[2012] UKFTT 519 (TC)

# TC02196

**Appeal number: TC/2009/12747**

***Income tax –Understated turnover-whether method of calculation accurate –NO-Discovery assessments based on presumption of continuity-whether reasonable and fair –No –Appeal allowed in part.***

**FIRST-TIER TRIBUNAL**
**TAX CHAMBER**

**ANDREW BARKHAM** **Appellant**

**- and -**

**THE COMMISSIONERS FOR HER MAJESTY'S REVENUE & CUSTOMS** **Respondents**

**TRIBUNAL: JUDGE DR K KHAN**
**CAROLINE DE ALBUQUERQUE**

**Sitting in public at Cambridge on 24 July 2012**

**For the Appellant: John Hallam, Accountant**

**For the Respondents: Karen Weare, Higher Officer,**

**Instructed by the General Counsel and Solicitor to HM Revenue and Customs, for the Respondents**

DECISION

Appeals

1. The Appellant gave formal notice of an appeal against 2004-05 assessment raised in the amount of £66,459 on 12 February 2008.

2. The Appellant also appealed against assessments for the years 2001/02, 2002/03 and 2003/04 raised in the amounts of £39,431.55, £3,746.37 and £8,592.65 respectively.

3. The total amount of tax due on the tax return for the year ended 5 April 2005 was £19,227.20 (with Class 4 National Insurance of £2,516.29). The additional tax assessed for the other years are as follows:

(i) 2001/02 £33,056.12 with Class 4 National Insurance of £240.17
(ii) 2002/03 £2,786.46 with Class 4 National Insurance of £959.91
(iii) 2003/04 £6,446.20 with Class 4 National Insurance of £2,146.45

4. The total amount of tax assess is £61,515.98 with Class 4 National Insurance of £5,862.82.These figures were confirmed on 11 March 2009 by the Respondents.

5. A statutory review was conducted on 9 July 2009 upholding the decision of the Inspector.

6. The appeal refers to 2005-06 for which a closure notice was issued on 8 August 2008. This year was amended on 8 January 2009, there are no additions to the return profits, no losses were brought forward. This year does not form part of the appeal.

Points at Issue

7. Whether the profits in the accounts of the Appellant for the year ended 31 December 2004 were understated and whether discovery was competent for earlier years.

Relevant facts

8. The Appellant operates a business in car sales and maintenance and trades under the name Audi Specialist from 40 The Causeway, Berwell, Cambs, CB5 0DU.

9. The business for the period 1 January 2004 to 31 December 2004 had a turnover of £2,144,377m with a taxable profit of £8,936. The declared profit was covered by a loss brought forward. The declared turnover for 2001/02 was £2.482.823; 2002/03 was £1.669, 894 and 2003/04 was £1.956, 077. The turnover is high due mainly to the sales of high value cars. The majority of the turnover (roughly 80% for 2004/05) is comprised of car sales.

10. The Appellant operated a personal account as well as business account at the bank. In order to avoid bank charges he paid cash into his private account and immediately arranged for the same amounts to be paid into his business account by way of cheques. This operated to reduce bank charges on the business account for money which was paid into the account.

11. The Respondents noted that using this system created accounting difficulties. The known cash receipts for the 2004/05 period were £186,024.64. The known cash banking and spending came to only £117,154.57 which left a minimum cash shortfall of £68,870.07 (£58,613 after VAT deductions). The Appellant had indicated that they arrived at the turnover by reference to banking statements (rather than invoices which were not complete). The banking statements showed cash of £117,154.57 whereas the business records showed minimum cash receipts of £186,024.64 and to that extent the allegation is that the turnover was understated by at least a difference between those two figures. The Respondents say that this method of accounting led to an understatement, since some cash which was collected wasnot paid into the business account.

12. The business figures for 2004 showed sales of £2,144.377, stock of £1,991,477, wages of £48,996, expenses of £94,973 and profits for the year of £8,936.

13. In a letter dated 28 November 2007, the Respondents explained that issued invoices rather than a bank statement should be used in calculating the turnover for tax and accounting purposes. They analysed the available invoices (several numbered invoices appeared to be missing) and arrived at the minimum amount of cash which was not taken into account in the turnover calculation as being £68,870.07. They then surmised that that cash sum may be only a proportion of the cash receipts which have effectively not been declared. This was because the missing invoices may have been paid in cash which was not deposited in the business bank account. The cash generated on the 208 missing invoices could be quite considerable particularly if they related to car sales. The Appellant proffered the explanation that some cash may have been spent on the acquisition of cars for which no stock expenditure was claimed. This however raised further questions regarding the reliability of stock records.

14. On 14 January 2008, the Appellant's tax adviser John Hallam, an accountant, provided quarterly schedules of figures from which the VAT returns were prepared. He also provided a summary of the years' figures. In the opinion of Mr Hallam, after comparing the Respondents' spreadsheets with his quarterly VAT schedules, the figures were substantially the same. He said that every entry in the cash column appeared in his schedules. He said that every car sale and every service sale had been included in his figures whether paid by cash, cheque or credit card and there was no undeclared cash. The Respondents' profit figure of £58,613 was not correct.

15. In their reply on 18 February 2008 the Respondents stated that there was no valid explanation why the turnover in the accounts for income tax purposes included only £114,600 worth of cash when according to the business records the cash receipts total was £186,024.64.

16. On 22 February 2008, Mr Hallam confirmed that all cash transactions totalling £186,000 were included in the total turnover.

17. On 9 April a meeting took place between the Appellant and Respondents and Mike Cherry, a local independent compliance accountant. The following findings were arrived at by Mr Cherry.

> (i) He lamented the absence of a reliable balance sheet for the business.
> (ii) If the VAT returns had been prepared with incomplete invoices and Mr Hallam had added over £100,000 for the invoice sales to get to the adjusted turnover for tax purposes then there would be a potential of VAT understatement.
> (iii) He said that the turnover figure was calculated incorrectly using banking figures which did not take account of cash receipts.
> (iv) He observed that the accounts were prepared on the basis of considerably guesswork.
> (v)The bankings figure would not have taken account of stock purchases and expenses paid in cash. The turnover would therefore be understated by a minimum of those cash figures.

18. On 9 June 2008, Chris Cross, a manager working on the enquiry, sought to summarise the position after the 9 April meeting with Mike Cherry, the Appellant and the Respondents, as follows:

> "When you came to calculate the sale figure you found that the total banked in the period was greater than the total of the sales invoices and you added an amount to sales. This is quite normal if there is no evidence that the excess bankings aren't business sales. The total sales figure in your accounts therefore became the total banked. However we know that substantial cash from sales was not banked, although it was on the sales invoices. This amount must therefore now be added to the bank sales. Our differing opinion rest, not on whether all sales were invoices or not, but on whether the way in which you constructed the accounts sales figure included the cash sales not banked".

19. On 7 June 2008, the respondents wrote to the Appellant to explain that for the 2004/05 year the sum of £58,613 (net of VAT) is being added to the gross profit which represents a 58% increase in gross receipts. This percentage was then used to increase gross receipts for the years 2001/02, 2002/03 and 2003/04. This resulted in a revised increased turnover with VAT and income tax implication.

Appellant's submissions

20. The Appellant says that its figures for the purposes of taxation include total vehicle and service sales. The figures include cash, cheques, credit cards and finance charges.

21. They say that the earlier year's calculations were accepted by the Respondents the calculations for the year 2004/05 were correct and therefore no adjustment is necessary for previous years and there are no justifications for raising assessments in those years. They say that the calculations by the Respondents of additional total profits of £304,000(for the total assessments) cannot be taken seriously.

22. They say that with regard to the servicing side of their business work is sometimes carried out on cars which were sold with no formal invoice raised for the repairs and this may explain some of the missing invoices and invoice numbers.

23. The Appellants say that they have included all sales in their schedules and therefore the declared turnover in the accounts is correct. They made no attempt to explain the cash differences which the Respondents alleged since cash transactions totalling £186,000 are included in the total turnover.

24. They say that the accounts presented for tax purposes are correct.

25. The appellant's accountant, Mr Hallam said that he arrived at the business turnover by reference to the stock records, which in turn have been extracted from records which the Respondents had analysed and whose figures more or less agreed with his own.

<u>The Respondents' submissions</u>

26. The Respondents say that the turnover used in calculating the income tax liability omitted cash sales. The business had generated more cash than was included in the declared turnover.

27. The figures for taxation were based on bankings and those bankings did not include all cash receipts which were underestimated by a minimum of approximately £70,000. It was fundamental that the turnover for tax purposes should be arrived at by reference to invoices since this gave a true view.

28. The Respondents say that the Appellant has been negligent in that they failed to provide information and documentation required under the relevant legislation and given this omission it is possible to make discovery assessments for earlier years.

29. Under the presumption of continuity, when there is evidence or omissions from one or more years returns then an inspector can infer that omissions would have occurred in other years. The Respondents rely on this principle to make assessments for earlier years.

Evidence

30. The hearing was provided with the documents and legislation bundle. Mr Green, Inspector of Taxes, gave oral evidence to the hearing and provided a witness statement. The Appellant, Mr Andrew Barkham also provided written and oral evidence to the hearing. The two bundle of documents included copies of correspondence, accounts, notes of meetings, notes of telephone conversations, calculations done by the tax advisers and the relevant law.

Relevant Law
Sections 9A, 28A, 29,34,36,50 (6) TMA 1970
Jonas v Bamford (1973) STC 519

Discussion and conclusion

31. The point in this case is a simple one. Whether the Appellant has correctly calculated the business turnover for the purposes of taxation and whether the declared turnover, based on bankings, was understated. The fact is that the bankings included £97,400 worth of cash whereas £186,024.64 worth of cash income had been generated by the business according to invoices raised. It is accepted that the invoices for the business were incomplete (certainly the certain numbered invoices were missing). The Inspector of Taxes dealing with this matter, Mr Green, had analysed all the invoices in detail and was able to isolate the cash which was not included in a declared turnover. His oral evidence gave a comprehensive explanation of the figures which he presented.

32. The business had not kept proper records and did not have a balance sheet for the year, as one would expect. It appeared that VAT returns had been made in relation to incomplete invoices. It is clear that there was more cash in the business than the banking records indicated. It is the accounting for this cash which is the basis for the dispute. It is possible that some cash was recirculated through purchases, but we have no clear evidence that this was the case. It is also possible that invoices were not raised for some repair work on cars which were sold , but again, there is little evidence to support this position. The accountant and tax adviser to the Appellant, Mr Hallam, arrived at a turnover for tax purposes by reference to the total bankings and sought to reconcile this sum in relation to the invoices by simply adding approximately £100,000 to that figure and so arriving at the declared turnover. This is an arbitrary way to arrive at the turnover and supports Mr Cherry’s conclusion that some guesswork was involved. What should have been done was to take the figure of the total bankings and add the unbanked cash and money spent on expenses. While Mr Hallam sought to explain he had taken into account the total bankings plus the cash outgoings (approximately £68,000) in arriving at the turnover figure, his explanation was not supported by the figures presented.

33. The Tribunal accepts that some of the unbanked cash could have been used for stock purchases but while both Mr Green and Mr Cherry were willing to accept this position, the evidence was not available to show this was the case.

34. In calculating the turnover it is necessary to take into account income from cheques, cards, banked cash and unbanked cash. The first three elements were taken ~~i~~into account by the Appellant. There appeared to be an amount of cash which was banked which falls short of receipts .

35. The Appellant indicated that not all of the money which was banked was business receipts. They said that some of the money came from investors. However they were unable to show which amounts came from investors and for what purpose. The tribunal therefore does not accept this argument.

36. The Appellant was given an opportunity to explain whether any sums paid into the business bank account were capital rather than taxable income. An explanation was not provided to the tribunal.

37. There is no evidence that the sales figure based on the bankings includes the total amount of cash which should have been banked. Mr Green gave reliable evidence to show that the figures had not taken into account the unbanked cash receipts. Mr Cherry, the independent accountant, made astute observations on the reliability of the turnover figures and the tribunal has taken these into account in making its decision.

<u>2004-2005 assessment</u>

39. The Tribunal therefore dismisses the appeal against 2004/05 assessment and the amount of tax in the assessment is therefore upheld as due.

<u>2001-2004 assessment</u>

40. For these years, the Inspector has applied a presumption of continuity to conclude that the under declaration for the year 2004/05 can be taken to point to under declaration in earlier years and discovery assessments were accordingly made. In such a case it is up to the Appellant to displace the assessments with evidence. 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. The Respondents say that the manner in which the taxable accounts have been created, based on bankings, raises questions on their accuracy.. Mr Green, the inspector, said that the Appellant’s turnover figures were incorrectly drawn up in previous years based on their admission that the turnover had been arrived at on a similar basis as in 2004/5. . This is also the view of Mr Cherry who said so far as he could see the bankings figure was used in previous years as well.

41. The ~~t~~Tribunal accepts that assessments should be raised for earlier years on the basis of the Appellant's admission of using similar (to 2004-5) methodology in preparing the turnover figures. It is up to the Appellant to adduce evidence to show that the amounts in the assessments should be reduced.

42. In this case the taxpayer has strongly denied any wrong doing. He has prepared comprehensive figures to show that the unbanked cash was taken into account in the preparation of a taxable turnover. The tax adviser to the taxpayer disagreed with the Respondents' figures and their claims about the costs of his client's lifestyle. A claim was made that the Appellant needed in the region of £40,000 per annum to live while his business was loss-making with profits of only of £8,936 for a three year period. The taxpayer explained in his evidence that he had borrowed over £200,000 over the past twenty years and got himself into significant debt with credit cards, litigation and his divorce. This view was supported by his accountant. The tribunal is inclined to accept the Appellant's argument, especially where supported by his tax adviser and to find that the Respondents had not clearly established the lifestyle argument to show that all of the income or money on which the taxpayer lived came from his business.

43. The Appellant states that the Used car market was difficult in the relevant period. During the period 2001 and onwards the UK car market became much less competitive, car volume sales were down, the used car market was more competitive and there is a preference for environmentally friendly cars with increase concerns of a global warming. The Appellant described the market in use cars as being "on its knees" in that period. It is therefore hard to accept the figures projected backwards of a 58% increase in the declared turnover for the earlier years. This seems a high percentage increase. The tribunal agrees with the making of the discovery assessments but finds the rate of 58% to be unfair and unreasonable. There is no evidence that the taxpayer was in the habit of acting improperly and his tax adviser confirmed this position. The evidence presented to the tribunal related to the year of enquiry and the "takings build up" exercise was in part an estimate of unbanked cash. In the circumstances, the projection percentage for the earlier years seems unreasonable.

44~~5~~. On the balance of probabilities, given the Appellant has been borrowing money to make ends meet, has significant debt liability, and the fact that the industry in the relevant period was in a serious recession, the Tribunal finds that applying a 58% increase to turnover is unrealistic. It is difficult for the Tribunal to make an actual estimate of the percentage increase, if any, in the turnover for those relevant years. We accept that the taxpayer has not provided strong evidence to rebut the Revenue's position but has nevertheless provided sufficient evidence which on a balance of probability suggests to the Tribunal that the figures for the increase in turnover are not accurate for the period 2001-2004. We have no information to enable us to provide any other figures. We can use a best judgment approach but given the evidence before us it would be difficult to arrive at a set of accurate figures which is fair to all parties.

45~~6~~. We will invite the parties to submit alternate figures within three weeks of the release of the date of this Decision. The parties should make representations in writing and support those representations with sufficient evidence to suggest alternative annual figures for the increase in turnover for the earlier years. The Tribunal would encourage the parties to discuss the matter and agree a set of figures which would be acceptable to both parties.

Conclusion

46~~7~~. The assessment for the year 2004-05 is upheld.

47~~8~~. The assessments for the years 2001-02, 2002-03 and 2003-04 are not upheld. The tribunal would like the parties to consider the market and economic conditions at the time, trading fluctuations, competition, sales and discounts and non-taxable sources of income among other factors .A simple projection of profits on a fixed percentage basis does not strike the tribunal as accurate or fair. .Therefore it is asking the parties to provide further written evidence of figures which would convince the Tribunal that the new figures are fair and reasonable in the circumstances. A negotiation between the parties may be the best way forward.

48~~9~~. It should be borne in mind that once the Respondents have raised an assessment, the onus of proof is on the taxpayer to show that on a balance of probabilities the assessments are excessive.

49~~50~~. 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.

**DR K KHAN**
**TRIBUNAL JUDGE**

**RELEASE DATE: 14 August 2012**