Newthwire Your Tax Roadmap — accountingweb Tax Zone

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Editorial Note

The subject of penalties and penalty negotiations must start with the relevant statute, which provides for tax geared and capped penalties (all statutory references are to Taxes Management Act 1970). It should be noted that where appropriate compliance failures involving National Insurance Contributions will also attract penalties geared in the same way as for Inland Revenue taxes generally.

Regards

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Disclaimer

Tax geared penalties

A tax geared penalty is one which is variable depending on the amount of tax affected by the compliance failure. Taxes Management Act provides for such penalties by defining the maximum amount as a figure equal to the difference between the tax now found to be payable and the tax payable on the basis of the original return (or the tax now payable in circumstances where no return was originally made).

Since the act defines a maximum figure the Inland Revenue has the right to mitigate a penalty and does so in given circumstances. Therefore the actual penalty can range (theoretically) from 0% to 100%. Prior to Finance Act 1989 the maximum penalty in cases of fraud was 200% of the tax difference.

Offences attracting a tax geared penalty

1. Section 7 (8) Failure to notify chargeability within six months of the end of the relevant year.

If the tax arising on any subsequent self assessment or assessment under S29 is not paid on or before 31 January next following the relevant year then the penalty is an amount "not exceeding" the amount of the tax so assessed or self assessed.

Note: This provision is operative as from 1995/96 for general tax purposes (consult the statute for some minor differences to this general rule). Prior to this year there were no tax geared penalties for failure to notify chargeability. The penalty was an amount not exceeding 100.pounds.

2. Section 93. Failure to make a return for income tax or capital gains tax.

Where a return has been issued but has not been submitted to the Revenue within 12 months of the filing date for that return there is a tax geared penalty not exceeding the amount of tax that would have been shown on that return.
Note: The filing date is either 31 January following the relevant year of assessment or if the return was issued after 31 October following the year then it is three months beginning with the day on which the return was issued (S 8(1A)). There is also provision in S93 for penalties in cases where there is a failure to submit a return but it is ultimately found that no tax would have been payable. These are naturally not tax geared.

The current S 93 is operative from 1996/97 but there was a tax geared penalty under the pre-SA rules if the failure continued after the end of the year of assessment following that during which the return was issued.

3. Section 95. Incorrect return or accounts for income tax or capital gains tax.

The penalty is tax geared if a return is made that is fraudulent or negligent. It is an amount not exceeding the difference between the income tax and/or capital gains tax payable for the year and the amount that would have been payable if the return had been correct.

4. The equivalent statute applying to companies

See Sections 10, 94 and 96 respectively for failure to notify chargeability, failure to submit a return and the submission of an incorrect return. FA 1998, Schedule 18 para 20 is also relevant to post SA company returns. There are also equivalent penalty arrangements concerned with the understatement of PAYE/NIC liabilities in S 98A(3).

Because tax geared penalties might apply in respect of a failure to notify chargeability under S7 and subsequently an incorrect return under S95 once the failure to notify is discovered and a return is issued, Section 97A operates to ensure that when two or more tax geared penalties are chargeable on the same tax the aggregate penalty does not exceed the greater or greatest of the penalties.

Capped penalties

Practitioners sometimes do not appreciate that capped penalties i.e. where the penalty must not exceed a certain absolute figure (unlike a tax geared penalty which depends for its limits on the amount of tax that can attract the penalty) is also variable below the cap and can be the subject of negotiation in exactly the same way as a tax geared penalty.

Negotiation is particularly apposite in the case of penalties covering failures in respect of forms P11D since the theoretical maximum penalty can often far exceed the tax that has been lost to the Revenue through the compliance failure. A fraudulent or negligent form P11D attracts a maximum penalty of 3,000 pounds per occasion so some minor infringement covering a given P11D for six years would determine a maximum of 18,000 pounds whereas the director's or employee's taxable benefit might amount only to a few pounds of tax.

Other examples of capped penalties are for failures to keep proper business records (S12B), failures to supply information under a S19A notice and where returns have been issued under S13 (persons in receipt of taxable income belonging to others) and S15 (forms P14, P35 and P11D). The penalty is initially a figure not exceeding 300 pounds and then not exceeding 60 pounds per day for a continuing failure – S98(1) apart from a S12B offence where the penalty is one not exceeding 3,000 pounds (S12B(5)).

Finally S99 should not be neglected. This section is sometimes used to devastating effect by Special Compliance Office. It provides for a penalty, usually applied to a practising accountant, in cases where a person has assisted in the preparation or delivery of any information, return or accounts or other documents that he knows are likely to be used for the purposes of tax which he knows to be incorrect.

The penalty is an amount not exceeding 3,000 pounds. As with incorrect forms P11D this penalty is applied per occasion therefore a massive maximum potential fine can accrue but it is still negotiable though advise ought to be sought in such a case owing to this and other ramifications of a S99 penalty (see S20A).

The determination of penalties

Inspectors have had the power to determine most types of penalty since Finance Act 1989. Section 100 excludes certain penalty situations from the inspector's powers of determination (mainly S93(1), S94(1) and S98(1)) but those penalties mentioned above all come under the Revenue's powers.

In the writer's experience the power of determination has never been used therefore it is probably rarely used overall. The Revenue clearly wishes to agree penalties by negotiation in normal circumstances although the threat of a determination has probably eased through some tricky cases over the years.

There is an appeals process in those cases where penalties are determined under the formal procedure (S100B).

Tax geared penalties are quasi criminal in nature

In recent years there have been some significant court decisions concerning the precise nature of tax geared penalties.

The following extract (under this heading) is taken from an article in Taxation Magazine written by the current writer (see XXXX), which dealt with this subject in detail.

The judgment in King v Walden [2001] STC 822 considered (amongst other matters) the nature of tax geared penalties. It was taken shortly after several VAT cases (including C & E Commissioners v Han and Yau and others [2001]STC1188) had found that penalties under VATA 1994 s 60 were essentially criminal in nature. The following is quoted from Tolleys VAT Case Digest section 32.4.

"In three appeals involving penalties under VATA 1994, s 60, the tribunal held, as a preliminary issue, that the imposition of a penalty under VATA 1994, s 60 gave rise to a 'criminal charge' within Article 6 of the European Convention on Human Rights. The chairman observed that 'cases where section 60 penalties are in issue usually involve allegations of dishonest and systemic suppressions of sales or use of fictitious invoices over a number of accounting periods ... the level of criminality alleged against the appellant does not appear significantly different from that involved in Crown Court fraud trials'. The CA upheld this decision (by a 2-1 majority, Sir Martin Nourse dissenting). Potter LJ held that the effect of the ECHR decisions in Bendenoun v France, ECHR Case 12547/86, 18 EHRR 54 (TTC 30.3) and AP, MP and TP v Switzerland, ECHR Case 19958/92, 26 EHRR 541 (TTC 30.6) was that the penalties had to be regarded as involving a 'criminal charge' for the purposes of Article 6."

The judge in King v Walden necessarily had to consider the impact of these decisions and the European cases that were at their root when dealing with the question of penalties applicable in the Inland Revenue investigation. He said that in his judgment "the system of imposition of penalties for fraudulent or negligent delivery of incorrect returns or statements is 'criminal' for the purposes of art 6(2) [of the European Convention on Human Rights]." (at page 880).

The penalties under consideration were those that apply in all Inland Revenue investigations where it is found that business profits have been understated either fraudulently or negligently i.e. the tax geared penalties under TMA 1970 s 95 (and its company equivalent). The following reasons were given for that conclusion (at pages 880-881):

1. Plainly the system is intended to punish the defaulting taxpayer and to operate as a deterrent.
2. The amount of fine is potentially very substantial.
3. The amount of fine is not related to any administrative matter. In particular the fine is not limited to the administrative and other extra cost of dealing with the taxpayer concerned.
4. The amount of fine imposed depends upon the degree of culpability of the taxpayer, the less culpable the more mitigation there is. Mitigation is an essentially criminal rather than civil consideration.
5. It is accepted that generally (leaving out of account s 46(2) and s 101) it is not for the taxpayer to show that the determination of penalties was wrong. On appeal the burden of proof lies on the Crown. In this regard there is a clear distinction between a penalty determination and an appeal against ordinary assessment where the burden of showing it was wrong lies on the taxpayer.

On the assumption that this analysis is correct does it have any ramifications for the way that the penalty element is applied in tax investigation cases? The answer is in the negative so long as the case is handled informally culminating in an offer being made to the Revenue (either as a lump sum or by installments).

Why is this so? The answer lies in the nature of the offer that is to be made to the Revenue. This is in the form of a contract made between the Revenue and the taxpayer. The taxpayer makes an offer "in consideration of no proceedings" being taken against him. Those proceedings involve the raising of assessments and the determination of interest and penalties.

The offer is thus a monetary amount calculated by reference to the tax, interest and penalties that the inspector might be able to put into legal charge. The offer does not constitute elements of tax, interest or penalty but simply a lump sum. If discovery assessments are in place and under appeal then these stay in place but in suspension pending completion of the terms of the offer. Indeed open assessments for years that are covered by a settlement offer are neither determined under S54 nor are they taken off the Revenue's books, since they may need to be resurrected if the terms of the offer are not finally complied with. Consequently neither the Revenue nor the client needs to worry about the true nature of a penalty in informal proceedings.

However, if penalty negotiations brake down so leading to a determination under S100 and an appeal under S100B then both sides should be acutely aware of their respective positions. The onus will be on the Revenue to establish that fraud or neglect has occurred. In doing so the Revenue will necessarily have to concede (if cross examined by the defending advocate) that a tax geared penalty is quasi criminal in nature. Consequently the defence open to the client would be that he was not properly informed of the position when the Revenue commenced the investigation. In particular he was not interviewed under caution at any point (see the case of R v Gill and another [2003] STC 1229) therefore the revenue's attempt to impose a penalty would be ultra vires.

Negotiating the penalty element under the informal offer

procedure

It is tempting to think of the penalty element of a settlement offer as if it were a completely separate subject unconnected to the process and conduct of the preceding investigation. After all it is a procedure that comes at the end of the investigation after the tax figure has been agreed and tends to be the subject of a sketchy discussion between inspector and adviser almost as an afterthought to the preceding battle of wills. This should not be the case. If a penalty is to be tax geared then the starting point for the penalty negotiation is the quantum of tax, not the percentage that will be applied to the tax.

Negotiators should not be inhibited from putting the penalty issue on the table for discussion at some point during the preceding investigation or at least to bear the penalty issue in mind when negotiating the additional profits that will give rise to the tax which will have the penalty applied to it. Given that the formal determination of penalties is a rarity and the possibility may never enter the inspector's mind

there is no reason why the spectre should overshadow the adviser's thought processes either. On this basis negotiation can be freer flowing than some people might think. The inspector is only human and may have his own agenda with regard to penalties and their interface with the quantification of tax.
[The next two paragraphs have been quoted from the writer's book for Tolleys entitled "Practical Representation in Tax Investigations".]

For example on some occasions, the technical basis behind some part of the additional tax element might be more important to the inspector than the absolute level of the additional profits that have to be taxed. For example, the inspector might consider a victory in a disagreement about a capital allowance claim or a capital/revenue argument to be more important than trying to increase the adjustment in the case of 'grey area' cash additions to the profits, whereas other inspectors may have the opposite view. Similarly the client may be adamant that he never pocketed anything like the amount of cash that the inspector has estimated but he may have no view about a more tax technical matter that might still culminate in the same bottom line number.

On other occasions the level of penalty might be more important to the inspector or the adviser than the amount of additional profits to be taxed. Theoretically the inspector might want to get a higher percentage penalty established but will concede a lower level of grey area adjustment to the profits or the adviser might want to achieve the opposite. The inspector may be prepared to concede a lower tax element so long as the adviser does not argue too much about the level of penalty, so that in money terms the amount might be the same but may have been arrived at via different routes by each party. This far sighted approach to penalty negotiations may even extend to the "size and gravity" element of the mitigation factors (of which more later). This element is the most difficult to influence during an investigation because the level of mitigation depends on what has already happened given that the fraud or neglect has already occurred whereas the other two elements of "cooperation" and "quality of disclosure" are fully under the control of the client and his adviser from the day that the enquiry or investigation commences. However, it is still worth trying to spot opportunities for influencing the size and gravity mitigation element if the case warrants it. For example, if the investigation gives rise to various open ended areas for negotiation it may be possible to substitute a less serious adjustment for a more serious one through negotiation so as to mitigate penalties, even though the tax figure might be the same. For example, if it is discovered that the stock valuation is only an estimate and that there is likely to have been significant cash defalcation as well then the inspector is more likely to want to maximize the adjustment to profits through additional cash sales than to adjust the stock valuation. This is particularly so in the case of a company because of the TA 1988 s 419 implications.

One case dealt with by the writer springs to mind in which this approach paid off successfully [Example taken from Tolleys Practical Representation in Tax Investigations]. A local tax district once investigated a family that had a thriving business in scrap metal, rubbish removal, the supply of crushed bricks for hardcore, and earth moving (salvage of top soil). Indeed they dealt in and processed virtually anything that other people wanted to throw away.

The inspector had perfectly reasonable suspicions that cash control was non-existent and that the family had made more profits than declared. The question was, how much. On the basis of cost of living indices she was adamant that the profits over a period of time must have been understated by more than 50,000 pounds. The family was adamant that the amount was nowhere near that sum, notwithstanding that neither side had any real idea of the amounts involved and neither did the advisers. The matter dragged on until the inspector decided that it was time for a showdown and insisted on meeting the family on site. Still there was stalemate.

Outside the office, which was housed in a battered portacabin, there was a pile of scrap metal, crushed cars, washing machines, dishwashers, torn and twisted metal and the like that must have been 20 metres in diameter and 10 metres high. During the heated discussions it dawned on one of the advisers that the pile of metal outside had never featured as end of year stock or work in progress, even though the accounts did recognise both in view of the business's activities. As with the cash problem no one knew how much was involved or had been spent in accumulating it nor had they any idea how to find a market value. In fact no one knew what was inside the mound which tended to wax and wane in size on the outside depending what was happening in the business at any one time. Arguably it had no stock value since it had been accumulated on a free basis over many years, in all sorts of ways.

The stock of scrap saved the day. All concerned could focus on the scrap and forget about the cash. The family could talk about the scrap without getting heated and the inspector could see it as a pile of money to be taxed. It did not take long to agree an adjustment of 50,000 pounds of which 25,000 pounds was cash and 25,000 pounds was accumulated understated stock. The clients were happy to accept the deal because they had 'won' the day on the cash argument. The inspector went in hard on the penalties to compensate somewhat for not achieving her cash target, so she was happy. Since this was a company, the adviser was happy that he had done his best to minimise the overall cost to the client and particularly the hit on the directors' loan accounts. Even the other adviser, who was the clients' accountant, was happy. After all one year's closing stock is another year's opening stock, so he could incorporate the deal into the next set of accounts, which had not yet been prepared (this was in the days before pay and file or self assessment) and then write it off at the end of that account (who was going to argue?).

Mitigating penalties

Section 102 states that the Board may in their discretion mitigate any penalty, or stay or compound any proceedings for a penalty, and may also, after judgment, further mitigate or entirely remit the penalty. However, this applies only to penalties that have been formally determined. The mitigation that is applied to penalties in investigation cases that lead to an informal offer is available through the Revenue's general remit to have care and management of the tax system since, as noted above, the percentage penalty that is negotiated informally is not in fact a penalty. It is merely part of an offer to stop proceedings being taken even though it is convenient to regard this element of the offer as a penalty. The Revenue applies mitigation to the theoretical maximum tax geared or capped penalty in order to encourage frank disclosure and cooperation from clients who may have an inherent bias against both conditions. However, even the most frank and cooperative must be punished for doing wrong therefore it also operates mitigation for the size of the problem that has been uncovered and its gravity geared to recognise the severity of the offence in relation both to the case itself and the taxpayer at large.

Most readers will be familiar with the concept of penalty mitigation and the parameters that are applied by the inspector in arriving at the expected percentage. This is calculated by reducing the maximum penalty (whether defined by the tax at stake or the capped maximum) through the award of points judged against the following parameters (EM 6065):

a) disclosure – up to 20% (or up to 30% in exceptional circumstances); and
b) co-operation in the investigation – up to 40%; and
c) size and gravity of the offence or offence – up to 40%.

Disclosure (EM 6070)

This is concerned with the circumstances surrounding a disclosure of some form of compliance failure and the nature of the disclosure per se. The inspector is instructed that disclosure 'implies a positive, voluntary and useful contribution to your knowledge of the irregularities. Thus, a statement which may constitute a disclosure at an early stage in the investigation (for example, assisting the quantification of the irregularities or the establishment of culpability) may, if made at a late stage in the investigation be no more than a worthless confirmation of what you irrefutably established.' [EM 6070].

A totally spontaneous disclosure i.e. one that is made in circumstances where the client has no fear of discovery and one which is sufficiently complete when made to be treated as a full disclosure will attract not only the full 20% mitigation but a further 10% as a reward for the frankness and spontaneity. This can then be set against one of the other penalty elements such as "size and gravity" where mitigation might be harder to achieve.

This does not mean that one should wait until a full disclosure report has been prepared before the matter is raised with the Revenue but it does mean that nothing of a material nature should be omitted when the disclosure is made. It would be folly, for example, for a client to disclose that he has settled an overseas trust with money derived from tax evasion without also mentioning that the precursor to the trust was an offshore bank account and that the interest has also been omitted from his returns.

However, the more time that elapses before a disclosure is made the more chance that circumstances might arise enabling the inspector to argue that the disclosure was not entirely spontaneous.

More than 20% but less than 30% may be given in cases where a voluntary disclosure has been made but where the fear of discovery might be present.. In one case within the writer's experience the SCO Group Leader refused to sanction the full 10% premium because the UK resident client had received a letter from an Irish bank explaining that one of his accounts had been singled out as part of a sample of accounts that were to be reviewed under the Irish Revenue's Deposit Interest Retention Tax (DIRT) investigations. The Group Leader's view was that the client would have realised that details of his account would filter through to the UK Revenue sooner or later therefore the disclosure was not totally spontaneous.

The following levels of disclosure are listed in the inspectors' instructions at EM 6070:
a) A voluntary and complete disclosure by a taxpayer who has
some reason to suspect early discovery.
b) Full disclosure on challenge.
c) A voluntary disclosure which turns out to be partial.
d) Partial disclosure on challenge.
e) Denial of irregularities on challenge, but disclosures
subsequently made.
It is suggested that 20% should be allowed for a case within the first two categories, and 5% if the disclosure is very belated under the final category.

Co-operation (EM 6075)

The inspector takes the following factors into account when the abatement for co-operation is considered:
a)the extent to which the taxpayer has been prepared to co- operate throughout the investigation and thus help to bring it to a speedy conclusion; and
b)the time taken to reach a settlement (but recognising that a
complex case will take longer to settle than a straightforward
case) taking into account the following matters:
I prevarication and procrastination;
ii concealment of assets;
iii piecemeal disclosures;
iv truthfulness;
v the number of Commissioners' meetings required to force progress;
vi the necessity for making further normal and extended time
limit assessments to force progress;
vii the use of information powers;
viii persistence in unacceptable stories of gifts, cash hoards,
betting wins;
ix necessity to have the liabilities determined by the Commissioners;
x irregularities continuing during the course of the
investigation;
xi payments on account

This is an impressive list of sub elements but when considered in relation to the size of the mitigation element and the type of sub elements that are listed it is clear that a well managed case should attract the maximum mitigation. Except in exceptional circumstances such as the decision to force a Commissioners' meeting on the grounds of principle there is virtually no excuse for not achieving the maximum. However, the abatement for co-operation is not affected by, say, disagreement with the inspector over the interpretation of a set of facts or the statute or reference of the matter to a Member of Parliament where the grievance is genuine and is not a cynical attempt to delay the inspector from proceeding. Delay or lack of co-operation by the adviser is deemed by the Inland Revenue to be the responsibility of the taxpayer.

Size and gravity (EM 6080)

This is a complex mitigation factor that depends partly on the nature of the offences that have been committed, partly on the size both in relation to the case itself as well as investigation cases as a whole, and partly on the seriousness of the offence in terms of its execution. 'Size' may be absolute or relative. Consequently under the criterion of size someone who deliberately omits, say, 20,000 pounds of sales from a business making 200,000 pounds taxable profit a year may be regarded in the same category of seriousness as a small trader who omits, say, 30% of his takings even though that may amount to only 10,000 pounds. 'Gravity' means the degree of culpability, ranging from a minor degree of negligence to a case of serious fraud, with a variety of intermediate steps as follows:
a) In cases in which fraud cannot be proved the abatement should be not less than 15%.
b) There is a range of abatements between 15% and 40% covering cases of neglect. For example 15% abatement would cover a most serious case in which culpability falls short of fraud; but
c) an offence which involves only a minor degree of negligence associated with muddle and confusion might, subject to size and circumstances, attract an abatement of say 35%.
d) An abatement of 40% would thus be a rare occurrence.

It should be noted that in normal circumstances a case handled by the Hansard section of Special Compliance Office is unlikely to attract a penalty of less than 15% even in the most favourable of circumstances except where the 10% premium has been awarded for a spontaneous full disclosure. The tax liability for each separate year is a discrete liability therefore it should be possible to argue for a different penalty for each year particularly in respect of the "size and gravity" mitigation element. This is certainly recognised in the penalty rules since tax geared penalties in respect of each separate tax bill are based on the difference between the tax that is now payable for a given year and the tax that would have been payable had the return been accepted without question. In practice inspectors tend to baulk against the "layering" of penalties look at the case as a whole when considering mitigation elements. Given that the Inland Revenue has the power to mitigate penalties more or less how it likes then it is difficult to argue against this general method of approach even though this can result in unfair situations between one client and another.

Next Week

Something about the second part in two weeks

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