Losing my mind

Management of taxes



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Anton Lane provides an overview of the issues an adviser needs to consider representing a client in discussions about planning with HMRC

Key Points

What is the issue?

Personal circumstances may affect whether transactions are legal, whether a tax liability arises as well as support a reasonable excuse argument.

What does it mean to me?

An adviser should explain the need to discuss the personal reasons for undertaking a transaction as well as knowing more about personal circumstances. An adviser should be aware that a client may avoid sensitive discussions.

What can I take away?

It is important to consider many perspectives when representing clients in discussions with HMRC over tax irregularities.

A client undertook tax planning which is now the subject of HMRC attention, and the adviser needs to make representations to HMRC. Ahead of doing so, the adviser:

- reviews the implementation documents; and
- considers the personal circumstances of the client at the time when the contractual arrangements were entered and subsequently.

The purpose is to establish whether the planning is implemented as legally intended, understand whether the client could have legally entered the arrangements and to consider any reasonable excuse argument.

HMRC will identify flaws in paperwork and contractual arrangements, although some flaws can change the legality of transactions undertaken. For example: a board minute resolving the issue of shares showed a meeting being held at Watford and was signed by one director. The director that signed the board minute had not

attended Watford and the articles required both directors to bind the company. HMRC agreed the transaction could not have legally occurred.

Contractual arrangements may also require consideration. For a binding contract to exist there must be an offer, acceptance, consideration and an intention by the parties to create legal relations. A valid acceptance must be communicated to the offeree, precisely match the terms of the offer and the agreement must be certain. Acceptance can be made through conduct. To illustrate the importance: A contractual arrangement was entered to make payments to a reward scheme although the scheme provider did not countersign nor provide documents to the payee. Funds were then transferred to a party undertaking administration and payments made to the director of the payee. The intended transactions were arguably to facilitate loans to the director funded by a reward scheme and from contributions from the company who sought a deduction against profits chargeable to corporation tax. However, the transactions were not implemented in a manner demonstrating acceptance of them. The tax liability could not be based on intended transactions; it had to be based on those actually undertaken – the reality was that the director's loan account had been overdrawn by the amounts paid through the party providing administration services.

Maybe rarely, mental capacity will affect the validity of transactions. The law provides protection for those with mental disability and who enter contracts. There are degrees of mental disability, those whose mental state is such that:

1. Their affairs are under the control of the court, by virtue of the Mental Capacity Act 2005;
2. They are not under the control of the court and they are unable to appreciate the nature of the transaction they are entering into; and
3. Those people who are capable of understanding the transaction and as a result of some mental disability, are more susceptible to entering into a disadvantageous contract.

For the second and third categories, a contract will be binding, unless affected by the rules relating to undue influence. Contracts entered by persons unable to appreciate the nature of the transaction will be enforceable unless it is proved that the other party was aware of the incapacity. The principle was formed in *Imperial Loan Co Ltd v Stone* where it was contended that the defendant when lunatic signed a promissory note as surety. The plaintiff brought an action and the defendant took

the defence of insanity. It was held that the defendant must show he was insane at the time of entering the deed, incapable of understanding the implications and that the plaintiff knew of the insanity. The burden of proof is with the defendant (the contended insane person).

> '…the validity of a contract entered into by a lunatic [sic] who is ostensibly sane is to be judged by the same standards as a contract made by a person of sound mind, and is not voidable by the lunatic or his representatives by reason of 'unfairness' unless such unfairness amounts to equitable fraud which would have enabled the complaining party to avoid the contract even if he had been sane.' Lord Bingham

The case of *Fehily v Atkinson* [2016] concerned whether a person had lacked the mental capacity to enter an IVA. On 6 November 2011, HMRC issued petitions seeking bankruptcy orders against four individuals, including Mr and Mrs Fehily. It was claimed the four were jointly and severally liable for unpaid tax due from the members of a partnership. The amount sought, including interest and penalties, was around £224,000. In January 2012, the four individuals proposed to their creditors, including HMRC, that they enter into individual voluntary arrangements ('IVAs'). The IVAs were voted in favour of and the bankruptcy petitions were dismissed. Each of the four were liable to 25% of the liability to HMRC. Mr and Mrs Fehily did not comply with the terms of their IVAs, and petitions for bankruptcy orders were issued against them. Bankruptcy orders were issued against them both. Mr and Mrs Fehily applied for orders annulling the bankruptcy orders on the basis that Mrs Fehily lacked the mental capacity to enter an IVA.

Mrs Fehily was not successful, although the High Court set out some important points of principle regarding a person's capacity to enter into a contract:

- Whether a person can understand the transaction is important and not whether they understood it;
- A person does not need the ability to understand the minute detail of a transaction;
- A person should be able to understand the key features of the proposed transaction;
- The fact a person did not receive advice would not affect capacity;
- The correct test is whether a person has the insight and understanding to realise that advice is needed, the ability to find and instruct an adviser, and the

capacity to understand and make decisions based on advice;

- A person needs the mental capacity to recognise issues for consideration, to obtain, receive, understand and retain relevant information, including advice;
- A person should be capable to weigh the information in the balance in reaching a decision;
- The capacity to enter into a transaction may vary over time and accordingly when determining whether a person has capacity; and
- Whether the person had capacity at the time of entering into the transaction needs to be considered.

What if a director had exceptionally distressing personal issues that affected his ability to understand the transactions proposed and subsequently undertaken? The advisers were aware of the personal situation and regarded their client as ‘unstable’. At the time of entering into arrangements, the client had become a father. His child was born prematurely, and his wife and daughter remained in hospital for around a year. His daughter came home although after a subsequent medical procedure died. Around the same time, his wife was suffering fatigue, which transpired to be Leukaemia and she spent the next year in hospital isolated from her family. Eventually a bone marrow donor was identified. After a short period of good health, the wife fell ill again. On this occasion the illness was due to a viral infection within the bone marrow – the donor had not had chicken pox whereas the recipient had. Following an induced coma and dripped anti biotics, the wife was brought out of the coma although paralysed. The husband during this period had looked after his children, suffered sleep deprivation and was emotionally unstable.

The facts of this case are extreme, although circumstances do not have to be as severe for a person’s capacity to be in question. The case concerned transactions intended to reduce profits chargeable to corporation tax although would potentially have created a PAYE liability – they would be regarded as remuneration paid to a third party although the funds were returned to the company for reinvestment. The director could not recall with any accuracy the transactions he had agreed to transact. He had no understanding why certain transactions were undertaken and his view on advice provided was substantially different to that contained within reports. The contention was that the director was incapable of understanding and making decisions based on advice.

By bringing the personal circumstances to HMRC’s attention, it would in any event assist to identify and agree a reasonable excuse.

The case of *John Clark* (TC04509) considered the ability of the taxpayer with a less than normal intellectual capacity and HMRC were criticised for not considering the taxpayer's vulnerability.

In the case of *Geoffrey A Wedgwood* (TC04148) reasonable excuse was considered where the taxpayer had mental health issues. It was explained that the appellant has been diagnosed with long term depression and anxiety and this was confirmed by a supporting doctor's letter. Representations explained that it was difficult for people who did not know the appellant to understand that he had a public and a private persona. The public persona was one of being in control and intellectually capable whilst his domestic life was the opposite. Reference was made to the First Tier Tribunal case of Award Framers International Ltd, which helpfully states: 'The question of whether a particular trader has a reasonable excuse should be assessed by the standards of reasonableness which one would expect of a taxpayer who sought to honour their obligations as a taxpayer. In making this assessment, the tribunal should also consider the particular attributes of the taxpayer, their circumstances and any other factors which are relevant to the situation. Therefore, while the reasonable taxpayer would give priority to complying with their duties to make payment on time and ensure returns are accurate and timely, the age and experience, health or difficulties experienced by the taxpayer are also relevant considerations in taking a balanced view and in arriving at a fair decision.'

HMRC has a needs enhanced support (NES) team. The team is structured to assist vulnerable taxpayers. However, the normal approach to this team is from an agent or taxpayer and in relation to ensuring tax compliance is regularised and kept up to date. Where a vulnerable taxpayer has implemented schematic planning, they should still be entitled to enhanced support. The benefits will not usually include a reduction of tax liability although there is an ability to write off tax debts. It should however result in more empathy and a smoother resolution. As identified by HMRC in Geoffrey A Wedgwood: 'some officers would have more empathy with the appellant's health problems than others'.