

Analysis

Ingenious Games and HMRC's allegations of dishonesty

SPEED READ Mr Justice Henderson (sitting in the Upper Tribunal) clarifies the rules which apply to litigants wishing to make allegations of dishonesty against their opponents' witnesses. When the burden is on the taxpayer to prove its case, HMRC can deploy allegations of dishonesty as part of its attempts to test the taxpayer's evidence without including them in their pleading and without giving advanced notice. However, professional duties and the rules of natural justice require that serious allegations must be put to the witness fairly and squarely, supported by evidence and the witness must be given the opportunity to rebut the allegations.



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The case of *Ingenious Games v HMRC* [2015] UKUT 0105 (reported in *Tax Journal*, 13 March 2015) is the second time that the Upper Tribunal has been asked to determine case management issues arising from the joined appeals brought by three LLPs operated by Ingenious Media Holdings Plc ('Ingenious Media'). This time, the issues arise from an application brought by the Ingenious LLPs to adjourn the First-tier Tribunal proceedings following developments in HMRC's arguments which were tantamount to allegations of dishonesty.

Before looking in detail at the Upper Tribunal's decision, it is worth taking a brief look at the context of the broader appeals.

Background

In 2012, HMRC issued closure notices to several investment vehicles operated by Ingenious Media, including Ingenious Games LLP (IG), Inside Track Productions LLP (IT) and Ingenious Film Partners 2 LLP (IFP2). Each of these LLPs involved large numbers of private investors becoming members, contributing capital, taking out loans from an Ingenious entity and putting those combined capital contributions and loan contributions towards various activities in the media industry to which they were directed. As the names suggest, IG was directed at video games; IFP2 (and IT) were directed at films (including, in IFP2's case, the highest grossing film of all time, *Avatar*). Each LLP claimed significant early losses and the investors, taking advantage of the partnerships' tax transparency, claimed sideways loss relief in amounts proportionate to the size of their investment. Many investors carried back their losses to previous years, resulting in substantial rebates of income tax which often equalled the amount of capital originally invested – in such cases, leaving the investors in a cash neutral position.

HMRC's closure notices issued to the LLPs

disallowed all losses claimed. While the closure notices were directed at the LLPs, the impact is felt by the investors who, if HMRC succeed, would have to repay the tax originally relieved. In fact, as a result of recently issued Partner Payment Notices, much of that tax has already been demanded and, subject to recent judicial review proceedings, will be repaid before the FTT decision.

The primary grounds for HMRC's conclusions are set out in para 9 of the UT decision. The disputed points include the now familiar HMRC arguments:

- that the LLPs were not carrying on a trade; and
- they were not operating 'with a view to a profit'.

If HMRC is correct on either point, the LLPs will not be treated as tax transparent under ITTOIA 2005 s 863(1), meaning that the investors will not be able to claim any losses incurred by the LLPs. The total amount of tax at stake, including interest, amounts to approximately £1bn (para 9). There are a number of other Ingenious LLPs which share the same characteristics, so the outcome in this case is likely to be felt more widely.

The FTT's case management decision

The appeals were listed before the FTT in November and December 2014 and adjourned over the festive break to be reconvened for some final witness evidence and closing speeches from 18 February. However, on the first day of the reconvened hearing the appellants applied for an adjournment because HMRC had served an evidence paper which effectively (though not directly) accused Ingenious witnesses (also executives) of dishonesty. The appellants' application to adjourn was made to the FTT 'to enable them to produce evidence to rebut the new allegations' (para 7). The FTT refused the application, but did grant the appellants permission to adduce further evidence, so long as they got it in before the witnesses were due to be heard (in practice, only a few days). The appellants appealed to the Upper Tribunal and HMRC cross appealed against the scope the further disclosure permitted by the FTT.

HMRC's allegations

HMRC's allegations were focused on the IFP2 information memorandum (IFP2 IM), a document prepared by Ingenious Media to market IFP2 to potential investors. HMRC's evidence paper stated that the IFP2IM 'contains inaccurate assumptions of which [three senior Ingenious executives] were or should have been fully aware'. The paper went on to say that 'the profit forecasts in the IFP2IM showed on any realistic view that IFP2 would be loss making' and, in summary, that Ingenious knew or ought to have known that this was the case. The obvious significance being that if the LLP was known to be loss making from the outset, it could not later be claimed to have been operated with a view to a profit.

Further detail is set out in paras 21–27. HMRC relied on a spreadsheet referred to as 'LS202' which formed the basis of the financial illustrations in the IFP2 IM. That spreadsheet included certain assumptions; one such assumption related to the

costs of DVD sales and was recorded in LS202 as 23%. HMRC alleged that the correct figure, used by Ingenious in other examples, was 35% and when tracked through the spreadsheet, that put IFP2 into loss rather than profit.

HMRC also focused on the profit forecasts in LS202, which proposed that 72% of IFP2's profits could be made on non-production activities which were supposed to be low risk; whereas only 28% of its profits were to come from high risk film production. HMRC argued that 'if Ingenious could obtain high rates of return on low risk investments it is difficult to see why Ingenious would have bothered with the high risk activities at all. An issue also arose in relation to the late disclosure by Ingenious of 10,000 pages of notebooks after their existence came to light in cross examination.

It is noteworthy that, with the possible exception of the issue on the notebooks, these points appear to arise in the sole context of IFP2. As noted above, these appeals also deal with IG and IT and stand as effective lead cases in relation to several other Ingenious Media operated schemes. It is unclear from the judgment whether HMRC intend to raise issues of dishonesty against the appellants/Ingenious Media more generally or only in relation to IFP2.

The issues before the Upper Tribunal

The appellants' grounds of appeal (which were amended significantly from their initial simple request for an adjournment) were that HMRC cannot make allegations of dishonesty or other serious forms of misconduct unless those allegations are *pleaded* in advance and the appellants are given proper opportunity to respond (para 59).

HMRC's cross appeal was on a comparatively minor point that the FTT's directions allowed the appellants to disclose additional evidence which ought to have been disclosed much earlier. In fact, neither HMRC nor the appellants were content with the case management directions handed down by the FTT for a number of reasons (nor was Mr Justice Henderson), so these issues were dealt with briefly and were largely uncontested.

The decision

Mr Justice Henderson's decision highlights the distinction between:

- appeals in which HMRC must make out a positive case that the taxpayer is dishonest; and
- appeals where the burden of proof lies on the taxpayer to prove that HMRC's conclusions in their closure notice are wrong.

In this case, the burden of proof was on the taxpayers and they put forward the IFP2IM as evidence in support of their case that IFP2 was operating with a view to profit. In these circumstances, it is not necessary for HMRC to plead their allegations, nor is it necessary to give the taxpayers advanced notice that they intend to make them. HMRC's allegations of dishonesty were simply part of their attempts to test and discredit the taxpayer's evidence as part of the cross examination process.

The answer would have been different had the

burden of proof been on HMRC to make out a positive case that the taxpayer was dishonest. One area of cases where the burden of proof is on HMRC is MTIC fraud. In those cases, HMRC would need to plead allegations of dishonesty in their statement of case and failure to do so may well result in the tribunal striking them out.

However, HMRC was not free from criticism.

Separate issues arose in the context of professional duties and the rules of fairness and natural justice. These rules prevent counsel from 'making allegations of dishonesty unless they have clear instructions to do so and have reasonably credible material to establish an arguable case of fraud'. Further, a court or tribunal can only make a finding of dishonesty against a witness if 'the allegation has been put to him fairly and squarely in cross-examination, together with the evidence supporting the allegation, and the witness has been given a fair opportunity to respond to it'. HMRC had not satisfied these rules to date which meant that the FTT was at present unable to make findings on these issues. As Mr Justice Henderson put it: 'I am sure unintentionally, the impression given to a neutral observer by some of HMRC's exchanges with the FTT could be one of ambivalence, even at times evasiveness, and a willingness to wound but not to strike, in an area where openness and clarity should be at a premium unless HMRC had some good reason for wishing to spring a surprise on an unsuspecting witness' (para 76).

Mr Justice Henderson therefore dismissed the taxpayers' appeal, holding that HMRC was free to make the allegations, but it must satisfy the criteria which would enable the tribunal to make findings on those points. He re-made the FTT's order for directions, ordering the following:

HMRC to produce a document clearly making out their allegations of dishonesty against the three individuals in question;


- each of the three witnesses to be recalled for further cross-examination; and
- prior to reconvening the FTT for the above, the appellants (and the witnesses) are to be allowed to adduce further evidence solely in relation to the allegations of dishonesty.

Unfortunately, these case management steps carry a necessary delay, which is likely to push the reconvened hearing back by several months.

Where does this leave us?

The legal issues raised in this appeal are not new, but the decision serves as a useful reminder to highlight the requirements which litigants must satisfy when making serious allegations against witnesses.

It should be noted that the FTT's findings on points of dishonesty will be findings of fact – findings which are extremely difficult to overturn on an appeal which will be limited to points of law under the Tribunals, Courts and Enforcement Act 2007 s 11. This case management decision and the resources expended on it by the appellants (who instructed no fewer than six barristers, two of whom are senior QCs) highlights the importance that the FTT's findings of fact will have on the ultimate outcome of these appeals. ■

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Cases: *Ingenious Games v HMRC* (11.3.15)

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Culpable conduct (Robin Mathew, 14.11.05)