

## Should we pretend?

*Mark McLaughlin looks at HMRC's use of the 'presumption of continuity' when assessing additional income for periods other than the period of enquiry.*

In tax return enquiries and investigations, where income or profits have been understated it is not uncommon for HMRC to assess additional tax not only the period under review, but also other periods based on the same understatement.

For example, a cash-based business owner who has understated turnover might find that HMRC assesses earlier (and/or later) tax years on the assumption that the individual understated their self-employment income in those other tax years as well.

### Spreading out

HMRC's practice of seeking to assess other years in addition to the tax year of enquiry is often referred to as 'spreading'; it is based on the 'presumption of continuity' (see HMRC's Enquiry manual at EM3236).

The presumption of continuity was expressed (by Judge Walton J) in *Jonas v Bamford* [1973] STC 519 as follows: "...once the inspector comes to the conclusion that, on the facts which he has discovered, the taxpayer has additional income beyond that which he has so far declared to the inspector, then the usual presumption of continuity will apply. The situation will be presumed to go on until there is some change in the situation, the onus of proof of which is clearly on the taxpayer."

However, HMRC accepts that in certain situations, there are potential limitations on the application of the presumption of continuity, such as when considering periods prior to the incorporation of a business.

### Contrasting fortunes

Tribunals have considered HMRC's attempts to apply the presumption of continuity to assessments outside the enquiry year in numerous cases.

For example, in *Allan v Revenue and Customs* [2016] UKFTT 504 (TC), the First-tier Tribunal (FTT) stated: "Once the threshold requirement is satisfied for there to be a 'discovery' of loss of tax, the presumption of continuity applies in the raising of assessments for earlier years"

More recently, in *Whitlock v Revenue and Customs* [2021] UKFTT 167 (TC), HMRC opened an enquiry into the taxpayer's self-assessment return for 2015/16. HMRC's enquiry was prompted because the return contained round figures (to the nearest £1,000) for income, expenses and profits from the taxpayer's business of removing household and garden rubbish.

Subsequently, HMRC amended the tax return for 2015/16 by increasing his originally declared turnover. In addition, HMRC noted that the appellant's earlier returns also tended to be in round numbers. According to the presumption of continuity it could be inferred similar under-declarations had occurred. Therefore, HMRC issued discovery assessments for earlier years in amounts based on the enquiry year 2015/16, adjusted for inflation in accordance with the retail price index.

The FTT noted the taxpayer's acceptance that not all cash receipts generated by his business were recorded as income. It was also clear that the taxpayer had carried out no detailed analysis of his income and expenses. The FTT concluded that the taxpayer under-declared his income for the tax years 2010/11 to 2015/16 inclusive and saw no reason why the presumption of continuity should be displaced.

Other cases in which the presumption of continuity was upheld include *Barreto v Revenue and Customs* [2017] UKFTT 101 (TC), *Whitlock v Revenue and Customs* [2021] UKFTT 167 (TC), and *Shariff v Revenue and Customs* [2021] UKFTT 256 (TC).

However, the tribunal has not always accepted HMRC's application of the presumption of continuity (e.g., *Chapman v Revenue and Customs* [2011] UKFTT 756 (TC), *Barkham v Revenue and Customs* [2012] UKFTT 499 (TC)) and *Aeroassistance Logistics Ltd v Revenue and Customs* [2013] UKFTT 214 (TC)). In *Syed v Revenue and Customs* [2011] UKFTT 315 (TC), the FTT stated: "In our view [Walton J's judgment in *Jonas v Bamford*] expresses no legal principle. It seems to us that it would be quite wrong as a matter of law to say that because X happened in Year A it must be assumed that it happened in the prior year." The FTT added: "This tribunal is not bound to conclude that what happened this year will happen next year."

### **Forwards or backwards?**

The presumption of continuity in *Jonas v Bamford* was expressed in the context of spreading forwards into later tax years. However, in practice HMRC often attempts to spread backwards as well.

Backwards spreading has been criticised in some cases (e.g., in *Chapman v Revenue and Customs* [2011] UKFTT 756 (TC)). On the other hand, backwards spreading has been approved in other cases, including in *Allan* as mentioned above.

Of course, decisions in FTT cases do not set a binding legal precedent (although they may be persuasive in similar cases). Until this point is finally decided either way at a higher level of jurisdiction, HMRC's attempts to spread backwards instead of forwards will no doubt continue to be challenged.

### **Fundamentally flawed?**

It is important to remember that any spreading adjustments in other tax years is based on the tax year or accounting period of HMRC's enquiry; if HMRC's adjustment for the enquiry period is wrong, the discovery assessments for other periods will almost certainly be wrong as well.

For example, in *Nelson v Revenue and Customs* [2019] UKFTT 36 (TC), the taxpayer was involved in an eBay business. The taxpayer and his wife were partners in the business, together with his father (MN). Following an enquiry into the taxpayer's self-assessment return for 2011/12, HMRC considered that two parallel businesses were being operated, one by the taxpayer and the other by MN. HMRC raised a discovery assessment for 2011/12, and assessments for five other tax years (i.e., 2007/08 to 2010/11 and 2012/13).

The discovery assessment for 2011/12 was based on an expenditure schedule provided by the taxpayer's wife. HMRC's assessments for the other five years relied on the presumption of continuity. The FTT found HMRC had wrongly decided that the taxpayer was running a second eBay business. As to the expenditure schedule provided by the taxpayer's wife (on which HMRC based their assessment for 2011/12), the FTT noted it was clear on the face of the document (and confirmed by the taxpayer's wife) that the expenditure was that of the taxpayer's family, not the taxpayer alone. The FTT held there was no basis for the application of the presumption of continuity, as the assessment for the 'base year' (i.e., 2011/12) was 'fundamentally flawed'.

### **Rebutting the presumption**

It will not necessarily be sufficient for HMRC to raise assessments for other tax years or accounting periods on the presumption of continuity without addressing those other periods and demonstrating that the circumstances resulting in the adjustment for the enquiry period were not 'one-off' but were the same (or similar) in those other periods.

For example, in *Barkham v Revenue and Customs* [2012] UKFTT 499 (TC), the FTT commented: "The presumption of continuity alone does not justify increases in assessments; the initial onus is on HMRC to show evidence in support of the making of the assessments. This would therefore be a limitation on the use of the presumption of continuity where previous year's accounts are sought to be reopened."

In conclusion, prevention is better than cure. Before HMRC can apply the presumption of continuity, it may be worthwhile attempting to resolve the matter without litigation by gathering all available evidence

for the tax year of the proposed adjustment, with a view to rebutting the presumption and persuading HMRC that the evidence supports a lower (or no) adjustment.

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