RPC

Tax Take +

Discovery assessments in direct tax cases

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Guidance note

Introduction

1. If a taxpayer has filed a tax return and HMRC have not opened an enquiry within prescribed time limits[1], a tax assessment can only be issued if the statutory conditions for issuing a "discovery assessment" are met[2].

2. The burden of proof is on HMRC in relation to whether the conditions for a valid discovery assessment have been met (see *Burgess and Brimheath Developments Ltd v HMRC* [2015] UKUT 578 (TCC) and *Nigel Bell v HMRC* [2016] UKFTT 0183 (TC)).

3. A discovery assessment can be issued if HMRC discover that:

    3.1 any income or chargeable gains which ought to have been assessed has not been assessed or

    3.2 an assessment to tax is or has become insufficient or

    3.3 relief has been given that is or has become excessive.

4. Subject to certain statutory protections (discussed further below), HMRC may make a discovery assessment in the amount or further amount that ought, in its opinion, to be charged in order to make good to the Crown the loss of tax.

What is a discovery?

5. Although "discover" is not defined in the legislation the courts have provided some guidance on its meaning. In *Cenlon Finance Co Ltd v Ellwood* [1962] AC 782, Viscount Simonds said:

> "*I can see no reason for saying that a discovery of undercharge can only arise where a new fact has been discovered. The words are apt to include any case in which for any reason it newly appears that the taxpayer has been undercharged and the context supports rather than detracts from this interpretation*".

[1] See section 9A, TMA.
[2] See section 29, TMA.

6. The Upper Tribunal in *Anderson v HMRC* [2018] UKUT 159 (TCC), confirmed that "discover" requires the satisfaction of a subjective test, as to the actual officer's state of mind, and an objective test, as to whether that belief was reasonable. The subjective test requires the officer to have more than a suspicion of insufficiency of tax but need not conclude that an insufficiency of tax was more probable than not. The officer must believe that the information available "points in the direction" of there being an insufficiency. The First-tier Tribunal (FTT) in Charlton and others v HMRC [2011] UKFTT 467 (TC), refers to the inspector having "reasons to believe" that there has been an under-assessment. The objective test requires the officer's belief to be reasonable that is a belief that a reasonable officer could form.

7. HMRC must have an evidential basis beyond mere suspicion to arrive at a conclusion that, on balance, there is an insufficiency in the self-assessment. HMRC cannot issue a "protective" discovery assessment just before the expiry of the relevant time limits if the officer only suspects a tax loss without proper evidence[3].

What are the time limits for making a discovery assessment?

8. A discovery assessment must be made within four years after the end of the accounting period to which it relates, or in cases involving carelessness on the part of the taxpayer (or a related person) within six years of the end of the relevant accounting period. However, where the case involves a loss of tax that has been brought about deliberately by the taxpayer or a related person, this is further extended to 20 years after the end of the accounting period to which it relates.

9. Section 80, Finance Act 2019, introduced legislation that increases the time limits for assessment of under-declared or over-paid income tax and capital gains tax (lost tax) arising from offshore matters or offshore transfers from the current four or six-year periods to 12 years (subject to certain limited exceptions).

Statutory protections

10. HMRC's power to make a discovery assessment where the taxpayer has delivered a return is subject to certain statutory safeguards (discussed further below under the headings: "Deliberate or careless conduct", "The hypothetical officer test" and "Practice generally prevailing"). If no return has been filed then these protections are not applicable and HMRC need only show that it has made a discovery.

Deliberate or careless conduct

11. HMRC can issue a discovery assessment where the loss of tax is attributable to careless or deliberate conduct on the part of the taxpayer or a person acting on behalf of the taxpayer.

What is careless conduct?

12. Section 118(5), Taxes Management Act 1970 (TMA), provides that:

> "*For the purposes of this Act, a loss of tax or a situation is brought about carelessly by a person if the person fails to take reasonable care to avoid bringing about that loss or situation*".

It is generally considered that this mirrors the test for negligence (see: *Field & Sons Ltd and others v HMRC* [2021] UKFTT 297 (TC)).

13. Section 118(6) provides that where information is given to HMRC and the person who gave that information, or the person on whose behalf it was given, later discovers that the information was inaccurate and fails to take reasonable steps to inform HMRC, any loss of tax or situation brought about by the inaccuracy, will be treated as having been brought about carelessly by that person.

[3] See HMRC's guidance at EM3251.

14. The test for carelessness is objective. In *Moore v HMRC* [2011] UKUT 239 (TCC), the Upper Tribunal noted, without disapproval, that the FTT had applied the following formulation of the test of negligence set out in *Anderson v HMRC* [2009] UKFTT 206 at [22]:

> "*The test to be applied, in my view, is to consider what a reasonable taxpayer, exercising reasonable diligence in the completion and submission of the return, would have done*".

What is deliberate conduct?

15. Although there is no comprehensive definition of deliberate, section 118(7), TMA, provides:

> "*In this Act references to a loss of tax or a situation brought about deliberately by a person include a loss of tax or a situation that arises as a result of a deliberate inaccuracy in a document given to Her Majesty's Revenue and Customs by or on behalf of that person*".

16. In *HMRC v Tooth* [2021] UKSC 17, the Supreme Court considered the interaction of section 118, TMA, with section 29(4), TMA. It said that where the conduct which brings about or results in a situation consisting of an insufficiency within section 29(1) is an inaccuracy in a document given to HMRC, the effect of section 118 is that the section 29(4) condition (for the insufficiency to be brought about deliberately) is fulfilled even if the insufficiency itself was not deliberate, provided that the inaccuracy was deliberate. The Court did confirm that deliberate action, like fraud, requires an intention to mislead.

The hypothetical officer test

17. This restriction requires HMRC, at the time it ceased to be entitled to give a notice of enquiry into the return, or completed its enquiries into the return, to demonstrate that a "hypothetical officer" could not have been reasonably expected, on the basis of the information made available to him by the taxpayer before that time, to be aware of the insufficiency in tax.

18. In *Langham (Inspector of Taxes) v Veltema* [2004] EWCA Civ 193, it was confirmed that the test is that the hypothetical HMRC officer must be aware of the insufficiency of tax from the available information, not merely be put on notice that such an insufficiency might exist.

Who is the hypothetical officer?

19. There is considerable case law on the characteristics of the "hypothetical officer". However, a good starting point for an understanding of the relevant characteristics is the Court of Appeal's decision in *Sanderson v HMRC* [2016] EWCA Civ 19. The Court provided, at paragraphs 17 to 25, the following guidance on how to approach the knowledge of the hypothetical officer:

19.1 the officer is not the actual officer who made the assessment but a hypothetical officer

19.2 the officer has the characteristics of an officer of general competence, knowledge or skill which includes a reasonable knowledge and understanding of the law

19.3 where the law is complex even adequate disclosure by the taxpayer may not make it reasonable for the officer to have discovered the insufficiency on the basis of the information disclosed at the time

19.4 what the hypothetical officer must have been reasonably expected to be aware of is an actual insufficiency

19.5 the hypothetical officer must, on an objective analysis, be made aware of an actual insufficiency in the assessment.

Practice generally prevailing

20. A discovery assessment cannot be issued where liability has been calculated in accordance with a "practice generally prevailing" at the time the return was made, even though that practice has later changed. Prevailing

practice is generally understood to mean the guidance published in HMRC's internal manuals (see *HMRC v Household Estate Agents* [2007] EWHC 1684 (Ch)).

21. The burden of proof is on the taxpayer. In both *Evelyn v HMRC* [2011] UKFTT 121 (TC) and *Rafferty v HMRC* [2005] UKSPC SPC00475, the taxpayer failed to successfully rely on the practice generally prevailing defence.

Top tips

- In most cases, disputes over whether HMRC have raised a valid discovery assessment will turn on whether the taxpayer has been "careless" or made adequate disclosure in their return. Although these matters tend to be fact specific, there is substantial case law to assist in deciding whether the taxpayer has been careless or made adequate disclosure and the relevant cases should be carefully considered when deciding whether to appeal a discovery assessment on these grounds.
- Whether there has been adequate disclosure can be a difficult question to answer. In a complex case, a taxpayer may need to provide more information to HMRC in order to give rise to a reasonable expectation of HMRC being aware of a potential loss of tax, such as an explanation of the tax law issues raised by the facts and the position taken in respect of those issues, whereas in a more straightforward case it might be sufficient for the taxpayer to simply provide full details of all relevant facts. Careful consideration needs to be given to the detail of disclosure provided to HMRC.