

## Penalties: Get it right!

*Mark McLaughlin highlights a difficulty that can sometimes arise in the calculation of penalties for errors in tax returns*

Taxpayers who submit tax returns to HMRC each year are at constant risk of penalties for errors in their returns. Tax return errors are often difficult to avoid. Fortunately, not every tax return error automatically results in a penalty. For example, no penalty arises if an error has occurred despite 'reasonable care' having been taken.

### That's a penalty!

A penalty arises broadly if (for example) an individual submits a tax return that contains an error resulting in a tax liability being understated, where the error was 'careless' (i.e., reasonable care was not taken) or deliberate on that individual's part (FA 2007, Sch 24, para 1).

This table shows the penalty ranges for 'domestic' errors; penalty percentages are potentially much higher for errors giving rise to penalties involving offshore matters (which are beyond the scope of this article):

Behaviour	Maximum penalty %	Minimum penalty (prompted disclosure) %	Minimum penalty (unprompted disclosure) %
Error despite taking reasonable care	No penalty	No penalty	No penalty
Careless	30	15	0
Deliberate	70	35	20
Deliberate and concealed	100	50	30

It is important to remember that the question of whether the disclosure of a tax return inaccuracy was 'prompted' or 'unprompted' can have a significant impact on the level of penalties charged.

### Careless or deliberate?

HMRC sometimes probe taxpayers about their actions (or 'behaviours') in certain circumstances, with a view to considering whether the taxpayer has committed a 'careless' or 'deliberate' error. There is anecdotal evidence of HMRC increasingly contending that tax return errors were caused by taxpayers' deliberate

behaviour, even though their behaviour would arguably only have been considered careless (at worst) in the past. Such HMRC contentions should be strongly resisted if appropriate, bearing in mind the adverse potential consequences of deliberate errors.

For example, the generally higher penalties for deliberate behaviour cannot be suspended. Other possible adverse consequences of deliberate (as opposed to careless) behaviour include the potential for HMRC to raise discovery assessments for additional earlier years, the possibility of the taxpayer being placed in HMRC's 'managing serious defaulters' regime, and even 'naming and shaming' (i.e., the publication of the taxpayer's details by HMRC (FA 2009, s 94)).

Maximum penalties are subject to potential reduction, depending on the quality of the taxpayer's disclosure of the error to HMRC, subject to a minimum penalty. The 'quality' of the taxpayer's disclosure of a tax return error involves three elements (FA 2007, Sch 24, para 9(1)):

- 'Telling' – informing HMRC about the error;
- 'Helping' – including giving HMRC 'reasonable help' and 'positive assistance'; and
- 'Giving access' – allowing HMRC access to relevant records and documents.

HMRC will potentially give a penalty reduction of up to 30% for telling, up to 40% for helping, and up to 30% for giving access. HMRC assesses the quality of these three elements of disclosure by reference to 'timing', 'nature' and 'extent'.

### **How long?**

The penalties legislation does not explicitly state that 'telling' HMRC about an error within a certain timeframe from when it occurred is a factor when determining a penalty reduction for disclosure. Indeed, prior to a change in HMRC's published approach, disclosing an error within a certain timeframe from when it occurred was not necessarily a factor considered by HMRC in arriving at a penalty reduction for disclosure.

HMRC's position on this point seemingly changed from 5 September 2016. HMRC's revised approach applies where the taxpayer has taken a 'significant period' to correct their non-compliance. HMRC published (on 17 December 2017) a revised factsheet on penalties for errors in tax returns etc. ([tinyurl.com/HMRC-Factsheet-Penalty-Errors](https://www.gov.uk/government/uploads/system/uploads/attachment_data/file/664442/HMRC-Factsheet-Penalty-Errors.pdf)). HMRC's guidance now states: "When we work out the quality of disclosure, we'll also consider how long it's taken you to disclose the inaccuracy. If it's taken you a long time, (such as 3 years or more), to make a disclosure, we'll usually restrict the maximum reduction we give for the quality of disclosure to 10 percentage points above the minimum of the penalty range. This means you will not benefit from the lowest penalty percentage that's normally available."

This three-year period generally runs from when the inaccuracy first occurred. Having said that, HMRC states (in its Compliance Handbook manual, at CH82465) there may be circumstances where it is not appropriate for the 10% penalty restriction to be applied, including a one-off careless error that the person would never have had reason to reconsider. Nevertheless, HMRC's 'three-year' approach is hardly likely to encourage taxpayers to 'come clean' and disclose errors found after the three-year period. As mentioned, HMRC's three-year time limit for disclosing a tax return error is non-statutory, and therefore open to challenge.

### **Undisclosed income and gains**

For example, in *Aggrey v Revenue and Customs* [2022] UKFTT 200 (TC), in December 1994 the appellant (a teacher who retired in 2010) purchased a flat in London for £60,000. He never lived in the property. His self-assessment returns for each tax year until 2013/14 included rental income. In February 2014, the appellant disposed of the property for £300,000. The appellant filed his tax return for 2013/14 on time but did not include any capital gain on the sale of the property, or any rental income for that tax year. Following a compliance check (under FA 2008, Sch 36), in November 2018 HMRC issued a discovery assessment for 2013/14, comprising: (1) rental income of £10,287 (tax £2,057); and (2) a capital gain of £212,157 (tax £57,245).

HMRC also charged a penalty of £1,002, being 48.75% of the tax on the undeclared rental income, based on a 'prompted' disclosure and deliberate behaviour. A further penalty of £14,740 was issued for the failure to report the capital gain based on a 'prompted' disclosure and careless behaviour. On appeal, the First-tier Tribunal (FTT) found that the appellant had acted deliberately in relation to his failure to include the rental income, and carelessly in relation to the capital gain. It followed that the discovery assessment was issued within the relevant time limits. However, the FTT reduced the discovery assessment on rental profits to £5,000, and the discovery assessment on the capital gain to £202,157 for certain allowable deductions.

### **Incorrect penalties**

The FTT in Aggrey also noted that HMRC had used incorrect minimum penalties in their calculations. HMRC calculated the penalties as follows (in rounded figures):

#### Per HMRC – Rental income

Minimum penalty = 45% (but see below).

Difference between the 70% maximum and HMRC's minimum = 25%.

HMRC reduced the 25% margin by 85% for quality of disclosure.

HMRC's penalty calculation: (a) Minimum penalty 45%; plus (b) 15% of the 25% margin = penalty 48.75% of potential lost revenue (PLR).

Total penalty: £2,057 x 48.75% = £1,002.

#### Per HMRC – Capital gain

Minimum penalty = 25% (but see below).

Difference between the 30% maximum and HMRC's minimum = 5%.

HMRC reduced the 5% margin by 85% for quality of disclosure.

HMRC's penalty calculation: (a) Minimum penalty 25%; plus (b) 15% of the 5% margin = penalty 25.75% of PLR.

Total penalty: £57,245 x 25.75% = £14,740.

However, the FTT noted that the minimum penalties according to FA 2007, Sch 24 in each instance were 10% lower than in HMRC's calculations. The FTT recalculated the penalties at £402 and £9,300 respectively, based on adjusted PLR and lower minimum penalties:

#### Per FTT – Rental income

PLR = £1,000.

Minimum penalty of 35% = £350

Maximum penalty of 70% = £700

Difference between the two = £350

Quality of disclosure calculation: £52 (£350 – [£350 x 85%])

Total penalty = £350 (minimum) + £52 = £402

#### Per FTT - Capital gain

PLR = £53,916

Minimum penalty of 15% = £8,087

Maximum penalty of 30% = £16,174

Difference between the two = £8,087

Quality of disclosure calculation: £1,213 (£8,087 – [£8,087 x 85%])

Total penalty = £8,087 (minimum) + £1,213 = £9,300

### **Ain't necessarily so!**

HMRC's calculation based on incorrect minimum penalties presumably reflected the 'three-year' 10% penalty loading approach for 'significant delays' as outlined above. HMRC's calculation had been endorsed in a

statutory review as being in accordance with the legislation. However, the FTT calculated the penalties according to the legislation, not HMRC's approach to applying it.

The moral is therefore to be aware of HMRC's approach to calculating penalties (see CH82510-CH82512), check HMRC's penalty calculations, and be prepared to challenge them, if necessary.

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