

Analysis

HMRC's refreshed LSS: no 'soft' option

The litigation and settlement strategy (LSS) sets out the framework and approach to be adopted by HMRC when handling and resolving tax disputes subject to civil law procedures, and is intended to ensure that HMRC applies the law fairly and even-handedly. It was introduced in 2007, and a refreshed version was issued in April this year. It applies to all stages of a dispute.

There was concern when it was first published as a draft last year that the refreshed version suggested that HMRC would be taking a 'softer' approach to dispute resolution.

As this article will show, that is far from being the case, and the real concern should be whether this policy document, designed to allow HMRC officials to carry on their business, in fact could act as a restraint on their ability to do so and should better recognise the range of powers actually vested in HMRC, judged by the number of judicial pronouncements on HMRC's powers in recent years.

Whilst the LSS sets out fairly detailed guidance for determining on what terms a dispute can be settled, by reference to considerations such as the 'right amount of tax' and whether the dispute is of an 'all or nothing' nature, the important question of HMRC's discretionary powers in collecting revenue is less clearly dealt with.

The LSS applies to areas that fall within HMRC's functions of 'collection and management of revenue' – Commissioners for Revenue and Customs Act 2005 (CRCA 2005) s 5 – in relation to which HMRC has a wide managerial discretion.

The question of the scope of that discretion has been addressed by the courts, in particular in the case of *IRC v National Federation of Self-employed and Small Businesses Ltd* [1982] AC 617 (the *Fleet Street casuals* case). In that case, Lord Diplock set out that the Commissioners had a 'wide managerial discretion as to the best means of obtaining for the national exchequer from the taxes committed to their charge, the highest net return that is practicable having regard to the staff available to them and the cost of collection' (see page 636 of the decision).

The LSS is not a legal document, but a statement by the Commissioners of how they will go about the exercise of their current management powers in relation to the resolution of disputes. It can itself therefore be seen as an exercise of this discretion. Interestingly it confirms that the discretion can allow HMRC 'not to pursue an amount of tax' in the context of tax disputes (see the LSS commentary, para 1 under the heading 'Scope and purpose') and that where that discretion is properly exercised, and an amount of tax is not pursued, it can still be said that the tax dispute has been resolved consistently with the law as required by the LSS.

The LSS as an exercise of HMRC's discretion

As set out in *Fleet Street Casuals*, HMRC must exercise its discretion for reasons of good

SPEED READ HMRC's refreshed litigation and settlement strategy (LSS) sets out the framework and approach to be adopted by the department when handling and resolving tax disputes subject to civil law procedures. The authors contend that the LSS potentially restricts HMRC from fully exercising its powers as vested by statute and decided by the number of judicial pronouncements in recent years. It narrows the range of reasonable outcomes, particularly in the context of the issue of 'splitting the difference', that HMRC may decide to use as a basis for settlement.



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management and not for some 'extraneous or ulterior reason' (see the judgment of Lord Diplock at page 637A–B). The courts have set out relevant factors that HMRC can take into account in exercising their discretion, including the staff available to HMRC; the cost of collecting the revenue; the extent of the relevant information that is likely to be obtainable and the difficulty involved in identifying the extent of the exact sum which is due (see the judgment of Lord Diplock in *Fleet Street Casuals* at page 636G–H and *Fayed v IRC* [2004] SC 745 at para 69).

The real concern should be whether this policy document, designed to allow HMRC officials to carry on their business, in fact could act as a restraint on their ability to do so

Whilst the LSS does not purport to set out a strategy for what 'tax' is in dispute in a particular case (quite rightly so, given the decision in the *Fayed* case), it clearly affects the outcome of disputes, and therefore affects what tax is collected and the means by which this is collected. As such, it falls within the scope of HMRC's discretion.

The scope and purpose of the LSS is stated to include the resolution of tax disputes consistently with HMRC's objectives of 'maximising revenue

flows whilst at the same time reducing costs and improving customer experience' (see the LSS commentary, para 1). Thus stated, this purpose seems consistent with HMRC's duty to obtain for the exchequer 'the highest net return' that is practicable.

The question of the scope of HMRC's discretion has been addressed by the courts, in particular in the *Fleet Street Casuals* case

The LSS also sets out the cost of collection or of litigation as being relevant to the question of how best to resolve the dispute. However, the LSS is not clear as to the effect that those other factors (i.e. the staff available, the extent of the relevant information that is likely to be obtainable and the difficulty involved in identifying the extent of the exact sum which is due) may have on HMRC's decision whether to litigate or to seek settlement of the dispute by agreement. For instance, the LSS commentary (para 11) states that HMRC will 'seek to establish and understand the relevant facts as quickly and efficiently as possible' but does not explain HMRC's litigation and settlement policy in relation to cases in which such facts cannot be established, or where establishing them would require a disproportionate call on HMRC's resources.

The LSS can therefore be regarded as a conservative exercise of HMRC's discretion due to the fact that several relevant factors (as determined by the courts) that could widen the range of possible actions HMRC could take by virtue of its discretion, have not been used to the extent that they might have been.

HMRC's 'collection' of revenue as an exercise of its discretion

The commentary to the LSS states that 'where discretion is properly exercised under the Commissioners for HMRC's legal powers of collection and management not to pursue an amount of tax, then the outcome is consistent with the law ... the scope of this discretion is described in the *Admin law manual* ...' The LSS itself does not expressly set out the fact that HMRC may in certain cases, forego an amount of tax and limits itself to stating that 'tax disputes must, in all cases, be resolved in accordance with the law' (see the LSS commentary, para 16).

Whilst the *Admin law manual* explains that HMRC is, in some cases, entitled to apply discretionary treatment in a given situation where such treatment might result in a higher net return to the exchequer (see ADML3400), the only relevant factor expressly considered in this respect is the cost of collection. The observation

made above that HMRC's discretion may have been narrowed because the other relevant factors have not been relied upon to the same extent, therefore also applies in respect of the discretion as considered in the *Admin law manual* too.

However, a more fundamental point relates to the fact that the LSS commentary deals with the issue of HMRC's discretion in relation to the collection of revenue as a separate issue to that of HMRC's general discretion in (i) drawing up the LSS, and (ii) deciding, on the basis of the LSS, what settlement strategy should be adopted in a particular case.

As accepted by Lord Scarman in *Fleet Street Casuals*, the conflict between the dual duties weighing on the Commissioners of collecting every part of due tax and the duty of good management, 'can be resolved only by good managerial decisions, some of which will inevitable mean that not all the tax known to be due will be collected' (see page 651B-C of that decision). Whilst it is clear that this necessity to forego tax due should not form a central pillar in the LSS, it is nonetheless a relevant aspect of HMRC's discretion that could sensibly be addressed in the context of the LSS.

Two areas in which the consideration of HMRC's collection powers might make a real difference, if they are considered together with HMRC's initial discretion in deciding the means by which (i.e. litigation or agreement) to settle a dispute, are in relation to 'splitting the difference' and 'interdependency' of issues.

Splitting the difference

The National Audit Office report *Settling large tax disputes* ('the report', available via www.lexisurl.com/5o20u) published in June this year examined five settlements, all of which were found to be reasonable. However, in relation to the settlement with company D, it was found that it was not clear that the settlement was compatible with the LSS (see the report, para 15).

The report sets out that there were some issues where the possible outcomes were either that the taxpayer owed nothing or owed the full amount. The LSS does not permit 'splitting the difference', that is settling for less than the full amount, in these cases. The report states that 'the agreed settlement with company D was lower than the tax liability that would have been paid if the department won in litigation. Given the uncertainties and costs of litigation, it was reasonable for the department to settle at the amount it did. However, it is not clear that this is compatible with the litigation and settlement strategy'.

The fact that the settlement was found to be reasonable, in circumstances where consideration of plainly relevant factors led to the conclusion that less than the full amount of tax could be reasonably collected by HMRC, but potentially not compliant with the LSS, is significant.

One possible reason for this discord is that the main focus of the LSS is to determine the best means of collecting the 'right amount of tax'. The LSS does not expressly incorporate HMRC's discretion in relation to the *quantum* of tax to be collected in a case in order to achieve the highest net return that is practicable having regard to the relevant factors.

Were the LSS to set out how both these facets of HMRC's discretion operate, it may have permitted for less than the full amount of tax to be collected, on the basis of HMRC's discretion not to collect the full amount where HMRC concludes, based on its exercise of 'good management' powers, that this result would produce the *highest net return*.

Interdependence of issues

As noted in the report (para 17), the LSS sets out that each disputed issue should be considered and resolved on its own merits but 'does not recognise the reality that when the department and a taxpayer enter a process to resolve multiple complex, finely-balanced issues at once, interdependency is created between these issues'.

The LSS is clearly, and rightly, focused on identifying the 'right amount of tax', and in ensuring that that amount of tax is ascertained in relation to each issue separately. No 'package deals'. The 2007 LSS in defining 'package deal' required each issue to be assigned value but did *not* prohibit settling the individual issues in a wider settlement on different terms than would be considered if the issue were to be settled by itself.

The refreshed LSS added the requirement that each issue should be considered on its merits. The commentary explains that this rules out the department conceding one issue in return for the taxpayer conceding another (the report, para 2.19).

However, the reality is that once the parties enter into a process to resolve multiple issues at once, interdependency is created between these issues and the outcome for individual issues may be different when settled as part of a package with other issues.

Dealing with HMRC's discretion in relation to the amount of tax it collects in conjunction with the issue of whether to pursue litigation or to seek agreement, may help to bridge the gap that will exist in some cases between the 'right amount of tax' overall and the 'highest net return that is practicable' having regard to the relevant factors.

This will be of particular interest in transfer pricing cases involving valuations and comparable studies where there is rarely one right answer.

Conclusion

The LSS narrows the range of reasonable outcomes, particularly in the context of the issue of 'splitting the difference', that HMRC may decide to use as a basis for settlement. This is mainly due to the fact that:


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- as an exercise of HMRC's discretion in deciding how to best manage and collect tax in the context of a dispute, it does not fully set out and make best use of all the factors relevant to the exercise of HMRC's discretion; and
- it fails to consider HMRC's discretion to forego the collection of revenue where this would lead, overall, to the best net return, having regard to relevant factors such as the staff available to HMRC and the cost of collection.

Were this aspect of HMRC's discretion addressed in conjunction with HMRC's discretion in deciding whether to litigate or to seek agreement, the range of reasonable solutions open to HMRC would likely be wider than is currently the case under the LSS.

The role of the new tax assurance commissioner, Edward Troup, includes the responsibility of seeing that tax disputes are resolved on a basis that brings tax in efficiently, in accordance with the LSS, and ensuring that the LSS is applied consistently. It is within his remit to monitor how the LSS functions and recommend changes either to it or the *Admin law manual* where there is evidence that the restrictions they contain go further than the law permits. This would allow the department to exercise the full extent of its discretionary powers in the collection and management of revenue producing a more efficient and fairer result for both taxpayers and the department.

HMRC's commentary on the refreshed LSS, titled 'Resolving tax disputes: commentary on the litigation and settlement strategy', is available via www.lexisurl.com/G9Ujn.

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