

BREAKING THE DEADLOCK – RESOLVING SME AND INDIVIDUAL TAX DISPUTES BY ADR¹

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This article reviews the success of HMRC's Alternative Dispute Resolution (ADR) pilot for Small and Medium Enterprises (SMEs) and individuals.

Imagine that you have a client, Mrs. Giles, who has been embroiled in a dispute with HMRC for a number of years over whether the bed and breakfast business she runs from her farmhouse should be jointly registered for VAT with her husband's farming business. It is plain (to you, at any rate) that the two businesses are run separately. HMRC, on the other hand, have adopted an intransigent position and contended from the outset that the farm and the B&B are not sufficiently at arm's length from each other: the reality is, say HMRC, that they are in fact one business and should be VAT registered as such.

The position is deeply unsatisfactory: the dispute has been running for so long that there are four years of assessments currently on the table. Mrs. Giles is very upset by all this. If the businesses are jointly registered, it will mean that she will be at a competitive disadvantage to the other B&Bs in the village because she will have to increase her prices to her customers in order to cover the VAT liability each quarter. If the B&B remains separate to the farming business, it will be below the VAT registration threshold, so there will be no need for Mrs. Giles to account for VAT. No one else seems to have the same problem and Mr. Giles is starting to blame you for failing to sort it out. Fairly early on in his enquiries, you and Mrs. Giles had a meeting with the officer at HMRC's offices. However, Mrs.

Giles became upset when the officer made a comment about her inability to run a business without her husband's financial support. Since then, relations have been frosty and the parties have stuck to letter writing. Lately, you feel that HMRC have become entrenched: the officer cannot see beyond the fact that Mrs. Giles does not pay her husband any rent to run the B&B from their home thereby proving (to HMRC at least) that the two businesses are not being run on arm's length terms.

It is not obvious how this impasse can be broken. Mrs. Giles has neither the money nor the desire to fight this case before the Tribunal. Indeed, she has recently been treated for depression by her GP and has no desire whatsoever to be called as a witness. She is thinking about shutting down her B&B altogether.

SOUNDS FAMILIAR?

The farming sector has been at the centre of many an enquiry in recent years with HMRC's Rural Diversification Project in 2009 following hot on the heels of their Shoot Project in 2006. Cases slide inexorably towards a hearing at a tribunal,⁴ but:

- from your client's perspective, litigation is costly, time-consuming and stressful – and will be all the more painful if you lose; and
- from HMRC's perspective, the appeal process is equally costly and time-consuming and a decision is unlikely to add much value in terms of elucidating the law.

Another problem with litigating a dispute such as this is that the Tribunal procedure is itself very rigid. Once an appeal has been notified to the Tribunal, attention naturally turns to complying with the case management timetable (Statements of Case, lists of documents, witness statements, skeleton arguments and the like) and away from focussing on whether the dispute can still be resolved without a hearing. Whilst it is often the case that very high value disputes will have a

separate settlement team conducting ongoing negotiations with HMRC right up to the door of the tribunal, there simply isn't the resource to do that in most SME matters.

Litigation should be the last resort for both sides.

A NEW APPROACH

In 2010, HMRC launched an initiative to test other ways of resolving disputes of this kind via ADR.⁵ In the context of SME tax disputes, ADR usually takes the form of mediation, in the sense that a third party who has not previously been involved with the dispute will be brought in to facilitate negotiations with the hope of reaching an agreement.

ADR can be particularly helpful in a case such as Mrs. Giles's where, for example:⁶

- the negotiations have become side-tracked, because, say, HMRC are failing to take account of relevant factors or are taking into account irrelevant ones (in our example, HMRC are focusing solely on a single financial factor and have lost sight of everything else);
- the relationship between the parties has broken down; and/or
- the negotiations appear to have reached deadlock.

The first phase of HMRC's pilot had two tracks – one for Large and/or Complex cases, and one for SMEs. During the consultation process HMRC have encouraged active and cooperative dialogue with professional bodies on the development of the pilot models through working groups.

The large business pilot is for both Large Business Service and for Local Compliance large and complex disputes. It has seen some high-value, long-running disputes resolved through structured, facilitated negotiations or by using independent mediators accredited by organisations such as the Centre for Effective Dispute Resolution (CEDR).

The SME pilot is different in structure, but the results are equally encouraging. The principal difference is that for the SME pilot, HMRC have trained a small team of their own staff, known as “facilitators”, to act as mediators. The facilitator will work with the taxpayer and/or the taxpayer’s representative and the original HMRC officer to try to reach an agreement and resolve the dispute. The facilitator will have had no prior involvement with the case and will not know the other HMRC personnel involved.

An early criticism made by those not involved in the SME pilot has been the use of HMRC staff to act as facilitators. How can they be said to be truly independent? Whilst at first sight that seems a reasonable cause for concern, to date, that concern has been unfounded. Each facilitator has received proper training in ADR techniques and, in the writers’ experience, takes their role as facilitator seriously. In the event, not a single taxpayer or adviser involved in the first phase of the pilot complained about a perceived lack of independence – a testimony to how successful the HMRC facilitators have been in achieving even-handedness and independence. One unrepresented taxpayer commented enthusiastically:

“A very useful service and my advice to anyone who has a dispute is to use this free service as you would find it valuable to talk to someone who is both very knowledgeable and impartial to either party”.

This mirrored the feedback from the HMRC facilitators themselves, with one commenting:

“It was an enjoyable and rewarding role. It was good to be able to battle the perception that HMRC don’t want to help”.

HOW CAN ADR HELP SME CLIENTS?

Turning back to Mrs. Giles’s dispute, ADR might work something like this:

- The facilitator would call you to explain how the ADR process works and discuss your client's case. In particular, he would explore the reasons why you consider Mrs. Giles's business to be separate from her husband's farming business.
- Next, the facilitator would speak to the officer to ascertain his position.
- The facilitator may then suggest that each side considers how they might put their case to a tribunal. What evidence supports their case? What evidence is missing? To what extent will the missing evidence cause a problem to their case? In particular, the facilitator would encourage both parties to consider all factors, not just the financing of the business (something you have been saying to the officer from Day One).⁷
- The facilitator would then talk through the officer's case with you and identify the officer's key concerns – in particular, the fact that Mrs. Giles does not appear to be paying any rent to her husband for the use of the farmhouse. During the ensuing discussion, it may emerge that the reason for that is because the Gileses co-own the farmhouse. Moreover, Mr. Giles has his own farm office in a separate building and none of the farm business is carried out from the farmhouse at all.
- The facilitator would repeat the exercise with the officer – discussing your client's case and your/Mrs. Giles's concerns. In particular, the fact that the farmhouse is jointly owned and not in fact used by the farming business would be brought to the officer's attention. The officer would be encouraged to go back over his notes and look at other factors which would influence whether the businesses were being run separately, for example:
 - * Does Mrs. Giles have her own bank account and records?
 - * Is Mr. Giles involved in the B&B in any way – for example, cleaning rooms, cooking meals, taking bookings?
 - * What happens if Mrs. Giles is ill or on holiday – are bookings cancelled or does Mr. Giles step in?

- * How does Mrs. Giles account for tax on the B&B takings – are B&B profits included on her tax return or on her husband's?
- * How does Mrs. Giles advertise the B&B? How are things such as food and cleaning costs paid for – from the B&B's funds or from the farming business?
- There might then be a conference call involving you, the officer and the facilitator. The facilitator would play a central role in this telephone call, inviting each party to explain how they see the factual position. During the call, it might become clear that the reason that Mrs. Giles set up the B&B business was because she enjoyed hosting people and wanted to make some money for herself. Indeed, she had in fact run a B&B from her former house in a seaside village before she met and subsequently married Mr. Giles.
- During the call, it might become apparent that most other factors point towards the B&B being run as a separate business. The officer might identify some gaps in documentary evidence currently before him. For example, he may not previously have been aware that Mrs. Giles designs her own leaflets to advertise the B&B, nor that the B&B had its own headed notepaper on which things like invoices and bills for guests are printed. The officer may wish to see these.
- The call would conclude with the facilitator setting an agreed timescale for the provision of further documents and a time by which the officer would be expected to have reviewed his position (say, 28 days after receiving the further information).
- After the call, further discussions might take place between you and the facilitator and the facilitator and the officer to tie up loose ends. The misunderstanding about the use of the farmhouse has been cleared up, some new evidence has

come to light and the officer has been encouraged to look more broadly at the situation. As a result, the officer is now satisfied that the B&B is being run as a separate business and does not need to be joined to the farm's VAT registration.

There is no set format for a facilitated negotiation such as this. The facilitator's role is as much about working out a suitable process which both parties are happy with, as it is about helping the parties to find a mutually acceptable solution to the tax dispute. For example, in our case study it may be felt by all concerned that it might be helpful to try another face-to-face meeting with the facilitator present. This time, the meeting might take place at the farmhouse. This would let the officer see how the B&B is run on the ground and the degree to which it is in fact separate from the farming business. Unlike an HMRC compliance visit, meetings in this context would only take place if your client was happy to agree to it.

NO SUCH THING AS WASTED ADR

Both writers believe that even if a final resolution is not found in the course of negotiation, the ADR process still confers real practical advantages on advisers and clients (provided of course that it is handled properly – clearly it is a waste of everyone's time if, for example, a taxpayer or an adviser signs up to the process then fails to answer the facilitator's telephone calls).

What if Mrs. Giles's dispute had not settled and had ended up in front of the tribunal?

- There is no doubt that the relevant issues in dispute would have been more clearly identified so there would be less to debate, or a more focussed debate, in front of the Tribunal. In one recent case, an anticipated 5-day hearing was reduced to 2 days following ADR – saving potentially thousands of pounds of costs and a corresponding amount of time and stress.

- Each party would have a better idea of the viability of their and the other party's case.
- A fresh review of the facts might have meant that by the time the hearing took place, only a narrow question of law remained in dispute. On that basis, HMRC might be prepared to agree a Statement of Facts and be willing not to call Mrs. Giles for cross-examination.

So ADR will have meant that Mrs. Giles is better off than before she embarked on the process, whether or not the dispute settles.

A SUCCESS

The first phase of the SME pilot ran from February to November 2011. Within that period:

- HMRC offered 149 taxpayers the opportunity to take part in the ADR pilot. 143 taxpayers – 96 per cent – took up the offer. (33 cases were subsequently withdrawn for reasons of HMRC policy or taxpayer disengagement);
- 95 facilitations were completed;
- 60 per cent of disputes were wholly or partly resolved to the mutual satisfaction of both sides;
- Resolving a case via ADR took HMRC (caseworker and facilitator combined) approximately 15 per cent of the working hours that would on average be spent taking a straightforward case to litigation. It is likely that the figures for taxpayer and adviser time saved would be comparable, which is particularly valuable since it often takes far longer for a taxpayer to prepare for an appeal to the First-tier Tribunal because it is the taxpayer's appeal.

Given that these were not simply cases selected at random but were all cases where negotiations had previously stalled, this is a remarkable result. In addition, ADR will have saved or reduced the cost of preparing for an appeal for both sides

and removed or lessened the scope for antipathy between taxpayer, adviser and HMRC.

A NEW OPPORTUNITY

The second phase of the pilot began in January 2012. Selection criteria have been expanded and in particular ADR can now be applied for by taxpayers, or suggested by HMRC caseworkers, in live disputes where an appealable decision has not yet been issued. The facility has been expanded in its scope and is open both to SMEs and to individuals. Applications are now accepted from any part of the United Kingdom.

HMRC's current approach is that not all cases are suitable for facilitated negotiation within the ADR pilot, for example where:

- resolving the case would be a departure from HMRC's established technical or policy view;
- the case cannot be settled within the framework of the revised principles of the LSS;
- the issues contained within the case requiring clarification are of interest to or may impact on the wider public; or
- the issues contained within the case are linked to other cases or appeals.

However, even where you feel that one of those exclusions might be relevant, the very act of applying to the ADR pilot opens up the avenue for fresh discussion. For example, if the issues currently on the table cannot in fact be settled within the LSS, are there other ways of looking at the problem which might offer up an LSS-compliant route to settlement? The essence of ADR is discussion at every stage in the process, so advisers and taxpayers should not take too pessimistic a view of their chances without running the facts past HMRC's pilot team first.

In our view, all professional advisers acting for SMEs and individuals should be reviewing their files now for suitable cases for ADR within the second phase ADR pilot. There is

little time left to use the facility but it deserves professional support. If you think you have identified a suitable case, visit www.hmrc.gov.uk/adr/index.htm and apply online.

USE IT OR LOSE IT

ADR is a costly facility for HMRC to run. In-house facilitators have to be specially trained, and are taken away from front-line compliance roles. While the future of ADR for the Large and/ or Complex cases seems assured, its future in the SME and individual sectors depends on the current pilot demonstrating that it is a viable and effective means of settling disputes.

That means that all professional tax advisers should do what they can to enable HMRC to validate the use of ADR in SME and individual cases. The cost/benefit analysis for both sides should be favourable, but if there are insufficient statistics to support it, the facility may well be lost forever to the millions of taxpayers in the SME and individual sectors who might be able to use it to their benefit.

And consider the bleak alternative: without ADR, a taxpayer would be left with only the statutory internal review process if he wants his case reconsidered before a Tribunal hearing. Statutory review is a very different proposition and has been widely criticised by many who have experienced it. The principal disadvantages are that:

- it is available only after the dispute has run into deadlock and an appeal has been made; and
- decisions are imposed by HMRC reviewers often without any dialogue, leading to a perception that the process is little more than a rubber-stamping exercise in many cases.

It is plainly an inferior alternative to ADR, which emphasises and facilitates bilateral dialogue and gives the parties the chance to come to their own resolution to their dispute.

ADR has the potential to be a step along the road to working

together better, and one which confers obvious advantages on taxpayers, advisers and HMRC. HMRC are to be congratulated in having taken the first step in that direction. Our job is to persuade ourselves and our clients that we should at least consider following them down that road.

Endnotes

- 1 This article was first published by Thomson Reuters (Professional) UK Limited in Private Client Business [2012] Issue 5 and is reproduced by agreement with the Publishers.
- 2 Andrew Gotch is principal of Chartered Tax Advisers TaxFellowship.
- 3 Both writers are CEDR accredited mediators.
- 4 See *A, D and J Forster v HMRC* [2011] UKFTT 469 (TC) for an example of a recent case on precisely this issue.
- 5 See <http://www.hmrc.gov.uk/adr/index.htm> for a summary of the results from the first phase of the pilot and information on the second part of the trial.
- 6 See <http://www.hmrc.gov.uk/adr/appendix-a.pdf> for further examples of cases which HMRC consider suitable for the ADR pilot.
- 7 This would have been a particularly helpful exercise for HMRC to have done in *A, D and J Forster v HMRC* [2011] UKFTT 469 (TC). During the course of cross-examination of HMRC's officer, he was referred back to 14 factors identified in his visit notes. On closer inspection, it became clear that most of the factors weighed in favour of treating the B&B separately from the farming business (see para.24).