Compliance Failures
(for all APS papers)

1. Introduction

An APS exam paper may have, as part of the question (or possibly even constituting the whole question), a “compliance failure” scenario. By “compliance failure” we mean a situation whereby a taxpayer – being an individual, company, partnership or trust – fails to take the necessary measures to comply with their statutory responsibilities to either file complete and correct returns or pay the correct amount of tax at the right time.

In an APS scenario, these compliance failures are likely to be “historic” in nature. For example, the examiner is likely to present you with a set of facts concerning various compliance mistakes your client has already been made and is looking for you to analyse these and thereafter advise your client on the best way forward.

In these cases **you cannot change what happened** and prevent the compliance failures, but **you can give sensible advice and make substantiated recommendations about the best way to resolve the problem** and settle any outstanding liabilities with HMRC.

You can also recommend that the client make certain changes to their record keeping procedures to prevent these mistakes from happening again.

The purpose of these notes is to provide guidance on how to go about answering such a question, and in particular how to approach the advisory aspect of such a scenario.

2. Types of compliance failures

The facts of the question will guide you as to the types of compliance failures that you should be advising on.

It is therefore very important to emphasise that **you must tailor your answer to the facts of the question**, rather than “brain dumping” everything you know about penalties, interest, etc into your answer. Your client will not appreciate you telling them everything you know about HMRC’s compliance regime or about penalties for failures which they are not even liable for. This is a waste of their and your time. Your advice should be limited to matters which are directly relevant to their situation and which strike at the heart of the client’s problem.

That said, the following provides a checklist of typical compliance failures that might be seen and the main areas of relevant legislation to consider when framing your answer:

- Errors in a return - Sch 24 FA 2007.

  Taxpayers have a duty to file returns which are correct and complete (and a declaration is made by the taxpayer to that effect when the return is submitted). If the return turns out not to be either correct or complete (whether by accident or otherwise), penalties can be charged for the compliance failure.

- Failure to notify chargeability – Sch 41 FA 2008.

  Taxpayers must tell HMRC if they have become chargeable to tax and they are not currently receiving a tax return. A failure to do so by the appropriate deadline could result in a penalty.

- Late filing – Sch 55 FA 2009.

  Taxpayers who have been issued with a notice to file a return are required by law to submit that return by the statutory due date. Penalties can be (and usually are) charged if the return is filed late.

- Late payment of tax – Sch 56 FA 2009.

  All tax payments have a statutory due date. Failure to pay the tax in full by this date will usually result in a penalty.

- Interest on late paid tax.

  As well as being liable for a late payment penalty, interest will be charged on any tax paid late. The interest runs from the due date for payment until the day the payment is made. HMRC regard interest as “commercial restitution” as this effectively compensates HMRC for the interest they could have earned had the tax been paid into the government’s bank account at the correct time. Although it is common for penalties to be “mitigated” – ie, the level of penalty charged is often less than the maximum which could be charged under the law – HMRC has no specific power to mitigate an interest charge. [Claims can be made to the HMRC Interest Review Unit if the taxpayer feels that errors or unreasonable delays on HMRC’s part have acted to create or increase an interest charge.] Interest is not charged on VAT that is paid late, where it is corrected on a subsequent VAT return.

There are some exceptions to the above list of legislation – for example, the penalty for an error in a P11D return is contained s.98 TMA 1970.

For VAT, late filing and late payment is still covered by the default surcharge regime in s.59 VATA 1994.

3. Disclosure

Taxpayers are actively encouraged by HMRC to inform them if they realise that they have made an error or omission in a tax return or have made any other mistake leading to a loss of tax.

A voluntary disclosure of an error will usually allow a taxpayer to settle their affairs and pay any outstanding underpayment without the imposition of significant penalties. In this regard, **clients who are proactive in putting their cards on the table and working with HMRC to settle any tax arrears are viewed in a much better light** that those who are less forthcoming but whose errors are discovered by HMRC in the course of their enquiries.

Voluntary disclosures will also remove any possibility of criminal charges being pursued in more serious cases.

It is therefore important in a question to identify, and advise the client, whether the disclosure is “prompted” or “unprompted” as this will affect the penalty weighting.

For example, a taxpayer who makes an unprompted disclosure of a careless error in a tax return may even escape a penalty charge altogether as the legislation in these cases permits penalties to be mitigated to zero. However a prompted disclosure of a careless error will carry a minimum penalty loading of 15% of the tax lost (possibly more).

If the client approaches HMRC and makes a disclosure before HMRC has discovered (or are about to discover) that a compliance failure has occurred, that is an unprompted disclosure. Any other disclosure is a prompted disclosure.

For example, if the client has identified an error in advance of a planned HMRC compliance visit, that would be a “prompted” disclosure and would carry a higher penalty percentage.

4. Remedying/correcting the failure

You should **always recommend in your answer that the client remedies or corrects the compliance failure as soon as possible**. This will help mitigate penalty loadings and reduce interest charges.

For example, in the case of an error in a return, the client should (if possible) amend the return and you should explain to the client how this may be done.

Do remember to consider whether the client is still within time to make such an amendment. If an error is discovered outside the statutory time limit for amending a return (normally 12 months from the statutory filing date), then the error should still be disclosed to HMRC but in a different form. This is typically using HMRC's Digital Disclosure Service – see further below.

For outstanding returns which will be submitted to HMRC after the statutory filing deadline has passed, the sensible advice would be to file the return(s) as soon as possible.

Similar advice applies regarding remedying failures in notifying chargeability and late payment of tax. Remember that paying the outstanding tax not only reduces the penalty loading, it will also stop the "clock" for the accrual of interest. You should be aware that even if the final figure of tax has not been quantified or formally agreed with HMRC, payments on account can be made which a) demonstrates a willingness to co-operate and pay the tax which is legally due and b) reduces any interest charges.

Always be aware that simply remedying or correcting the failure does not remove the risk of penalties applying and does not in itself amount to a disclosure to HMRC of the compliance failure.

5. How to disclose

You must ensure in your answer that you advise **how** the client should go about disclosing the compliance failure to HMRC, most particularly re errors in a return. This is often overlooked in exam answers as you might assume that simply telling your client that they need to disclose his error(s) is enough to secure the available marks. It isn't. A client doesn't simply want to know what the problem or exposure is. They want to be told **what they need to do** to solve the problem and **when they should do it**.

Disclosures of errors outside the statutory amendment window are typically made using HMRC's Digital Disclosure Service (DDS) which is accessed via the gov.uk website. The DDS can be used by individuals, trusts and companies to make a disclosure of unpaid tax.

The DDS applies for the following taxes:

- Income Tax
- Capital Gains Tax
- National Insurance Contributions
- Corporation Tax

The following cannot be disclosed via the DDS (although a contract settlement can nonetheless be agreed with HMRC):

- Employer liabilities (eg, PAYE underpayments); and
- Inheritance Tax and tax arising during administration periods of estates.

DDS is not available for VAT, which has its separate rules – see below.

The disclosure starts by the taxpayer notifying HMRC via the DDS that they wish to make a disclosure. Advisers can also use the DDS to notify HMRC of a client's disclosure.

HMRC confirm receipt of the DDS and issue a unique Disclosure Reference Number (DRN) and a Payment Reference Number (PRN) to use when paying the amount owed.

Once acknowledgment has been received, the client then makes the actual disclosure of the error(s) telling HMRC what went wrong and why the mistakes or omissions were made. In addition, an apology is never a bad idea!

The actual disclosure must be made within 90 days of the date that HMRC acknowledges the notification. Payment of the amount owing (estimated if necessary) must be made at that time using the PRN. Note that income which has already been reported on a tax return does not need to be included within the disclosure.

The number of years that need to be disclosed within the DDS is detailed below and depends on whether the error arose from either a:

- Failure arising despite the taxpayer taking reasonable care – 4 years
- Failure due to carelessness – 6 years
- Failure due to deliberate act or omission – 20 years

HMRC then checks the disclosure and if the Tax Officer is satisfied that a full disclosure has been made, they notify the taxpayer of their acceptance. HMRC will not accept disclosures that, when checked, are found to be largely wrong or incomplete.

For disclosures of VAT errors, there are two potential methods available, where a trader discovers an inaccuracy/error. The two methods are:

1. Notification can be made by letter or on form VAT 652 to the VAT Error Correction Team and HMRC will raise an assessment; or

2. Certain errors can be corrected by adjusting the next VAT return (see below)

Net errors that arise from failing to take reasonable care, or due to carelessness, can be corrected under method 2. above if they do not exceed the greater of £10,000 or 1% of turnover on the VAT return of discovery (subject to an upper limit of £50,000). Deliberate errors cannot be corrected in this way even if they are within the monetary limits and must be notified under method 1.

If method 2 is used then it is not regarded as an unprompted disclosure for penalty purposes. Therefore, it is advisable to either submit a form VAT 652 or send a letter as well disclosing the error. If form VAT 652 is used then a 'tick' needs to be put in the box 'error adjusted on VAT return'. If a letter is sent, then it needs to contain the same information as that on the VAT 652.

HMRC will inform the trader of any penalty due and there is a right of appeal within 30 days.

6. Contract settlements

Once the disclosure is accepted, in the case of an error in a return, the next step is to quantify the extent of the error(s) and thereafter reach an agreement with HMRC on the amount of additional tax due as a result of that failing.

Once the tax figure is established, compliance failure cases are typically settled by negotiating a "contract settlement" with HMRC. This is a contractual agreement between the taxpayer and the government under which the client offers to pay a monetary figure which is made up of tax, interest and penalties in full and final settlement of any tax arrears. In return, the government agrees to take no further action in relation to the client's compliance failure(s).

The contract settlement is a legally binding agreement and provides an administratively convenient way of bringing the case to an end. It avoids the need for HMRC to raise assessments to collect the tax due and avoids any recourse to the tribunals or the courts.

Contract settlements only apply to direct tax – they cannot be used for VAT matters.

If it is not possible to agree a settlement figure, HMRC would then use the formal legislative means available to them to pursue the matter, for example by raising estimated assessments of the tax they believe to be due and thereafter having any appeals against those assessments heard via the tribunal / court system.

7. Mitigating penalties

In the disclosure, the client is asked to indicate the penalty thought to be appropriate. HMRC may disagree with this penalty percentage and seek a higher one.

The legislation contains tables which set out the maximum and minimum penalties that could apply to the particular compliance failure. These are not reproduced here (look them up in your legislation handbooks should you need to). In the case of the most common type of compliance failure (being an error in a return), you should turn to Sch 24 FA 2007.

HMRC can, at their discretion, mitigate (ie, reduce) any penalty within the limits prescribed by the legislation. Penalty mitigation will only be considered after the maximum penalty has been determined and the failure or error that led to the penalty has been remedied or corrected.

To this end, mitigation is a matter for the HMRC Officer to consider once the tax has been quantified.

Therefore a very important part of giving advice in this area is to explain to the client **how their actions can help mitigate the financial cost of the compliance failure**. You cannot change what happened, but your advice can help soften the financial blow.

Once the range of penalties is determined based on the disclosure of the error, the actual amount of the penalty is determined by the "quality" of the disclosure. In simple terms, the higher the "quality" of the disclosure, the lower the penalty loading.

The disclosure of an inaccuracy is defined in Sch 24 FA 2007 as:

a) **Telling** HMRC about the inaccuracy;

b) **Giving HMRC reasonable help** in quantifying the inaccuracy; and

c) **Allowing HMRC access to records** for the purpose of ensuring that the inaccuracy is fully corrected.

The extent to which each of these three elements is met is referred to as the quality of the disclosure, and this determines the amount by which the penalty percentage is reduced. Each of these is covered below:

a) <u>Telling HMRC about the inaccuracy (maximum reduction 30%)</u>

"Telling" includes admitting the inaccuracy, making a full disclosure and explaining how and why it arose. The time scale to be considered begins when the inaccuracy is first disclosed.

You should recommend that your client act positively and proactively when telling HMRC about the errors and make sure that all relevant details are provided and none withheld.

b) <u>Helping HMRC quantify the inaccuracy (maximum reduction 40%)</u>

"Helping" refers to the reasonable assistance given by the client to HMRC in quantifying the inaccuracy to ensure that the matter may be brought to a speedy conclusion.

Pro-active assistance would include quantifying liabilities, providing evidence and information in a timely manner and attending meetings when requested.

c) <u>Giving access to HMRC to ensure full disclosure (maximum reduction 30%)</u>

"Giving access" refers to positive responses for requests for information and allowing access to relevant records.

HMRC has powers to request certain documentation and can ask the tribunal or the courts to enforce these powers if information requested is not forthcoming. Co-operating with requests for information without making HMRC formally enforce their requests will be looked on favourably and should be encouraged.

Before entering into the contract settlement, HMRC will considers each of the above elements and allocate an appropriate percentage. The total of the above percentages will then be used to calculate the actual penalty reduction. It is possible – with a very high quality of disclosure – to secure a 100% maximum reduction within the appropriate penalty range. This does not in itself mean that no penalty will be charged. It simply means that HMRC would then impose the minimum penalty specified by the relevant table.

In summary this demonstrates the positive ways in which the client can give their co-operation to HMRC over the course of the disclosure. In compliance failure cases, you should recommend to your client that they:

- **Establish good ongoing relations** with HMRC during the enquiry;
- **Respond to HMRC's requests in a timely and cooperative manner**; and
- **Adopt a proactive approach** to identifying and dealing with the issues arising.

8. Suspending penalties

Where a client has made an error in a return which leads to an understatement of tax, the client is exposed to a penalty. The rate of the penalty is based on the behaviour of the person and whether the disclosure is prompted or unprompted. Once the rate is determined, this is then applied to the "potential lost revenue" which is the extra tax due as a result of correcting the error.

If the penalty is due because of careless behaviour or failure to take reasonable care, **HMRC has discretionary powers to suspend all or part of a penalty for up to two years**.

As part of your advice, you should therefore consider referring to the possibility of HMRC granting "suspension" of penalties. Such a suspension usually comes with conditions which, if satisfied, result in the penalty being cancelled at the end of the suspension period. If those conditions are not satisfied, the penalty remains payable at that point.

In determining whether or not to suspend a penalty, HMRC will consider the penalty history of the taxpayer. A client with a good compliance record who has previously paid tax on time, and who has made an unprompted and full disclosure of an inaccuracy are all factors likely to persuade HMRC to grant suspension.

HMRC will not normally suspend a penalty in the case of deliberate errors or for failing to notify chargeability.

9. Computing the exposure

If the question provides enough information for you to calculate the financial exposure for the client in terms of under-declared tax, then you should compute this figure and include it in your Report. Unless it is an immaterial amount, you should always include this in your Executive Summary.

If possible, you should also compute in financial terms, the penalty exposure. For example, it may be possible to compute the precise amount of the late payment penalty that will apply.

However, it is likely that you will be unable to compute the precise penalty exposure for errors in a return as that will depend on whether the disclosure is prompted or unprompted, and on the quality of the disclosure. Especially with regard to the latter, it is unlikely you will be able to state precisely where in the percentage band the penalty will fall.

However, you will be able to indicate the maximum penalty percentage from the band, and thus compute in financial terms, the maximum penalty for errors that will likely apply. Again, you should include this your Report.

In the Executive Summary, include the overall figure for penalties that may apply (unless immaterial).

It will generally not be worthwhile (or expected) for you to compute the interest on late paid tax that will apply, but you should indicate in the Report that interest will be charged and will therefore increase the amount due.

10. Deductibility from trading profits

The extra tax on profits that are understated will not itself be deductible in computing profits. However employment taxes (for example, additional PAYE) and employer's national insurance costs will be deductible from trading profits and this should be mentioned in any answer as it reduces the cost of the compliance failure to the client.

Penalties are generally not tax-deductible nor is interest on underpaid tax. However, interest on underpaid Corporation Tax is specifically deductible under the loan relationship rules.

Typical APS exam errors to be avoided!

Here is a list of typical mistakes/omissions that a student might make in this kind of answer and which you should try to avoid!

- Not calculating the amount of understated tax when the facts of the question provide sufficient information to allow this.
- Not appreciating that tax must sometimes be calculated on a grossed-up basis – common in employment income questions.
- Omitting an estimate of the financial cost of the understated tax and penalties from the Executive Summary.
- Misunderstanding what ‘potential lost revenue’ means – it is the amount of tax HMRC would lose if the error had not been picked up (it is not the understated profit/income).
- Mentioning penalties for compliance errors which are not relevant to your client. For example, if the client has been issued with a return and files it on time, there is no need to discuss failure to notify or late return penalties. Always keep your answer relevant to your client.
- Not covering whether the tax understated is deductible from trading profits and the position on deductibility of penalties.
- Forgetting to mention that interest on overdue tax will be charged (if applicable).

What would a good APS answer contain?

More positively, the following lists the points you would expect to see in a very good answer:

- Computation of the tax due on understated profit/income.
- Reference to the overall financial exposure in the Executive Summary.
- Explanation of what penalties are relevant and in particular how the penalty regime for errors works.
- Providing advice to the client, for example;
  - ✓ How to disclose;
  - ✓ Action to be taken to reduce the percentage penalty that will apply; and
  - ✓ Covering the elements relevant to quality of disclosure.
- All of the above focused on what is relevant to the client – i.e. a compliance failure answer tailored to the scenario laid out in the question.

APPENDIX

Overpaid tax relief

It may be that the APS question, or part of it, is concerned not with a compliance failure leading to underpaid tax, but rather a situation where the taxpayer has overpaid tax, perhaps as a result of an earlier error or due to an excessive assessment.

This Appendix considers the legislation to allow a claim for overpaid tax to be made in order to recover that amount from HMRC.

A claim may be made to recover overpaid income tax, CGT, Class 4 NIC or corporation tax or to reduce an excessive assessment. The person must make the claim within four years of the end of the relevant tax year or accounting period.

Relief is not available if one of the exclusions listed in the legislation applies. These can be found at Para 2 Schedule 1AB TMA 1970 and, for corporation tax, Para 51A Schedule 18 FA 1998 and are as follows:

- The amount of relief sought arises from a mistake concerning any other claim, election or notice, or capital allowances.
- Where the person can correct the overpayment or over-assessment by other means.
- Where the person could have obtained relief by other means when they first knew, or ought reasonably to have known, that the relief was available within a period now expired.
- Where a court or tribunal has already considered the grounds on which the overpayment relief claim is made. It also covers the situation where HMRC has considered the grounds and settled the appeal by agreement.
- Where the person knew, or should reasonably have known, the grounds for the overpayment relief claim at a time when they could have put them forward on an appeal to a court or tribunal.
- Where HMRC has taken proceedings to enforce payment of the amount in the overpayment relief claim.
- The amount was understood to be due under the practice generally prevailing at the time the liability was calculated.
- In the case of PAYE income, the amount was calculated in accordance with the practice generally prevailing 12 months after the end of the tax year.