

Compliance Failure Example – APS IHTTE

The Lester Stokes Family Settlement is a discretionary trust established by the Will of Lester Stokes in 2012. The Trustees are Lester's brother Barry and his wife Tracy.

Barry is a Chartered Accountant and prepares the annual trust accounts and self-assessment tax returns.

The Trustees filed the 2017/18 trust tax return on 29 January 2019. The trust has profits from a UK property business, bank interest and dividends from a share portfolio. The balancing payment for 2017/18 was made on the same day. All returns are up to date and the Trustees have never had a HMRC enquiry.

In July 2020 the Trustees received a letter from the Tax Office asking them to review the 2017/18 tax return as they have evidence to suggest that not all income and gains in this tax year may have been disclosed.

Barry checked the trust records and realised that the Trustees had sold a rental property (73 Greenpond Close) in June 2017 and although he had included the rental profits for April - June 2017 within the overall property income figure, he had not disclosed the gain. This was due to Barry's misunderstanding of the CGT system because, as a beneficiary had lived in the property when the Trustees first bought it, Barry had assumed (incorrectly) that all gains would then be exempt.

Barry has contacted you for advice on how to deal with the HMRC enquiry.

You explain that HMRC (through its "Connect" system) can cross-check taxpayer records with other databases and use this to highlight potential inaccuracies or anomalies in tax returns. It may be that the sale of 73 Greenpond Close was registered at the Land Registry and details of that change of registered owner have reached HMRC. The Tax Officer would then expect a disposal to be reported on the capital gains pages of the 2017/18 trust tax return and HMRC are therefore enquiring as to why no gain has been reported.

Although HMRC can only raise an enquiry into a return within 12 months of the filing date (a deadline which is now passed), under their "discovery" powers they can (if needed) raise an assessment to make good a loss of tax due to an omission from a return.

The window for the Trustees to amend the 2017/18 trust tax return closed on 31 January 2020, but nevertheless the omission can still be (and should be) disclosed to HMRC. As the Tax Office has written to Barry as Trustees, you agreed to draft a letter in reply.

The letter to HMRC was duly drafted which:

- Included a calculation of the capital gain on the sale of 73 Greenpond Close;
- Was supported by a copy of the solicitor's letter confirming the net sales proceeds and a copy of the original conveyance report which showed the purchase cost;
- Provided a detailed analysis of periods of beneficiary occupation to show the percentage of the gain which is exempt from CGT;
- Calculated the Trustees CGT liability for 2017/18 showing tax due of £15,000;
- Apologised for this "innocent error";
- Explained to HMRC that the error was caused by the client's failure to fully appreciate the complexities of capital gains law rather than there being any deliberate attempt to avoid tax; and
- Expressed the Trustees' willingness to provide any further information required by HMRC in order to bring this matter to a swift conclusion.

After an exchange of correspondence, HMRC agreed that their enquiry would be confined to this issue and they had no reason to believe that income and gains have been incorrectly disclosed in previous returns. Therefore a tax adjustment will be made for 2017/18 only. 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 the Trustees 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 £15,000).

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%	HMRC are aware that a disposal was made but the client quickly admitted the inaccuracy, made a full disclosure and explained why the error arose.	20%
"Helping"	40%	Client quantified the inaccuracy, calculated the underpaid tax and provided evidence in support of the figures in his computations. Requests from HMRC were answered quickly and politely.	40%
"Access"	30%	Client 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 the Trustees that HMRC should be asked to reduce the maximum penalty 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:	£15,000 x 16.5%	15,000
Interest for late payment:	31.1.19 to 30.9.20 (608 days)	2,475
	£15,000 x 2.6% x 608/365	<u>650</u>
		<u>18,125</u>

This should be paid within 30 days of the settlement agreement being signed (ie by 30 October 2020).

Note: There will be no late payment penalty here because this penalty only applies to tax either contained in a person's self-assessment or which is payable under a HMRC assessment. As the CGT was not included in the self-assessment and has not been the subject of an assessment, there is no penalty charge for late payment under Sch 56 FA 2009. A late payment penalty will only apply if the Trustees fails to pay the tax within 31 days of the 30 October 2020 due date.

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 the Trustees make no further mistakes and files all returns / makes tax payments on time for two years, the penalty will be cancelled.