How to avoid the VAT traps

Andrew Park and Greg Mayne explain how you can navigate the VAT error disclosure system and explain the steps you can take to avoid HMRC penalties

VAT is often sardonically called the 'Very Awkward Tax'. That's not for nothing. It can be confusing and is often dealt with by busy taxpayers on borrowed time. Errors are easily made but it is how taxpayers, and their advisers, respond to those errors that makes the difference in rectifying them efficiently with HMRC and with minimal adverse consequences. In this article we give an overview of how and why VAT errors are commonly made, and how to go about correcting them.

Common causes of UK VAT errors

Rushed returns: Mistakes often occur from overlooking basic VAT processes, such as forgetting filing deadlines and then rushing to get the returns in and, for instance, omitting some of the data. For example, in quarterly VAT returns an entire month may be missed because the most recent month wasn't reviewed before submission.

Inadequate knowledge: As harsh as it sounds, incompetence, or a lack of understanding of VAT requirements and classifications, is another common cause of errors. Without knowledge of how VAT works, or what data is required, it is easy for taxpayers to make mistakes even when they try to take care in preparing and reviewing returns. Misunderstandings about the nature of supplies, applicable VAT rates and the correct amounts to charge or recover are also common.

Complacency: The attitude of 'I've always done it this way' can lead to errors. The world of VAT changes frequently and can be very nuanced in its application. Therefore, staying updated on current developments in legislation and case law is crucial to avoid mistakes, rather than assuming past methods and treatments will automatically still apply.

Thresholds and rates: Awareness of VAT thresholds is also a common issue in errors being made. Firstly, not being aware of what the thresholds are and, secondly, that once you exceed the relevant threshold that you need to take appropriate action – for example, that you need to register for VAT.

Bad advice: Often the professionals get confused themselves and businesses are given incorrect advice, or new businesses try to minimise their costs by relying on amateur advice from friends and family.

Deliberate errors: Finally, of course, there is always the potential for deliberate error. VAT is a major business expense and has a major impact on cash flow. The temptation to suppress Output VAT can be hard for some business owners to resist – particularly when their business is struggling.

In that regard, as well as understating VAT, HMRC also take a dim view on businesses purposely paying their VAT late in order to manage their cash flow position. HMRC can not only regard this behaviour as deliberate wrongdoing for the purposes of civil penalties, but in some circumstances might even pursue it as a criminal matter.

Sectors more susceptible to VAT errors

No specific sector is immune to VAT errors, but cash-intensive businesses like hospitality, leisure and retail face unique challenges. Keeping track of cash transactions is more difficult compared to card or credit transactions.

It is also well documented that food and consumables sectors frequently encounter VAT complexities and changes borne out of new case law in the tax courts. This topic would warrant its own detailed discussion.

Post-Brexit, international businesses face increased risk and exposure to errors due to changes in import and export VAT processes, which were previously unnecessary within the EU. International businesses have had to change the way they process information and the way they deal with the VAT.

It's not surprising that people struggle with VAT, given its constant changes. Just when businesses think they've mastered it, new complexities arise, such as Brexit adjustments, import procedures, property and construction regulations, and VAT rate changes for energy-saving materials.

Those responsible for VAT must stay updated and understand these changes' implications for their business.

Correcting errors in a VAT return

When a VAT error has been made, depending on the circumstances of that error, it can sometimes be difficult to know what the best course of action is.

From HMRC's perspective, the VAT652 form – with which many advisers are unfamiliar – is intended to be a general 'catch all' when the next return cannot simply be amended. However, in practice the best course of action depends upon the circumstances.

Unfortunately, VAT does not currently fit within HM Revenue's Digital Disclosure Service so that is not one of the options.

Below we set out the normal best practice for reporting VAT errors, depending on the seriousness of the error – from simple mistakes, through to deliberate and fraudulent omissions. At all stages, however, in basic terms HMRC want to know what happened, how it happened, when it happened, how much was involved and what has been done to prevent it happening again.

1. **A simple VAT error or oversight – qualifying for amendment in next return.**

   For errors in the preceding four years if the net value of errors is either:

   - £10,000 or less, or
   - between £10,000 and £50,000 but less than 1% of the total value of your sales

These kinds of errors can be adjusted for or corrected in the next VAT return.

2. **A simple VAT error or oversight – not qualifying for amendment in next return.**

   For minor errors or omissions for which the next return cannot simply be amended, completing and submitting the VAT652 form to HMRC is normally the best course of action. This form notifies HMRC of the accidental error and provides them with the necessary basic information to process the VAT adjustment.

3. **An accidental VAT error with a more complicated explanation than what the VAT652 can accommodate.**

   If the error requires more detailed explanation, the VAT652 form is normally best avoided. Instead, it is normally advisable to contact HMRC via letter or email explaining the error, how it occurred and the corrective actions taken. All relevant data should be included to give HMRC a complete picture, demonstrating that the mistake was unintentional – and, where possible, that reasonable care was take. HMRC may take time to respond, so ensure all information is provided and send documents via recorded delivery or request a ‘read receipt’ for assurance.

   The same approach should be taken for claiming any repayments too, in informing HMRC of the money owed, the relevant period and any other details relevant to supporting the repayment.

4. **The business has deliberately overlooked its VAT obligations.**

   In these circumstances, particular care needs to be taken in bringing the matter to HMRC’s attention as this constitutes tax evasion – for which punitive civil penalties can be levied on the business and for which HMRC could potentially seek to criminally prosecute the individuals responsible.

In these circumstances professional advice should be sought from a tax investigation specialist and/or criminal lawyer. In the ordinary course of events, they are likely to advise that the director or controlling individual responsible should apply to HMRC to make a voluntary Code of Practice 9 (COP9) disclosure through the Contractual Disclosure Facility (CDF). Assuming HMRC accept the application in the usual way, they will then receive a guarantee of non-prosecution in return for their full co-operation and an upfront admission of deliberate wrongdoing and the business involved will be subject to the civil penalty regime.

The message is that if a taxpayer makes a basic, simple VAT error – albeit, maybe involving a lot of money – then do not escalate it into something else by trying to cover the error up, for example by creating false paperwork. Those who do will put themselves in a completely different situation where they will be involved in tax evasion, and the individuals involved might even leave themselves open for possible criminal prosecution.

The Kittel Principle

The Kittel Principle – established in the international Courts – allows HMRC to investigate executives who knew, or should have known, about fraudulent activity, extending liability to the supply chain. Although this might technically fall beyond the definition of an 'error', and into the category of 'fraud', it remains a significant consideration.

As mentioned previously in respect of VAT on food products, the potential impact and implication of Kittel could warrant a whole article by itself. However, the basic points are that a business that is involved in a transaction with a supplier or customer should be aware of the status and validity of that other business and of the specific transaction being entered into. There should be robust and regular reporting and recording of the relevant checks carried out under due diligence to support that relationship and transaction, in order to avoid being seen as complicit in any fraudulent activity. If the transaction looks suspicious, or 'too good to be true', it should ring alarm bells.

Penalties

As with direct taxes, HMRC charges civil penalties for failing to comply with VAT obligations to the extent that the failure or error was culpable and there was no reasonable excuse.

Unlike direct taxes for the moment, the VAT filing penalties have undergone recent reform to a new point-based system.

Failure to comply with filing obligations

Under the new system, failing to submit a VAT return on time falls into the category of failure to comply. Penalties for failure to comply work much like speeding points, with points accruing. Taxpayers will receive a point for each late submission and once a penalty threshold has been met a fixed penalty of £200 will be issued, with another £200 for every subsequent late submission.

As the system is also introduced for other filing requirements – starting with Income Tax Self Assessment – points will accrue separately for each requirement.

For culpable errors, as with direct taxes, whether basic, such as filing a return with a transposition error, or more complex, such as partial exemption calculations, penalties are calculated based on a percentage of the tax owed. The extent of the penalty that HMRC seek to charge will be dependent on HMRC's assessment of the behaviours involved with mitigation for the degree of 'telling', 'helping' and 'giving' provided by the taxpayer as part of the disclosure process. One of the key reasons for making a prompt voluntary disclosure is to maximise the degree mitigation accepted by HMRC.

As with direct taxes, the value of the penalty is worked out on a percentage of the 'potential lost revenue' – that is, the VAT HMRC stood to lose for the error:

- If the error is deemed careless then penalties range between 0%–30% for unprompted disclosures (15%-30% if prompted).
- If the error is deemed deliberate penalties increase to 20% to 70% for unprompted (35%-70% if prompted).
- If the error is deemed deliberate and concealed, then penalties can range from 30%-100% for unprompted (50%-100% if prompted).

HMRC have 12 months from the date they establish the amount of tax lost to issue a penalty notice. They also have some discretion in suspending a penalty where they believe full enforcement sanctions may not be justified or reasonable.

Best practice for disclosures

- When an error is identified, HMRC should be notified as soon as reasonably possible through the most appropriate route.
- Comprehensive details should be provided about the error, its cause and corrective actions.
- The business should demonstrate that it has taken reasonable steps to prevent future errors.
- Proactively volunteering information can lead to reduced penalties and, in some cases, suspension of penalties.

Given the complexity of VAT, seeking advice from a specialist VAT adviser is prudent to navigate VAT obligations and ensure accurate filings in the first instance or to rectify any errors that might already have occurred.

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