

Compliance Failure Example – APS HC

It is the end of July 2020, and you have recently joined Stokes Ltd (“Stokes”) as payroll manager. The Finance Director (“FD”) has informed you that he has just received notification of a HMRC PAYE and NIC compliance visit in the near future. The FD is confident that Stokes will receive a ‘clean bill of health’, but just to be on the safe side, has asked you to carry out a review of the company’s PAYE and NIC compliance procedures in advance of that meeting.

In performing your review you discover one issue – namely that, since November 2019, the company’s sales director, Joe Green, has been travelling extensively abroad, meeting with prospective clients across Europe, to further the company’s strategy of expanding into new markets. This was Stokes’ first foray into overseas markets and equated to Joe spending approximately 6 days a month outside the UK.

Since then, Stokes has been paying Joe £4,000 a month to cover his travel and accommodation costs as well as any costs incurred entertaining his business contacts. The company did not put this through the payroll as it was simply intended to cover his various expenses. Joe was not required to account for how this allowance was spent, nor provide receipts for any expenditure – and if any money was leftover at the end of each month, Joe did not have to return it to Stokes. This seemed to be the easiest solution at the time as Joe was travelling all over Europe. Joe is an additional rate taxpayer.

You meet with the FD and explain that cash allowances are treated as additional taxable employment income where they do not clearly relate to specific and identifiable deductible expenditure. The £4,000 per month paid to Joe since November 2019 should therefore have been subject to PAYE and NIC withholding. In quantifying the tax and NIC due, HMRC are likely to consider that the £4,000 per month received by Joe is net of any employee income tax and NIC due. Thus the £4,000 net amount paid equates, on a grossed-up basis (at 45% income tax and 2% primary Class 1 NIC), to £7,547 extra remuneration per month (£4,000 x 100/53). Thus income tax and Class 1 primary NIC of £3,547 per month should have been remitted to HMRC, increased by secondary Class 1 NIC of £1,042 (13.8% of £7,547), a total of £4,589 per month.

You agree with the FD that the £4,000 allowance will cease with effect from 1 August 2020 and that, going forward, all Joe’s costs relating to European travel will be directly reimbursed on an expense claim basis supported by receipts. The July 2020 cash allowance will be processed through payroll correctly – ie on the above grossed-up basis. As regards the past PAYE compliance failings (ie the eight months from November 2019 to June 2020 inclusive), the FD is keen to advise HMRC and rectify the matter as soon as possible.

For payments still within the current tax year, 2020/21, the underpayment can be corrected via this year’s payroll filings by updating the year-to-date figures. You advise the FD that this can be done in next regular payroll “Full Payment Submission”. The 2019/20 underpayment can also be corrected via the payroll. As this tax year has already ended, Stokes will submit an additional Full Payment Submission showing the correct figures. There were 5 months of allowance paid in 2019/20 and 3 months in the current tax year. The tax and NIC understated is thus $8 \times £4,589 = £36,712$.

While this will correct the error and ensure Stokes pays over the under-deducted PAYE and NIC to HMRC as quickly as possible, you advise that the company should nonetheless contact HMRC and make a full disclosure of the error, as HMRC will wish to levy penalties for errors and late payment as well as interest. You explain to the FD that even though Stokes has identified the error itself, as a HMRC visit was planned, this will be treated as a “prompted disclosure” thus carrying a higher minimum penalty.

The FD agrees and you draft a letter to HMRC which:

- Includes a calculation of the PAYE and NIC under-deduction, on a grossed-up basis by tax year;
- Details how the amounts due will be paid through payroll as soon as possible, thus correcting the error;

- Apologises for this “innocent error”;
- Explains to HMRC that the error was caused by the company’s failure to appreciate that round sum amounts such as this, even if used for what would be qualifying expenses, nonetheless should be processed through payroll; and
- Expresses Stokes’ willingness to provide any further information required by HMRC in order to bring this matter to a swift conclusion.

After an exchange of correspondence and after HMRC’s compliance visit (which found no further errors) HMRC agree that their enquiry will be confined to this issue and these tax years. This will be incorporated in a contract settlement. HMRC would like this to be finalised by 30 September 2020.

Now that the tax has been quantified and the error remedied, the next stage is to agree the penalty loading.

As Stokes made a prompted disclosure of a careless error, under Sch 24 FA 2007 the penalty range is between 15% and 30% of the potential lost revenue (here being £36,712).

In the light of the above, you analyse HMRC’s criteria for mitigating penalties based on quality of disclosure:

<u>Criteria</u>	<u>Maximum mitigation</u>	<u>Reasoned support</u>	<u>Suggested mitigation</u>
“Telling”	30%	Stokes quickly admitted the inaccuracy, made a full disclosure and explained why the error arose.	20%
“Helping”	40%	Stokes quantified the inaccuracy, calculated the underpaid tax and provided support calculations. The under-deducted tax was paid over as soon as possible and requests from HMRC were answered quickly and politely.	40%
“Access”	30%	Stokes agreed to provide access to any appropriate records and duly did.	30%
Suggested mitigation for quality of disclosure			<u>90%</u>

You therefore suggest to HMRC that the maximum penalty should be reduced by 90% of the penalty range (in this case by 90% of 15% being 13.5%). The penalty loading would then be $(30 - 13.5) \% = 16.5\%$.

Assuming this can be agreed with HMRC, the contract settlement to be sought would be as below:

Under-declared tax:		£
Penalty for incorrect return:	£36,712 x 16.5%	36,712
Penalty for late payment:	See Note below	6,057
		<u>918</u>
		<u>43,687</u>

Of this figure, £36,712 has already been paid over through the RTI filings, leaving £6,975 due and this should be paid within 30 days of the settlement agreement being signed (ie, by 30 October 2020). It should be noted that interest for late paid tax will also be added (not calculated here).

Note: The first late payment in a tax year does not count as a default. Thus there were four defaults in 2019/20 as the November 2019 failure is not counted. Once a taxpayer reaches four defaults, the 2% penalty applies to all defaults, even defaults one to three.

There are two defaults in 2020/21 (April is not counted). For the May and June defaults, the penalty is 1% of the tax paid late.

Two of the payments (being those for November and December 2019) are more than six months late, and are therefore liable to an additional 5% penalty (this is the case even though the November 2019 late payment did not itself count as a default).

The late payment penalties are therefore as follows:

Defaults charged at 1%	$\text{£}4,589 \times 1\% \times 2$	£ 92
Defaults charged at 2%	$\text{£}4,589 \times 2\% \times 4$	367
Additional penalties at 5%	$\text{£}4,589 \times 5\% \times 2$	<u>459</u>
		<u>918</u>

Of the above settlement, the under-declared tax of £36,712 will be deductible from Stokes' trading profits, thus yielding a corporation tax saving at 19% of £6,975. The penalties and interest are not deductible.

Before formally agreeing to pay this amount, as this is a careless error by a taxpayer with an otherwise unblemished compliance record, HMRC should be asked to consider suspending the penalty for two years. In this case HMRC would seek immediate collection of the tax and interest but would postpone collection of the penalty. If Stokes makes no further mistakes and files all returns / makes tax payments on time for two years, the penalty will be cancelled.