Supreme Court Judgment in *Droog*: A Timely Decision

John Cuddigan *Tax Partner, Ronan Daly Jermyn*

Introduction

On 6 October 2016 the Supreme Court, through Clarke J, handed down the eagerly awaited decision in the case of *The Revenue Commissioners v Droog* [2016] IESC 55, upholding the decision of the High Court[1] in favour of the taxpayer in that case. The case involved an appeal by Revenue against the decision of Laffoy J in the High Court, where she in turn had upheld the decision of the Appeal Commissioners in an appeal by way of case stated.

The decision of the Supreme Court, although again finding in favour of the taxpayer, did so following different reasoning from the decision of the High Court. Indeed, the decision of the Supreme Court has perhaps widened the scope of the decision beyond the narrow points at issue in the immediate case and will be required reading for any student and practitioner with an interest in the application of time limits: specifically, in relation to s811 TCA 1997 for historical transactions and, more generally,

1 *Revenue Commissioners v Droog* [2011] IEHC 142.

in relation to interpretation of the provisions of Part 41 and Part 41A TCA 1997.

Although the decision is arguably of little relevance to transactions carried out or undertaken since 19 February 2008,[2] falling under s811 or which fall under the new provisions of s811C[3] – a provision with seemingly no time limits as to application – some *obiter dicta* in the decision of the Supreme Court may perhaps be relevant to provide some limits in the application of this section.

Before considering the decision of the Supreme Court and examining its impact generally, it is necessary first to consider:

› the facts of the case to get some understanding of the issues under appeal,

› the provisions of s811 that applied to the facts in the case (and also amendments to s811 that post-dated the High Court decision),

› the provisions of Part 41 containing the time limits that were considered to apply in the immediate case and

› the reasoning behind the High Court decision handed down by Laffoy J.

Facts of the Case

The taxpayer in the case, Mr Droog, filed his income tax return for the tax year 1996/1997 on 30 January 1998. He was a member of a partnership known as Taupe Partners, which was involved in the acquisition, distribution and licensing of films. In his return, Mr Droog claimed loss relief in the amount of £50,046 in respect of partnership losses.

Taupe Partners was, it seems, only one of a number of different partnerships that were carrying on similar activities that generated tax losses for partners in such partnerships. The ability to claim loss relief was curtailed in Finance Act 1998 through amendments to s1013 TCA 1997 that restricted such loss relief to "active partners"[4] and again through further changes in Finance Act 2000.[5]

Revenue on 22 February 2007 issued a notice of opinion under s811(6) to Mr Droog. Importantly, Revenue accepted that the tax return filed by the taxpayer in the case was true and complete and that there was no suggestion of fraud or neglect on the part of the taxpayer in relation to the matters at issue.

Mr Droog appealed the notice of opinion pursuant to the provisions of s811(7) and also relied on the grounds that the notice of opinion was out of time by virtue of ss955 and 956 TCA 1997.

At the Appeal Commissioners' level, Commissioner O'Callaghan delivered his determination on 18 December 2009, determining that the four-year time limits provided for in ss955 and 956 were applicable to the forming of an opinion under s811 and that, as the opinion was made outside of these time limits, the opinion was invalid.

This decision of Commissioner O'Callaghan was appealed by way of case stated by Revenue to the High Court.

Section 811 TCA 1997: Relevant Provisions

An examination of the terms of s811, and its application, is beyond the scope of this article. However, it is worth examining certain of the provisions referred to in the Supreme Court judgment and also in the previous High Court judgment to gain a fuller understanding of the decisions made.

In the High Court and Supreme Court, Revenue relied mainly on the provisions of s811(4), in particular its wording stating that the Revenue Commissioners, as respects any transaction, "may at any time" form the opinion, among other matters, that a transaction is a tax-avoidance transaction.

Section 811(6) stipulates that where Revenue forms the opinion that there is a tax-avoidance transaction, it must then takes steps to give notice in writing of the opinion. The sub-section sets out certain requirements to be specified in the notice of opinion.

Section 811(7) provides details of the limited grounds for the making of an appeal against the notice issued under s811.

Section 811(5) confirms that no liability to tax arises until the appeal process has been exhausted, when the opinion of Revenue becomes final and conclusive. The tax consequences arise only at that point. Therefore, the issue of a notice of opinion under s811(6)

2 In light of the terms of s811A(1A), as introduced by s140(1)(a) Finance Act 2008. This amendment made the raising of an enquiry or the taking of any action under s811 possible notwithstanding the provisions of ss950(2), 955(2)(a) or 956(1)(c) (or ss959Z, 959AA or 959AB from 1 January 2013).

3 In light of the terms of s811C(6), as introduced by s87(1)(c) Finance Act 2014 (which applies to transactions commencing on or after 24 October 2014).

4 See s50 Finance Act 1998.

5 See s70 Finance Act 2000.

only puts in train a process that may lead to an assessment and does not amount to an assessment itself (something that is now changed under the new s811C[6]). The provisions of s811(5) grant Revenue the right, "notwithstanding any other provision of the Acts", to make all such adjustments to collect the tax.

Time Limits in Legislation

Background

In the context of income tax, CGT and corporation tax, time limits first appeared on the introduction of the self-assessment regime through Finance Act 1988. The time limits were contained in s14 (which became s955 TCA 1997) and s15 (which became s956 TCA 1997) Finance Act 1988.

Before 2003, there was no general entitlement on the part of taxpayers to seek a refund of tax, such entitlement generally being limited to error and mistake claims and under other specific provisions.[7] Additionally, there was no entitlement to interest on the part of taxpayers where repayments were due.

Following certain decisions of the Ombudsman in the late 1990s and indeed the decision in the case of *O'Rourke v The Revenue Commissioners*,[8] which confirmed a right under general law to interest on repayments of tax, Finance Act 2003 introduced what Laffoy J, in her High Court judgment in the *Droog* case, referred to as the "balanced scheme" under which Revenue would be time limited in seeking tax (save in the case of where a taxpayer did not make true and complete disclosure) and taxpayers would be time limited in seeking repayments of tax (and limited on the quantum of interest) to protect the Exchequer. The latter concern was the main driver for the introduction of the legislation, as the decisions of the Ombudsman and the courts had indicated an open-ended entitlement to seek repayment of tax.

The new legislation took the form of amendments as follows:

- ss955 and 956 were amended to change the then six-year limit on the making of enquiries and assessments to four years and
- s865 was replaced with a new section to incorporate a four-year time limit on the ability of taxpayers to seek repayment of taxes (s865A was also introduced to prescribe a (lower) rate of interest that would apply to any such repayments).

It is interesting to note from the Dáil records the statement of the Minister for Finance at the time that the intention behind the changes to the time limits was to provide balance between the ability of Revenue to seek taxes and the taxpayer's entitlement to seek repayment of taxes, the latter being driven by the wish to protect the Exchequer from open-ended claims.

Except in so far as otherwise expressly provided, this Part shall apply notwithstanding any other provision of the Tax Acts or Capital Gains Tax Acts.

This aim of achieving balance between the entitlements of Revenue and of taxpayers is relevant to being able properly to consider and construe the time limit provisions of Part 41 (and now Part 41A).

Part 41 TCA 1997

Part 41 had been replaced for the tax year 2013 and subsequent tax years by Part 41A. However, in relation to Mr Droog's appeal, and indeed for all tax years up to 2012, the provisions were in force, and they need to be reviewed to get a fuller understanding of the decision in the Supreme Court.

Section 950 is the interpretation section in relation to Part 41. Section 950(2) provides:

> *"Except in so far as otherwise expressly provided, this Part shall apply notwithstanding any other provision of the Tax Acts or Capital Gains Tax Acts."*

Section 956 provides the machinery under which Revenue may raise enquiries and amend assessments. Section 956(1)(c) provides:

> *"Any enquiries and actions referred to in paragraph (b)* [the making of enquiries or amending of assessments] *shall not be made in the case of any chargeable person for any chargeable period at any time after the expiry of 4 years commencing at the end of the chargeable period in which the chargeable person has delivered a return for the chargeable period unless*

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6 See Marie Bradley, John Cuddigan, David Fennell, Frank Mitchell and Denis Herlihy (ed.), *FINAK: Finance Act 2014 Explained* (Dublin: Irish Tax Institute, 2015) for explanatory notes on the new provisions of s811C.

7 See for example s563 TCA 1997.

8 [1996] ITR 81. This decision found that interest was due under general law on repayments of tax and the courts' rate of interest of 8% would be appropriate.

> *at that time the inspector has reasonable grounds for believing that the return is insufficient due to its having been completed in a fraudulent manner."*

Section 955(2)(a) provides:

> *"Where a chargeable person has delivered a return for a chargeable period and has made in the return a full and true disclosure of all material facts necessary for the making of an assessment for the chargeable period, an assessment for that period or an amendment of such an assessment shall not be made on the chargeable person after the end of four years commencing at the end of the chargeable period in which the return is delivered and*
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> *(i) no additional tax shall be payable by the chargeable person after the end of that period of four years; and*
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> *(ii) no tax shall be repaid after the end of the period of four years commencing at the end of the chargeable period for which the return is delivered..."*

Sub-paragraph (b) provides certain exceptions to the limit of four years, none of which applied in the particular case of Mr Droog's return, as it was accepted that his return had incorporated a full and true disclosure for the purposes of the section.

One reading of these provisions is the taxpayer protection in Part 41 occurs at two inter-related levels. Section 956 prohibits any enquiries or actions outside the four-year window. Section 955(2) prohibits any amendments of assessments outside the four years. An amendment of an assessment must of necessity be preceded by some enquiry on the Inspector's part. An enquiry is the precursor to an amended assessment.

Adopting this reading, the only purpose of an Inspector making an enquiry is potentially to amend the assessment. But to make the enquiry he or she must first prove fraud or neglect on the taxpayer's part. In short, ss955 and 956 are arguably two sides of the same coin.

It is important to note that this view was not accepted necessarily by Revenue or the Appeal Commissioners in practice, as the alternative view was that s955 stood independent of s956. This view led to an entirely different approach to applying the time limits.

High Court Decision in *Droog*

In addressing the terms of s955, at para. 5.2 of her judgment, Laffoy J commented:

> *"as counsel for the respondent* [Mr Droog] *submitted the time limit imposed by S.955(2)(a) in its application as provided for in sub-paragraphs 1 and 2 gives effect to a balanced scheme, in that it not only proscribes the imposition of additional tax on the tax payer but it also precludes the tax payer from seeking a repayment of tax outside the limitation period."*

Laffoy J in effect expressed that the time limits in ss955 and 956 were part of the balanced arrangements that prohibited Revenue seeking assessments for tax, except in certain accepted situations outlined in s955, and equally prevented taxpayers recovering tax outside of the four-year time limit. When one considers the purpose of the statutory scheme introduced in Finance Act 2003, this view would appear entirely logical and correct.

The question, however, remained as to whether this statutory scheme held precedence over the provisions of s811. In particular, the terms of s811(4) permitted Revenue, it would seem, to form the opinion "at any time".

The question, however, remained as to whether this statutory scheme held precedence over the provisions of s811. In particular, the terms of s811(4) permitted Revenue, it would seem, to form the opinion "at any time". Even if this was not sufficient, Revenue could point to the provisions of s811(5), which allowed Revenue to make any adjustments "notwithstanding any other provision of the Acts".

Counsel for Mr Droog submitted that those provisions were subject to the statutory scheme concerning time limits in Part 41, over which s811 did not hold primacy, and pointed in particular to the terms of s950(2), which provided that Part 41 applied notwithstanding any other provision of the Tax Acts or CGT Acts "[e]xcept in so far as expressly provided". There was no express disapplication of Part 41 – in particular of ss955 and 956 – in s811.

Laffoy J reasoned that once the opinion was formulated and notice was given pursuant to s811(6), a process (or enquiry) had

commenced that could give rise to the taxpayer being liable for additional tax. It was therefore permissible to assess whether the time limits stipulated in ss955 and 956 were applicable at the stage of the notification of the opinion. In para. 5.6 of her judgment, Laffoy J held that the issuing of the notice of opinion had of necessity to be preceded by enquiries. It simply could not have materialised on its own.

Laffoy J then went on to hold, in dealing with the core issue in the case stated, that the words, "at any time" in s811(4) and the words "notwithstanding any other provision of the Acts" in s811(5) were subject to the times limits in Part 41 as there had been no express disapplication of Part 41, as was in her view required by s950(2).

The High Court decision in the *Droog* case, and Laffoy J.'s reasoning, was followed in the High Court decision in *The Revenue Commissioners v Lacey*,[9] where the provisions of s35 Finance Act 1987 (s481 TCA 1997) were in question. The particular issue in the case was whether the terms of s35(6) Finance Act 1987 (s481(19) TCA 1997), which allowed an assessment to be made "notwithstanding anything in the Tax Acts…at any time", were subject to the time limits of Part 41.[10] The decision of Binchy J was that to set aside the provisions of Part 41, there was a requirement to do so by express reference to the sections in Part 41. Wording such as appeared in s35(6) was not sufficient to do this, following the decision of Laffoy J in *Droog*. It is understood that the decision in *Lacey* is under appeal to the Court of Appeal, but whether this will continue in light of the decision of the Supreme Court in *Droog* is perhaps in question.

[I]s to protect a tax payer who makes a 'full and true disclosure' of all relevant 'facts'. In such a case no further assessment can be made after the relevant four year period and, importantly, no additional tax is to be paid and no tax is to be repaid by reason of any matter contained in the return.

Supreme Court Decision in *Droog*

General

The decision of the Supreme Court was handed down by Clarke J on behalf of the court.

Part 41: Time limits

Clarke J provides a useful examination of the terms of Part 41, in particular s950(2) and ss955(1) and (2). In relation to s955(2), he highlighted that the substance of the provision:

> *"is to protect a tax payer who makes a 'full and true disclosure' of all relevant 'facts'. In such a case no further assessment can be made after the relevant four year period and, importantly, no additional tax is to be paid and no tax is to be repaid by reason of any matter contained in the return."*

Clarke J went on to state:

> *"where a tax payer has made a full and true disclosure of all the relevant facts, the Oireachtas must have considered that it would have been significantly unfair to allow Revenue to reopen the amount of tax due after the relevant four year period".*

He also referred to the terms of s956, which, although stated to be subject to s955(2), were consistent by imposing a time limit on enquiries and actions outside the four-year period in the absence of fraud or negligence. In para. 4.7 Clarke J went on to state:

> *"Thus again the structure is clear. A person who makes a full and true disclosure and pays their tax on foot of an assessment raised thereon cannot have their tax affairs reopened after four years have elapsed. An Inspector is given wide power to inquire into the accuracy of any return but is precluded from engaging in such inquiry outside the four year period unless the Inspector has reasonable grounds for believing that the original return was fraudulent or negligent and thus not a full and true disclosure.* ***An Inspector is not, therefore, entitled to engage in a purely 'fishing' exploration of whether old returns…were inaccurate but rather is required to have some reasonable basis for considering that the return was fraudulent or negligent before embarking on inquiries*** [emphasis added]".

9 [2015] IEHC 529.
10 The High Court decision in the case of *Fortune v The Revenue Commissioners* [2009] IEHC 28 had held that the rights of assessment under s35(6) Finance Act 1987 were open-ended. The argument on the primacy of Part 41 (and in particular s950(2)) had not been made in that case, however.

In summary, Clarke J stated:

> *"it follows that, at least in general terms, Sections 955 and 956 are designed to prevent the re-opening of the tax affairs of a tax payer in respect of the types of tax covered by Part 41 outside of a four year period except in circumstances where the original return was, or was reasonably suspected to be, fraudulent or negligent.* ***Even if such a reasonable suspicion exists no ultimate exposure to adverse tax consequences can be placed on the tax payer concerned unless it is ultimately established that the relevant return was in fact not full and true in its disclosure*** [emphasis added]."

Of importance is the fact that he is stipulating that the time limits in, and the provisions of, ss955 and 956 operate together and indeed must operate in a particular order.

Clarke J concluded that what s955(2) prohibits is a liability to tax arising outside the four-year time limit. This was done in clear and unambiguous language.

Anomaly in s811?

Clarke J drew attention to two issues that had been raised by Revenue:

- If Part 41 time limits had primacy over s811, this would produce an anomaly in that the legislation governing time limits in Part 41 did not apply to PAYE, VAT and CAT, which could also be the subject of s811 challenges.
- If s955(2) time limits were to apply to the assessment of tax pursuant to the operation of s811, this would mean that s811 would be rendered effectively useless as the assessment only arose when the opinion became final and conclusive – i.e. when the appeal process was exhausted.

On both points, he concluded that if the legislature had intended to exclude the time limits in Part 41 from application to s811, or make the time limits run up only to the notice of opinion, this could have been provided for, but it was not. It was therefore not open to him to construe terms into legislation that went against the plain meaning. He went on to state:

> *"if the proper construction of the Taxes Acts leads to Section 811 being governed by the time limits in Part 41 then the answer to that problem would have been to make an express provision in Section 811 which stopped time running, for the purposes of Section 955, as soon as notice of the relevant opinion was given".*

Primacy of Part 41 time limits over s811?

Clarke J concluded that, given the plain wording of s950(2), any disapplication of the provisions of Part 41 required "clear and unambiguous" language. He held that the inclusion of the words "at any time" in s811(4) was not sufficiently clear and unambiguous to do this and that the time limits of Part 41 had primacy over s811.

He did not, however, see it necessary to consider whether Laffoy J was correct in her finding that the making of the opinion involved an enquiry for the purposes of s956(1). His finding was that as the making of the opinion would inevitably give rise to a liability to tax where it became final and conclusive, and this would be outside the time limits in s955(2), this was impermissible.

Observations on the Decision of Supreme Court

The decision of the Supreme Court is relevant, it would appear, in relation to the following.

Section 811 appeals: existing and completed (transactions before February 2008)

The Supreme Court decision has relevance for:

- existing s811 appeal cases where the notices of opinion were issued outside of the four-year time limit in Part 41 and the transactions were effected before 19 February 2008;
- existing s811 appeal cases where the notices of opinion were issued before the expiry the four-year time limit in Part 41 but where the appeals will be finalised outside the four-year time limit and the transactions were effected before 19 February 2008; and
- s811 cases in respect of which Revenue issued opinions and where the tax became final and conclusive (with tax paid by a taxpayer) outside of the time limits in Part 41 and the transactions were effected before 19 February 2008; in such cases, absent any agreed settlement, there may be a question over the validity of the assessment.

Section 811/811C (transactions after February 2008)

It should be noted that the impact of the decision on s811 transactions effected since 19 February 2008 will be somewhat less, given the changes to s811A and the introduction of s811C, where the provisions of Part 41 and indeed Part 41A are expressly excluded.

Nonetheless, *obiter dicta* in the judgment of Clarke J at para. 6.5 would appear to throw up a warning that the conferring of an open-ended right to reopen the tax affairs of otherwise compliant taxpayers "would itself give rise to potential unfairness".

Section 481 appeals

It would appear that the Supreme Court decision has direct impact on the circumstances in the *Lacey* case mentioned above, given that the terms of s481(19) do not appear to exclude the Part 41 time limits in a "clear and unambiguous" manner.

Part 41A/Part 41

Outside of the general anti-avoidance rule, the decision of the Supreme Court has served an important role in clarifying the application of time limits in Part 41 and also in Part 41A, under which the time limit issues tend to come up more frequently.[11] In particular, it now stipulates a strict order that must be followed on the part of any Inspector seeking to examine a return for a matter falling outside the four-year time limit, which can be summarised as follows:

› For the Inspector to make any enquiry, the Inspector must have reasonable suspicions that the taxpayer has been negligent or fraudulent in relation to the return in question. The Inspector in this regard cannot carry out pure "fishing expeditions" and must have a reasonable basis for the enquiry.

› Where reasonable grounds exist for the purposes of making the enquiry, it must separately be shown that the taxpayer has not made a true and complete return in relation to the year in question and/or the exceptions to the four-year time limits in s955(2) have application.

The clarification by the Supreme Court is welcome in this regard.

In relation to Part 41A, although the terms of the "balanced scheme" have been amended somewhat in the new legislation, the new provisions are largely similar to the terms of s955 (replaced by s959AA) and s956 (replaced by ss959Z and 959AJ). Therefore, the decision will be relevant in future tax years in construing the terms of Part 41A.

Practitioners should however, note the time limits in s955 and in s865 that prevent tax reclaims outside the four year period. This is, of course, the other side of the coin. The Supreme Court decision has, in this regard, affirmed the balanced scheme approach.

Time limits under other tax heads

When the provisions of Finance Act 2003 were introduced to TCA 1997, similar time limits or balanced schemes were introduced for stamp duty, CAT and VAT. Although the legislation does not contain provisions similar to the terms of s950(2) (and the primacy of the time limits might be in question at least where s811 is in question), the clear instruction from the Supreme Court is that, the time limit provisions must be given due regard in raising assessments. For example, in the CAT legislation,[12] Revenue may not issue an assessment beyond four years save in the case of fraud or negligence. The Supreme Court Decision now supports the requirement for reasonable suspicion (and not a fishing exploration) on the part of Revenue to set aside these time limits.

Equally, the time limits, as part of the balanced scheme, will apply to cases involving repayment of tax. As the time limits legislation differs between tax heads, careful review of legislation is required on the part of tax practitioners to ensure that any claims for repayment can qualify and not be time barred.

Conclusion

The decision of the Supreme Court in the case of *Droog* has finally reached the end of the road for the taxpayer in question. While the decision will have significant impact on a number of existing and potential appeals, it is to be welcomed in that it provides certainty on the law in this area, after years of uncertainty. It also serves as a reminder for practitioners and Revenue alike of the importance of time limits that apply for the purposes of achieving the balanced scheme introduced in Finance Act 2003.

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11 Part 41A, however, applies only in relation to accounting periods commencing on or after 1 January 2013.
12 See s49(6A) CATCA 2003.