The increasing use of ADR in HMRC disputes and getting your legal costs back from the Taxman

Beale & Company are frequently instructed in tax litigation related matters. Our clients are often surprised to find out that (i) ADR is available to settle tax disputes with HMRC and (ii) even if a taxpayer unsuccessfully challenges a tax assessment before the First-tier Tribunal, they are not generally entitled to recover their legal costs of doing so from HMRC.

The recent First-tier Tribunal judgment in Sussex Cars Association v HMRC [2017] UKFTT 0691 (TC) (13 September 2017) draws both of these issues together and is a rare example of legal costs being awarded in the taxpayer’s favour.

ADR

Historically most tax assessment disputes were settled in Court or by direct negotiation with HMRC. However, there has been a recent rapid growth in the use of ADR (alternative dispute resolution) to settle tax assessment disputes. HMRC are increasingly open to this procedure although the process requires their agreement and the use of one of their own “neutral facilitators” - ie a HMRC officer unconnected with the tax case team who can also (potentially) be used alongside a third party independent mediator.
Industry feedback suggests HMRC are now agreeing to ADR in well over 50% of cases where it is requested and that the facilitators provided are, on the whole, scrupulously impartial.

The usual costs rule before the First-tier Tribunal

The two-tiered tax tribunal system was introduced to be user friendly and easily accessible to taxpayers with less formality than that of the High Court system. In keeping with that approach, the general rule is that neither party can recover its costs of the tax proceedings before the First-tier Tribunal. This can obviously work in the taxpayer’s favour where they can exercise their right of appeal without the substantive threat of an order to pay HMRC’s costs if they lose the case. In that scenario they are not faced (as they would be in High Court litigation) with a large bill for their opponent’s (HMRC’s) costs, in addition to their own lawyer’s costs. As taxpayers caught up in this type of litigation know, the costs of litigating such matters rapidly escalate and specialist tax Counsel/experts required to advise on the more esoteric tax areas/strategies are not cheap.

However, the usual cost rule can be displaced and the First-tier Tribunal has particular discretion to award costs against a party on the basis that it has “acted unreasonably in bringing, defending or conducting the proceedings”.¹

Sussex Cars Association v HMRC

HMRC raised assessments for approximately £1.4m VAT on the taxpayer, the taxpayer appealed those assessments and HMRC subsequently withdraw its defence as it realised rather late in the day (18 months after the taxpayer’s assessment appeal was lodged) that (even if it was correct in its position) the outcome of arguing its position was likely to be cash neutral for the Exchequer on the particular facts ie where another related taxpayer would effectively be able to reclaim the VAT that HMRC were seeking to recover from Sussex Cars.

HMRC argued that they should not be liable for Sussex Car’s costs as the reason for withdrawal did not concern the merits of the tax assessment against Sussex Cars (HMRC maintained that its VAT assessment was correct) but it was based on the belief that continuing the proceedings would not be a good use of public funds.

¹ Rule 10(1)(b) of the Tribunal Procedure (First-tier Tribunal) (Tax Chamber) Rules 2009 (SI 2009/273). The costs rules in the Upper Tribunal are different and the “loser pays” rule generally applies.
The First-tier Tribunal did not agree that “…HMRC are somehow a special case because it needs to consider the use of public funds. A taxpayer bringing an appeal has to make exactly the same assessment regarding funds, i.e. is the money it would save on winning an appeal be enough to justify the expenditure on securing the victory… a party to litigation should always be free to walk away, but … that freedom does not release the person from the consequences of doing so i.e. the possibility of costs if the conduct in coming to that conclusion is unreasonable…

…the potential for the outcome to be cash neutral for HMRC … were matters that were just as relevant at the date the Notice of Appeal was issued as they were at the date HMRC withdrew their defence”.

The Tribunal held that HMRC should have understood the “cash neutral” issue much earlier in the proceedings and reached its decision to withdraw at a materially earlier point, and it would likely have done so had it taken legal advice at an earlier more appropriate stage.

The Tribunal also found that HMRC’s conduct during the ADR process held during the course of the proceedings had also been unreasonable. HMRC had sent tax officers to the ADR who were unable to engage in the technical arguments involved, therefore failing to participate meaningfully in the ADR process at all.

Costs of the proceedings against HMRC (including the ADR process) were ordered in favour of the taxpayer.

Commentary

There are relatively few reported cases where adverse costs orders have been made by the First-tier Tribunal and the usual costs rule will apply in most cases absent unreasonable behaviour by one of the parties.

The recent rapid growth in HMRC’s use of the ADR process to settle tax assessments is an increasing trend and can be a cost effective resolution process for the right case. As with High Court litigation, however, the parties need to engage properly in the ADR process to avoid potential costs sanction.

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