Withering frights

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Keith Gordon reviews the first decision of the Court of Appeal to look at Follower Notices

Key Points

What is the issue?

The Court of Appeal decision in *Haworth v HMRC* is a rarity in that the taxpayer was successful in challenging the validity of the Follower Notice.

What does it mean to me?

This decision will undoubtedly be a major blow to HMRC, given the large number of Follower Notices that they have issued.

What can I take away?

Judicial reviews are subject to very strict time limits. Therefore, if you are considering challenging a Follower Notice then I would recommend you take specialist advice as a matter of urgency.

Background

I have often wondered whether, ten years ago say, we could have predicted that Parliament would enact legislation that says that any taxpayer who dares challenge an HMRC decision risks paying a 50% surcharge if they were to take their case to the Tribunal and end up losing. Given that one of the apparent benefits of living in a democracy is that we have access to an independent judiciary, the risk of such a surcharge strikes me as a major impediment to justice and not something that one would expect to see in a civilised country.

Of course, Follower Notices (as legislated for in the Finance Act 2014) are not quite as I have set out in the previous paragraph: they are in fact more onerous. First, they can be issued by HMRC even before HMRC have made any formal decision about the underlying arrangements. Secondly, the 50% surcharge (being a penalty for non-adherence to HMRC's wishes) is payable to HMRC themselves – i.e. the other side in the dispute. Thirdly, the recipient of a Follower Notice is denied the normal right of access to a Tribunal, where one can usually take tax disputes. Instead, the taxpayer has to embark upon the far more expensive process of judicial review where (strictly) a remedy is not guaranteed but is subject to the discretion of the Court. Fourthly, it remains my view that Follower Notices are totally unnecessary and that the Tribunal's own rules and procedures could always be invoked to discourage frivolous appeals. I do suspect that part of the rationale for introducing Follower Notices was to cash in on the penalties.

Last year, three cases involving judicial reviews of Follower Notices were heard by the High Court. In all three, the High Court upheld the notices (although in one, *Broomfield*, HMRC radically watered down the notice a fortnight before the hearing). In all three cases, the taxpayers sought permission to appeal against the decision and in all three cases permission was granted by the Court of Appeal. *Broomfield* has since settled. Another (Locke) is due to be heard by the Court in October. However, the first of the trio has now been considered by the Court: *R (oao Haworth) v HMRC* [2019] EWCA Civ 747.

The facts of the case

Mr Haworth entered into a set of arrangements, colloquially known as the 'Round the World' scheme. A test case concerning the scheme was defeated by HMRC in the Court of Appeal – see my article 'Around the world in 73 days' in the September 2010 issue of *Tax Adviser* which discussed that earlier case (*Smallwood v HMRC* [2010] EWCA Civ 778).

Although Follower Notices are generally supposed to be given within a year of the relevant judicial ruling becoming final, a transitional rule permitted HMRC a two-year period to issue Follower Notices in relation to pre-FA 2014 precedents on which HMRC would wish to rely. HMRC duly issued the Follower Notice in the present case to Mr Haworth on 24 June 2016.

In that notice, HMRC pointed to the *Smallwood* decision and required Mr Haworth to abandon his own appeal in the light of the Court of Appeal's decision. Key to the Court's decision in *Haworth* was its analysis of what the Court had previously held in *Smallwood*.

The Smallwood decision

The scheme was devised to exploit the terms of the Double Taxation Agreement between the UK and Mauritius so far as capital gains tax is concerned. To work, the scheme was thought to require a trust to be resident in Mauritius at the time of the key disposal but, before the end of the relevant tax year, to be resident in the UK. However, in *Smallwood*, the Court of Appeal adopted a slightly different analysis. In particular, the Court sought to identify the jurisdiction in which the trust's place of effective management is situated up to and including the date of the disposal. That jurisdiction is 'where key management and commercial decisions that are necessary

for the conduct of the [trust's] business are in substance made': this was later restated as 'where the real top-level management of the trustee occurred rather than the day to day administration of the trust'.

In *Smallwood*, the Court of Appeal then considered the findings of fact by the Special Commissioners (one of the appeal bodies which preceded the First-tier Tribunal for appeals before April 2009). Lords Justice Hughes and Ward considered that the Special Commissioners had been entitled to conclude that effective management was in the UK. Indeed, the scheme was devised in the UK by Mr Smallwood on the advice of his Bristol-based advisers and the steps of the scheme were carefully orchestrated throughout by the UK advisers. The overall supervision of the steps represented 'a scheme of management which went above and beyond the day to day management exercised by the trustees'.

Lord Justice Patten, however, considered the Special Commissioners' decision to have been flawed. In particular, he read the primary facts as saying no more than that the scheme was devised in the UK but the Mauritian trustees had considered the advice and properly exercised their own discretion. In short, the place of effective management was validly transferred to Mauritius at the relevant date. As Patten LJ was in the minority, however, HMRC won the case based upon the views of the majority.

The Court's decision in Haworth

The *Haworth* case came before Lords Justice Gross and Newey and (retired judge) Sir Timothy Lloyd. It focused on one of the key provisions within the Follower Notice legislation (the Finance Act 2014, section 205(3)(b)) which requires, in relation to the earlier precedent, 'the principles laid down, or reasoning given … would, if applied to the … arrangements [now under review] deny the asserted advantage or a part of that advantage'.

The Court rejected one argument put forward on behalf of Mr Haworth – based on the interpretation of 'the principles laid down, or reasoning given'. The Court accepted HMRC's case that that test can apply as much to questions of fact as to questions of law.

However, Mr Haworth had more success with the second argument which turned on the meaning of 'would'. HMRC had issued the Follower Notice on the basis of a view

that they were more likely than not to repeat their success in *Smallwood* in any appeal pursued by Mr Haworth. However, Lord Justice Newey considered that to be the wrong approach. He held that the legislation ‘demands more certainty than just a perception that there is a 51% chance of the advantage being denied’; follower notices are not meant to be available to HMRC ‘otherwise than in relatively exceptional circumstances’. Given the risk of considerable penalties, he held that the regime was ‘applicable only in a limited class of cases’. Any other interpretation would amount to an inappropriate ‘intrusion on a taxpayer’s constitutional right of access to the courts [which] is inherent in the rule of law’.

The other two Judges agreed with Newey LJ’s analysis.

Upon analysis of HMRC’s internal reasoning for the issue of the Follower Notice, it was clear that they had misdirected themselves when authorising the notice and therefore the Court considered that the notice ought to be quashed.

Commentary

This decision will undoubtedly be a major blow to HMRC, given the large number of Follower Notices that they have issued. However, it represents a major triumph for common sense and justice.

It should be remembered that, strictly, HMRC failed only because they had misstated the correct test when authorising the Follower Notice that was issued to Mr Haworth. Indeed, as Newey LJ noted, it is possible that had HMRC applied the right test, they might ‘still have decided to give a follower notice’. There is a risk, therefore, that the long-term consequence of the decision is simply that HMRC express their reasons more robustly in future cases.

On the other hand, HMRC cannot simply roll out Follower Notices in cases where the underlying arrangement is fact-sensitive (as was the case in *Smallwood*): they would need to analyse each case carefully and ascertain whether the facts of the specific case are inevitably going to lead to the defeat of the arrangements, based upon the finding of the earlier case. Given the widespread fear that HMRC have taken a conveyor-belt approach to their powers in the Finance Act 2014, this decision ought to cause HMRC to slow down and recognise that Follower Notices are not simply a device to permit HMRC to bear down on taxpayers and dissuade them from exercising their right of appeal but instead are a powerful tool to be used in very

limited circumstances. It is my view that, even if HMRC prepare their internal documentation so as to comply with the Court’s judgment, a Court will now look carefully at any case where a Follower Notice has been issued to check that it is truly justified.

What to do next

Judicial reviews are subject to very strict time limits. Therefore, if you are considering challenging a Follower Notice then I would recommend you take specialist advice as a matter of urgency.

However, it is clear that HMRC have been rather cavalier with the use of their new powers and, accordingly, notwithstanding the threats of penalties from HMRC, many Follower Notices are now clearly susceptible to challenge.