A Comedy of errors

Management of taxes | Personal tax



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Keith Gordon discusses the implications of the First-tier's decision in *Bubb v HMRC*

Key Points

What is the issue?

The discovery provisions are a powerful weapon in HMRC's armoury. Discovery assessments are increasingly common, and the law is changing rapidly.

What does it mean for me?

It is ironic that HMRC need not have issued discovery assessments in this case. Both tax returns were submitted to HMRC late and HMRC would have been in time to open enquiries into those returns. Had it done so, it could have avoided any of the difficulties it subsequently encountered in this case.

What can I take away?

It will be interesting to see whether HMRC chooses to appeal against this decision because, at least on first impressions, the outcome is inconsistent with earlier case law. Once HMRC was able to show that the self assessments were carelessly understated, one might think that their assessments were bound to be upheld. Nevertheless, the decision appears to be correct.

For many years, the necessary conditions for a discovery assessment were well known and understood. As a result, the provisions found in the Taxes Management Act 1970 s 29 were rarely considered by what is now the First-tier Tribunal (or the higher courts, now to include the Upper Tribunal).

The introduction of self assessment 20 years ago and the overhaul of s 29 so as to impose further restrictions on HMRC's use of discovery assessments gave rise to a little more interest in the provisions, particularly in the light of the line of authorities starting with *Langham v Veltema* [2004] STC 544, which turns on the sufficiency of the information made available to the so-called 'hypothetical officer' for the purposes of the test in s 29(5).

In the past year or so, however, discovery cases seem to be all the rage. In particular, having argued for the taxpayer in the discovery cases of *While* [2012] UKFTT 58 (TC), *Charlton* [2013] STC 866 and *Sanderson* [2016] STC 638, it was only a few years ago when I needed to spell out slowly and carefully how s 29 operated each time I appeared in the tribunal in such a case. Nowadays, whenever s 29 (and for these purposes I do of course mean any of the other equivalent sets of provisions scattered through the various statutes dealing with taxes other than income tax and capital gains tax) crops up, all I need to do is to ask the Judge whether they are familiar with the provisions and I almost invariably receive a weary reply in the

affirmative, allowing me to proceed quickly with the main thrust of my case.

The result of this is that the case law on discovery assessments is becoming increasingly more refined and any attempt to capture the law in any printed document is bound to become outdated very quickly. Fortunately, Harriet Brown's excellent summary in the March 2016 issue of *Tax Adviser* has so far stood the test of time. Nevertheless, the recent case of *Thomas Bubb* provides yet more colour to a canvas that was, until recently, distinctly monochrome.

Facts of the case

During the 2009/10 and 2010/11 tax years, Mr Bubb was in receipt of three pensions (a naval pension, a civil service pension and, latterly, a state pension). Since his retirement, he had worked as a consultant but, in order to avoid difficulties that he had seen other consultants experience, arranged for his pay to be subject to deduction of tax under PAYE. This was effected by a firm of accountants which, according to the decision notice, put Mr Bubb on its own payroll and charged his sole client (the Ministry of Defence) for his services.

The firm of accountants, despite being fully aware of his other income sources (and the fact that Mr Bubb's personal allowance had been allocated to the civil service pension), put Mr Bubb on the 'emergency code' (which replicates the personal allowance) rather than the more appropriate BR code, meaning that Mr Bubb's consultancy income suffered insufficient deductions of income tax. It also appears that HMRC should have been similarly aware of the inappropriateness of the emergency code, but it too did nothing to effect the more suitable BR code.

So far as the 2009/10 and 2010/11 tax years were concerned, Mr Bubb's relevant tax returns contained a number of bizarre errors. In short, they tended to understate the amount of Mr Bubb's income for the relevant years and overstated the tax deducted from that income. These might seem rather inexcusable (as well as inexplicable) but the tribunal noted that Mr Bubb, at the time living in France, had claimed to have encountered considerable difficulties in submitting his tax returns online. The system repeatedly rejected his French address, generating error messages, and unilaterally started to delete certain entries and to amend others. Mr Bubb estimated that he had eight failed attempts to complete the returns causing him to have to restart the entire process. The tribunal asked HMRC to investigate these issues after the hearing. Although HMRC's response appeared not to address

the points raised, it did partially corroborate what Mr Bubb had alleged.

One error that could not be so excused, however, was Mr Bubb's omission of his state pension from the tax return – this was overlooked because it had been paid into his wife's bank account.

Eventually, HMRC realised that the returns (as received by it) understated Mr Bubb's tax liability and issued discovery assessments to recover the under-assessed tax.

Mr Bubb appealed against the assessments.

The tribunal's decision

The case came before Judge Sarah Falk, sitting with Elizabeth Bridge.

Although it is not clear whether Mr Bubb specifically argued the point, the tribunal (correctly) considered the first question that has to be asked in such cases: was there a discovery – in other words, was the condition in s 29(1) satisfied? The tribunal noted that the officer newly formed the view in early 2013 that tax had been underpaid and that this amounted to a discovery for the purposes of s 29(1). For these purposes, as shown in *Charlton*, it is not sufficient for the taxpayer to point out that HMRC had all the information so as to reach such a decision earlier: what counts is when the penny dropped or, as per *Charlton*, when was 'the Eureka moment'.

Having concluded that there was such a discovery, the tribunal then proceeded to consider whether or not either of the conditions in subsections (4) and (5) were fulfilled so as to entitle the officer to make the assessments. HMRC chose not to rely on the condition in s 29(5) (it is not clear whether this was a conscious decision or an oversight by HMRC) and instead it relied on the requirement in s 29(4) which requires them to prove carelessness.

The tribunal seemingly had no hesitation in concluding that the omission of the state pension amounted to careless conduct. On the other hand, it considered that HMRC had failed to discharge the burden of proof to show carelessness in relation to the other errors.

Ordinarily, this might be thought to be upheld. However, on the facts of the particular case, the discovery assessments were in fact made specifically to correct the errors relating to the overstatement of tax deducted and the understated navy

and civil service pensions (in other words, not to rectify the omission of the state pension). The tribunal concluded, therefore, that s 29(4) was not satisfied and, thus, the appeal was allowed.

Commentary

It will be interesting to see whether HMRC chooses to appeal against this decision because, at least on first impressions, the outcome is inconsistent with earlier case law. For example, in *Hudson v Humbles (HM Inspector of Taxes)* (1965) 42 TC 380, it is clear from 384 that once HMRC has established (what was in those days) some form of fraud or wilful default, the burden of proof then shifts to the taxpayer to show that the assessment is for the wrong amount. On this basis, once HMRC was able to show that the self assessments were carelessly understated (by reference to the omission of the State pension details) one might think that their assessments were bound to be upheld.

Furthermore, the more recent Court of Appeal decision in *Hankinson v HMRC* [2012] STC 485 makes it clear that the officer making the discovery does not at that stage need to articulate clearly which of (and how) the conditions in subsections (4) and (5) are said to be satisfied in any particular case – such a matter can be determined by the tribunal with the benefit of hindsight.

Despite these precedents, it is my view that the tribunal reached the correct decision in the present case. The *Hudson* decision concerned a different point altogether – in particular, it was in the context of time limits where, even today, the statutory test (in s 36) is slightly different from that in section 29(4). Ditto in *Hankinson*: the decision in that case concerns a very narrow point (despite HMRC's regular attempts to suggest it has a much broader relevance). Although, in most cases, the approach in *Hankinson* would suggest that the finding of carelessness can be retrospectively applied so as to validate a discovery assessment, the facts of this case were unusual in that the omitted State pension income was not in fact part of the subject matter of the discovery assessments or, therefore, the subsequent appeal before the Tribunal.

Furthermore, the tribunal's decision does have considerable logic to it which is consistent with the underlying importance that the self assessment regime gives to the concept of finality (see, for example, paras [5] and [23] of the judgment in *Hankinson*). The officer identified certain errors in Mr Bubb's return but was unable

to prove that those errors had been caused by carelessness. Given that s 29(5) was not being relied upon, it should follow that Mr Bubb should not be subject to a discovery assessment in relation to such matters. If HMRC (as it undoubtedly did in this case) subsequently learns that a further source of income has been omitted from the returns, it has the option of making a further discovery assessment under s 29 (subject, of course, to all the various conditions that govern such assessments).

It is ironic that HMRC need not have issued discovery assessments in this case. Both tax returns were submitted to HMRC late and, therefore, as it happens, HMRC would have been in time to open enquiries into those returns. Had it done so, it could have avoided any of the difficulties it subsequently encountered in this case.

That fact also gives rise to another question which could have affected the validity of the discovery assessments. This question has to date not been resolved or, to put it more accurately, has been subject to different views by different judges. If an officer forms the view that tax has been underpaid during the enquiry window for a particular return, is that officer entitled to deal with the matter by way of a discovery assessment or must the officer open an enquiry? Or to put it another way, can a discovery assessment be founded on a view formed during the enquiry window? In *Trustees of the Bessie Taube Discretionary Settlement Trust v HMRC* [2010] UKFTT 473 (TC), Judge Berner held 'Section 29 does not contain any time limit on the making of a discovery assessment'. The alternative view recognises the inherent connections between the discovery provisions and the statutory enquiry process and was expressed by the Special Commissioner, Dr David Williams in *Lee v HMRC* SpC 715: 'One limit is that the s 29 powers can only be used after either the 'window' under s 9A has passed in respect of that tax return or the Officer has closed an enquiry into that tax return: s 29(5).'

It is also worth noting that the tribunal was critical of a number of aspects of HMRC's handling of the case. First, HMRC seemed to ignore the significance of the entries made by the taxpayer in the white space of his returns which showed the correct figures for his non-state pension income and which explained the fact that the consultancy income might well be inaccurate. Secondly, it was noted that one arm of HMRC had willingly made repayments to Mr Bubb, despite another part of the department being aware of the underpayments. Thirdly, echoing a comment I made in my article in the June 2016 issue of *Tax Adviser* in relation to the *Revell* case, the tribunal seemed unimpressed with HMRC's attempts to investigate complaints which were to the effect that its computer records might somehow be wrong. Given the

increasing reliance which HMRC is putting on computer technology (and the compulsion towards digitalisation), it is imperative that HMRC ensure that its systems are in fact robust and that taxpayers' complaints are dealt with seriously. Indeed, to pick up the theme of the recent CTA address by Professor Judith Freedman (published in the June 2016 issue of *Tax Adviser*), a failure to do so will further decrease the trust between citizen and state and damage the integrity of the tax system.

The discovery provisions are a powerful weapon in HMRC's armoury. Indeed, as was established more than 100 years ago, 'discovery' does not have its usual meaning of 'acquisition of knowledge with reasonable certainty' but instead means no more than 'acquisition of grounds sufficient to have a reason to believe'. As long as that relatively low threshold can be overcome and the other procedural obstacles to the assessment can be dealt with (these being the cause of HMRC's downfall in the present case), the assessment is treated as valid until the taxpayer can provide evidence to displace it.

Or, as the Bard said in a different context: 'Until I know this sure uncertainty, I'll entertain the offer'd fallacy.'

Further information

Read Harriet Brown's article on the uncertainties that discovery assessments can cause.