Penalty shootout

Management of taxes | Personal tax

01 March 2020

Anton Lane explores the framework for HMRC’s penalty regime, and how this can be negotiated in practice

Key Points

What is the issue?

Whilst the penalty regime provides a framework for penalties, there is still the risk of inequality between treatment of taxpayers.

What does it mean to me?

Negotiating penalties is not straightforward and may take time to prepare considered representations.

What can I take away?

Being aware of HMRC guidance and having experience of other negotiations may prove valuable.

The legislative framework for penalties was intended to provide fixed parameters so that penalties became more standard for all taxpayers; i.e. treating taxpayers equally. However, whether a penalty is on equal footing for taxpayers is still at the mercy of discussions between the taxpayer and/or their agent and an HMRC officer.

Taxpayers often believe an HMRC officer has targets that include maximising revenue and charging higher penalties. According to the official voice, that is not the case. So, what considerations might an HMRC officer take into account in agreeing to mitigate a penalty? In this article, I consider the mitigation of tax geared penalties and unusual circumstances faced in practice.

Broadly, tax geared penalties can arise for:

- errors (Finance Act 2007 Sch 24);
- failure to notify (Finance Act 2008 Sch 41);
- failure to make returns (Finance Act 2009 Sch 55); and
- failure to make payment on time (Finance Act 2009 Sch 56).

The tax geared penalties for errors and failing to notify are based on the potential lost revenue (PLR), whereas those for failure to make returns and make payment on time are based on any liability to tax which would have been shown in the return.

Potential lost revenue

The first area for a disagreement may therefore be what constitutes PLR. The normal rule for PLR relating to errors is: ‘The “potential lost revenue” in respect of an inaccuracy in a document (including an inaccuracy att ributable to a supply of false information or withholding of information) or a failure to notify an under-assessment is the additional amount due or payable in respect of tax as a result of correcting the inaccuracy or assessment.’ (FA 2007 Sch 24 para 5)

The treatment of an error therefore needs to be ‘agreed’ if the PLR is to be determined. For example, the tax due on a payment to a shareholder/director needs to be agreed as either subject to PAYE or treated as a director’s loan. Both treatments also have an impact for corporati on tax and this needs to be considered when arriving at the PLR.

The calculation of PLR is more problematic where there are multiple errors. PLR in respect of each inaccuracy may depend on the order in which they are corrected. The legislation deems the order in which the inaccuracies are to be corrected as: careless inaccuracies; then deliberate but not concealed inaccuracies; and finally deliberate and concealed. Overstatements are off set against understatements following the same order.

A penalty can still arise where an inaccuracy results in a loss being wrongly recorded and not wholly used. The PLR is calculated under the normal rule in respect of the used loss, plus 10% of any unused loss.

The penalty regime applies to the difference between the amount recorded and the true amount. Where an inaccuracy has the effect of creating or increasing an aggregate loss recorded for a group of companies, group relief may be taken into account. In circumstances where there is no prospect of the loss being used to reduce a tax liability, the PLR in respect of a loss is nil.

The PLR where an inaccuracy resulting in tax being declared later than it should have been is 5% of the delayed tax for each year of the delay, or proportionate amount thereon.

The definition of PLR for failures to notify is different than that for errors:

- The PLR for income tax and CGT purposes is that which the individual is liable to and which is unpaid on 31 January following the tax year.
- The PLR for corporati on tax purposes is that which the company is liable to in respect of the accounting period and which remains unpaid 12 months after the end of the accounting period.
- The position is similar for VAT.

Prompted or unprompted

HMRC guidance broadly follows the statutory definition of an unprompted disclosure [FA 2007 Sch 24 para 9(2), FA 2008 Sch 41 para 12(3) and FA 2009 Sch 55 para 14(3)]: ‘A disclosure is unprompted if it is made at a time when the person making it has no reason to believe that we have discovered or are about to discover the inaccuracy or under-assessment. Otherwise it is a prompted disclosure.'

The legislative test is to consider whether the taxpayer has no reason to believe. It is an objecti ve test – it is not based on or influenced by personal feelings or opinions. The legislation requires considerati on where a person has 'no reason to believe' rather than their 'believing'. For example, a person may have received a self-assessment reminder from HMRC, which made them feel that they were being targeted and HMRC knew of their undisclosed income. That belief is irrelevant. The fact that a reminder was sent would not give a reason to believe the undisclosed income would be identified by HMRC.

Guidance states that HMRC want to encourage unprompted disclosures and includes the following advice to HMRC officers:

- A disclosure can be unprompted even if, at the time it is made, the full extent of the disclosure is not known, as long as the full details are provided within a reasonable time.
- There can be no halfway house between an unprompted and prompted disclosure. It is either one or the other.
- All the facts need to be considered before deciding if a disclosure is unprompted or prompted. A common sense approach is needed. Hasty judgments should be avoided.
- An HMRC campaign highlighting an area of the trading community on which HMRC will be concentrating would not stop a disclosure from being unprompted.
- A disclosure would be prompted if made after specific contact from HMRC to advise of a compliance check or a visit to premises.
- It will be exceptional for a disclosure to be unprompted if a compliance check is in progress. The disclosure will be unprompted only if it is about something the compliance officer has not discovered or is not about to discover.

It is therefore accepted (albeit exceptionally) that a disclosure may be unprompted even if a compliance check is in progress. In one case, HMRC had opened an enquiry into the husband's tax return and no information had at that time been provided to HMRC. The husband had undeclared income although it appeared that the husband and wife were acting in partnership, one being responsible for administration of the business and the other for undertaking services to clients. The husband had received cash payments, which he had not disclosed to HMRC. Did the wife have reason to believe that HMRC were about to discover that the wife had an inaccuracy?

The facts for the wife were that HMRC did not have information and were not in possession of information for the husband's tax affairs. Would HMRC, during their enquiries, identify that the spouse had undeclared income? Should it be assumed that husband and wife communicate openly, although as many married couples will know, communication between them is a belief and not a fact? It is acknowledged that the situation is a difficult one, although given that HMRC want to encourage unprompted disclosure, it would appear counterproductive to penalise the wife in these circumstances.

Consider the situation of friends, one of whom has received an enquiry letter and one whom has not. Both have undisclosed rental income from flats within the same block. Following a conversation in the pub, the friend without an enquiry approached HMRC to disclose irregularities. This is an unprompted disclosure, is it not? Would the position be different if the two friends owned one rental flat between them and divided the income?

HMRC guidance clearly states that 'a disclosure can be unprompted even if at the time it is made the full extent of the disclosure is not known, as long as the full details are provided within a reasonable time'. The disclosure is of the facts and not necessarily quantifying the tax liabilities. Often during an enquiry, an officer and adviser will debate whether an irregularity is taxed one way or another. However, in one case, an HMRC officer refused to accept that an unprompted disclosure had been made where, after the basic facts had been disclosed, HMRC argued that the profits should be taxed in a company and not in a partnership. The adviser recommended that the taxpayer agreed with HMRC's contention to settle the matter – but HMRC then refused to accept that the disclosure was unprompted.

Behaviour

For penalties arising under FA 2007 Sch 24, the three 'behaviours' for which standard levels of penalty are set are:

- careless action;
- deliberate but not concealed action; and
- deliberate and concealed action.

For penalties arising under FA 2008 Sch 41, the three ‘behaviours’ for which standard levels of penalty are set are:

- non-deliberate failures;
- deliberate but not concealed failure; and
- deliberate and concealed failure.

Assuming the PLR can be agreed, the behaviour of the taxpayer needs to be considered. This is where it is more likely that one officer’s view will differ from another’s. Maybe one officer will hold a belief that any taxpayer who has made an error has done so deliberately, whereas another may empathise with the personal circumstances of the taxpayer.

The personal circumstances of the taxpayer are important when considering behaviour because, when determining the type of behaviour, it is necessary to sit in the shoes of the taxpayer. A simple illustration is that of a practising accountant who continually underdeclares income or overstates expenses. An accountant is considered more knowledgeable than someone who is not trained to complete accounts and prepare tax returns. Therefore, to demonstrate that the behaviour of a knowledgeable person is careless has a much higher benchmark. HMRC’s Compliance Handbook clarifies the point as follows:

> ‘Every person must take reasonable care, but reasonable care cannot be identified without consideration of the particular person’s abilities and circumstances. HMRC recognises the wide range of abilities and circumstances of those persons completing returns or claims. So whilst each person has a responsibility to take reasonable care, what is necessary for each person to discharge that responsibility has to be viewed in light of that person’s abilities and circumstances.
>
> ‘For example, we do not expect the same level of knowledge or expertise from a self-employed unrepresented individual as we do from a large multinational company. We would expect a higher degree of care to be taken over large and complex matters than simple straightforward ones.’

It is thus important that the adviser helps the HMRC officer with information about the taxpayer’s academic level, including literacy and numeracy. Disabilities such as dyslexia or dyscalculia should also be considered, as medical advice may consider that an individual’s ability to keep and understand business records could be impaired by their condition.

Conclusions

No two penalty negotiations are the same and that is probably because no two officers (and perhaps no two advisers) are the same. Maybe there is a motivation to penalise but not driven by HMRC leadership. I think the reality is no one knows what motivates the inconsistencies applied by different officers. Whilst it’s important that HMRC should work on being consistent to remain fair to all taxpayers, advisers have a part to play in ensuring that all relevant facts are properly drawn to the officer’s attention.