

Tax: alternative dispute resolution

Latest Update

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In 2012, following an internal review of tax disputes and their outcomes, HM Revenue & Customs ("HMRC") introduced the application of alternative dispute resolution ("ADR") procedures including the use of facilitative mediation in the resolution of certain tax disputes.

Overview of Topic

1. HMRC's Litigation and Settlement Strategy ("LSS") was first published in 2007 but revised with a refreshed version and a 47 page commentary in April 2012. It sets out a framework for achieving a fair and even handed resolution of tax disputes which are defined very widely as being any difference of view of what is the "right tax at the right time".
2. HMRC also published extensive guidance to HMRC staff on the use of ADR in large and complex cases and established a dispute resolution unit ("DRU") to develop an ADR program and review the LSS.
3. During 2012, the DRU has run a number of pilot studies to introduce ADR techniques to tax disputes applying the extensive guidance set out in the LSS Commentary and ADR Guidance.
4. The three core principles are: maximising revenue; reducing costs; and improving customer experience. Underpinning all three principles, is the adoption throughout the process of a more collaborative approach.
5. The ADR Guidance covers what sort of cases are (and are not) suitable for ADR, who within HMRC decides whether or not ADR is appropriate in a particular case, describes the typical ADR timetable and process issues and has a number of useful annexes containing more detailed guidance and templates to assist the process.

Key Acts

Commissioners for Revenue and Customs Act 2005 - s.5 sets out HMRC's powers of collection and management of revenue which is the statutory basis for the LSS and the ADR initiative.

Key Subordinate Legislation

Tribunal Procedure (First-tier Tribunal) (Tax Chambers) Rules 2009/273, rule.3(1)(a) empowers the Tax Tribunal to bring to the attention of the parties the availability of ADR procedures and to facilitate their use.

Key Quasi-legislation

None.

Key European Union Legislation

None.

Key Cases

Al-Fayed v Advocate General for Scotland [2004] S.T.C. 1703

Key Texts

www.hmrc.gov.uk/complaints-appeals/how-to-appeal/adr.htm HMRC's website link hosting the "refreshed" LSS, its Commentary and ADR Guidance together with other material published by HMRC on related dispute resolution issues

Discussion of Detail

Background

1. In 2007, HMRC published their LSS. It was a five page document setting out their strategy for how they would exercise their care and management powers in respect of the collection of tax where there was a tax dispute. It set out the circumstances and parameters in which a dispute would be settled without recourse to litigation and those in which litigation would be the inevitable end result.

2. The principal objective was to provide a level playing field for HMRC's approach to disputes - treating all taxpayers the same and even-handedly. No longer would "deals be done"; nor compromise agreements reached by "splitting the difference". There would need to be some tenable legal basis for reaching a settlement agreement without requiring a judicial determination to make such a result good in law and not vulnerable to being treated as ultra vires (*Al-Fayed v Advocate General for Scotland* [2004] S.T.C. 1703).

3. Although the objective and principles were sound and the LSS itself stated that issues should be resolved in a non-confrontational and collaborative way, the absence of any accompanying guidance or HMRC staff training as to how, in practice, the LSS would or should be administered, resulted in the perception - some say the reality - that HMRC adopted a strict and aggressive approach and were "litigation hungry". As Dave Hartnett, then HMRC Permanent Secretary for Tax, said in a Financial Times interview (August 2010):

 ""We got it a bit wrong in the way we explained it to our people. They thought it was a great sword of justice.""

4. In 2009, after an extensive review, HMRC published an internal 86 page Report "Improving Dispute Resolution - report of the review of tax disputes" containing some 35 recommendations. These included the need to focus on working relationships with customers and their agents / advisers; greater clarity of the roles of HMRC officers in resolving the ambiguity on decision making powers within HMRC; and the need to spend more time on establishing the facts and moving to resolution rather than focusing on debating principles. To illustrate this point, the writer was involved in one case where the CRM had said to the Tax Director of a large multinational that HMRC "does not work to suit the customer's own timetable", a reaction which the HMRC Director of Large and Complex Business at the time said was a disproportionate reaction, far removed from HMRC's declared approach.

5. The recommendations in the Report also contained a proposal to consider the application of Alternative Dispute Resolution ("ADR") techniques including the use of mediation in resolving tax disputes.

6. ADR has been firmly established in commercial litigation as an effective means of resolving such disputes, and there is now a requirement that parties consider its application before resorting to judicial means - the courts or arbitration - for resolution. And it is also used in other areas of conflict (eg family and workplace disputes).

7. Could it be used in a tax dispute? The dynamics here are very different. Fundamentally the disagreement is between a private individual or entity and the State; not between commercial entities or private persons.

8. The Report received support from Ministers and senior HMRC officials and a Dispute Resolution Unit ("DRU") was established to develop an ADR programme and review the LSS.

9. In 2011, the DRU devised two pilot studies to introduce ADR techniques to tax disputes: the first one covered over 150 disputes in direct and indirect tax involving small and medium sized businesses: the second, comprised 15 large or complex business cases.
10. The pilot studies used the application of mediation techniques involving a third party to facilitate the discussion between taxpayers and HMRC officials concerned with the case. In the majority of small and medium sized business cases, the facilitator was an HMRC officer trained in mediation techniques but with no previous involvement in the case.
11. At the same time, the original LSS was "refreshed" and in June 2011 republished in draft together with 45 pages of guidance.
12. That publication was accompanied with 47 pages of draft guidance to HMRC staff on the use of ADR in large or complex cases (and was followed with a comprehensive training programme later that year for senior HMRC staff).
13. The "refreshed" LSS and its guidance was more balanced and less strident in tone. It identified three core principles being the keys to change: maximising revenue; reducing costs and, perhaps surprisingly, improving customer experience. It is this last core principle which is fundamental to producing a shift in approach on the part of HMRC to dispute resolution in its widest sense.
14. The "refreshed" LSS therefore had, at its heart, the need for a collaborative approach to disputes right from the start with a range of ADR techniques playing a key role in their resolution.
15. In an article in Tax Journal at the time (April 2010), Dave Hartnett had said:

""Behavioural changes are needed to make ADR work well. Taxpayers have to change, their advisers have to change, the tax administration has to change most."
LSS and its Commentary (in its refreshed version)
"
16. The final version of the LSS and its commentary was published in April 2012. It sets out a framework for achieving a fair and even handed resolution of tax disputes. In its scope and purpose, it defines a "dispute" as any "disagreement" or "argument" which clearly goes wider than issues which are in a formal dispute process.
17. It defined a tax "dispute" very widely: any difference of view of what is the "right tax at the right time" and covering enquiries into return, audit, pre-return work (pre- / post-transactions), and HMRC's legal interpretation. Significantly, the guidance expressly

stated that:

""HMRC does not have a monopoly on understanding how tax law applies to a particular set of facts.""

18. It offers guidance to HMRC staff on techniques for minimising the scope for disputes, how to engage in them; and handle them, describing in s.5 (on page 17) the concept of "collaborative working" with the benefits to be derived from fostering a non-confrontational approach. There is then a whole section on how to resolve disputes and the approach to litigation.

ADR And Its Guidance

1. Although the final version of the ADR Guidance was also published in June 2011, it was updated earlier this year for the reasons set out below and republished along with a suite of other guidance on related dispute resolution issues in January 2013. (www.hmrc.gov.uk/complaints-appeals/how-to-appeal/adr.htm)

What Is ADR?

1. The essence of ADR is that a third party is brought in with the agreement of both parties either to determine the dispute (as an arbitrator) or facilitate a bilateral agreement (as a mediator).
2. In the context of a tax dispute, however, ADR has focused on mediation including facilitated discussions - both of which are forms of Collaborative Dispute Resolution ("CDR") - rather than arbitration which is part of the judicial court process.
3. This article describes the processes involved in mediation and facilitated discussion in more detail below.
4. The use of ADR in commercial disputes is well established and its acronym - ADR - well known, although the word "alternative" is a bit of a misnomer, certainly in the context of tax disputes, where the word "appropriate" would be more representative of the process involved and reduce the risk of any suggestion it produces special arrangements at the margins of (or beyond) the scope of the LSS and the discretionary "good management" powers of HMRC and the recently established Governance Protocol.
5. The ADR guidance is primarily aimed at providing practical guidance to HMRC staff on the use of ADR in large and complex cases. However, as a published document it provides taxpayers and their advisers with a comprehensive description of how HMRC sees this

policy operating and applies in practice to all tax disputes with all taxpayers.

6. Its 47 pages cover what sorts of cases are (and are not) suitable for ADR and who within HMRC decides whether or not ADR is appropriate in a particular case.
7. It also describes the typical ADR timetable and process issues and has a number of useful annexes: a template for HMRC to notify the DRU of a potential ADR case ([Annex 1](#)); HMRC's checklist for ADR cases ([Annex 3](#)); model Facilitation and ADR Process Agreements ([Annexes 2 and 4](#)); a protocol for facilitated discussions ([Annex 5](#)); and some worked examples ([Annex 6](#)).

Where ADR Might (And Might Not) Be Suitable

1. ADR can apply to a dispute in respect of any of the range of taxes and for any taxpayer from large multinationals to small and medium sized enterprises, sole traders, partnerships and private individuals.
2. ADR can be particularly useful in the following circumstances where:
 - a. the parties are unclear or unable to articulate the points in dispute;
 - b. the parties have taken entrenched views or relationships have become strained;
 - c. there is a dispute over facts (particularly in fact heavy cases);
 - d. there is no dispute over any technical analysis but the parties need to agree the methodology to quantify liability;
 - e. there are "non-tax" issues with no precedent value or wider impact.
3. The circumstances in which ADR would not be suitable is where:
 - a. the resolution of the disputes could only be achieved by departure from an established "HMRC" view on a technical issue;
 - b. there is doubt over the strength of evidence and HMRC wants to test it by

cross-examination at a tribunal;

- c. an issue needs to be clarified judicially so that the precedent gained can be applied to other cases; and also
 - d. the customer does not appear to be working collaboratively with HMRC.
4. This last point goes to the fundamental question of trust (and the level of trust needed) between the parties.
 5. HMRC is scheduled to publish a Report on the pilot studies in June 2013 and is expected to announce that ADR will now be a permanent feature of the LSS programme with HMRC developing a "business as usual" model and a further refinement of the dispute resolution guidance and published materials.
 6. The 15 cases which comprise the Phase 1 pilot study (2011/12) for large and complex cases are now all settled (or withdrawn) with the target for the Phase 2 pilot study (2012/13) of 50+ cases being well on the way to being achieved. 25 cases have been completed (20 have been successfully resolved and five withdrawn) and 43 other cases are in progress.
 7. For the SMEs (and individuals) pilot study, around 450 invitations / applications were received with a 70% acceptance rate of which almost 70% were either fully or partially resolved through the ADR process.

When Is The Best Time To Engage The ADR Process In Any Disputes?

1. The most frequent situation in which ADR can offer the best way forward is where it appears to either or both parties that little progress has been made despite their best collaborative attempts to do so or even because of the absence of genuine collaboration "best practice" as set out in the LSS Commentary (see s.5 "what is collaborative working" at page 18).
2. Unless the case is one which has elements which make it unsuitable for ADR (see above) the introduction of an independent third party trained in mediation techniques can be the very catalyst to bring the parties together.
3. Although the ADR Guidance appears to suggest there is a rigid structure to the process, in fact there is no reason why either party, taxpayer and HMRC officer, cannot between them seek to re-engage in a matter that has stalled, adopting the collaborative working "best practice" guidance set out in the LSS Commentary. In this respect, ADR is only part of a

continuum in the new CDR holistic approach to dispute resolutions

4. However, there are many situations where the involvement of a third party "neutral" person, independent of the dispute, can be the very catalyst to produce that re-engagement and get the stalled negotiation back on track.
5. In these circumstances, either the taxpayer or HMRC officer can suggest the use of ADR and follow the processes set out in the ADR Guidance. That would involve a reference to the DRU for a determination as to whether it was appropriate to apply ADR to the dispute (see [paras 7 and 8 of the ADR Guidance](#)).
6. That application could involve the use of the facilitated discussion process or an immediate reference to mediation.

Facilitated Discussions

1. During the course of the pilot study process, it became apparent in the way in which cases were being resolved, that a process stopping short of formal mediation but benefiting from the use of an independent third party trained in mediation techniques could be useful to bring efficiency to the process of agreeing a taxpayer liability.
2. Although such a process can be formalised through the use of a facilitation agreement entered into between the parties (see Annex 2), a less formal structure can be agreed when the parties engage in the process either with a single facilitator or two facilitators, one appointed by each side, who then work together. In the case of a small and medium sized dispute, in practice a single facilitator is usually appointed from the pool of HMRC trained mediators, none of whom have had any prior involvement in the case in dispute.
3. The process is expected to be relatively short and should be concluded within a three month period. It is confidential, conducted on a "without prejudice" basis, and consensual.
4. The parties are encouraged to work together and to adopt a resolution mindset, agreeing at the outset that:

""Meetings are to be conducted expressly on equal terms recognising the dispute as a shared issue which the parties have a shared interest in resolving.""
5. The facilitator(s) agree a timetable and can use a decision tree approach to draw out and identify and agree the issues in dispute and the order in which they should best be addressed. Some might be more important than others: or depend for their resolution on what can be agreed in respect of other issues. Unless the facts can be agreed, how can the

law be applied to them? Even assuming the law is also agreed?

6. A description of the facilitation discussion process is set out in [Annex 5 to the ADR Guidance](#).

Mediation

1. Where a facilitated discussion engagement is accepted, it is not expected that mediation will follow, although a request for mediation can be made as part of the facilitated discussion which then needs to be considered by the DRU.
2. Mediation has been defined by the Centre for Effective Dispute Resolution ("CEDR") as:

"A flexible process conducted confidentially in which a neutral person actively assists parties in working towards a negotiated agreement of a dispute...with the parties in ultimate control of the decision to settle and the terms of resolution."

3. The important points to stress about this process are these:
 - a. each party is in control of the process and the progress, unlike the position with a judicial arbitration;
 - b. the role of the mediator is to challenge assumptions and test strengths and weaknesses of each of the parties' positions and help clarify their interests and needs underlying the negotiating position and provide a channel of communication for that purpose;
 - c. the process involves joint and separate sessions which the mediator has with each party, with all sessions being confidential to those present. In this way, each party can feel confident in its ability to speak openly with the mediator who in turn can encourage each party to "look in the mirror" and focus on what is there, not what they want or hope to see;
 - d. in many cases, what appears to be in intractable dispute has arisen because one or both sides have adopted an entrenched position but that on reflection jointly with the mediator, the two opposing positions may not be irreconcilable;
 - e. a mediator can often resolve many if not all of the issues, testing each side's position with them, and then start to introduce the views of the other side but only where consent to do so has been obtained;

- f. a mediation can often uncover a wider range of possible resolutions to those generated by the traditional negotiating process without detracting from the statutory correctness of the result and in that way "enlarge the pie" which is a process not open to the courts. By way of example, agreeing for an audit year that the agreed transfer pricing methodology should apply to subsequent years up to the date of the mediation and, for future years, to consider an Advance Pricing Agreement;
 - g. at best, the outcome is a settlement. At worst, the parties are better prepared for litigation since they should have reached a better, deeper and earlier understanding of the facts and legal issues that remain in dispute and to jointly identify, articulate and agree the key questions that need to be resolved.
4. The mediation process is relatively short and should normally be concluded within a six month window from the agreement reached to proceed with it.
 5. The parties may decide to enter into an ADR Process Agreement ([Annex 4, ADR Guidance](#)) to regulate the process which can include the way in which the mediator should be briefed prior to the mediation and ensuring that each party fully understands and accepts the basis on which the mediation is taking place.
 6. In turn, the mediator should test and manage the expectations of each party to ensure that on the day, no misunderstandings arise as to the basis on which each party is engaging in the process.
 7. Unlike other mediations, the ability of HMRC to engage in the widest possible range of settlement proposals is constrained by their powers of "good management" which have been judicially determined and the practice set out in the "refreshed" LSS.
 8. A mediation agreement will be signed prior to the mediation day and sets out a number of factors including the basis on which either side have authority to conclude a settlement and what further governance procedures are involved in that process.
 9. In this respect, HMRC published earlier this year a Code of Governance for resolving tax disputes which informs and affects the decision making processes which can be applied by HMRC officers in reaching a settlement of any dispute (see "some final observations" below).
 10. The mediation usually takes place on one day, although if it fails to resolve all the issues, the parties can agree to further meetings whether or not on a mediated basis, where they believe the issues are likely to be resolved at that stage, having given further thought to matters that have arisen on the day.

Choosing A Mediator

1. The parties should discuss what form of mediation is most suitable for the particular case and whether there are any particular individuals who might be appropriate to mediate the issue. Most mediations involving tax disputes will be facilitative where the mediator works with the parties to help them find a solution rather than evaluative, or involving the non-binding expert determination.
2. The DRU is available to advise on what might be the most appropriate form of mediation and also help suggest a suitable mediator.
3. The mediator should be a neutral, independent third party respected by both parties having proven negotiating skills and the ability to build trust and confidence. In the case of a tax dispute, the writer believes a mediator should have experience and knowledge of tax and a reputation in the tax community. Whilst the mediator's role is not to find or offer his own solution to the issues, having an understanding of the technical issues in dispute should help the process.
4. HMRC have now trained over 30 officers in mediation techniques and a similar number of tax practitioners - lawyers and accountants - have also undertaken such training. Most have attended the course run by CEDR and their names can be found on the CEDR website. CEDR also have appointed a tax panel of mediators (www.cedr.com/solve/tax-panel) and created a tax dispute resolution hub (www.taxadr.net) to provide more information on the use of mediation in tax dispute resolution.

Some Final Observations

1. At the time when the "refreshed" LSS was first published, there was concern that in advocating a more collaborative approach and having regard to "customer experience", HMRC were going "soft" and could be criticised for not properly exercising their statutory powers in connection with the collection of tax. There was also a nervousness as to how, in practice, ADR would work.
2. In this latter respect, the pilot studies have produced successful results measured on a variety of bases: collection of tax, efficiency in process, certainty for both sides, better working relationships and cost reductions (again, for both sides).
3. As regards the first point, whilst no one can criticise an approach which seeks to treat similar taxpayers even-handedly, there is a concern that the LSS and its Commentary fall short of recognising the extent of HMRC's "good management" powers for both the collection and management of revenue set out in s.5 Commissioners for Revenue and Customs Act 2005. Those powers have been described in the following terms:

""that the Commissioners have to balance the duty to collect the taxes which Parliament

has decreed shall be paid with the principles of good management. It means they have the discretion not to collect the full amount of tax due where that would give the highest net return that is practicable, having regard to the costs of collection and resources available."

4. The LSS narrows the range of reasonable outcomes, particularly in the context of the issue of "splitting the difference" that HMRC may decide to use as a basis for settlement.
5. This is mainly due to the fact that:
 - a. as an exercise of HMRC's discretion in deciding how to best manage and collect tax in the context of dispute, it does not fully set out and make best use of all the factors relevant to the exercise of HMRC's discretion; and
 - b. it fails to consider HMRC's discretion to forego the collection of revenue where this would lead, overall, to the best net return, having regard to relevant factors such as the staff available to HMRC and the cost of collection.
6. It is interesting that in its report "Settling Large Tax Disputes" (www.nao.org.uk/report/settling-large-tax-disputes) published in June last year, the National Audit Office examined five settlements, all of which were found to be reasonable in the context of the Commissioner's duty of good management, although in respect of one they stated "it is not clear that this is compatible with the litigation and settlement strategy". Were this aspect of HMRC's discretion specifically addressed in connection with HMRC's discretion in deciding whether to litigate or to seek agreement, the range of reasonable solutions open to HMRC would likely be wider than is currently the case under the LSS.
7. This position does cause a certain amount of frustration, certainly to taxpayers and their advisers, and a review of how the LSS is now working two years on should be carried out with a view to recommending changes either to it or HMRC's Administrative Law Manual if there is evidence that the restrictions it contains go further than the law permits. This would allow the Department to exercise the full extent of its discretionary powers in the collection and management of revenue, producing a more efficient and fairer result for both taxpayers and the Department. That review could be carried out by the new Tax Assurance Commissioner whose responsibility includes oversight of tax disputes to ensure they are resolved on a basis that brings tax in efficiently in accordance with the LSS and ensuring that it is applied consistently.
8. The current sensitivity about whether certain taxpayers are paying a "fair" amount of tax and the Reports emanating from the Public Accounts Committee in respect of the way some multinationals are structuring their tax affairs should not be seen as a deterrent to developing and promoting a full range of possible outcomes to a tax dispute using ADR techniques for that purpose. The concern that any agreement settled without judicial intervention might be criticised as an unacceptable compromise, has potentially been neutralised and managed with the publication by HMRC of its Code of Governance bringing

with it more transparency about HMRC's decision making processes for tax disputes.

9. Unlike some areas of commercial litigation, there is no obligation on either party to a tax dispute to engage or consider mediation. However, the Tribunal is empowered to bring to the attention of the parties the availability of alternative dispute resolution procedures and to facilitate their use. The Tribunal is also empowered to seek, if the parties wish, "and provided that it is compatible with the overriding objective" to facilitate the use of the procedures. However, the Tribunal is only required to take this action "where appropriate" and there is no requirement yet on either the Tribunal or the parties to do so.
10. There has been some discussion which continues as to whether there should be a requirement or more encouragement on parties to demonstrate (with an explanation of their actions) to the Tribunal that they have considered ADR (including mediation) with possibly some incentive (or sanction on costs) as a way of influencing the parties' behaviour in this respect.
11. What the use of ADR techniques in tax disputes has so far demonstrated is that it can be a very useful and efficient tool helping to produce either a settlement of the case or leaving the parties better prepared for litigation, in both cases with consequent time and cost savings as a result.

Analysis

KEY AREAS OF COMPLEXITY OR UNCERTAINTY

See section above headed "Some final observations".

LATEST DEVELOPMENTS

HMRC is expected to publish a Review in the summer of 2013 of the outcome of the pilot study work and to make recommendations for the permanent use of ADR procedures in dispute the resolution process.

POSSIBLE FUTURE DEVELOPMENTS

The use of ADR techniques and mediation could play a significant part in resolving Double Tax Treaty disputes between Member States where there exists in a Double Tax Treaty between those two countries a mutual agreement procedure including an arbitration mechanism. In these circumstances, both States know that ultimately the dispute would be referred to arbitration if it could not be resolved by settlement and that the use of ADR processes could facilitate such a settlement producing savings in time and cost and avoiding the need for arbitration.

HUMAN RIGHTS

None.

EUROPEAN UNION ASPECTS

None.

Further Reading

National Audit Office Report 2012 "Settling large tax disputes" - www.nao.org.uk/report/settling-large-tax-disputes: an examination of the discretionary management powers of HMRC in five settlements.

Centre for Effective Tax Disputes Resolution ("CEDR") Tax Dispute Resolution Hub - www.taxadr.net providing more information on the use of mediation in tax dispute resolution

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