

LITIGATE OR DIE

by Patrick Way

Introduction

“Litigate or die”, so some Revenue officials would have us believe, is the new mantra of HMRC. It means, in effect, that it is much more difficult to negotiate out of court settlements with HMRC and that if matters do proceed to court the taxpayer can now expect a much rougher ride, in the form of a more antagonistic cross-examination, than might have been expected previously. Worse still, the reality is that HMRC are now minded, or so they say, to take *all* cases involving tax avoidance to the Commissioners¹. The expression itself comes from a meeting attended by some instructing accountants of mine. They had promoted a scheme which had subsequently been stopped by a change in the legislation (usually a strong indication that the planning worked) and in relation to which the Revenue authorities had, at first, conceded that no tax was due. Subsequently, before matters had been “signed off”, as it were, the Revenue contacted the accountants for a meeting. They said that their new approach was “litigate or die”, and consequently they would withdraw their concession and would litigate all the way to the House of Lords, if necessary, no matter how weak their chances of success.

Farthings Steak House

In this article I describe how and why HMRC have moved to this position, and how it manifests itself in

general dealings with HMRC and – more particularly – in court proceedings. I also suggest ways of accommodating the approach of HMRC, particularly in relation to hearings before the Commissioners, where the new hostile approach manifests itself to a large extent. The starting point is the case of *Scott & Another (trading as Farthings Steak House) v. McDonald (Inspector of Taxes)* [1996] STC (SCD) 381 (SpC 91). It is an important case because it was the first case in which costs were awarded against the Revenue, in relation to a Special Commissioners’ hearing. It is, of course, virtually unheard of to win costs at this level.

The background is that the Revenue considered that the owners of Farthings Steak House, Mr. and Mrs. Scott, had produced incomplete records, and accordingly their tax returns understated the profit in question. On this basis, the Revenue argued that they were entitled to make additional assessments of the further amounts which they thought should be charged. At the hearing, the Special Commissioner referred to the case of *R v. Bloomsbury Income Tax Commissioners* [1915] 3 KB 768 at 783, 7 TC 59 at 64, where Lord Reading CJ had relied upon the judgment of Parke B in *Allen v. Sharp* (1848) 2 Exch. 352 at 364: an assessment could be made in these circumstances only if the authorities:

“... honestly and bona fide, after due care and diligence, believe[d] [additional tax] to be chargeable.”

In *Farthings Steak House* the Commissioner decided that none of the inspectors of taxes involved

could possibly have held the necessary honest and bona fide belief, and, accordingly the appeal of the taxpayer was upheld. The Commissioner then had to consider the question of costs since in very unusual circumstances costs of a Special Commissioners' hearing may be obtained by the winner. The Special Commissioner found that the Revenue had "acted wholly unreasonably in connection with the hearing, having shown bad faith", and accordingly the Special Commissioner took the punitive and most unusual step of awarding costs against the Revenue.

The Appeals Unit

The awarding of costs caused such a stir that, as I understand it, the Revenue introduced specialist appeals units in various parts of the country. The remit of each of these appeals units was to consider the merits of cases which the Revenue were proposing to bring before the Commissioners, with a view to ensuring that the mistakes in *Farthings Steak House* would not be repeated. It seems that, over time, these units developed an approach by which they would sanction Revenue appeals to the Commissioners only if they considered that there was at least a 50% chance of the Revenue succeeding (what I call the "gentlemanly" approach). Otherwise, the case would be conceded. So, for the last few years taxpayers and their advisers have worked on this basis, and if it was felt that a tax avoidance scheme had a better than 50% chance of success that was usually sufficient to give it the green light.

The Sea Change

And yet, as mentioned at the beginning of this article, we now have a situation where apparently even if HMRC consider that there is *no* chance of success, they will still bring tax cases before the Commissioners. So, what has precipitated this “sea change”?

The 2005 Latimer Conference

One of the first indications that the old somewhat “gentlemanly” approach (“*50% chance of success or concede*”) might be about to be replaced by a more aggressive approach (“*litigate or die*”) came at the Latimer Conference (for members of the Chartered Institute of Taxation and officials of HMRC), which took place on 30th September and 1st October 2005. Rather tellingly perhaps, its title in 2005 was “New Beginnings”. At that conference, Dave Hartnett, who is the HMRC Director General responsible for compliance, strategy, and anti-avoidance (amongst other things), spoke about countering avoidance and negotiating tax settlements. (As an aside my old friend, Edward² Troup, the director of Business and Indirect Tax at the Treasury, also spoke on a similar subject.) Mr. Hartnett described his aim as being, by 2008, to know about all schemes, and to be proactive where necessary to stop schemes, stating that he would always litigate if he felt this was appropriate. He wanted to make sure that avoiders were no better off than what he called *compliant* taxpayers, and he wanted people entering into avoidance to recognise that government was bearing down on them. Most relevantly, his feeling was that the Revenue should

litigate all “unacceptable tax planning”, because he was concerned that – increasingly – people were entering into avoidance arrangements with a pre-planned object of settling out of court, in due course, at an amount which would still make the avoidance scheme worthwhile. Consequently, his feeling was that the Revenue should litigate “in full”, and would certainly litigate – to use his terminology – if it was considered that the scheme in question “undermined the integrity of tax legislation” *no matter how slim the chances of success were*. In addition, his view was that national insurance avoidance was “off limits”, and – whatever the merits of the case – he would always want to recover 100 pence in the pound in relation to national insurance planning and not a penny less.

Other signs of impending change

Dave Hartnett’s talk should also be put in the context of other steps which were happening at much the same time and have happened since. I now set out those which I have identified but in no particular order.

Disclosure

The disclosure rules set out in Finance Act 2004 Part 7 came into force on the 1st August 2004. Initially, these were to counter employment-related schemes and – broadly speaking – schemes involving financial products, but such has been their success, from HMRC’s viewpoint, that they have been widened significantly by the introduction of the Tax Avoidance Schemes (Prescribed Descriptions of Arrangements) Regulations

2006 (SI 2006/1543). Apparently, at the time the original regulations were introduced there were approximately 1,300 contentious matters involving EBTs alone, which – it can readily be seen – involved a significant amount of the Revenue’s management time quite, and moreover, by the time the Revenue got to hear of these schemes much of the “damage” (at least in the Revenue’s eyes) had been inflicted. Disclosure was intended (a) to bring employment-related and finance-related schemes to an end as soon as they were disclosed and (b) through the reference system, which would apply to all schemes emanating from the same promoter, to allow otherwise disparate cases to be marshalled into one manageable entity. By and large these aims seem to have been achieved.

Meetings with senior members of the profession

Then there was the occasion when senior members of the accountancy and legal professions were summoned to 11 Downing Street to meet the Chancellor of the Exchequer, in order for him to explain his irritation and annoyance with the tax avoidance industry and Dave Hartnett met, separately, with most of the senior partners of the accountancy firms to ask them to pull out of the tax avoidance industry. In addition, there were threats that if firms of accountants continued to involve themselves in the promotion of tax avoidance schemes they could not expect to be invited to carry out remunerative government-related work.

Employment avoidance

A further clue to the germination of this hard-nosed approach can be gleaned by reading the transcript of another of Dave Hartnett's addresses, this time to the Chartered Institute of Taxation as part of its seventy-fifth anniversary celebrations in 2005. In that address, he described the particular sorts of steps which taxpayers had taken to avoid being within the PAYE net and to avoid paying NIC. Most readers will be familiar with these techniques: they involved, among other things, no doubt, employees receiving – rather than cash - (a) trust interests (b) gold bars (c) carpets (d) platinum sponges (e) vintage wines and even (f) hay and (g) animal skins. Over time, various measures had been introduced by governments of different persuasions to try to stop this sort of tax avoidance, but – so Mr. Hartnett said – the Revenue were generally on the back foot, because the absence of disclosure and other matters meant that they found out about schemes well after they had been completed.

Schedule 22

From my own point of view, however, it was the introduction of Finance Act 2003 Schedule 22, (which very quickly became consolidated as Part 7 of the Income Tax (Earnings and Pensions) Act 2003), that quite unwittingly encouraged the utilisation of a plethora of schemes – which were almost certainly the last straw so far as HMRC were concerned. (This legislation is still referred to as “Schedule 22” by way of shorthand.) Schedule 22 dealt with employment income and income

and exemptions relating to securities, and it introduced provisions which allowed employers to transfer securities in a particular way to employees tax-free and then to take various steps to reduce the value of the asset or to pass its value out in a much more beneficial fashion, so that the overall the result to the employees was a significant reduction in income tax and an entire avoidance of NICs. (The 25% scheme referred to at Endnote 1 is a classic example.)

Press Release of 2nd December 2004

The Revenue's reaction was to issue the now famous press release of the 2nd December 2004, in which the Paymaster General (Dawn Primarolo), after some fairly emotive language denouncing the wholly unpalatable avoidance industry, introduced anti-avoidance provisions into the legislation and, most significantly, said that the Revenue regarded themselves as being entitled to bring in *retrospective* legislation to counter Schedule 22 avoidance dating back to the 2nd December 2004 if they thought it fit, in order – in effect – to preserve the integrity of the legislation.

Merger of the Revenue and Customs & Excise

Some readers would say that, in seeking to identify the driving force behind “litigate or die”, I am missing the main point, which is that in 2005 the Revenue and Customs & Excise merged. Indeed, various commentators have pinpointed this as being the principal catalyst for the new-style approach of HMRC, based on the fact, of course, that Customs traditionally were much

more in the mould of “shoot first and ask questions later” than the somewhat more reasoned and analytical personnel of the Revenue, and Customs’ approach has been adopted by the merged HMRC.

City booms

Additionally, as Dave Hartnett acknowledged in his address to the Institute of Taxation, the City has enjoyed an enormous boom in recent years, with the result that some quite extraordinarily huge bonuses have been paid to staff, and some similarly extravagant schemes have been utilised to avoid paying tax. No doubt to the chagrin of HMRC, when one such scheme – involving a relevant discounted security – was taken to the Special Commissioners by HMRC, it was not rejected but endorsed by that tribunal, and the case was not taken further by HMRC (*Campbell v. IRC* ([2004] STC (SCD) 396 (SpC 421)).

Need to raise more tax

Finally, it needs to be pointed out that the Government considers that it loses significant amounts of tax from avoidance and wants to “rectify the situation”.

Where are we now?

The new approach (crystallised in the expression “litigate or die”, but extending to all means of making life uncomfortable for the tax avoidance industry) seems to have been successful. Many of the large firms of

accountants have withdrawn from the promotion of “retail” tax avoidance schemes and now limit themselves to one-off bespoke schemes for special clients and special events. The disclosure regime does seem to have flushed out very quickly a large number of tax avoidance schemes, enabling the Revenue to put an end to them. A salient example is the recent introduction of Finance Act 2003 s.75A which stops virtually all the SDLT avoidance schemes that were prevalent beforehand, and produces a situation to be contrasted with the pre-disclosure regime, where, particularly in relation to stamp duty, avoidance schemes carried on for years with impunity.

The new approach to litigation

The United Kingdom has, of course, the adversarial system rather than the continental inquisitorial procedure in court hearings. This means that the evidence is tested through the means of examination and cross-examination, and each party is obliged to put its arguments as forcefully as it can. By contrast, the inquisitorial system involves much more of an overview of the position, with the facts being gleaned by the court and tested from time to time. Counsel is the client’s mouthpiece (*adversarial*) rather than a relatively dispassionate presenter of legal opinion (*inquisitorial*) for the judges’ consideration. The adversarial system has stood the country well, but from time to time it does produce a very lop-sided effect, and increasingly – following the Revenue’s new approach to litigation and their “litigate or die” rallying cry – it can leave the

taxpayer who is cross-examined in court feeling that he has been very badly treated.

Counsel for the taxpayer may in some cases speak for no more than half a day in a five-day hearing, whilst counsel for the Revenue may speak for four and a half days, four days of which is spent in brutal cross-examination of the client. The taxpayer feels it is unfair and feels that there is a lack of kilter in the process, and may complain that nothing is done to stop this unfair process and nothing is done to even things out. It may be that the Revenue have changed their approach in the last two or three years and have moved from fairly anodyne cross-examination to hostile cross-examination; that is the perception in any event. Whilst the Revenue would deny that this new approach is because of their “love of bloodsports”, nevertheless increasingly the feedback is that the taxpayer is left feeling very disadvantaged at the disproportionate time in which his case is attacked, together with the unpleasantness of the attack, and the process – frankly – can be an uncomfortable one to observe.

What can you do?

So how can you even things out and how can you protect your client prior to what may be a very brutal cross-examination before the Commissioners? The first thing to do is to warn the client that cross-examination is almost invariably unpleasant but that it is a necessary way of flushing out the evidence. On the basis that the client has been advised (presumably) that he has a meritorious case he should remain control and not lose

his temper or calm demeanour. He should answer the questions without emotion and, of course, honestly. He should not involve himself in speculation and if he does not now the answer or cannot remember he should say so. A matter of fact, “I don’t know” is perfectly acceptable and can be disarming.

Also he should bear in mind that no matter how dissatisfied and uncomfortable he finds the process (and this article is focussing on the client’s experience and sensitivities) the Commissioners have seen it all before and will factor into their overview their knowledge that people under cross-examination are frequently nervous and unsure. In other words, no matter how badly a client may feel he has performed in the witness box if he has given his answers honestly and helpfully, there is nothing more to be done. And just because he has had a rough ride under cross-examination, this will not (whatever the client may think) result, by virtue of that fact alone, in his losing an otherwise winnable case (“*snatching defeat from the jaws of victory*”).

Notwithstanding this, you should consider how you can legitimately prepare your clients for this process. The relevant codes of professional practice are entirely candid on this, and you must remain within the clear parameters which they set out. Accordingly, a barrister categorically must not rehearse, practise or coach a witness in relation to his witness statement (Code of Conduct of Work by Practising Barristers Rule 705), and a solicitor must not, of course, tamper with the evidence of a witness and must have regard to paragraph 6.5 of the

advocacy code for solicitors, which includes very similar wording to Rule 705 of the Barristers' Code.

So, if you cannot rehearse, practise or coach, what can you do beforehand? As a starting point, when formulating the case or settling the witness statement the solicitors or barrister should "test the evidence". This means that they must, on a step-by-step basis, ask the witness as they go along whether each of the relevant points is correct. This, quite legitimately, will highlight *en passant* the sort of questions that are likely to be asked in the cross-examination, but great care needs to be taken, because there is a very narrow dividing line between acceptable preparation of a witness and entirely unacceptable rehearsing or coaching. So, as a consequence, it may be advisable to consider enrolling a client on a specialist course of familiarisation, but, given the limits that attach to these courses (they must relate to entirely hypothetical facts and to circumstances entirely distinct from the actual case) their benefits are reduced to giving a *general* understanding of how the process works and no more.

In addition, great care must be taken in connection with all witness familiarisation courses, because there are dire consequences if a witness, rather than being "familiarised" is "coached": this is borne out by the case of *R v. Momodou* [2005] EWCA Crim.177, which was considered in the civil case *Ultraframe (UK) Limited v. Fielding & Others* [2005] EWHC 1638 (Ch). Following *Momodou*, the Bar Council introduced a guidance on witness preparation in October 2005, to assist barristers

in relation to the difficult issues that arise, in the light of the case, in respect of prohibited witness coaching. It is to be emphasised that the main rule mentioned above (paragraph 705) still takes precedence (*absolute prohibition on coaching and rehearsing*). So, the guidance confirms that, whilst witness coaching is prohibited, a process of witness familiarisation is permissible in order to prevent witnesses from being disadvantaged by ignorance of the process or being taken by surprise at the way in which it works.

The following is taken from the guidance:

“12. The following guidance should be observed in relation to any witness familiarisation process for the purpose of civil proceedings:

- (1) Any witness familiarisation process should normally be supervised or conducted by a solicitor or barrister.
- (2) In any discussions with witnesses regarding the process of giving evidence, great care must be taken not to do or say anything which could be interpreted as suggesting what the witness should say, or how he or she should express himself or herself in the witness box – that would be coaching.
- (3) If a witness familiarisation course is conducted by an outside agency:
 - (a) It should, if possible, be an organisation accredited for the

purpose by the Bar Council and Law Society;

- (b) Records should be maintained of all those present and the identity of those responsible for the programme, whenever it takes place.
 - (c) The programme should be retained, together with all the written material (or appropriate copies) used during the sessions.
 - (d) None of the material used should bear any similarity whatever to the issues in the current or forthcoming civil proceedings in which the participants are or are likely to be witnesses.
 - (e) If discussion of the civil proceedings in question begins, it should be stopped.
- (4) Barristers should only approve or take part in a mock examination-in-chief, cross-examination or re-examination of witnesses who are to give oral evidence in the proceedings in question if, and only if:
- (a) its purpose is simply to give a witness greater familiarity with and confidence in the process of giving oral evidence; and

- (b) there is no risk that it might enable a witness to add a specious quality to his or her evidence; and
- (c) the barrister who is asked to approve or participate in a mock examination-in-chief, cross-examination or re-examination has taken all necessary steps to satisfy himself or herself that the exercise is not based on facts which are the same as or similar to those of any current or impending trial, hearing or proceedings at which a participant is or is likely to be a witness; and
- (d) In conducting any such mock exercises, the barrister does not rehearse, practise or coach a witness in relation to his/her evidence: see para.705(a) of the Code. Where there is any reason to suspect that a mock examination-in-chief, cross-examination or re-examination would or might involve a breach of the Code, a barrister should not approve or take part in it.”

In addition, the guidance has the following to say about witness statements:-

“Witness Statements

13. Barristers in civil proceedings are typically involved in settling witness statements. However, the courts have emphasised that a

witness statement must, so far as possible, be in the witness's own words: see eg. *Aquarius Financial Enterprises Inc. v. Certain Underwriters at Lloyd's* [2001] 2 Ll.Rep. 542 at 547; Chancery Guide, Appendix 4, para.1; Commercial Court Guide para.H1.1(i) and H1.2 and Technology and Construction Court Guide para.6.10. When settling witness statements, great care must be taken to avoid any suggestion:

- (1) that the evidence in the witness statement has been manufactured by the legal representatives; or
- (2) that the witness had been influenced to alter the evidence which he or she would otherwise have given.

14. Furthermore, the evidence in a witness statement must not be partial; it must contain the truth, the whole truth and nothing but the truth in respect of the matters on which the witness proposes to give evidence: see Chancery Guide, Appendix 4, para.6 and Queen's Bench Guide, para.7.10.4(1). A barrister may be under an obligation to check, where practicable, the truth of facts stated in a witness statement if he or she is put on enquiry as to their truth: see Chancery Guide, Appendix 4, para.6. Moreover, if a party discovers that a witness statement which has been served is incorrect, it must inform the other parties immediately: see Chancery Guide, Appendix 4, para.6 and Queen's Bench Guide, para.7.10.4(6). Barristers therefore have a duty to ensure that such notice is given if they become aware that a witness statement contains material which is incorrect."

Other preparation

The client should be encouraged to set aside plenty of time before the hearing to read through again the witness statement and all the relevant papers so that he can be fully prepared for the cross-examination. He should think carefully for himself what questions he is likely to be asked and should practise his answers – in front of a mirror if necessary! In fact, in my experience, such preparation can turn a case back in favour of the taxpayer³.

What can be done in the hearing itself?

In a typical case, however, as noted above, the taxpayer's evidence will initially be in the form of a written witness statement. Usually, the taxpayer will not be asked to read out the witness statement: this puts him at something of a disadvantage, because he then moves very quickly into the heated atmosphere of cross-examination without time "to draw breath"; whereas it would be desirable if he could answer "friendly" questions to give him confidence and calm his nerves before the cross-examination starts. Accordingly, it is appropriate for Counsel to ask the Commissioners that the taxpayer does read out the witness statement (this request is often denied as it would be in a fully blown trial). Reading a familiar witness statement slowly, however, gives time for the witness to "get into his stride". Thought should then be given to asking the taxpayer some questions in relation to the witness statement although, frankly, the witness statement should have set everything out as fully as possible. The purpose,

however, of any such questions is, again, to put the witness at ease. Consideration should also be given to formulating these questions in such a way that the difficult points which the Revenue's barrister is going to raise are anticipated, so giving the taxpayer the opportunity of stating the position in the first place by reference to "sympathetic" questions rather than hostile ones. This in turn *may* mean that it is possible for the barrister acting for the taxpayer to object to further questions being asked on these difficult areas, in the subsequent, cross-examination, on the basis that the information has already been given – but this is probably a vain hope in most cases. Further possibilities to help the taxpayer who has to give evidence are to see whether the cross-examination by the Revenue counsel can be interrupted legitimately, on the basis that a question is not relevant or is a repetition of an earlier question, or, frankly, that it is plainly hostile and nothing else. Usually this is done without much success.

Once the cross-examination has been completed, the barrister for the taxpayer is then given the opportunity to ask further questions. It is a judgment call whether further questions should be asked. If the witness statement is clear and the taxpayer has had a difficult experience in cross-examination, the risk always is that the taxpayer may simply end up contradicting the witness statement (because he is just not thinking straight) and it may be best simply to leave matters as they are and rely on the written statement itself as best presenting his evidence. It should be said, of course, that even though the whole process may leave the taxpayer

drained and miserable, he should resist the temptation of giving up⁴. Despite all the foregoing, as already mentioned, the Commissioners are seasoned adjudicators, and – whatever the taxpayer may think about the apparent unfairness – the Commissioners are entirely capable of applying the right balance to the proceedings when weighing up the evidence and producing their decision.

Conclusion

So for the future, taxpayers need to be aware of the position. They certainly need to be made aware that notwithstanding the merits of their case (and bear in mind they may have at least a 50% chance of success or perhaps significantly more – otherwise they would not have brought the appeal in the first place) the courtroom experience is likely to be unpleasant and to require careful preparation. So the taxpayer should be forewarned. It may be appropriate to take the client on a witness familiarisation course, as I mentioned, and in the drafting of the witness statement care can be taken to test the evidence, so that the taxpayer can at least be given, in a wholly legitimate way, an understanding of the sort of things he must be able to deal with. It should also be borne in mind that although cross-examination is part of a fact-finding exercise, which is most important – not to say critical, nevertheless ultimately the case will in the end be decided on its legal merits, and that is where the tax barristers worth their salt should come into their own, no matter how draining and unpleasant the courtroom experience for the client may prove to be.

¹ However, there was a blanket settlement of the “25% scheme” (involving restricted shares and a dividend) and this suggests that notwithstanding the somewhat virile claim that all cases will go to the courts, this is not necessarily the practice so far.

² I was forgetting! Because the Treasury is a “Right-on” department, Edward’s crossing of the Rubicon from law firm to Treasury has required him to change his name to the much more “*au courant*” ‘Ed’!

³ Richard and Judy’s evidence in *Madeley and Finnigan v. HMRC* [2006] STC (SCD) 573 (SpC 547) was a particularly salient example of how witnesses who have prepared can give powerful and ultimately winning answers from the witness box.

⁴ This article has its roots in a number of cases where members of the Tax Bar have been involved, including one involving a husband and wife in which one spouse conceded rather than face a similar grilling to that just suffered by the other spouse, and others where taxpayers have come away with the impression that the system is unfair and makes them appear criminal (even though the Commissioners ultimately find in their favour).