. It is suggested that *Jones v Garnett* is an example of a very rare species of tax case indeed: cases where the courts feel that a scheme has sufficient (non-technical) merit that potentially applicable anti-avoidance legislation is found not to apply.

### **Challenges to Aggressive Self-Assessments**

The second major species of case is what might neutrally be termed as challenges to “aggressive self-assessments”. It is thought that, as HMRC has become better organised and more business-oriented, the attacks which it makes are becoming more concentrated against individual business sectors, and particular transactions which recur frequently. These kinds of challenges are likely to continue to be made and some of them are discussed below. Although the issues at stake differ, cases where HMRC challenges what it perceives as an unjustified self-assessment often tend to follow a similar kind of pattern. The essential question is whether the judge decides to agree with HMRC that the particular self-assessment is a step too far and therefore abusive, or whether the taxpayer has self-assessed legitimately. This kind of case is inherently more winnable than one which involves defending a scheme, but it is still difficult. Taxpayers should also bear in mind that HMRC is likely to put forward weak (for the taxpayer) test cases on any given issue. The way the facts are presented and how the Commissioners react to them are therefore of key importance. HMRC is likely, if at all possible, to paint a picture of abuse, and in response the taxpayer must show the inherent commerciality of what has been done in order to capture the merits of the case. It will help the taxpayer to show the sensible commerciality behind what he has done, just as being shown to have undertaken a scheme will damage him.

#### *Residence Challenges*

Challenges to the residence of both companies and individuals remain popular with HMRC. The most important recent case as regards individuals is *Gaines-Cooper v. HMRC*<sup>9</sup>. The taxpayer was born (in 1937) and educated in England. From 1958 he ran various UK businesses. In the mid 1970s he developed business interests abroad, bought a house abroad and spent large amounts of time overseas and declared himself non-resident. At all times he retained a house in the UK which was available for his and his family’s use during the years of assessment in question (1992 to 2004) although it had been let for earlier years. The taxpayer worked in the UK during some of the disputed years under a UK contract of employment. The issue was whether the taxpayer was resident and ordinarily resident in the UK and domiciled in England during the relevant tax years. The Special Commissioners decided that he was, and an appeal on domicile was recently dismissed by the High Court.

The result of *Gaines-Cooper* is well-known, but it is perhaps worth considering some aspects of the reasoning. The Commissioners' decision begins with a 22-page account of the taxpayer's adult life. This is clearly designed to read in a (rather odd) neutral way and to negate the way in which the taxpayer and his advocates had sought to present the facts. Considerable emphasis is put on small details. For example, it clearly did not help the taxpayer that he had made planning applications describing his UK home as being "used wholly ... as his private UK residence." Unsurprisingly, the taxpayer relied on IR20 and ignored the dates of arrival and departure and unusual events. The Commissioners, equally unsurprisingly, declared they "must apply the law rather than the provisions of IR20". However, HMRC, contrary to IR20, argued that to ignore both dates of arrival and departure and single days (where arrival was on one day and departure the next) was distortive. HMRC argued that a visit where the taxpayer arrived on one day and left on the next should count as one day: one should look at the nights spent in the UK, an approach which the Commissioners accepted. On the issue of residence, the taxpayer lost because of the time spent in the UK, because he had a permanent residence in Henley, and because his family lived here and he had business here. The day-count figures are not dealt with until para.92 of the decision. Section 336 ICTA did not provide an escape, because his residence was not "temporary" in purpose - in the sense of a transient purpose, as distinguished from pursuance of the regular habits of his life<sup>10</sup>. To acquire a domicile of choice, the taxpayer had to demonstrate both residence and an intention of permanent residence. If a person is resident in two countries then the country of domicile must be his main residence. Evidence as to intentions is weighed up in the light of all the facts. Ultimately the taxpayer lost because of the continued strength of his connections with the UK and his failure to establish his family permanently in the Seychelles<sup>11</sup>.

### *Challenges to the Tax Treatment of Termination Payments*

This is another popular challenge for HMRC, which may become more topical given the state of the economy. The issue is whether termination payments are taxable as earnings or only under s.401 ITEPA (formerly s.148 ICTA) - so that the first £30,000 is exempt. HMRC tends to leave redundancy payments alone, even if these are increased above the statutory entitlement, provided that they are referable to the statutory formula and can genuinely be shown to have been paid to ease hardship. The usual battleground concerns payments which the taxpayer claims are damages, especially when the employer has a right to make a payment in lieu of notice or "PILON". The key distinction as regards PILONs is between payments made under the contract itself, which are taxable, and payments made as damages for breach of the employment contract, which are not taxable as earnings but are compensation for a breach of contract, as in *Cerebus Software v. Rowley*<sup>12</sup>. Where the contract is ended by mutual consent, and a payment is made by the employer, who has a right to make a PILON, the amount will be taxed as earnings - following *Richardson v Delaney*<sup>13</sup>, because it is paid under the contract rather than as damages for breach. To avoid the termination payment being taxable as earnings, where there is a provision for an employer to make a discretionary PILON payment, the solution is to terminate the employment in breach of contract and without agreeing to pay anything before settling the damages.

Termination payments have been the subject of two recent cases. In *SCA Packaging Ltd v. HMCE*<sup>14</sup>, employees who had the benefit of notice periods in their

contracts of employment, were made redundant. A memorandum agreed by the employees' trade union, which was supplemental to their employment contracts, gave the employees the right to be paid in lieu of notice in the event that their employments were terminated. The relevant employees agreed to PILONS being made when they were made redundant. HMRC argued that the PILON payments were chargeable as employment income in the normal way as emoluments. The taxpayers contended that the payments were only taxable under what was then s.148 ICTA 1988. Lightman J agreed with HMRC. The key point was that the employees were entitled to the payments under their contracts upon termination of their employments: "[t]he payments were made under and pursuant to the provisions in their contracts of employment ..." Lightman J's decision is clearly correct. The source of the payments was the employment contract itself rather than a secondary right to damages which only arose upon breach of the employment contract.

In *McGrotty v. HMRC*<sup>15</sup> the taxpayers were directors of a company whose employment contracts contained a discretionary PILON clause. The taxpayers' employment contracts were terminated by mutual consent. The taxpayers were paid sums described as 'pension contributions' and compensation for "loss of share option rights". It was accepted that there was no contractual entitlement to these sums. However, HMRC argued that they were taxable under s.148 ICTA 1988 (subject to the £30,000 exemption) as received in connection with the termination of a person's employment and not otherwise chargeable to tax. Unsurprisingly, the payments were found to be chargeable under s.148 ICTA, as they formed part of the consideration in exchange for which the employment was terminated by mutual agreement.

### *IR 35 Avoidance Arrangements and Contractors Operating Through Companies*

The first step in any tax dispute is to establish the facts. Sometimes a proper review of the facts will quickly establish the correct tax position. For example, as stated above, where the tax treatment of termination payments is at issue - most frequently when a payment is made by an employer who has the benefit of a discretionary PILON clause, the issue is simply whether that payment was made following a termination of employment in breach of contract, so that it is damages. Where tax planning has not been properly implemented, which seems to be a frequent problem with "IR 35" planning involving so-called composite companies, then the taxpayer may be struggling to make a case. If these kinds of issue are properly identified prior to a hearing, the case is unlikely to proceed to trial. If the hearing starts by unravelling the facts and this produces a clear answer then the case can easily be disposed of.

The first issue in an IR 35 case is whether the structure has been set up properly. If the implementation is defective, HMRC will typically claim the PAYE tax from the agency responsible for creating the structure. If the structure has been implemented correctly, then, prior to the new legislation on managed service companies, HMRC's attack was under IR 35, contending that the hypothetical relationship between contractor and end client amounted to employment. In *Island Consultants Ltd v. HMRC*<sup>16</sup> the Appellant ("IC") contracted with an IT agency to provide the services of Mr. H, its shareholder and director, ultimately to Severn Trent Water. HMRC concluded that the arrangement was caught by the IR 35 legislation. The taxpayer's appeal was dismissed. The relevant hypothetical contract was between IC and the ultimate client. The Special Commissioner considered the 'badges of employment' in

the context of the hypothetical contract. The factors predominantly pointed towards employment.

Despite succeeding in a number of IR 35 cases, HMRC has brought in the new rules on Managed Service Companies. The new rules illustrate the problems with IR 35, which were the need to make individual challenges, the inability to recover tax which was found to be due and the lack of deterrent effect. A serious cause for concern for HMRC and taxpayers alike is whether the new rules are being properly adhered to.

### *Salaried Persons Postal Loans and The Question of What is a business?*

Where there is real doubt as to how the law applies to the particular facts, then there is scope for open litigation. It will help the taxpayer to demonstrate that it is carrying on its normal business and that HMRC is making an unreasonable challenge. Some cases will involve arguing an open point of law on agreed facts. An example of this is *Salaried Persons Postal Loans Ltd v. HMRC*<sup>17</sup>, where a company which had ceased to trade let out its former trading premises, which it had vacated in 1966. There had been a single tenant since 1966. HMRC concluded that the company carried on a 'business', so that it was an associated company for the purposes of computing the level of small companies' relief under s.13 ICTA 1988. The taxpayer appealed and denied that the company carried on any business. The Special Commissioner (Dr John Avery-Jones) found in favour of the taxpayer, and Lawrence Collins J upheld the decision on appeal. HMRC unsuccessfully relied on the judgment of Lord Diplock in *American Leaf Blending v. Director General of Inland Revenue*<sup>18</sup>, where he said that "[w]here the gainful use to which a company's property is put is letting it out for rent their Lordships do not find it easy to envisage circumstances that are likely to arise in practice which would displace the prima facie inference that in doing so it was carrying on business." Nevertheless, the Special Commissioner found that on the particular facts the lack of activity relating to the investment meant that there was no business. The High Court declined to overturn the decision as there was no error of law.

The decision clearly has relevance beyond the associated companies rules. For example, if investment properties are transferred to a company then there is an issue as to whether they qualify as a business for the purposes of relief under s.162 TCGA 1992. HMRC's Manuals state that the mere passive holding of property is unlikely to qualify for s.162 relief, and it is understood that it may be taking this point more aggressively. Nevertheless, my view is that *Salaried Persons* is an exceptional case. The property simply sat where it was for over 30 years with the same tenant. The general lack of activity means that there is no business. This follows *Jowett v. O'Neill*<sup>19</sup> where cash sitting on deposit did not amount to a business. Generally, *Salaried Persons* will not prevent taxpayers from concluding that there is a business when property is let<sup>20</sup>.

### **How to Successfully Avoid and Defeat HMRC Challenges?**

The best scenario of course is to avoid disputes with HMRC entirely. The way to try and achieve this is to ensure that the taxpayer's self-assessment position is as strong as possible. If deliberate planning is undertaken, or the taxpayer takes an aggressive filing position, there is inevitably going to be some risk of challenge

(unless HMRC has expressly indicated that it approves of the planning). Recent cases reiterate that if there is more than a hint of tax planning involved and HMRC shows the taxpayer's position to be aggressive, he is in trouble even if he has not done a scheme: see, for example *Gaines-Cooper* and *Island Consultants*, discussed above.

There will always be disputes because it is not the job of taxpayers to resolve points of doubt in favour of HMRC. Risk of challenge can be minimised by taking proper advice at the outset and not doing anything which is too provocative. It may well be better to play a little safer rather than to push the boundaries: the *Gaines-Cooper* appeal is a perfect illustration of this. Failure to take proper advice and to implement a tax saving idea in the correct manner can be very costly in the event of a challenge. On the other hand, steps taken to guard against a *Ramsay* attack can be exposed as nothing more than that: see eg *Astall*. If a challenge does arise then the stronger the taxpayer's position, the greater the chance he has of succeeding. It is in the taxpayer's interest to adopt an appropriate litigation strategy at the outset. If he has a strong case, it may be suitable to try and present it comprehensively to HMRC at an early stage, rather than respond piecemeal to correspondence and hope the challenge goes away. Taxpayers with strong cases are often well-advised not to be bullied by HMRC or to allow them to enter into protracted correspondence, but rather to invite them to issue assessments so that an early appeal can be brought.

If the case reaches the Commissioners, it is crucial that the taxpayer gives himself the best chance of winning. The High Court is notoriously reluctant to interfere with the Commissioners' decisions, unless there is a clear error of law. So, when a case turns on the facts – which one way or another it inevitably does - it is important that the taxpayer does everything he can to win before the Commissioners, because there are no second chances. The key is to try and demonstrate the merits in the taxpayer's case, and this must be done by proving the relevant facts. There is no substitute for proper preparation. The points of law where evidence is required must be identified and the relevant evidence obtained. Every opportunity should be taken to prove the taxpayer's case, so witness statements must be drafted. Thought must be given to what witnesses are needed and whether expert evidence is required. It can be very dangerous to assume that the Commissioners will infer what the taxpayer considers is obvious. Taxpayers should beware of the Commissioners appearing less rigorous and more easily satisfied than they actually are. I would also recommend against simply agreeing a statement of facts drafted by HMRC as they will naturally have been written in a manner favourable to HMRC.

To prepare a case properly due consideration must be given to the weaknesses in the taxpayer's case and how HMRC is likely to try and exploit them. What to do will depend on the facts of the particular case. As a general rule, it is likely to be better to try and deal with potentially unfavourable facts in the taxpayer's witness statement and during examination in chief, rather than let HMRC have a field-day during cross-examination. In this regard, it is important that the advocate tests the witness's evidence beforehand: there is nothing worse than having some detrimental fact unexpectedly appear during cross-examination. Witness familiarisation courses are increasing in popularity, but the best (and only) advice to witnesses is simply to answer all the questions as truthfully as they can. It is a dangerous tactic for a witness to try and anticipate a line of cross-examination or to play games with the advocate. At risk of stating the obvious, witnesses must never be told what answers to give and

coaching is contrary to the Bar's Code of Conduct. Taxpayers and their witnesses can expect to be robustly challenged during cross-examination from HMRC. Some of the sting may be taken out of this by having the witness deal with likely cross-examination questions in advance. The taxpayer's advocate may also object to any questions by HMRC which are too vague or irrelevant. Aggressive cross-examination can also be counter-productive, especially if it fails to achieve its ends. The taxpayer's advocate should keep this in mind when cross-examining HMRC's witnesses. At all times the taxpayer's advocate should try to marshal the evidence so that it supports his theory of the case and underlines the taxpayer's merits. Where the taxpayer's case lacks merit - generally because he has done an aggressive scheme, it will help if the facts are kept to a minimum, so that the argument can focus on the technical merits, but HMRC is unlikely to allow this!

### **The Future of Tax Litigation?**

Looking to the future, there is likely to be more direct tax litigation than in previous years. Some of this will be challenges to schemes, where HMRC will usually start as favourites. Other litigation will determine the boundaries of the legislation, sometimes on fundamental issues but also on more obscure points. Given the volume of the modern tax code there is no shortage of points to litigate! However, my suggestion is that HMRC is likely to pick on points which will recur time and again, such as company residence. In some cases, once the facts are cleared up there is a clear answer or at least a point of law. A case on a novel point of legal principle, where there is no scheme involved, is quite different from one which turns on the facts. Where there is no legal bright line rule, then how the Commissioners react to the facts is crucial, and so presenting them properly is the challenge for the taxpayer's advocate. As ever, the best way is to avoid litigation altogether, and the chances of this are maximised by the taxpayer obtaining detailed advice at the outset so that it is harder for HMRC to challenge the self-assessment position.

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<sup>1</sup> Which is based on a talk I gave for Longmark Conferences on 18 November 2007. The conference was aimed at SMEs and the cases discussed reflect that bias.

<sup>2</sup> [2006] STC 1908.

<sup>3</sup> In *Collector of Stamp Revenue v Arrowtown Assets Ltd* [2003] HKCFA 46 approved by the House of Lords in *Barclays Mercantile v Mawson* [2005] STC 1

<sup>4</sup> [2007] SpC 617

<sup>5</sup> [2007] SpC 628

<sup>6</sup> See eg *Herman v HMRC* [2007] SpC 609, where the "Mark 2 Flip Flop Scheme" was accepted as achieving its aim preventing stockpiled gains in one trust being carried into another but was defeated on the basis that the gains from the first trust could be attributed to the beneficiaries under s.87(4) TCGA 1992.

<sup>7</sup> [2007] EWHC 163.

<sup>8</sup> See at para.47 of his judgment.

<sup>9</sup> [2006] SPC 00568.

<sup>10</sup> In the PBR HMRC states that legislation will be introduced in the 2008 Finance Bill to ensure that when determining if an individual is resident in the UK in any year, days of arrival and departure are covered. This is subject to a consultation and will apply after 6 April 2008.

<sup>11</sup> A number of taxpayers are seeking judicial review of HMRC's refusal to apply IR20: none is yet understood to have obtained leave.

<sup>12</sup> [2001] IRLR 66

<sup>13</sup> [2001] STC 1328

<sup>14</sup> [2007] EWHC 27 (Ch)

<sup>15</sup> [2007] STC (SCD) 582

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<sup>16</sup> [2007] SpC 618

<sup>17</sup> [2006] SR 1315

<sup>18</sup> [1978] STC 511

<sup>19</sup> [1998] STC 482 per Park J

<sup>20</sup> See also *Rashid v. Garcia (Status Inspector)* [2003] SCD 36 where it was held, again by Dr. John Avery-Jones, that receipt of rents did not make the taxpayer self-employed for NICs purposes as he did not carry on any “business”. This decision is more open to attack. It perhaps demonstrates that, despite what the courts might say, the test applied varies depending on the context. In *Rashid* the taxpayer, who had spent time in prison, was trying to claim benefits. The result may have been different had he been claiming s.162 relief?