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**Mercury rising**

**Features**

**Powers**

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*Pete Miller considers the messages that can be decoded from two recent cases concerning HMRC powers.*

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**Key Points**

- HMRC obtained search warrants in an ex parte hearing.
- Warrants are quashed on appeal as unlawful.
- The importance of correct implementation of schemes.
- Is a dividend right a 'financial product'?
- The relevance of counsel's opinion to penalty charges.

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Mercury Tax Group has been in the tax news recently, having been successful in two cases against HMRC where the department's use of administrative powers was challenged. One case concerned HMRC's use of powers to enter and search properties, while the other was about penalties under the disclosure of tax avoidance schemes (DoTAS) rules. Both cases are useful demonstrations of the checks and balances within the system and, particularly in respect of the first case, will be at least as important under the new HMRC powers regime -- introduced with effect from 1 April 2009 -- as they were under the old.

So, what were these cases and why were they important?

## Entry and search powers

The first case is *R (on the application of Mercury Tax Group and another) v HMRC* [2009] STC 743, which related to a judicial review of a notice given under TMA 1970, s 20C.

Mercury had sold a tax planning idea to a number of its clients. The basic plan is in the website version of this article, but the result of the plan was that the client had a tax loss, without suffering an economic loss, as the value was in the trust.

The scheme required a total of 25 discrete steps and it was common ground that, if the scheme had been implemented correctly, the planning was effective. HMRC formed the view that the implementation had not been carried out properly and that 'there was reasonable ground to suspect that there were serious flaws in the way that the scheme was implemented and that the claimant was aware of those flaws but sought dishonestly to conceal them'. As a result, HMRC asked for warrants under s 20C to enter into the premises of Mercury, the home of its principal shareholder, and the homes and offices of the majority of the clients who had used the scheme.

These warrants had to be obtained from a Crown Court judge, who could only grant the application if 'satisfied on information on oath given by an officer of the Board that there is reasonable ground for suspecting that an offence involving serious fraud in connection with, or in relation to, tax is being, has been or is about to be committed and that evidence of it is to be found on premises specified in the information'. The hearings are held 'ex parte', meaning that the people whose properties may be raided are not made aware of the hearing and are not entitled to be present or to argue their case.

HMRC actually made two applications under s 20C: the first in Leeds which covered the majority of the premises, followed by a hearing in London to obtain a warrant for Mercury's London office (of which HMRC had apparently previously been unaware). Both warrants were granted and HMRC carried out the searches of premises. HMRC's case was based on the apparent flaws in implementation and the view formed by the investigating inspectors that Mercury sought to fraudulently conceal the deficiencies. Some of the matters that gave HMRC cause for concern in the implementation arose from the way in which this scheme was operated in practice.

Mercury subsequently challenged the validity of the warrants on the basis that the information given to the judge at the hearing was misleading. Mercury's grounds were that, 'on the information put before the Crown Court, there was no reasonable ground to suspect that any tax fraud had been committed; and that, in any event, the Revenue had not complied with their duty of full and frank disclosure'.

The case went to judicial review in front of Mr Justice Underhill, who considered separately, first, whether there was reasonable ground to suspect the flaws in the implementation of the scheme and, secondly, whether, if so, there was reasonable ground to suspect that those flaws were the result of dishonesty.

## Implementation

Essentially, Mercury put together a package of documents and a step plan for the transactions (referred to as 'the chronology'). The documents were set up so that the client only needed to sign and date the documents and insert the appropriate amounts of money in the relevant blank spaces (presumably, the amount of income which it was intended should be sheltered by the scheme). These documents were then submitted to the promoters, who implemented the various steps in the process in order to achieve the required result. So, what did HMRC object to here?

The major issue raised by HMRC concerned the signature pages of three documents of which clients had

signed incomplete drafts. This was the principal fraud suspected by HMRC.

Again, fuller details are on the website, but basically signed pages from the draft documents were added to fresh, revised documents. The judge held that there were fundamental differences between the draft and final documents. Furthermore, all three documents were deeds for which there are specific legal requirements that the signature be attested by two witnesses. The judge held that these and other issues threw doubt on the validity of the documents and hence on the scheme as a whole.

Two other areas of concern (see the website version) were raised by HMRC, which they contended suggested them as being indicative of a willingness by the parties to act fraudulently.

Taking all of these factors together, Underhill J agreed that the information laid before the judges gave reasonable grounds to suspect that there were serious flaws in the implementation of the scheme. On that basis, he then had to decide whether those flaws were the result of dishonesty, giving 'reasonable ground for suspecting that an offence involving serious fraud in connection with, or in relation to, tax is being, has been or is about to be committed' (s 20C(1)).

## Serious fraud

As noted above, HMRC had come to the view that Mercury sought to fraudulently conceal the deficiencies in implementing the scheme. This view was expressed strongly to the Crown Court in the warrant application, both in the written submission and in the discussion between the judge and the inspector. Mercury took issue with the way in which the case was presented in a number of areas. Although only one of Mercury's contentions was upheld, in the judicial review application Underhill J decided that this one issue was of sufficient importance as to justify the quashing of the warrants.

The crux of the decision in the Crown Court, to issue the warrants, is in the following extract (see paragraphs 2.4.22 and 2.4.23) from HMRC's written submission:

'Once the decision had been taken to proceed with the June 2004 strips the scheme users ought to have been made aware of this and to have signed and executed revised documents. Mr K [one of the clients who used the scheme] says that he did become aware at some point that the scheme had not proceeded with the December 2003 strips, but he does not now recall precisely who made him aware of this or when this happened. The e-mails retrieved by Mr K are highly significant here in what they do not include. Although the e-mail search was carried out for the whole of the period 1 November 2003 to 31 January 2005 inclusive the last e-mail that has been obtained from the search is dated 21 November 2003. If Mr K had been made aware that a different financial instrument was being used and that revised documents would be required then I would have expected at least some references to this to have appeared in e-mail traffic, whether between Mr K and Mercury or Mr K and the other scheme users. No such emails have been recovered, however.

'I suspect that the reason for this is that, as for Mr G [another client], those responsible for implementing the scheme decided not to seek properly amended documentation. *I suspect that, instead, they decided to falsify documents in order to make it appear that they had been properly signed and executed*' (author's emphasis).

This was a crucial part of the decision to issue the warrants, as demonstrated by this extract from the transcript of the proceedings:

'Q. (The judge). At the moment, on what you tell me, it seems that the parties having set up this arrangement, that these are the persons offering the tax avoidance strategy, having for whatever reason got themselves unable to use December 2003 maturing securities, substituted securities maturing in June 2004, right, have I correctly understood?

'A. (The inspector). Yes, yes.

'Q. And that was not the deal which the scheme users thought they were getting, we understand?

'A. Mm that's right.

'Q. And your position is, so far as the scheme users are concerned, when they are presented with a tax return to sign, and it says "security maturing June 2004", they should have thought "blow me over, I signed something that said December 2003"?

'A. Exactly, your Honour.'

The position understood by the Crown Court judge was therefore that Mercury had, at a late stage, changed the gilts to be used in the scheme and attempted to mislead the clients into thinking there had been no change.

While Mercury had not specifically drawn the attention of clients to the change of gilts, they had required clients to sign formal facility letters that referred to the replacement gilts. Mercury's position was that it could be inferred from the fact that the clients had signed the letters that they were aware of the change of the gilts, even if that change had not been specifically advertised.

More important in the context of the issue of the warrants, those letters were in HMRC's possession at the time of the application for the warrants, but they had not been shown to the Crown Court judge. Indeed, in the judicial review proceedings Underhill J expressed some surprise that no original documents were presented to the Crown Court in support of HMRC's case, although he decided that the failure to do so was not sufficient of itself to merit the quashing of the warrants.

But the essence of Mercury's position was that HMRC represented them as having deliberately misled their clients, while it was clear from documents in HMRC's possession that this was not the case and that the clients had had a letter referring to the replacement gilts. Underhill J held that this was 'an important misrepresentation/non-disclosure. In my judgment that nondisclosure was material. That conclusion seems to me inescapable in view of the [Crown Court] judge's expressed understanding that the misleading of the clients was at the heart of the fraud'.

## Remedy

After some discussion as to how to deal with the non-disclosure, his honour decided to quash the warrants on the basis that they had been issued unlawfully. He actually gave four reasons, the first of which was the misrepresentation discussed in detail above.

The second reason is quite interesting, in that he felt that the overall case for suspicion of dishonesty was not particularly strong and that, had he himself been asked to issue warrants on the basis of the other weaknesses in the implementation, he would not have done so. He also noted that, despite only finding one 'clearly material misrepresentation', this was not 'a case where the presentation of the application otherwise was entirely faultless' by HMRC. And finally, he felt that the public interest would not be damaged by the quashing of the warrants.

Underhill J's summary was that:

'Overall, this seems to me to have been something of a borderline case for the deployment of the nuclear weapon of an application under s 20C. If HMRC were to persuade the court that this was a proper case for the issue of search warrants (covering not only business premises, but the private homes of over 20 individuals) on an ex parte basis, it was incumbent on them to put their case with scrupulous accuracy and in such a way that the judge was able to make a fair assessment of the grounds for suspicion being put forward. That did not occur.'

## Comment on the case

At first glance, one might look at this decision and say that justice was, in fact, done (subject to any right of appeal by HMRC), and that may be true. But the more important question is whether Mercury and its clients should have been put to the trouble and expense of taking the Crown Court warrants to judicial review. As Underhill J made clear in his closing remarks, HMRC were required 'to put their case with scrupulous accuracy' which they clearly failed to do. Mercury evidently has pockets deep enough to fund these proceedings, but many other taxpayers will not. One cannot help but be very nervous about the fact that, so soon after the new and enhanced HMRC powers came into force, we have such a public demonstration of what can go wrong with ex parte proceedings.

The only possible silver lining to this case is that the courts may be a little less ready to accept all HMRC's submissions at face value in the future, and may subject the evidence to more detailed scrutiny before deciding to issue warrants under the new rules. But some of the new powers to insist on visiting the business premises of taxpayers do not require warrants, so even this ray of hope is of limited application.

One area that concerns me even more is that the background set out in the case report states that HMRC were unwilling to release copies of the submissions to the Crown Court and the transcript of the hearing. These were only released when they were warned that failure to do so might prejudice their position. It seems to me almost inconceivable that a government department should have such apparent disregard for the authority of the courts as to need such a warning.

Another point of interest, not unrelated to the above thoughts, is the fact that the Crown Court was not shown any of the documents referred to in the submissions. Mr Justice Underhill commented that he found it 'surprising that the judge was being asked to reach a conclusion about a suspected fraud whose essence depended entirely on the effect of a number of documents without being supplied with copies of the documents in question'. In this case, he decided that nothing hung on this point, but it is surprising nevertheless.

Finally, from the perspective of advisors discussing tax planning ideas with their clients, this case makes some interesting points about implementation. I do not propose to discuss the implementation of tax planning schemes in any detail. But anyone who has been the subject of an HMRC investigation into such schemes will know that HMRC will always look to see if the scheme has been implemented correctly. It doesn't matter how robust the technical analysis, if the scheme has not been implemented correctly, it may fail on the ground that the client has not in fact done what they say they have done. Furthermore, HMRC has suggested in the past that a failure in implementation can leave a client open to tax-gearred penalties for an incorrect return. Penalties are much less likely where a properly implemented scheme is held by the tribunals or courts to fail on the technical issues.

## Disclosure of an avoidance scheme

The second case under consideration, *HMRC v Mercury Tax Group* (SpC 737), was an appeal against the imposition of a penalty for failing to make a disclosure of a tax avoidance scheme under the DoTAS rules. The scheme involved a loss being created for tax purposes by the sale of the right to a dividend. It was common ground that Mercury was a promoter of the scheme and was under an obligation to notify the arrangements if those arrangements were within the description in the regulations then in force. At the relevant time, these were the 2004 regulations (SI 2004 No 1864), which were superseded by SI 2006 No 1543 from 1 August 2006.

The 2004 regulations broadly required disclosure of schemes that were either employment products or financial products. The definition of 'financial products' included, amongst other things, a share. On this

basis, HMRC took the view that the scheme should have been disclosed, as there were shares involved, as there must be where there is a dividend. In HMRC's view, it was enough that there were shares that were the source of the dividend and, on a wide (and possibly purposive) construction of what is, after all, anti-avoidance legislation, there was no requirement to restrict the application of the DoTAS rules to schemes involving transactions in shares.

Mercury contended that the regulations referred to the financial product giving rise to a tax advantage, and the definition of a financial product referred to a share and not to rights derived from a share. This is in direct contrast with the definition of 'employment products', which included securities, interests in securities, securities options and anything the right to which is derived from securities. Such a wide definition would clearly include dividends, but Mercury was entitled to infer from the fact that the definition of financial products did not include such a widely worded definition that the right to a dividend was not within the definition of a financial product. Mercury also pointed to a number of other statutory provisions that distinguish between shares and dividend rights, such as TA 1988, s 703, in respect of which it has been held that a dividend is not a transaction in securities. In this case, therefore, they argued that the tax advantage derived from the rights to dividends, not from the shares as such, and the rights to dividends were not within the definition of a financial product.

Mercury also noted that they had acted responsibly in that they had sought counsel's opinion on the issue. Therefore, even if the tribunal ruled against them on the niceties of the interpretation of the regulations, no penalty should be levied as they had taken all possible precautions. HMRC's riposte was that counsel's opinion on this point lacked any detailed analysis and should therefore be ignored in mitigation.

The Special Commissioner, Dr John Avery Jones, said that the regulations were not easy to interpret. However, he noted that the definition of financial products included a number of items, such as stock lending, derivatives and repos, where shares are usually the underlying asset. He also analysed the structure of the regulation, which required not just that there be a financial product, but also that the financial product give rise to the tax advantage. Applying this approach, he found that there was a financial product -- the shares -- but that the proximate cause of the tax advantage was the dividend right, not the shares, and the dividend right was not a financial product. Therefore, the scheme was not disclosable and the penalty levied on Mercury must be quashed.

Dr Avery Jones said that he did 'not reach the conclusion without doubt', so he also considered what penalty would be due if he were wrong. He noted HMRC's suggestion about the lack of analysis, but said that that 'the more important point is that Mercury went to the trouble and expense of taking counsel's opinion. Counsel addresses his or her mind to the point and reaches a justifiable conclusion, with which I happen to agree'. So Dr Avery Jones fixed the penalty at nil, in case he was wrong on the substantive point.

## **Comment on the case**

Once again, perhaps, justice has been done in the wider sense, but not without the appellant having to go to a great deal of trouble and expense. In this case, to be fair, there was clearly an ambiguity in the regulations. But, once this was recognised, and especially since Mercury had a favourable counsel's opinion, it is difficult to see how HMRC considered a penalty to be justifiable.

One other point of interest is that HMRC contended that Mercury had refused to give up a list of clients that had used the scheme. It became apparent during the hearing that Mercury had, in fact, supplied the information to HMRC and it is a matter of major concern that HMRC's internal communications were so poor that their counsel was unjustifiably arguing for enhanced culpability in front of the Special Commissioner on this issue.

## **Conclusions**

Only time will tell how HMRC uses or abuses both existing and new powers. But in one of these cases the court found that HMRC had misrepresented the position to the Crown Court and in the later case it was clear that part of HMRC's position was based on incomplete information having been supplied to their counsel.

In both of these cases Mercury had to incur material costs in both time and money to get matters resolved in their favour. Other people, who do not have Mercury's resources, may well find that appeals or judicial reviews are beyond their financial means, so that HMRC's position will stand by default, whether that position is justified or not.

Overall, both cases may have reached the right answer; but not, I feel, by the right route.