Business Tax Update

Spring 2009

MAJOR CHANGES TO TAX PENALTIES

A new tax penalty regime will shortly take effect, and this will have a significant impact on the tax affairs of many businesses, from sole traders to listed corporations. It is therefore vital that all businesses are aware of the new rules, and that they make efforts to protect themselves from the imposition of the new penalties.

Background

Current law defines the maximum penalty for errors on tax returns, but gives no indication as to the minimum. The means that the amount of any tax penalty is open to debate, and good negotiating skills and experience can be very effective in achieving a more favourable result for a taxpayer.

According to HMRC, the new tax penalty regime has been introduced in an attempt to avoid this variation in penalties, and to encourage voluntary compliance with the law. However, it is also clear that HMRC expect a greater number of penalties to be imposed under the new regime, and that they will not be slow in defending their position before the Courts.

When A Penalty Is Charged

The new tax penalty regime is relevant across all of the main taxes including Corporation Tax, VAT, Income Tax, Capital Gains Tax, Employer's PAYE and National Insurance Contributions. For Corporation Tax purposes, the new regime will apply to all tax returns for periods starting on or after 1 April 2008.

An inaccurate tax return must satisfy two conditions before a penalty can be charged. Firstly, the error must lead to:

- An understatement of the tax liability;
- A false or inflated statement of loss; or
- A false or inflated claim for a tax repayment.

Secondly, the error must have been either "careless" due to a failure to take "reasonable care" by the taxpayer, or "deliberate".

The new regime imposes a graduated tax-geared penalty linked to the behaviour of the taxpayer. The amount of the penalty is based on the Potential Lost Revenue ("PLR"), being the value in tax terms of the error, which is not necessarily the same as the difference in the actual tax payable. An appropriate percentage is then applied to this PLR depending on whether:

1. The error was made despite the taxpayer taking reasonable care;
2. The error was careless due to failure of the taxpayer to take reasonable care;
3. The error was deliberate, but was not concealed by the taxpayer; or
4. The error was deliberate, and was concealed by the taxpayer.

The penalty percentage also varies depending on whether the taxpayer spots the error and then "unprompted" notifies HMRC, or whether HMRC spots the error itself and "prompts" the taxpayer. The penalty percentages are detailed in the table below, together with examples of where a penalty may arise.

Type	Maximum	Minimum prompted	Minimum unprompted	Examples
Reasonable care	No penalty			Claiming a tax deduction based on a considered interpretation of the law (which subsequently turns out to be incorrect), and fully disclosing the position taken on the tax return
Careless	30%	15%	0%	Inadequate systems to determine the disallowable element of advertising costs
Deliberate	70%	35%	20%	Withdrawing money from the business for personal use and failing to treat it correctly on the tax return
Concealed	100%	50%	30%	Backdating documents or creating false invoices

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Definition Of "Careless"

In practice, it is anticipated that most tax penalties will fall under the "careless" category. The meaning of the terms "careless" and "reasonable care" will therefore be very important. These terms are not formallly defined in the new rules, although HMRC state that:-

- Once a tax return has been filed, if a non-careless error is later discovered by the taxpayer, then it will be treated as "careless" if not corrected.
- If a tax return is not filed and HMRC subsequently issues a tax assessment, failure to notify HMRC within 30 days that the assessment is understated will be regarded as "careless".

A taxpayer's behaviour will therefore be key in determining the level of penalty to be applied.

Computing The PLR

For direct taxes, all allowable deductions and reliefs should be taken into account when calculating the amount of the PLR. However, where there is group relief, tax losses or timing differences, new rules apply as detailed below.

Group Relief

Penalties will apply to group companies in the same way as to single stand-alone companies, i.e. if an error creates either an understatement of the group's overall tax liability, or an overstatement of the group's tax losses, then a penalty will potentially apply.

When calculating the PLR in a group situation, group relief is ignored and cannot be used to reduce the PLR. For example, consider a group of companies X and Y that returns the following results:

	£	
Profits of X	50,000	(group relief of 50,000 from Y)
Loss of Y	(75,000)	
Group Taxable Profits	Nil	

Should a careless error arise in company X's tax return whereby its true profit should have been £90,000, company Y can amend its group relief claim to allocate the whole of its £75,000 loss to company X, so that company X pays tax on additional profits of only £15,000. However, the PLR is calculated as follows:

	£
Profits Per "Careless" Tax Return	50,000
Correct Profits	(90,000)
PLR	40,000

As a result, although the taxable profits of company X after group relief have only increased by £15,000, the penalty is based on the full amount of the error of £40,000.

Tax Losses

Where there are overstated tax losses that have been used to reduce a taxpayer's tax liability, the PLR will be calculated in the normal way. However, although the overstated tax losses will have no immediate tax effect, the taxpayer will still be liable for a penalty even though no tax will have been underpaid as a result of the error. In this situation, the PLR is computed as 10% of the overstated loss.

Timing Differences

Where a tax return contains an error that leads to tax being paid later than it should have been, the PLR is computed as 5% of the delayed tax for each year of delay.

What To Do Now?

The new tax penalties regime will shortly take effect, and represents a significant change of focus away from a mathematical test towards a test that is directed towards the behaviour of taxpayers. As a result, businesses cannot safely sit back and disregard penalties under the new regime. All businesses must now demonstrate compliance with the law, particularly where one-off transactions are involved, or where they are loss-making or within a loss-making corporate group (as loss-makers would not previously have been exposed to penalties).

Businesses should therefore take action as soon as possible to prevent these penalties applying to them. Actions may include reviewing and documenting internal accounting procedures to ensure that it can be demonstrated to HMRC's satisfaction that all tax returns are prepared with "reasonable care".

Should you require further assistance in understanding the new tax penalties regime and the likely impact on your business, please get in touch with Andrew Shilling on 020 7842 2135 or, if you are a client of the firm, with your normal Rawlinson & Hunter contact.

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