

## Analysis

## Haworth: the Supreme Court's ruling on follower notices

## Speed read

The Supreme Court has confirmed that HMRC is only entitled to issue follower notices where it is of the opinion that there is no scope for a reasonable person to disagree that an earlier judicial ruling determines the taxpayer's case. The judgment confirms that HMRC's application of the legislation since its introduction in 2014 has been fundamentally flawed. It also gives comfort to taxpayers that the higher courts are willing to restrict HMRC's anti-avoidance powers, especially where those powers intrude upon taxpayers' access to justice.


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The follower notice (FN) legislation was one of a series of statutory powers granted to HMRC in the last decade to address tax avoidance. Broadly, the legislation empowers HMRC to issue a notice to a taxpayer where it considers that the judgment in another case has determined their case. The consequences of receiving a FN are harsh: if the taxpayer does not concede their case, they face a penalty of up to 50% (30% for penalties assessed from 10 June 2021) of the tax at stake. However, the precise circumstances in which HMRC could issue an FN have been unclear until the decision of the Supreme Court in *R (oao Haworth) v HMRC* [2021] UKSC 25.

### The follower notice legislation

Whilst there are various requirements that must be met before HMRC can issue an FN, the critical condition is that HMRC is of the opinion that there is a final judicial ruling that is 'relevant', which is defined as meaning that 'the principles laid down, or reasoning given, in the ruling would, if applied to the chosen arrangements, deny the asserted advantage or a part of that advantage' (FA 2014 s 205(3)(b)).

There is no right of appeal against an FN. Taxpayers can appeal against a penalty issued for refusal to comply with the notice, although that means they bear a significant financial risk if they wish to have their case determined by an independent tribunal.

The FN legislation was the subject of two consultations prior to its enactment which made references to it targeting 'unmeritorious appeals' and 'hopeless cases'. The 2014 consultation on tackling marketed tax avoidance stated (at para 3.9): 'At the heart of this notice is the proposition that the likelihood of the taxpayer's scheme succeeding is remote.'

In light of the nature of the powers and the statements in the pre-legislative consultations, many tax advisers

understood that FNs were limited to circumstances in which it was entirely obvious that a lead case had determined the outcome of another taxpayer's case. If a taxpayer seeks to prolong their dispute by re-arguing the same point that had already been decided in the lead case, then it is part of the legislative purpose that he be subject to a significant penalty if he subsequently loses or withdraws: in such circumstances it might be said that a taxpayer who knows that they have no realistic prospect of success is not truly exercising their right of access to justice but is abusing the tax system and their right to appeal to an independent tribunal.

### HMRC appealed seeking to reverse the limits on its powers that were imposed by the Court of Appeal. However, this move has backfired, as the Supreme Court has restricted its powers even further

However, in fact, HMRC made extensive use of the FN legislation, issuing approximately 22,000 FNs between 2015 and December 2020 and imposing the maximum 50% penalty in two-thirds of cases in which the taxpayer refused to concede their position (according to the consultation paper on follower notices and penalties, dated 16 December 2020). The notices have proved extremely effective, at least from a tax collector's perspective, and over 60% of taxpayers who received such notices conceded their cases.

The legislation and HMRC's application of the legislation led to serious concerns, not only among taxpayers but even within Parliament (but only after the legislation had been enacted). In a 2018 report, the House of Lords Economic Affairs Committee criticised the FN regime and recommended that FN penalties be abolished: 'Penalties associated with General Anti-Abuse Rule and Follower Notices are draconian and restrict access to justice. We recognise that they were introduced to inhibit taxpayers from delaying settlement by appealing, but at their present level they are disproportionate and cannot be justified' (*The powers of HMRC: treating taxpayers fairly*, 4 December 2018, para 103).

### Mr Haworth's FN

Mr Haworth's case concerned a tax arrangement which was known colloquially as 'round the world'. Under this arrangement, a trust migrated to Mauritius (or another country which had a low CGT rate and a treaty with the UK which conferred exclusive capital taxation rights on the country where the alienator was resident), made decisions to dispose of certain assets, and then the Mauritius trustees were asked to retire in favour of UK trustees in the same tax year. The view was that the relevant double-tax convention relieved any gain realised when the trustees were resident in Mauritius.

The first case to consider this type of arrangement was *Smallwood* [2010] EWCA Civ 778: the Court of Appeal unanimously concluded that treaty relief was not available simply by considering the residence position of the persons holding office as trustees at the moment of disposal, but by showing that the 'place of effective management' (POEM) of the trust was in Mauritius rather than the UK, a question that was highly fact sensitive. The Special Commissioners had found that

the POEM of the Smallwood trust was in the UK and therefore the gain in that case was not relieved by the treaty: the majority of the court (Patten LJ dissenting) applied the well-established principles in relation to appeals against findings of fact (*Edwards v Bairstow*) and held that there was a sufficient factual basis for the Special Commissioners to have concluded that POEM was in the UK – in other words, it could not be said that no person acting judicially and properly instructed as to the relevant law could have come to that conclusion. However, Hughes LJ (with whom Ward LJ agreed) did not state that he agreed with that conclusion and he summarised certain facts which in that case that entitled (but did not compel) the fact-finding tribunal to reach its conclusion on POEM. Critically, the decision in *Smallwood* did not confirm that all reliance on the ‘round the world’ planning would necessarily fail: it confirmed that, in principle, the arrangements *did* work, provided that the POEM of the trust was in Mauritius.

Following *Smallwood*, HMRC issued an FN to Mr Haworth. HMRC’s decision making process was that it had received legal advice that *Smallwood* would be *likely* to defeat a taxpayer’s appeal if the facts referred to by Hughes LJ in his judgment were also present in another taxpayer’s case (these facts were referred to internally within HMRC as the *Smallwood* ‘pointers’). This was on the basis of HMRC’s entirely erroneous understanding that the Court of Appeal had found that POEM was in the UK was the ‘inevitable consequence’ of the planning. An officer of HMRC undertook a review of the documents in Mr Haworth’s case looking for confirmation that the pointers were present, following which a senior governing body within HMRC approved the issue of the FN (without looking at the facts of the case themselves).

The FN issued to Mr Haworth therefore raised a number of fundamental questions concerning the interpretation and application of the FN legislation, including:

- Is it sufficient that HMRC is merely of the view that it is ‘likely’ to succeed or must HMRC form a different, more demanding, opinion as to the effect of the judicial ruling on the taxpayer’s chances of success?
- What is the consequence of HMRC misunderstanding the judicial ruling that it claims is ‘relevant’?
- Can HMRC apply factual ‘reasoning’ to another taxpayer’s case when forming its opinion?
- Can HMRC issue an FN where the issue in dispute is highly fact-specific?
- Can HMRC’s decision-making body delegate all substantive decision-making to one officer?

### The High Court and Court of Appeal

Mr Haworth’s claim for judicial review was advanced on a number of grounds before the Administrative Court, in particular that HMRC had misinterpreted its statutory powers on the opinion it needed to form and misunderstood *Smallwood*, that factual findings were not ‘reasoning’ capable of being applied to another case, and HMRC had effectively delegated its decision to issue the FN to one HMRC officer.

The Administrative Court dismissed all of the taxpayer’s grounds for challenge, in particular holding that Parliament had chosen not to specify a threshold such as ‘no reasonable prospect of success’ or ‘hopeless’. In addition, factual findings could constitute ‘reasoning’ for the purposes of the legislation, the decision-making process was lawful, and the fact that HMRC

had ‘mangled’ the significance of *Smallwood* did not undermine the decision.

However, the Court of Appeal unanimously upheld Mr Haworth’s challenge on two separate grounds. Firstly, as matter of language and in the context of the draconian nature of the FN legislation, those powers should be carefully circumscribed and HMRC must have ‘a substantial degree of confidence in the outcome’ of a case before issuing an FN. Secondly, the Court of Appeal confirmed that HMRC had misdirected itself as to the significance of *Smallwood*, and therefore the FN ought to be quashed.

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### The Supreme Court

HMRC appealed seeking to reverse the limits on its powers that were imposed by the Court of Appeal. However, this move has backfired, as the Supreme Court has restricted its powers even further.

In interpreting the legislation, the Supreme Court took particular account of the fact that FNs evidently discourage taxpayers from pursuing their appeals and applied the principle that, where a statutory power authorises an intrusion upon the right of access to the courts, it must be interpreted as authorising only such a degree of intrusion as is reasonably necessary to fulfil the provision’s objective (*R (UNISON) v Lord Chancellor* [2017] UKSC 51). On this basis, the court concluded in relation to s 205(3)(b) and the definition of ‘relevant’: ‘Applying that principle, the use of the word “would” in the provision requires that HMRC must form the opinion that there is no scope for a reasonable person to disagree that the earlier ruling denies the taxpayer the advantage ... An opinion merely that is likely to do so is not sufficient.’

This threshold is significantly higher than the Court of Appeal’s interpretation that HMRC must have a ‘a substantial degree of confidence in the outcome’. The Supreme Court also set out four factors for determining whether a judicial ruling is ‘relevant’:

1. How fact sensitive is the application of the relevant ruling?
2. Does the relevance of the earlier ruling turn on HMRC rejecting the taxpayer’s evidence as being untruthful?
3. What are the particular legal arguments put forward by the taxpayer?
4. What is the nature of the earlier ruling, including its precedential value?

The Supreme Court also confirmed that HMRC had misdirected itself in its analysis of *Smallwood*. However, it did dismiss the taxpayer’s alternative argument that factual findings could never constitute ‘reasoning’ that might be relied upon by HMRC to issue an FN, even where the final ruling applies the *Edwards v Bairstow* ([1956] AC 14) principles; but, given the high threshold identified by the court, the effect of the judgment is that HMRC’s powers to issue FNs remain strictly confined.

The court also appears to have been interested in the argument that the delegation of the substantive decision-making to one HMRC officer might not meet the statutory condition that the opinion is formed by 'HMRC' as a department. However, that issue was not before the Supreme Court and has therefore been left open for another case.

#### What now for HMRC and taxpayers?

The Supreme Court has confirmed that HMRC may only issue FNs in very limited circumstances in which there is no scope for a reasonable person to disagree that the judicial ruling determines the taxpayer's case. This interpretation is consistent with the manner in which the legislation was presented to Parliament and also with the original view of many advisers that FNs were only ever meant for extreme cases in which a taxpayer unreasonably refused to concede a hopeless case. The consequence of the judgment is that HMRC's approach to issuing FNs since 2014 may have been fundamentally flawed.

### The Supreme Court has confirmed that HMRC may only issue FNs in very limited circumstances in which there is no scope for a reasonable person to disagree that the judicial ruling determines the taxpayer's case

Taxpayers who have received FNs should consider asking HMRC to withdraw them in light of *Haworth* (even if a review has been undertaken and HMRC has confirmed the notice). In addition, there may be taxpayers who previously settled with HMRC following receipt of an unlawful FN who may now wish to resurrect their cases. Those taxpayers might face a number of challenges, in particular if they have entered a final and binding settlement – but there is a possible argument that a settlement entered into under the pressure of an unlawful FN is one from which the taxpayer should be entitled to resile.

The Supreme Court also confirmed that the threshold it has laid down is the same threshold that the FTT must apply when determining an appeal against an FN penalty – albeit that the FTT will be undertaking its own assessment of whether that threshold is met, whereas a court considering a judicial review is asking whether HMRC formed the requisite opinion and had reasonable grounds for doing so. As the FTT will undoubtedly apply the factors identified by the Supreme Court, taxpayers who received FNs and have penalty appeals before the FTT are now in a significantly stronger and more certain position following *Haworth*.

More generally, the judgment in *Haworth* confirms that the courts (or at least the higher courts) are willing to scrutinise and appropriately confine statutory powers granted to HMRC, even when those powers purport to counter tax avoidance and especially when HMRC seek to restrict access to justice. ■

*The author acted for the taxpayer in this case.*

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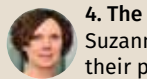


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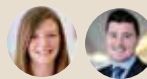


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