[2018] UKFTT 355 (TC)

TC06569

Appeal number: TC/2016/03014

INCOME TAX – profits of a trade – barrister's income from work done pursuant to conditional fee agreements – adjustment profits to the earnings basis – appeal against closure notice allowed in principle – appeal against discovery assessment allowed

FIRST-TIER TRIBUNAL
TAX CHAMBER

SIRAJ AHMED	**Appellant**
- and -	
THE COMMISSIONERS FOR HER MAJESTY'S REVENUE & CUSTOMS	**Respondents**

TRIBUNAL: JUDGE JONATHAN CANNAN

Sitting in public in Manchester on 5 April 2018

The appellant appeared in person

Mr Tony O'Grady of HM Revenue & Customs appeared for the Respondents

DECISION

Background

1. The appellant is a practising barrister. This appeal concerns the basis on which the appellant has accounted for income in tax years 2010-11 and 2012-13. If the appellant is successful in his appeal in relation to those tax years, HMRC accept that an adjustment will be required in relation to tax year 2011-12 in relation to which there is presently no appealable decision.

2. The issue between the parties, at least up to the date of the hearing, was the treatment of the appellant's income in respect of conditional fee agreements ("CFAs"). In particular, the basis period in which the income should be recognised.

3. Where the appellant has carried out work pursuant to a CFA it is common ground that no income is to be accounted for until a fee becomes payable, in other words when the case has been successfully concluded. The appellant made no adjustment in his accounts for CFAs where the case had been successfully concluded before the end of the basis period but where payment of fees had not been made.

4. There was no dispute as to the relevant statutory provisions. The real issue is as to the application of those provisions to the particular circumstances of the appellant.

5. *Section 25(1) Income Tax (Trading and Other Income) Act 2005* provides as follows:

> " The profits of a trade must be calculated in accordance with generally accepted accounting practice, subject to any adjustment required or authorised by law in calculating profits for income tax purposes."

6. The effect of that provision is that profits must be calculated on the earnings basis rather than the cash basis, in other words on income earned rather than cash received. There are special rules for barristers in the early years of practise but those rules are not relevant for present purposes.

7. In applying the earnings basis, any debtors at the period end which have yet to be paid or settled must be brought into account in the calculation of income. The application of the statutory provisions is helpfully summarised in the Bar Council "Taxation and Retirement Benefits Guidance" 7th edition which states as follows:

> " 40. Accounting practice requires the following:
>
> a. profits are the profits earned for the year, not cash received in the year
> b. a net increase in debtors (closing debtors – opening debtors) constitutes income, which must be included in profits. A net decrease will conversely be a reduction in income and hence will reduce profits.

…

41. …

42. For completed work at year end, a barrister has to bring in the fee that is reasonably expected to be received (whether or not billed). For incomplete work, the barrister must make a reasonable assessment of the amount earned so far.

Particular situations

Conditional Fee Agreements and Damages-based Agreements

43. In the case of agreements where payment is contingent on outcome, no right to consideration arises until the contingency occurs (i.e. the case is won). In those circumstances, no amount can be brought into account until the result of the case is known."

8. A note to paragraph 42 of the Bar Council guidance refers to Urgent Issues Task Force 40 ("UITF 40"), published by the Accounting Standards Board. UITF 40 deals with the reporting of profits by service providers and provides at [19] that:

> " Where the substance of a contract is that a right to consideration does not arise until the occurrence of a critical event, revenue is not recognised until that event occurs. This only applies where the right to consideration is conditional or contingent on a specified future event or outcome, the occurrence of which is outside the control of the seller."

9. There was no dispute between the parties that the guidance set out above properly reflects the statutory requirements in relation to the recognition of income by barristers. Where a barrister works on a "no win, no fee" basis, revenue should not be recognised until a case has been won. Only at that stage does the barrister have a right to the fee.

10. The issue in the present case is essentially one of timing. The appellant has paid or will pay tax on all his income, but the respondents contend that the tax was due in earlier tax years to those in which it was taken into account. The appellant contends that the respondents are wrongly seeking to tax him in relation to ongoing CFA cases where no fee was payable at the end of the relevant basis period.

Findings of Fact

11. On 2 October 2012 HMRC opened an enquiry into the appellant's self-assessment return for tax year 2010-11. In the course of correspondence, the accountants acting for the appellant acknowledged that the accounts had been prepared on the cash basis with no adjustments. The reason for this was said to be because the majority of the appellant's work was carried out on a contingent fee basis.

12. The officer conducting the enquiry considered that the appellant had wrongly been using the cash basis in calculating his profits for the basis period which ended on 31

March 2011. Following correspondence, the officer focussed his enquiry on CFA cases in which the appellant had been instructed. In a letter to the appellant dated 23 April 2014 he wrote:

> " I am writing to you direct in respect of the question of earning recognition, and in particular in respect of your income arising from Conditional Fee Arrangements (CFAs).
>
> Conditional Fee Arrangements
>
> … Not recognising any of the CFAs as earnings means that the accounts are not prepared under UK [Generally Accepted Accounting Principles] as recommended at Paragraph 13a of the Bar Council Guidance."

13. The officer took the view that there must be some cases where the result was known at the end of the basis period but where payment of the fee had not been made. Rather than review each case individually, the officer went on to make an estimate of the income which fell due for payment before the end of the basis period but which was not paid until after the end of the basis period.

14. In order to make his estimate the officer took total debtors recorded by the appellant as at 31 March 2010. He then looked at the ratio of payments made to the appellant in the 3 months following that date to the debtors recorded as follows:

$$\frac{\text{Fees received in period 1 April 2010 to 30 June 2010}}{\text{Total debtors as at 31 March 2010}}$$

$$\frac{£34,796}{£305,398} = 11.4\%$$

15. The officer then reduced the total debtors as at 31 March 2010 by those debtors which were then more than 12 months old to reflect information provided by the appellant's accountant that any debtors more than 12 months old were unlikely to be recovered. The debtors as at 31 March 2010 which were less than 12 months old amounted to £186,450 and applying the percentage to those debtors gave a figure of £21,255. This figure appears to represent what the officer considered to be the adjustment to opening debtors for 2010-11 to reflect CFA cases as at 1 April 2010 which ought to have been recognised as income in the previous year.

16. A similar adjustment was then made to the closing debtors less than 12 months old as at 31 March 2011, giving a figure of £29,995. The net adjustment of £29,995 less £21,255 was said to represent income which should have been treated as taxable profits for 2010-11 but which had instead been treated as taxable in 2011-12. Similar calculations produced the following adjustments to net profits for the three relevant years as follows:

Tax Year	Adjustment

	£
2010-11	8,740
2011-12	9,066
2012-13	25,774

17. Initially the appellant's accountants indicated that the appellant was prepared to accept these adjustments as an estimate of fees in relation to CFAs where the cases had been won before the year end but in respect of which payment was not received until after the year end. I must say I struggle to understand how the calculations give such an estimate. In particular, why the proportion of fees paid in the three months following a year end to the debtors less than 12 months old at the year-end is a reliable proxy for fees in CFA cases won before the year end but not paid until the following year.

18. The difficulty can be illustrated by considering what the figure of £34,796 used in the calculation actually represents. It is all fees received by the appellant in the 3 months following the year end. It includes all fees received on non-CFA work, on CFA work where the case has been both won and paid in that period and on CFA work where the case has been won on or before 31 March 2010 but not paid until after that date. Indeed, when the officer first set out his calculations he acknowledged that they included "private fees", although it is not clear what he meant by that, and whether he used the term to distinguish non-CFA cases.

19. Even if all the payments were assumed to be payments in respect of CFAs, the proportion of CFA payments in the 3 months following the year end to the total amount of debtors says nothing about when the CFA payments fell due. Similarly, applying the resulting percentage of 11.4% to debtors less than 12 months old does not in my view give a meaningful figure.

20. The officer has since retired and was not available to give evidence. In the light of his approach it is not clear whether he understood the nature of the appellant's practice. The appellant's work at the Bar involves common law work, and the majority but not all of his work is done on a conditional fee basis. The appellant will not know whether a fee is payable until the case in question is determined by a court, or the case is settled.

21. I was not shown any examples of CFA agreements or background documentation in relation to any CFA case conducted by the appellant. It would have been helpful to see such evidence. In the circumstances, I invited the appellant to describe the types of cases he was instructed in and how they might be resolved resulting in the payment of his fees. The following scenarios involving CFAs where identified:

> (1) A straightforward case in which the appellant advised on quantum in respect of personal injury. There might be a fixed fee of £150 + VAT.
>
> (2) A less straightforward case where breach of duty was admitted, but causation and quantum were in issue.

22. The appellant accepted that in Scenario 1 if the case was won before the year end but the fee remained outstanding then it should be accounted for as income in that year.

23. In Scenario 2 the appellant maintained that entitlement to the fee under a CFA would be triggered only where breach, causation and quantum were all established.

24. In any case the appellant may not be made aware that a particular case has been won until the solicitor sends a cheque for his fees. It may be that the solicitor will call the appellant's clerk to say that the other side are only willing to pay a certain percentage of the appellant's fees and asking whether the appellant be prepared to accept that percentage. The appellant said that 9 times out of 10 he will take what is on offer.

25. As and when the appellant does work on a particular CFA case his clerks will send a fee note to the instructing solicitor. The fee is not payable until the case is won. The appellant's clerks will also chase recovery of outstanding fees, which involves sending fee notes by way of reminder every few months.

26. Where a CFA case is resolved successfully in relation to liability, there may still be issues as to quantum. Even where issues as to liability and quantum have been resolved, the appellant's fees may still be challenged. His fees may be challenged in their entirety, for example with an argument that it was not necessary to instruct counsel. Alternatively, the amount of the fee may be challenged in which case a detailed assessment of costs may be necessary in default of agreement. A detailed assessment of costs could take up to 6 months.

27. The evidence before me included a debtors report showing the appellant's debtors as at 31 March 2010, with a breakdown on a case by case basis. The total debtors amounted to £305,398. In relation to each case, the age of the debt was identified as 0-6 months, 7-12 months and 13+ months. The total of debtors aged 0-12 months was £186,450. These are the figures used by the officer in his calculations.

28. There was also an analysis of debtors as at 31 March 2010 which were paid in the 3 month period 1 April 2010 to 30 June 2010. The total payments were £34,796. For example, this included a payment on one case of £150 received on 1 April 2010. That case must have been won prior to 1 April 2010 although I accept that the appellant would not necessarily know that the case had been won unless the information was volunteered by the instructing solicitor prior to payment.

29. Closer inspection of the analysis of payments reveals that for each case the appellant's accounting system identifies the "type" of case. The following table sets out all the references and meanings, together with the amount of fees paid by reference to each type of case. It can be seen that CFA receipts amount to approximately 56% of total receipts in that period.

Case Type	**Meaning**	**Total Payment £**

CV-PR	Civil private	6,180
CV-IM	Immigration	1,833
CV-CF	CFA	19,496
FA-LA	Family Local Authority	4,881
CV-IN	Instructed by Insurer (not CFA)	2,406
TOTAL:		34,796

30. It became clear during the hearing that for a number of the cases included within those payments the work had been done and billed on or before 31 March 2010. Some of these were not CFA cases. For example, there was a payment in respect of Halton MBC for Family Local Authority work of £4,046. This was not a CFA case, but the appellant had not recognised the income in 2009-10 as he should have done.

31. A closure notice was sent to the appellant on 26 January 2016. The effect of the closure notice was to increase the appellant's taxable profits for 2010-11 by £8,740. A notice of assessment in relation to 2012-13 was also sent to the appellant dated 25 January 2016. The assessment charged to tax additional profits of £25,774.

32. No penalties were imposed. In a letter dated 4 September 2015 the officer had stated: "I deem the behaviour to be classed as a mistake despite taking reasonable care and therefore no penalties will be charged".

Reasons

33. The appellant's notice of appeal was lodged with the tribunal on 10 May 2016. The grounds of appeal are as follows:

> "We have obtained Bar council guidance and advice on the recognition of conditional fee arrangements and we do not believe that debtors on this type of work should be recognised until payment has been received. We are aware of the opinion that the outcome of what will be received for my client will only be known very close to the time that payment is received."

34. I am satisfied that the appellant made no adjustments to reflect the earnings basis of taxation in the tax years 2010-11, 2011-12 and 2012-13. The respondents' closure notice and the discovery assessment issued to the appellant sought to rectify this omission. One difficulty with this case is that in so doing the officer sought to identify and charge to tax adjustments to the appellant's trading profits solely by reference to his treatment of CFA income. I was referred to a small selection of correspondence although the hearing bundle indicates that there was a considerable amount of correspondence. It is difficult for me to see why the officer focussed on the CFA cases. It appears, at least in 2009-10 which was not a year for which there has been any amendment or assessment, that the appellant had non-CFA income for which he failed to account on the earnings basis. The example given above is for fees in connection with Halton MBC.

35. It was the appellant's treatment of his CFA income that formed the basis on which the respondents issued the closure notice and the discovery assessment. Further, the appellant in this appeal has challenged the respondents' treatment of his CFA income. The focus of the parties' submissions in their skeleton arguments and at the hearing was on the CFA income.

36. Mr O'Grady submitted that the adjustments made by the officer were about as reasonable as one could estimate. I do not accept that submission. I consider that there are justified criticisms to be made of the basis on which the respondents sought to estimate CFA cases which had been won by the year end but which had not been paid:

(1) Payments made in the three months following the year end and relied on by the respondents included not only payments in connection with CFA cases but also a significant amount of payments made in connection with non-CFA cases.

(2) The method of calculation does not provide any sort of proxy or give any reliable estimate for the amount of CFA cases paid after the year end which had been won before the year end.

37. Those criticisms are fundamental to the nature of the exercise which the officer was seeking to perform. It seems to me that there was at least one obvious approach to take to adjust the appellant's accounts so that they properly reflected the earnings basis. Using the payments schedule for the 3 months following the year end, it is easy to identify non-CFA cases which had been billed before the year end and which were paid after the year end. That income would be properly taxable in the year prior to payment. In relation to the CFA income, each case or a sample of cases could be looked at to consider when as a matter of fact the case had been won so as to trigger the right to payment. It would then be straightforward to identify what proportion of all payments received in the 3 months following the year end should properly be accounted for as earnings in the tax year prior to payment. For the purposes of the enquiry, the respondents could have looked at each relevant year end and carried out a similar exercise, or extrapolated using the figures for 31 March 2010 and payments in the following 3 months.

38. I am satisfied that as a result of the approach taken by the officer the closure notice and the discovery assessment are both likely to overstate the adjustment necessary to take into account CFA income paid in 2011-12 and 2013-14 which should have been treated as earnings in 2010-11 and 2012-13 respectively. However, the appellant has not satisfied me that no adjustment was necessary. There may well be instances of payments in relation to CFAs where a case has been won before the year end triggering entitlement to the fee, with payment only occurring after the year end. It may be that it is right not to take into account such instances if they would not materially affect the accounts. However, on the evidence before me I cannot say what adjustments ought to me made.

39. The appellant submitted that even where a case had been won on a CFA, there would still be uncertainty as to what fee would be recovered. However, that does not affect the need to account for the income in the year in which the right to payment

arises. Any doubt as to the amount of any fee that would be recovered is a matter of judgment. A best estimate of the fee that has been earned would have to be made.

40. The appellant also contended that HMRC were acting inconsistently in relation to revenue recognition by barristers compared to solicitors. There was no reliable evidence before me that is the case. In any event, there was no dispute between the parties as to the appropriate principles to be applied in relation to revenue recognition. The real issue on this appeal is whether the appellant has applied those principles correctly in recognising income from CFAs in the correct basis period.

41. Mr O'Grady who appeared for the respondents accepted that in relation to the discovery assessment for 2012-13 there was a burden on HMRC to establish that one of the conditions for making a discovery assessment pursuant to *section 29 Taxes Management Act 1970* ("TMA 1970") had been satisfied. He relied on section *29(4) TMA 1970* which on the present facts requires HMRC to establish that the appellant had carelessly failed to make any adjustment to his profits for 2012-13.

42. Mr O'Grady submitted that the appellant should have been aware of the need to make an adjustment to reflect the earnings basis on which he was required to prepare accounts. As such he was careless.

43. The appellant justifiably points out that the respondents' case on carelessness has never properly been set out. Even now, the facts and matters that the respondents rely on to justify carelessness have not been particularised. No case on carelessness was put to the appellant during his evidence. Further, the only reference to carelessness in the documentation I have seen is in relation to penalties where the officer expressly acknowledged that whilst the appellant had made a mistake he had taken reasonable care.

44. In those circumstances it would not be right for me to make a finding of carelessness on the part of the appellant. The respondents have not satisfied me that they were entitled to make a discovery assessment. The appeal against the assessment for 2012-13 is therefore allowed.

45. Returning to the appeal in relation to 2010-11, I shall allow the appeal in principle. I have found that the adjustment in the closure notice was overstated but that the evidence before me does not enable me to say what, if any adjustment ought to have been made. The parties will now have to consider what if any adjustment ought to have been made by the appellant to reflect CFA income received in 2011-12 which ought to have been treated as earnings in 2010-11. If the parties are unable to agree that adjustment then either party may apply to the Tribunal within 90 days of the date of release of this decision for the Tribunal to determine the adjustment.

Conclusion

46. For the reasons given above the appeal against the discovery assessment is allowed and the appeal against the closure notice is allowed in principle.

47. This document contains full findings of fact and reasons for the decision. Any party dissatisfied with this decision has a right to apply for permission to appeal against it pursuant to Rule 39 of the Tribunal Procedure (First-tier Tribunal) (Tax Chamber) Rules 2009. The application must be received by this Tribunal not later than 56 days after this decision is sent to that party. The parties are referred to "Guidance to accompany a Decision from the First-tier Tribunal (Tax Chamber)" which accompanies and forms part of this decision notice.

JONATHAN CANNAN
TRIBUNAL JUDGE

RELEASE DATE: 27 JUNE 2018