Compliance Failure Example for APS TOLC

Stokes Ltd ("Stokes") is an investment company, with a 31 March year end, which has various shareholdings in UK companies together with a 15% shareholding in Fiscali SA ("Fiscali"), a trading company resident in Utopia. This is Stokes' only overseas investment.

You have recently been appointed as Tax Manager for the company. Prior to your appointment, Lester Stokes, majority shareholder and Managing Director of the company, prepared Stokes' tax filings himself. Lester is a Chartered Accountant and, whilst he has some tax knowledge, he admits he is not a tax specialist.

You have been reviewing the company's past tax returns (all of which have been filed on time) and discovered that a substantial dividend of £1.5m was received from Fiscali in the year ended 31 March 2018. This is the only dividend Fiscali has paid over the years and has been treated as exempt income in the company's corporation tax computation, as Lester's understanding is that all dividend income is exempt from corporation tax. However, you are aware that Utopia allows a local corporate tax deduction for dividends paid and that therefore, under Part 9A CTA 2009, the UK dividend exemption is not applicable.

As a result, the corporation tax liability has been understated. As Stokes has more than 10% of the voting rights in Fiscali, underlying tax relief for Utopian corporate tax paid is available. You compute the next underpayment of corporation tax, after double tax relief, to be £225,000.

You inform Lester of this and he is keen to make a full disclosure to HMRC as soon as possible. He was unaware that Utopia allowed a tax deduction for dividends paid and also unaware that this meant under UK legislation that the dividend was therefore taxable in the UK. You have explained that as the dividend was material in amount and unusual in that it was the only overseas dividend Stokes has received, HMRC would have expected Lester to check the UK tax position carefully. It is likely therefore that a penalty for a careless error will be due.

The window for Stokes to amend its CTSA return for year ended 31 March 2018 closed on 31 March 2020, but nevertheless the omission can still be (and should be) disclosed to HMRC.

You draft a letter of disclosure to HMRC which:

- Includes a calculation of the corporation tax due on the dividend of £225,000, including the calculation of double tax relief for the underlying Utopian corporate tax;
- Is supported by a copy of the Fiscali's accounts and Utopian corporate tax paid;
- Apologises for this "innocent error";
- Explains to HMRC that the error was caused by the Lester's failure to fully appreciate the complexities of the dividend exemption rules rather than there being any deliberate attempt to avoid tax; and
- Expresses Stokes' willingness to provide any further information required by HMRC and bring this matter to a swift conclusion.

After an exchange of correspondence, HMRC agree that this was the only error in the return and as they are satisfied that income and gains have been properly disclosed in previous returns, a tax adjustment will be made for the year ended 31 March 2018 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 Stokes has made an unprompted disclosure of a careless error, under Sch 24 FA 2007 the penalty range is between 0% and 30% of the potential lost revenue (here being £225,000).

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

Criteria	Maximum mitigation	Reasoned support	Suggested mitigation
"Telling"	30%	HMRC were unaware that a taxable dividend was received and Stokes admitted the inaccuracy as soon as it became aware of the issue, made a full disclosure and explained why the error arose.	20%
"Helping"	40%	Stokes quantified the inaccuracy, calculated the underpaid tax and provided evidence in support of computations. Requests from HMRC 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			90%

You therefore ask HMRC to reduce the maximum penalty by 90% of the penalty range (in this case by 90% of 30% being 27%). The penalty loading would then be (30 – 27)% = 3%.

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

		£
Under-declared tax:		225,000
Penalty for incorrect return:	£225,000 x 3%	6,750
Interest for late payment:	1.1.19 to 30.9.20 (638 days)	
	£225,000 x 2.6% x 638/365*	10,225
		241,975

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

*Whilst augmented profits are above £1.5m for this accounting period, the company is not large for quarterly instalment purposes as it was not large in the preceding period and augmented profits are less than £10m.

Note: There will be no penalty for late paid tax 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 corporation tax was not included in the self-assessment and has not been the subject of an assessment, there is no penalty charge under Sch 56 FA 2009. A late payment penalty will only apply if Stokes 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 Stokes makes no further mistakes and files all returns / makes tax payments on time for two years, the penalty will be cancelled.