

WHEN ARE YOUR CLIENTS' TAX AFFAIRS FINAL?

Introduction

This article aims to set out the main time limits within which HMRC can challenge returns and claims for relief, the exceptions to the basic rules and how best you can try to ensure finality for clients.

The basic rules

Income tax

For personal and partnership returns, if the return has been filed on time, HMRC have 12 months from the date the return was filed. If the return was filed late, HMRC have until the quarter day following the anniversary of the date the return was filed (S9A and S12AC TMA 1970).

If the return is amended by the taxpayer, that gives HMRC a further breathing space and they have until the quarter day following the anniversary of the date the return was amended. This is to stop taxpayers sneaking in amendments just before the enquiry window closes.

By the way, if the client just keeps under the tax radar, they would need to stay in hiding for 20 years before the income becomes non-assessable (S36(1A)(b) TMA 1970).

Corporation Tax

For company returns, the rules are nearly the same except that for late returns HMRC have until 31/1, 30/4, 31/7 or 31/10 following the anniversary of the filing date and for amendments, the relevant dates are as above instead of the quarter days (Para24 Schedule 18 Finance Act 1998).

PAYE/NIC

The time limits for PAYE are set out in the Income tax (PAYE) Regulations 2003 and are given statutory force by S684 ITEPA 2003. Following the introduction of RTI, if HMRC think that any RTI returns are wrong, they have the power to issue a Determination on an employer under Reg 80. The Determination is treated as an assessment to income tax on the employer and the time limits are normally 4 years from the end of the tax year concerned (S34 TMA 1970).

VAT

For VAT the normal time limit is 4 years from the end of the relevant quarterly accounting period. However, there is a further restriction in that HMRC only have 1 year from when they become aware that all is not well to make an assessment S73(6) VATA 1994.

Exceptions to the basic rule

It is probably easiest to deal with this on a tax-by-tax basis as above:

Income tax

Once the self-assessment enquiry window has closed, the client is not out of the woods. If HMRC “discover” that any tax has been underpaid, they can issue assessments within 4 years of the end of the year of assessment if there is no carelessness (S34 TMA 1970), 6 years if the client has been careless (S36(1) TMA 1970) and 20 years if the client has deliberately under-declared income or gains (S36 (1A) TMA 1970). Discovery has a technical meaning and is discussed further below.

Corporation tax

The same limits (and also Discovery) apply for Corporation Tax as for income tax except that the limits are based on the accounting period not the tax year.

PAYE

As PAYE assessments are treated as income tax assessments on the employer, the normal extended time limits of 6 and 20 years for careless or deliberate behaviour apply.

VAT

The concept of Discovery does not apply to VAT as S73 VATA 1994 gives HMRC the power to issue VAT assessments “where it appears to the Commissioners that such returns are incomplete or incorrect”. The normal time limit of 4 years from the end of the relevant accounting period can be extended to 20 years for deliberate defaults.

Discovery

The concept of Discovery applies to income tax and corporation tax because of the bar on HMRC opening enquiries into returns once the enquiry window has closed. If they can’t open an enquiry they can’t issue assessments to correct the position in the absence of further enabling legislation. S29 TMA 1970 enables them to ignore the finality otherwise given by the limits on opening enquiries provided either of the two conditions set out below are met:

Condition 1

The taxpayer has acted carelessly or deliberately;

Condition 2

At the time the enquiry window closed or, if an enquiry had been opened, at the time the enquiry finished, the officer could not have been reasonably expected, on the basis of the information made available to him before that time, to be aware of the under-declaration of tax.

So, if a taxpayer has been careless or deliberate in under-stating his income or gains, HMRC are home and dry and have either 6 or 20 years to issue Discovery assessments.

If, however, the taxpayer hasn't been careless or deliberate, HMRC have to be able to satisfy Condition 2 and have only 4 years to assess. Condition 2 has caused most of the case law generated in respect of discovery.

Before looking at the Condition 2 details, we need to look at what "Discover" means. As usual with tax, it doesn't mean what the layman might think it means. Essentially it means merely that an Inspector has had a change of mind about the subject matter of the discovery or a different Inspector has taken a different view. Maybe rather oddly, it does not require any new fact or information to have emerged. HMRC can simply change its mind. It can of course find out something new but this is not a pre-requisite.

Condition 2 is almost an article in itself, but a brief summary is as follows.

Discovery principles relevant to condition 2

In Charlton v HMRC, the Tribunal reviewed the case law on discovery and formulated the idea that what the court had to do was ask itself the question "Whether an averagely competent Inspector, relying on the information that such Inspector is notionally assumed to have, would have reached the conclusion at the time the enquiry window closed that there was an under-statement in the return". If so, there can't be a discovery (as HMRC would have been deemed to be aware of the situation but not to have acted on it). If not, a discovery assessment would be possible.

The Charlton case concerned a tax avoidance scheme notifiable under the DOTAS rules and disclosed as such on the tax return. It was made clear that there was a huge loss on a second-hand insurance policy (with no corresponding gain) and the DOTAS reference and tax year concerned were disclosed too. There was no suggestion that there was any attempt at concealment of relevant facts or at obfuscation.

The Tribunal said it was clear from the preceding case law that the information the average Inspector was assumed to have was information derived from the return, not information an Inspector might have been expected to obtain had he made further enquiries. There is also some information which the Inspector is deemed to be aware of in S29(6):

- Information in the return itself or attachments thereto;
- Information in any claim made for that year;
- Documents provided during an enquiry for that year;
- Information which could reasonably be inferred from the above.

The main issue which the Tribunal felt it had to decide (simplifying a fairly complex reasoning process) was whether the inspector could simply make a decision "in a darkened room" with no external technical aid or assistance or

whether, given the clear existence of an avoidance scheme, he should have been alerted. Even if unsure about the technicalities of the scheme, should he have used his common sense and spoken to the technical sections of HMRC who could have briefed him on the fact that the scheme had been held by the courts not to work? Not surprisingly, the Tribunal held that he should have used a bit of common sense having been clearly alerted to the existence of the scheme and huge losses arising over an unusually short period of time.

Conversely, what is also clear from other cases is that HMRC do not have to go grubbing about for information which may have been provided to a different department, at a different time, or for a different purpose. For example it is no defence to omitting employment income to say that HMRC have the P14 somewhere in their system.

Situations where the under-declaration is not certain

Most cases regarding discovery deal with situations where the under-declaration is not in dispute and where the only question is “should HMRC have acted earlier” (i.e. within the enquiry window) but sometimes, particularly with alleged profit under-declarations, it is not clear whether there is in fact any under-declaration. The situation here is not clear but the view has been postulated that all HMRC have to satisfy is the requirement that on the balance of probabilities there has been an under-declaration.

How long do HMRC have to assess after making a discovery?

It’s unclear. Obviously they have to operate within the statutory limits for discovery (discussed above) but are they also precluded if they wait for too long after “discovering” something before they make an assessment? In other words has the discovery lost its “essential newness”? The case of Pattullo v HMRC implies that there may be circumstances where that is the case. However, it would be unwise to rely solely on this as a defence as there would probably have to be significant unjustified delays for “staleness” to be an argument to run.

How to maximize the probability of finality

With anything where, as the legal profession say, “the matter is not entirely free from doubt”, the name of the game is full disclosure. Although including more than is legally required on the return may go against the grain of the average professional adviser, it must be remembered that the Inspector, although he has to use a degree of common sense, does not have to go beyond what is contained in the return. The less information is disclosed, the greater the opportunity for discovery later. It is not possible to set out what should be included in the white space in every situation but the following might be a useful list to work from:

- A full description of the transaction(s) giving rise to the relevant entry on the return;
- Copies of (independent professional) valuations obtained;
- Details of any connected parties involved;

- DOTAS details (compulsory where relevant);
- Form AAG1 (notification to HMRC by scheme promoter) – not compulsory but sensible;
- Reasons why the transaction(s) are considered not to give rise to a liability or are considered to create a loss;
- A brief resumé of any similar cases currently going through the courts and arguments advanced by HMRC against such schemes;
- Any other information which may be considered relevant.

To forestall a discovery assessment on alleged undeclared business profits, the clear advice is to ensure the client keeps proper accurate accounting records and that all queries encountered when preparing accounts or returns are satisfactorily cleared. Cash reconciliations need to be robust and the client's systems need to be fit for purpose. Any weaknesses are likely to enable HMRC to satisfy the "more likely than not" hurdle.

Conclusion

When preparing accounts and returns, always have regard to the possibility of future discovery and consider how well placed you would be to resist it on behalf of your client.

It is not the adviser's job to "finesse" things past HMRC.

More is more. The more information is provided at the time, the smaller is the risk of discovery in the future.

Clients need to be educated that it is in their best interests to provide full and frank information to HMRC.

They should also be reminded that any scheme or arrangement that relies on non-disclosure rather than the legitimate use of the taxes acts is probably evasion i.e. a criminal offence.

If they still aren't happy, you probably don't want them as a client.