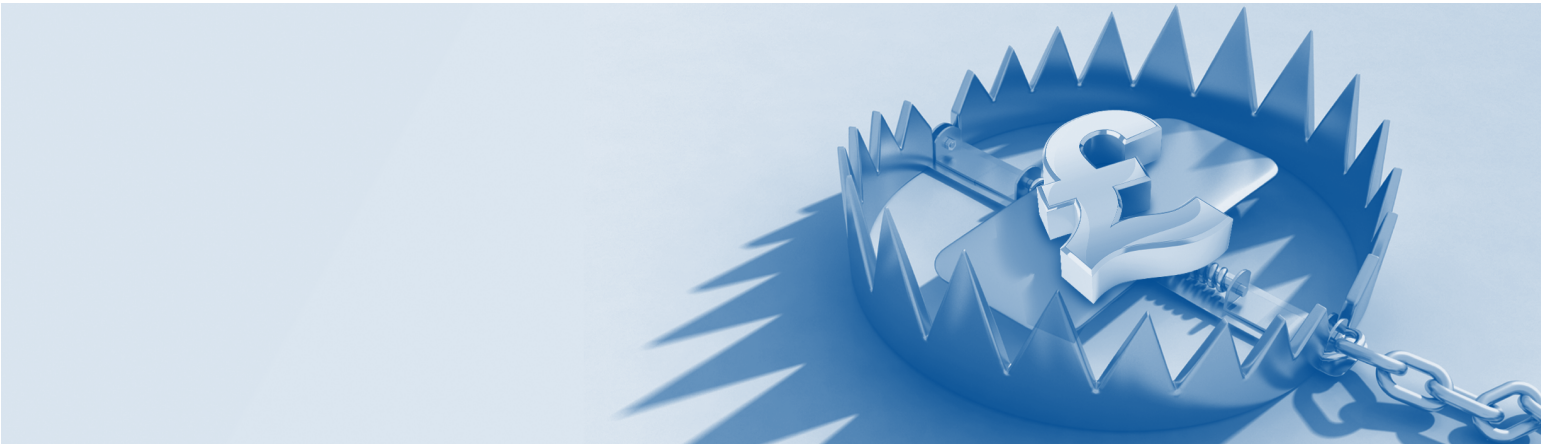


HMRC: The New Era of Penalties Begins...

On 1 April 2009 HMRC brought into effect new legislation in respect of penalties for tax offences. This legislation had been enacted in Finance Act 2007. The new rules apply to any return submitted to HMRC after 1 April 2009, in respect of a period which commenced on or after 1 April 2008. The rules therefore cover the 2008/09 personal tax returns, and PAYE year end returns as well as corporation tax and VAT returns that are submitted after that date.

The rules will not yet apply to the wider range of taxes such as inheritance tax and stamp duty land tax. The new penalty powers in respect of those taxes will be introduced from April 2010.

This briefing explains how the new penalty system will work, what will trigger a penalty, how a penalty will be levied, how a penalty can be reduced and the procedure for assessing a penalty.

What will trigger a penalty?

A penalty will be triggered in two possible ways. Firstly a document (basically any type of HMRC return) is delivered to HMRC and contains an inaccuracy that leads either to a loss of tax, or to an inflated claim for relief. The inaccuracy must arise as a result of the careless or deliberate action of the taxpayer. Secondly, the taxpayer accepts an assessment by HMRC knowing that it is insufficient and takes no action within 30 days to advise HMRC of their error.

The legislation identifies three types of taxpayer behaviour which will trigger a potential penalty:

- Careless
- Deliberate but not concealed
- Deliberate and concealed.

Careless

The legislation defines this as 'failure to take reasonable care'. This phrase is not defined in the legislation but where the taxpayer took reasonable care there will be no penalty. HMRC guidance suggests that the term 'reasonable care' must be considered in the context of the situation of the taxpayer. In simple terms they would expect that a large company would have a greater burden to show reasonable care than an individual taxpayer whose tax affairs are basically simple and straightforward.

What they will expect is that a taxpayer who comes across something different or unusual in their own tax affairs and is uncertain about what the tax consequences might be will seek advice before submitting their return. This could either be from HMRC or from an advisor. If that advice turns out to be incorrect it would be unlikely that HMRC would seek a penalty. They would look for a penalty if no attempt was made to get any advice because they would argue that the taxpayer has not done what they would expect a reasonable person to do.

Records

They would also expect every taxpayer to have sufficient records to ensure the accuracy of their return. Having records that are significantly incomplete would be regarded as a careless act. So too would be repeating the same error in making VAT returns.

Example

Paul, a self employed plumber, does not pay much attention to his record-keeping responsibilities and has no structured system for making sure that his records are accurate.

When Paul completes his income tax return he cannot be certain that his figures are correct and is unable to check them. This attitude towards record keeping indicates a lack of reasonable care.

Simple mistakes

HMRC will not penalise simple arithmetical errors such as transposing figures or simply adding up incorrectly.

Example

Jane enters her car benefit on her self assessment return as £4,190 instead of £4,910. This mistake is a simple arithmetic error so no penalty should arise.

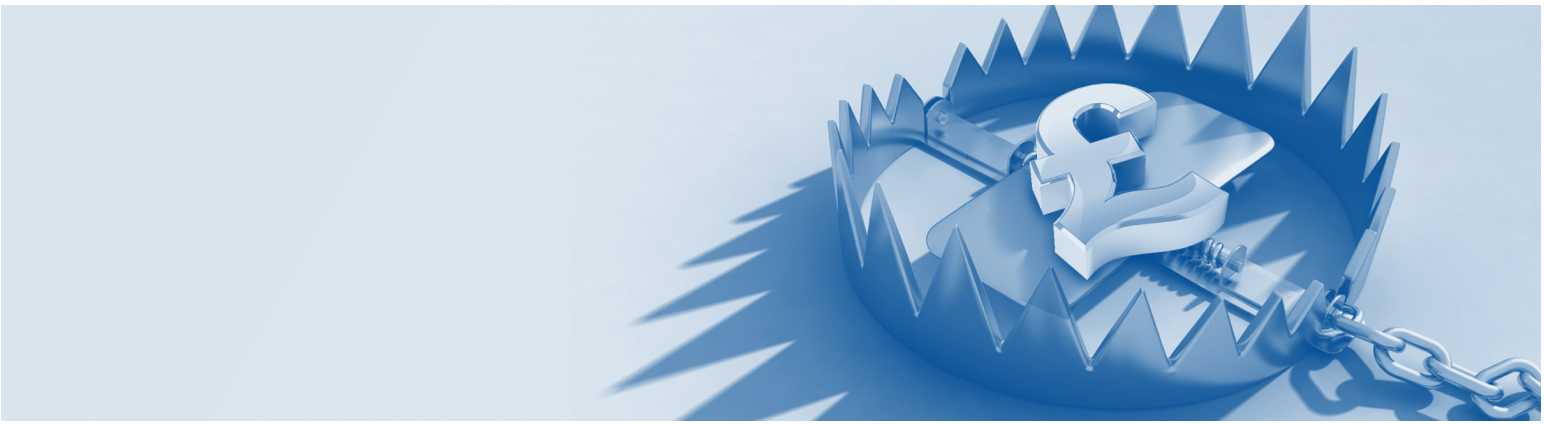
Deliberate but not concealed

HMRC state that this will arise when a person knowingly and intentionally gives HMRC an inaccurate document. Examples would be:

- systematically paying wages without operating PAYE or NIC;
- knowingly failing to record all sales, especially where there is a pattern to the under-recording, such as omitting all transactions with a particular customer or at a particular time of the week, month or year;
- claiming a deduction for personal expenses of such a size or frequency that the inaccuracy must have been known;
- deliberately withdrawing money for personal use from an incorporated business and not making any attempt to make sure it is treated correctly for tax purposes; and
- deliberately undervaluing stock or work in progress at the year end.

Deliberate and concealed

This is regarded as the most serious offence. It occurs where a document containing a deliberate inaccuracy is given to HMRC and active steps have been taken to cover up the inaccuracy either before or after the document has been sent in. This might involve creating fictitious records, notes of meetings, or deliberately destroying documents.



Example

When completing one of his VAT returns, Nilesh decides to enter an inflated input tax figure on his return in order to reduce his declared net liability. He hopes that the false return will not be selected for checking. In order to make the inaccuracy more credible, Nilesh creates a false purchase invoice which he enters in his business records.

In this case Nilesh has taken active steps to conceal the inaccuracy through the creation of a false invoice specifically designed to mislead.

How will a penalty be levied?

Starting point

The starting point will be the type of behaviour that HMRC consider to have been involved in triggering the inaccuracy. This will be the subject of discussion and debate with HMRC and will be crucial in determining the ultimate level of penalty. The law sets out a maximum level of penalty for each offence as a percentage of something called 'potential lost revenue' (PLR). This is broadly the tax that has been lost to HMRC as a result of the offence.

No penalty will be charged if it can be shown that the error was due to a simple mistake that did not amount to carelessness. In the other situations the maximum penalty will be as follows:

- careless action 30% PLR
- deliberate but not concealed 70% PLR
- deliberate and concealed 100% PLR
- accepting underassessment 30% PLR.

HMRC will consider each action of the taxpayer quite separately and will assess the penalty accordingly. They may consider that one mistake has arisen as a result of simple carelessness but another has a deliberate element to it.

Taking account of disclosure

The law allows HMRC to reduce the penalty to take into account the nature and quality of any disclosure made to them. A number of issues emerge here.

Firstly the legislation introduces the concept of 'unprompted disclosure'. Basically this will happen if the taxpayer brings the error to HMRC's notice without HMRC being aware of it or having already started an inquiry. The law states that any other type of disclosure will be regarded as prompted and that will make a significant difference to the level of penalty.

Disclosure does not just mean bringing the matter to HMRC's attention. Account will also be taken of the co-operation which is given to HMRC in quantifying the error and in providing access to records. Guidance in HMRC's manual suggests that the reduction to be made in the penalty will be greatest where:

- the original disclosure is full and complete and covers not only what the error was but how and why it arose;
- the taxpayer provides full co-operation in enabling the investigation to be concluded as quickly as possible; and
- the taxpayer allows HMRC access to records and documents without the need to resort to formal orders.

HMRC will take these issues into account in determining the level of reduction which can be made to the maximum penalty. They are not allowed, however, to go below a minimum level which the law stipulates.

These minimum levels are as follows:

Nature of offence	Max %	Min unprompted	Min prompted
Careless action	30%	0%	15%
Deliberate no concealment	70%	20%	35%
Deliberate with concealment	100%	35%	50%

It is very obvious that there is a significant effect in making a full unprompted disclosure. Even in prompted disclosure situations the level of co-operation will make a large difference to the ultimate penalty level.

Assessing the penalty

Basic procedure

The law requires that a penalty should be formally assessed by HMRC. They have an important power to suspend some or all of any penalty which relates to careless action only. If they decide to do this, they can stipulate the period for which the penalty is suspended and can impose conditions on the taxpayer which must be complied with. At the end of the period HMRC will consider whether the taxpayer has met the conditions. If the conditions are satisfied then the penalty will be dropped. If they have not then the penalty can be imposed. HMRC are only likely to do this where they can set and measure the conditions to improve compliance. It is unlikely that they would agree to suspend a penalty in relation to a one-off item like a capital gain.

Right of appeal

Any taxpayer who has been assessed to a penalty has the right of appeal to the new First Tier Tribunal. This appeal can be against:

- the basic imposition of a penalty at all
- the amount of the penalty assessed
- a decision not to suspend some or all of the penalty
- the conditions relating to a suspension.

The Tribunal has the power to revoke a penalty assessment and to amend the amount of a penalty – including a power to increase it! They must still act within the parameters set out by the legislation.

Liability of an officer of a company

The penalty provisions extend to situations in which a company becomes liable to a penalty and the inaccuracy arose as a result of the deliberate action of an officer of the company. In those circumstances HMRC can seek to recover some or all of the penalty from the officer personally. This approach is likely to be followed where it is clear that the officer may have gained personally from the deliberate inaccuracy or where the company is, or is likely to become insolvent and will not have funds to pay the penalty.