

# **More than you bargained for!**

Mark McLaughlin warns that lack of proof when HMRC challenges unidentified bank lodgements can prove costly.

Some individual taxpayers subjected to a self-assessment enquiry (particularly the self-employed) might find HMRC contending that their taxable income is higher than originally declared. For example, there may be bank deposits that cannot immediately be identified or explained.

## **Additional profits**

HMRC officers have a responsibility to exercise their best judgment when assessing the self-employed taxpayer to additional profits. In the absence of documentary evidence and/or a satisfactory explanation of the source of the bank deposits, the HMRC officer is likely to issue an enquiry closure notice and assessment of further tax. Penalties for careless behaviour (or possibly worse) are also likely.

HMRC's Enquiry manual highlights case law in support of the proposition that the onus is on the taxpayer to prove the source of additional assets (e.g. unexplained cash). For example, HMRC cites (at EM2104) *Kilburn v Bedford* Ch D 1955, 36 TTC 262. In that case, HMRC assessed a hairdresser for additional profits, whereas the taxpayer contended that the increases in his wealth were derived from betting winnings.

The High Court upheld HMRC's assessment, commenting (Harman J): "He alleged that these were betting winnings. It was for him to prove that but he really made no serious attempt to do so. The Commissioners merely had his statement. Other statements made by him and by his accountant showed that statements of his were quite unreliable. The Commissioners said: 'You have not discharged this burden and therefore the assessments must stand. They were under no duty to take any other course.'" Prove it It is therefore important for taxpayers to challenge such proposed income adjustments where appropriate before an enquiry into the relevant tax return is closed. This is because when an HMRC officer has closed the enquiry and made an assessment from the records and information available, the burden of proving that the assessment is excessive falls on the taxpayer.

By contrast, for discovery assessments it is generally accepted that HMRC has the burden of showing that a discovery has actually been made, the discovery assessment is valid, and that the assessing HMRC officer has used their best judgment to determine the amounts assessed and additional tax due (see EM3251).

## **Evidence is key**

Whether the taxpayer is seeking to rebut additional income assessed by HMRC on the closure of an enquiry, or HMRC is attempting to satisfy the burden of proof in an appeal against a discovery assessment, evidence to support their respective cases will often be crucial.

For example, in *Merchant v Revenue and Customs* [2020] UKFTT 130 (TC), following an enquiry into the taxpayer's self-assessment return for 2015/16, HMRC issued an income tax assessment. The taxpayer offered explanations about the amounts assessed. However, the First-tier Tribunal (FTT) considered that the appellant's explanations and evidence of the amounts shown in the table had been "replete with inconsistencies". The FTT commented that had a clear audit trail been shown by bank statements and the taxpayer's evidence was otherwise consistent, the lack of documentary evidence of the loans would not be determinative. However, that was not the case here. The taxpayer's appeal was dismissed.

## **Is it realistic?**

If an individual is self-employed and HMRC identifies unexplained income, it might not be unreasonable to attribute that income to the self-employment, in the absence of evidence to the contrary.

However, what if there is additional income but no readily identifiable source for that income (e.g. trading, rental, employment, etc)?

In *Ashraf v Revenue and Customs* [2018] UKFTT 97 (TC), HMRC opened an investigation focusing on the taxpayer's personal affairs, including his bank accounts and a Spanish property purchase. HMRC queried certain large credits and a shortfall in the taxpayer's declared income. HMRC concluded that there were 'deficits' in the taxpayer's finances. Discovery assessments (under TMA 1970, s 29) were subsequently made on the taxpayer for the tax years 2005/06 to 2013/14 inclusive, together with penalty determinations and assessments. The taxpayer appealed. The FTT was unable to see any description of the amounts of income charged by HMRC's discovery assessments. HMRC informed the FTT that they had not been able to identify an income source and had allocated the amounts to 'other income' and pointed out that ITTOIA 2005, s 687 charges tax on income sources not otherwise charged.

The FTT considered it was clear that section 687 did not apply to the deficit. HMRC had not identified any sources, and indeed had positively asserted that there were none outside those admitted by the taxpayer in his tax returns. HMRC had sought to rely on section 687 when they realised they needed to show a taxable source, but section 687 could not apply. HMRC's burden of proving that there was a loss of tax was not, on the evidence, capable of being discharged. The taxpayer's appeal was allowed. It was pointed out in *Ashraf* that the taxpayer was not entirely without fault, but the FTT added: "...we would have found there were substantial inconsistencies and difficulties with timing and credibility of many of the explanations for the

deficit. But that by itself is insufficient in the absence of a source, whether belonging to the appellant or one or more of his companies.”

### **HMRC's view**

HMRC updated its guidance (at EM3251) following Ashraf regarding the need for a compatible source on income to which unexplained amounts can be potentially attributed. If there is such a source, HMRC are not necessarily precluded from issuing an assessment due to insufficient evidence that the unexplained amounts emanate from that source. However, the ‘compatible source’ issue will arise where all identified sources of income have been ruled out as the source of the unexplained amounts.

Subject to any appeal, the Ashraf decision indicates that HMRC will be unable to proceed to issue assessments under the ‘other’ or ‘miscellaneous’ income charging provisions without a proper explanation.

### **Leave nothing to chance**

If there is a compatible source for unexplained amounts, it does not automatically follow that the receipts will be treated as undisclosed income from that source simply because the receipts cannot categorically be attributed to a non-taxable source.

For example, in *Bekoe v Revenue and Customs* [2017] UKFTT 772 (TC), the FTT held that there was no requirement for it to be certain that the appellant’s explanation of unidentified receipts was correct; it was merely necessary for the FTT to be satisfied on the balance of probabilities that the deposits in question were something other than undeclared income. However, it will clearly be preferable for the taxpayer to keep satisfactory evidence to substantiate that a particular receipt originates from a non-taxable source, in terms of avoiding the uncertain outcome of an appeal before the FTT against an HMRC assessment.

- Mark McLaughlin CTA (Fellow) ATT (Fellow) TEP is a consultant with The TACS Partnership LLP ([www.tacs.co.uk](http://www.tacs.co.uk)). He is also editor and a co-author of HMRC Investigations Handbook (Bloomsbury Professional)