National Audit Office

REPORT BY THE
COMPTROLLER AND
AUDITOR GENERAL

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HM Revenue & Customs

# Settling large tax disputes

# Summary

## Introduction

**1** Section 2 of the Exchequer and Audit Departments Act 1921 requires the Comptroller and Auditor General (C&AG) to examine the accounts of HM Revenue & Customs (the Department) to ascertain that adequate regulations and procedures have been framed to secure an effective check on the assessment, collection and allocation of revenue, and that they are being duly carried out.

**2** In July 2011, the Comptroller and Auditor General (C&AG) published his report (the C&AG's Report)[1] on HM Revenue & Customs 2010-11 Accounts. The C&AG's Report concluded that the Department's governance processes for resolving tax disputes were sound and that these were followed in a substantial majority of the 27 cases examined. However, in four of the largest settlements, the Department decided to use alternative governance arrangements. In three of these four cases, there was no, or limited, separation between negotiating and approving the settlements. This reduces the demonstrable assurance that these settlements were appropriate. The C&AG's Report also noted two cases where the Department overlooked key stages in its established governance processes.

**3** The Committee of Public Accounts (the Committee) held hearings on the C&AG's Report on 12 and 17 October and 7 November 2011. Its report on these hearings made clear that the Committee had serious concerns about how the Department handled the settlements where it bypassed or overlooked governance arrangements until it was too late.[2] The Committee also concluded that the Department refused to disclose taxpayer information and that this made it impossible for Parliament to hold the Department to account. The Committee concluded that there was no absolute statutory bar on disclosing taxpayer information and that this was a policy decision by the Department's commissioners. It concluded that, in making this decision, the Department had not given proper regard to its duty to assist the Committee and asked the Department to set out in greater detail how it came to this decision. The Department takes the view that to disclose taxpayers' confidential information in evidence to a Parliamentary Committee would be unlawful because it would hinder rather than help the Department's function of collecting tax.

1 Comptroller and Auditor General, *HM Revenue & Customs Annual Report and Accounts 2010-11*, Session 2010–2012, HC 981, 7 July 2011.
2 HC Committee of Public Accounts, *HM Revenue & Customs 2010-11 Accounts: tax disputes*, Sixty-first Report of Session 2010–12, HC 1531, 20 December 2011.

**4** The Department recognises the need for increased accountability and is proposing to strengthen its internal governance arrangements. The Department intends that these new governance arrangements will be sufficient to assure the Committee that the settlements it reaches are appropriate. There should not be a need for external reviews of settlements, such as this one, to provide this assurance. The NAO will have a role in providing assurance that the Department's arrangements are operating effectively, and will continue to have access to the detail of individual settlements.

**5** There has been significant press coverage of the concerns expressed by whistle-blowers in some of these cases. Whistle-blowers have also directly contacted the C&AG and the Committee. In undertaking this work, we have been aware of the issues raised by whistle-blowers, and have examined the basis of these concerns.

**6** To address the lack of assurance over the settlements where the Department set up alternative governance arrangements, or overlooked existing governance arrangements, we have examined five of these settlements. These five include the settlements where the Committee had particular concerns.[3] Sir Andrew Park, a retired tax judge, provided expert tax advice. For each of the five settlements, we asked Sir Andrew Park to consider whether:

- the settlement value was reasonable in view of the circumstances of the case;
- the settlement was consistent with the Department's *Litigation and Settlement Strategy*;[4]
- the Department obtained appropriate legal advice and acted upon the advice at all relevant stages; and
- the Department followed its own procedures.

**7** In evaluating reasonableness, we have considered whether the settlements represent fair value for the Exchequer and were in the public interest. This included considering whether the settlement was as good as or better than the outcome that might be expected from litigation, considering the risks, uncertainties, costs and timescale of litigation.

3 In the C&AG's Report of July 2011, we found two settlements where the Department overlooked its existing governance arrangements. In one of the settlements, the error in process was relatively minor and did not have significant consequences. In the other settlement, the errors in process, and the consequences, were significant, so we included the settlement in the scope of this review.

4 HM Revenue & Customs, *Litigation and Settlement Strategy*, 2007, available at: http://www.hmrc.gov.uk/practitioners/lss.pdf

**8** The C&AG is bound by Section 182 of the Finance Act 1989, which makes it an offence to disclose information about an identifiable taxpayer. The Act allows for lawful disclosure of such information for the purposes of the C&AG's functions. This report focuses on the reasonableness of individual tax settlements and the Department's actions in reaching these. Whilst it is necessary to give some of the details of the tax issues under consideration to show how we reached our conclusion on reasonableness, the identity of the taxpayer is not central to making these judgements, or to assessing the Department's processes for reaching settlements. The C&AG considers that it is not necessary to identify taxpayers to fully report on these issues. For this reason, we have not named taxpayers, and refer to them in this report as Companies A to E, respectively. Where possible, we have also omitted details of the settlements that would reveal the identity of the taxpayer. In some cases, certain details of the settlements are already in the public domain and we recognise that these taxpayers may be identifiable.

**9** Sir Andrew Park reported the results of his examination of each settlement to the C&AG in detail. These reports contain extensive details about the disputed tax issues that are confidential to taxpayers. Sir Andrew Park's reports allowed the C&AG to make a full judgement on the reasonableness of the settlements and the Department's processes for reaching these, and we have set out these judgements and conclusions in this report. The C&AG considers that disclosing Sir Andrew Park's reports would breach taxpayer confidentiality.

## Key findings

### On reasonableness

**10 All five settlements were reasonable, and at least one may have been better than reasonable.** We found that all five settlements were reasonable ones for the Department to have reached in the circumstances. The concerns raised by whistle-blowers were often based on a partial understanding of the settlement because the details were confidential. In this context, the concerns made sense. The conclusions on reasonableness depend upon understanding of the settlement as a resolution of several issues, as well as the detail of the individual issues.

**11 These large tax settlements are complex and there is no clear answer as to what represents the 'right' tax liability.** The Department used its judgement to decide how the law applied to the complex facts and, in each case, there was a range of justifiable positions the Department might have taken. For example, three of the cases involved the Department challenging, and developing defensible alternative scenarios for, the companies' long-standing transfer pricing arrangements. Where the Department and the taxpayer disagree, they can either reach a compromise settlement that both sides can accept, or pursue the issues in litigation, which is likely to involve a long and very expensive process of appeals through the courts.[5]

5 This is explained in the C&AG's Report of July 2011, Figure 5 and paragraph 2.9.

**12 The Department introduced senior decision-makers to help deliver settlements to an accelerated timescale, but it did not always ensure that the specialist staff involved in the cases understood the reasons for settlement.** Some of the specialist staff working on some of the cases where the Department operated alternative governance arrangements were excluded from the final negotiations. These specialist staff had concerns about the appropriateness of the settlements reached, and did not feel that the Department adequately addressed these. While the settlements reached were reasonable, poor internal communication of the reasons for settlements has resulted in a loss of confidence in the settlements, internally and externally.

**13 In settling these cases, the Department resolved multiple, long-outstanding tax issues.** All of the cases involved multiple tax issues and covered multiple tax years. Some of the issues had been outstanding for well over a decade. In four of the cases, the Department successfully used an accelerated negotiation process to reach a settlement. The resolution of these issues is in line with the Department's commitment to reduce the number of long-running enquiries with large businesses. Given that the settlements reached were reasonable, the resolution of the issues is welcome.

## The Department's processes for reaching the settlements

**14** Although all five settlements were reasonable, this work confirmed our concerns about the processes by which the settlements were reached.

### The compatibility of settlements with the *Department's Litigation and Settlement Strategy*

**15 Four settlements were fully compatible with the *Litigation and Settlement Strategy*. It is less clear that the settlement with company D was compatible with the *Litigation and Settlement Strategy*.** There are some issues where the possible outcomes are either that the taxpayer owes nothing or that it owes the full amount. In these circumstances, the *Litigation and Settlement Strategy* does not permit 'splitting the difference', that is settling for less than the full amount. 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*.

**16 When negotiating the settlement with company E, the Department's staff believed that there was a barrier to charging interest on the employer's National Insurance contributions (NICs). There was no barrier to charging interest, and the Department did not check this before agreeing to settle without interest.** The Department's decision not to charge interest was reasonable in the context of reaching a settlement on several issues, but the Department should have checked the position on interest so that it could have made an informed decision on this issue.

**17 The definition of a package deal in the *Litigation and Settlement Strategy* requires each issue to be assigned a value. It does not prohibit settling the individual issues in a wider settlement on different terms than would be considered if the issue was settled by itself.** The Department updated the *Litigation and Settlement Strategy* in 2011. The updated version addresses this point by adding that each disputed issue should be considered and resolved on its own merits. However, it 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.

### Obtaining and acting on legal advice.

**18 The Department did not always need to seek legal advice before agreeing settlement terms. In one case, there was litigation ongoing but the Department did not consult its lawyers.** In most cases, there was no need to seek legal advice during the settlement negotiations. The issues were not in litigation and the negotiations were about technical or accounting issues, with which the Department's other relevant specialists were best placed to deal. However, litigation was in progress on the employer's NICs issue when company E and the Department met and agreed a settlement. The Department did not obtain legal advice on the settlement terms for this issue before agreeing it with the taxpayer.

**19 In negotiating the settlement with company C, the Department's Solicitor's Office gave legal advice orally, not in writing. Given the circumstances of the case, and the nature of the advice, the advice should have been confirmed in writing.** This advice was on an issue where the Department's action was reasonable, but it was not easy to find a technical legal basis to underpin it. This review confirms our conclusion in paragraph 2.36 of the C&AG's Report in July 2011 that it would have been appropriate to have had the advice in writing.

### Complying with governance processes

**20 The findings from the review of these five settlements confirm our concerns over the governance arrangements operated in these cases.** Although the settlements reached were reasonable, there was no clear justification for setting up alternative governance arrangements. All cases should have followed standard governance procedures, including being referred to the High Risk Corporates Programme Board. There should have been independent review of large settlements, and separation of roles in negotiating and approving settlements. We also confirmed that the Department did not always keep notes of key meetings, including meetings at which settlement terms were agreed in principle with taxpayers.

**21 The Department has acknowledged that its governance arrangements needed strengthening. It is introducing new arrangements to provide greater transparency, scrutiny and accountability.** The Department intends to appoint an assurance Commissioner, who will have to approve all settlement proposals over £100 million. The assurance Commissioner will have no role in individual taxpayer's affairs, so that their role as an independent check on settlements is not compromised. The assurance Commissioner will also review future settlements to check whether internal governance processes have been followed.

## Overall conclusion

**22** All five settlements were at least reasonable, and the overall outcome for the Exchequer was therefore good. There is a strong case for improving the processes for reaching these settlements, particularly separation of roles in negotiating and authorising settlements. It is not appropriate to set up specific governance arrangements, or to fail to apply processes correctly and there is a need for stronger assurance that the Department has applied its processes correctly. The Department has accepted this and is changing its governance arrangements. The *Litigation and Settlement Strategy* needs to better reflect the reality of settlements in complex cases where multiple issues are resolved.

## Recommendations

**23 The Department should update the *Litigation and Settlement Strategy*, or the guidance accompanying it, to make clear how cases involving controlled foreign companies are compatible with the *Litigation and Settlement Strategy*.** The Department negotiated a settlement that was not clearly compatible with the *Litigation and Settlement Strategy*, despite the outcome being reasonable. It may be clear to the Department's staff how cases involving controlled foreign companies comply with the strategy, but external observers may misunderstand it. This could undermine confidence in the appropriateness of the settlements reached.

**24 The Department should update the *Litigation and Settlement Strategy*, or the accompanying guidance, so that it sets out more clearly the extent to which it is acceptable to settle individual issues in the context of a wider settlement.** The Department has updated the *Litigation and Settlement Strategy* so that it now requires each issue to be resolved on its own merits and not as part of a package deal, but it could do more to recognise the potential interdependency of issues in these circumstances.

**25 The Department should ensure that lawyers are always consulted before finalising settlements on issues that are in litigation.** The Department negotiated a settlement on an issue that was in litigation without consulting its lawyers.

**26 The Department should explain more clearly to its specialist staff how settlements are reached, including, where appropriate, the rationale for the settlement terms on individual issues.** Some of the Department's specialist staff working on settlements had concerns about the appropriateness of the settlements reached. The Department did not do enough to address these concerns satisfactorily. The Department's revised governance arrangements, particularly appointing an assurance Commissioner, should also help to restore confidence that the settlements reached are appropriate.

**27 The Department should ensure that it makes clear to taxpayers that settlements agreed in principle should not be considered final until they have been through all relevant approval processes.** The Department held a meeting with a taxpayer at which a settlement proposal was reached. It did not tell the taxpayer that the settlement depended on further governance processes, and effectively bound itself to settling on the terms discussed in that meeting.