Penalties for careless and deliberate VAT accounting errors

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INTRODUCTION

Penalties for careless and deliberate VAT accounting errors were introduced in 2009. The purpose of this penalty system is to incentivise taxpayers to take care in dealing with VAT by penalising those who do not. Evidence suggests that HMRC is now applying these penalty rules more strictly than it did initially.

As well as a large increase in the number of cases referred to CVC, there has been an increase in penalty cases involving alleged deliberate and careless errors at the First-tier Tax Tribunal. Also, some of our larger clients have been advised by their Client Relationship Manager that HMRC has recently issued a policy edict that penalties are to be applied more rigorously. In short, penalties for VAT accounting errors will become an increasingly important issue.

The following only deals with penalties for careless and deliberate accounting errors. There are many other penalty powers available to HMRC.

This is not marketing material that should be ignored or digested quickly. <u>We strongly recommend that you read this guidance carefully and retain it for future reference.</u>

There are steps that any organisation can take to reduce the risk of penalties. If you wish to discuss this please speak to your usual CVC contact or email laura.beckett@ukvatadvice.com

WHEN IS A PENALTY APPLIED?

VAT law imposes a penalty when both of the following conditions are met:

Condition 1

An inaccurate document either amounts or leads to:

- *an understatement of the person's liability to tax, or*
- *a false or inflated statement of a loss by the person, or*
- *a false or inflated claim to repayment of tax*

Condition 2

The inaccuracy was careless or deliberate.

HMRC recognises four types of inaccuracy:

i. *<u>Mistakes made despite taking 'reasonable care'</u>: No penalty is due*

ii. *<u>Careless mistakes</u>: A penalty of 30% of the potential lost revenue is due*

iii. *<u>Deliberate (but not concealed) inaccuracy</u>: The penalty percentage is 70%*

iv. *<u>Deliberate and concealed inaccuracy:</u> The penalty percentage is 100%*

PENALTY MITIGATION

Penalty mitigation is available for:

Telling	This requires that an error is disclosed to HMRC. • A disclosure is "unprompted" if made at a time at which the taxpayer has no cause to think that HMRC would find the error. • A disclosure is "prompted" if at the time the disclosure was made the taxpayer had reason to think that HMRC would discover the error.
Helping	This involves proactively trying to assist HMRC, for example in quantifying the error.
Giving Access	This involves responding quickly to requests for information and providing HMRC with access to business records.

HMRC will mitigate penalties when all or some of these criteria are met using a formula that weights each element.

MINIMUM PENALTIES

There are statutory minimums below which HMRC cannot reduce a penalty unless there are "special circumstances". For example, if HMRC discovers an error or there is a prompted disclosure the minimum penalty will be 15% of the potential lost tax regardless of how much mitigation is secured by cooperating with HMRC.

Type of behaviour	**Statutory minimum penalty with unprompted disclosure**	**Statutory minimum penalty with prompted disclosure**
Careless	0%	15%
Deliberate but not concealed	20%	35%
Deliberate and concealed	30%	50%

MITIGATION IN SPECIAL CIRCUMSTANCES

HMRC has the power to reduce penalties in special circumstances. These are taken to be:

- uncommon or exceptional, or
- where the strict application of the penalty law produces a result that is contrary to the clear compliance intention of that penalty law.

The fact that HMRC has not lost tax when considering the supply chain as a whole is explicitly ruled out as a basis of penalty mitigation. This means that if you fail to charge VAT in a situation in which your customer could have reclaimed that VAT (the Exchequer has not lost money) a penalty of between 30% and 100% may still be imposed, subject to any mitigation.

PENALTY SUSPENSION

HMRC has the power to suspend penalties. A suspended penalty will not be applied provided that a taxpayer meets conditions imposed by HMRC for a pre-agreed period of time. In the event that the taxpayer fails to keep his side of the penalty suspension agreement the suspended penalty immediately becomes payable.

COMMONLY OVERLOOKED RISKS

An entitlement to adjust a VAT return does not mean that a penalty is not due

A taxpayer may be able to adjust a mistake made in an earlier period on a current VAT return. Alternatively, there may be a requirement to make a separate error notification to HMRC. Obligations and rights as regards error correction are not based on whether the original error was careless or deliberate but are dictated by statutory value thresholds pertaining to error adjustment. Smaller errors can be adjusted on a current VAT return, larger errors cannot.

The crucial points as regards the application of penalties are:

- An entitlement to make an adjustment without informing HMRC does not prevent an error from being careless or deliberate.

- If a taxpayer believes an error to be careless, or is unsure and wishes to be certain of securing mitigation, he should inform HMRC even if he is permitted to adjust the error on a VAT return.

- The law requires that a taxpayer takes "reasonable steps" to inform HMRC when an error is discovered. If he does not then the original error automatically becomes classified as careless, even if it was not a careless error at the time it was made. When a taxpayer adjusts an error above the error adjustment value threshold on a VAT return then HMRC's policy is that the taxpayer has failed to take reasonable steps.

We often encounter situations in which businesses prefer to adjust VAT returns rather than make a separate disclosure. They worry about attracting HMRC's attention by making a disclosure and there is a sense that "it's a technicality, HMRC won't mind". Of course every case will turn on its own facts but as a general rule:

- HMRC does not view voluntary disclosures of errors as a bad compliance indicator. Quite the contrary, HMRC is more likely to select a business that it has not had contact with for a number of years for an inspection than a business that has demonstrated that it takes VAT seriously by spotting and adjusting errors.

- By failing to follow the correct procedure the business has exposed itself to a potential 30% penalty.

But the error worked in HMRC's favour!

An error that leads to an overpayment of tax will not be penalised. However, adjusting that error incorrectly may lead to a penalty. The following example involving Joe reproduces a section of HMRC guidance; the emphasis we have added!

HMRC example

Joe received a VAT repayment that he was entitled to. Due to a posting error he mistakenly accounted for the receipt to HMRC as taxable sales in his next VAT return. The large size of the output tax related error meant that Joe should have notified HMRC via the VAT error correction report process. However, he mistakenly corrected the error in his next VAT return.

We carried out a pre repayment credibility check. When prompted, Joe explained what he had done. We decided that the error was careless because a prudent VAT taxpayer should have been aware of the error correction return adjustment limit. This meant Joe was liable to an inaccuracy penalty of 15% minimum for a prompted disclosure.

In these precise uncommon and exceptional circumstances, where Joe had mistakenly paid his VAT refund back to HMRC and clawed it back via his next VAT return instead of notifying HMRC using the error correction process, we would consider reducing the penalty to a more appropriate level through special reduction. The reduced penalty would take into account these relevant facts but still be sufficient to encourage Joe to comply with the error correction report requirement for larger VAT errors in future.

In this example the Exchequer has benefited from Joe's error (effectively Joe provided the government with an interest free loan). Joe was entitled to have his overpayment of VAT refunded. However, Joe is considered deserving of a penalty because "*He asked for his refund in the wrong way*".

Not dealing with mistakes quickly can lead to a penalty

On discovering an error a taxpayer is required to correct the position. As regards VAT penalties, the law dictates that if such a taxpayer does not take "*reasonable steps*" to inform HMRC then the error will be reclassified as careless even if it was not careless when it was originally made.

Accepting an incorrect assessment can lead to a penalty

If HMRC issues an assessment that is too low and HMRC is not notified of this within 30 days then a careless error penalty will be applied. This would, for example, be the case if a VAT return is submitted late and HMRC issues an estimated assessment that is too low and the taxpayer does not notify HMRC within 30 days.

You can suffer a penalty on money that you never received

If HMRC examines a claim and decides that it is invalid then not only may you not receive the money you asked for but you may be fined 30% or more of the amount you requested. This would apply also if a claim is simply reduced. Of course HMRC does need to show that the overstated claim contained a careless or deliberate error.

This is a particular risk when it is difficult to calculate an amount due - for example if the claim needs to be submitted quickly because of a statutory cut-off or there are different ways to approach the claim calculation.

The approach:

> "*We will ask for as much as possible because the worst that can happen is HMRC will say No",*

is likely to lead to the response:

> *"We reject your claim and here is your penalty bill for asking for money you are not entitled to!"*

Penalties apply to all forms of claim, not just VAT returns

Whatever the mechanism used to declare VAT or request a VAT rebate it is potentially subject to a penalty. One area in which HMRC seems particularly keen to issue penalties is in relation to DIY House builder claims. For example in a recent First-tier Tax Tribunal case HMRC argued that a taxpayer was careless in asking for a refund because he should have realised that his supplier had charged VAT incorrectly (fortunately the First-tier Tribunal rejected HMRC's argument that a house owner who employed a tax agent to prepare his claim had himself been careless in not identifying a VAT liability error by his supplier on a complex point of VAT law).

The meaning of "deliberate error"

Most people assume that a deliberate error involves a taxpayer identifying an amount of tax that should be paid and simply deciding not to pay it. This is <u>not</u> what the law says. As HMRC guidance states:

> *A deliberate inaccuracy occurs when a person gives HMRC a document that they know contains an inaccuracy. It is not necessary to demonstrate that the person knew what the accurate figure was, only that they knew that the figure they put on the document was not accurate.*

A taxpayer could have no knowledge of the size of the error and be uncertain whether the net effect of different errors is an overpayment or an underpayment of tax. As far as the penalty rules are concerned he is deliberately submitting an inaccurate return. In short, if you know that there is an issue that needs to be resolved in relation to your VAT accounting and you continue to submit VAT returns, perhaps with every intention of addressing that issue when you have time, then you are deliberately submitting inaccurate returns.

The other point is that HMRC will be asked to prove their case based on "the balance of probabilities". Or to quote again from HMRC guidance:

> *The standard of proof is the balance of probabilities. This means that on the evidence, it is more probable than not that the inaccuracy was made carelessly or deliberately.*

The starting position in making this assessment will be what HMRC considers that a reasonably competent person would have known and done. There is a risk that HMRC will judge that inaccurate VAT returns have been submitted deliberately not because you were aware of inaccuracies on those returns but because <u>you should have known</u> that those returns contained inaccuracies.

Periods open to assessment

In most circumstances HMRC are able to raise VAT assessments for a period of only 4 years. However, if HMRC can show that errors are deliberate then assessments can be raised for a period of 20 years. These rules provide a strong incentive for HMRC to view an error as deliberate when the 4 year cap may otherwise prevent HMRC from collecting underdeclared or overclaimed VAT.

Directing "officers" to pay penalties

If HMRC can show that a business has deliberately submitted inaccurate returns and that this is attributable to the behaviour of an officer, or officers, of the business then HMRC secures the right to issue payment liability notices against the company's officer(s) as individuals. This is done where the individual(s) gained personally or the business is insolvent, even when the individual gained nothing personally.

We decline to act for clients that we do not consider to be honest. However, it has been impossible not to feel sympathy for individuals who have approached us (too late) who face financial ruin because a company has become insolvent. Surprisingly we have encountered cases in which a taxpayer's accountant has advised "*It will be cheaper to liquidate the company than argue with HMRC on the liability*" an incredibly short-sighted stance bearing in mind HMRC tends to issue assessments for as much money as possible to protect its position and force the taxpayer into a proper discussion. HMRC is not exposed to any penalty risk for failing to take reasonable care when estimating liabilities.

HMRC guidance says*:*

> *The liable officers do not individually have the right to appeal against the amount of the penalty assessed on the company. This can only be appealed by the company or the administrator/insolvency practitioner, if they are being wound up.*

This means that once a business has become insolvent then it will often be impossible for the individual who has been directed to pay all or part of a penalty to contest the penalty, except as regards his/her own conduct and the proportion of the penalty allocated to him/her.

The right to issue personal liability notices extends to: members in an LLP, shadow directors and "managers". There is no statutory definition of the term "manager", although in relation to non-corporate bodies it is defined to be *"any other person managing or purporting to manage any of the company's affairs"*. In principle, this might extend to include employees with a managerial responsibility.

Naming and shaming

HMRC has the power to name and shame taxpayers who are involved in tax evasion. This extends to the following circumstances:

- a penalty for a deliberate inaccuracy has been applied;
- the wrongdoing occurred after 1 April 2010 (when the rules allowing public disclosure were introduced);
- HMRC discovered the error;
- the taxpayer has not secured maximum mitigation for the quality of the disclosure; and
- the potential lost revenue exceeds £25,000.

IT COULDN'T HAPPEN TO ME - A REAL EXAMPLE

Many people reading this document will no doubt be thinking "*This is all well and good but this would never happen to me because I am honest and try hard."*

We would simply point to the following example of a recent case dealt with by CVC.

- Company *X* (*X*) has been trading for more than 20 years and has an excellent compliance record across all taxes.

- In 2011 HMRC withdrew an agreement with a trade association that <u>potentially</u> impacted on *X*'s liability to charge VAT.

- The change to VAT accounting required as a result of the withdrawal of the agreement with the trade body was not clear. HMRC (subsequently) argued that it had withdrawn a concession. We take the view that HMRC had never granted a concession, it had merely indicated that it could be relied upon to interpret a complex point of law in a particular way that was itself entirely consistent with VAT legislation.

- Changes were implemented by *X* in 2012. These changes eliminated any ambiguity about whether *X* should charge VAT. From January 2012, *X* started to charge VAT.

- As part of a campaign (targeting a large number of businesses operating in the same sector) HMRC carried out an inspection of *X* in 2015. HMRC then issued an assessment for £1.2 million in relation to sales made in 2011, including against one VAT quarter that was more than 4 years old when the assessment was raised (normally not open to assessment).

- HMRC also decided to impose a penalty because *X* had deliberately submitted inaccurate VAT returns.

- The total bill that HMRC sought to impose was £1.8 million.

HMRC's position was:

- *"We told a trade association of which you are a member that we were withdrawing a concession and it notified its members."*

- *"*X *was told of this change by its trade association and therefore during 2011* X *was deliberately submitting inaccurate VAT returns."*

- *"The fact that* X*'s customers would all have been entitled to reclaim any VAT charged by* X *is not a relevant consideration when it comes to applying penalties"*

In short, HMRC was able to conjure up a £1.8 million windfall from a situation in which, irrespective of whether the taxpayer should have charged VAT, the Exchequer had not actually lost a penny. This included a penalty for deliberately submitting inaccurate returns of £420,000 (HMRC generously mitigated the potential £840,000 penalty to the statutory minimum due to *X*'s cooperation).

CVC was in this case able to help eliminate *X*'s VAT costs and interest and penalties. Our settlement strategy involved a technical submission that showed that the underlying assessment was contrary to HMRC's own published guidance and a subsequent agreement with HMRC that:

- HMRC would raise assessments covering VAT that the client could retroactively charge and recover from customers.

- All penalty and interest charges would be suspended or dropped.

- Part of the assessment was withdrawn on the basis that it covered a VAT period that ended more than 4 years before the assessment date.

We believe that HMRC was keen to avoid a legal challenge on a point that was generating large assessments against other businesses (our client was one of a number caught up in a "campaign").

For our client it was expedient to reach an agreement that avoided litigation costs. However, had it not been properly advised our client would have incurred a penalty of £420,000 on an "error" that cost the Exchequer nothing and in our view was not even a mistake (HMRC never responded to our technical submission).

Our client struggled to understand why HMRC would behave in this way given its impeccable track record of declaring and paying tax.

The salient point is that every year thousands of taxpayers who believed "*This couldn't happen to me*" discover that the reality is "*Oh yes it could* ".

If you would like to discuss how VAT impacts on your organisation please speak to your usual CVC contact or call or email Dean Carey:

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Alternatively, please visit our website at www.ukvatadvice.com where you can view some of the services we offer in more detail and subscribe to our free general and regular VAT alerts and updates. Visit our website for current news updates. You can also follow CVC on Twitter.

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