

White paper

Navigating the grey areas of tax

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When you filled in your firm's tax return, or a tax return for a client, how careful were you? For most small business owners, the automatic response would be "extremely careful", reflecting professional pride and a fear of getting on the wrong side of the taxman. But no matter how careful we try to be when completing a tax return, errors still occur.

HM Revenue & Customs (HMRC) says it understands that people do their best to get a tax return right but still make mistakes. However, the department is cracking down on businesses that are negligent in their financial affairs, or those who deliberately file an inaccurate return and try to hide their errors.

HMRC is phasing in the introduction of a new penalty regime, to apply consistently across all the main types of tax. The first phase covers Income, Corporation and Capital Gains Taxes, the Construction Industry Scheme, PAYE, VAT and most classes of NIC. It applies to returns or other documents for return periods starting on or after 1 April 2008 that are due to be filed on or after 1 April 2009. More taxes will fall under the penalty regime in 2010.

Understand the rationale behind the rules

The shake-up in penalty rules comes after HMRC reviewed its powers, including its penalty rules, in a consultation last year (2008) (['Modernising Powers, Deterrents and Safeguards: Penalties reform - the next stage'](#)).

Under the new rules, taxpayers who make errors in their tax returns will need to prove that they took "reasonable care" when filling out their return, or have a "reasonable excuse" for the errors – or face a financial penalty.

This test of "reasonable care" is to help tax officials decide whether any errors in the form – such as an under-estimate of tax owed, or an exaggerated loss – are an honest mistake, rather than attempted fraud or negligence.

A sliding scale of penalties will be charged depending on whether the error is judged to be "careless, deliberate, or deliberate and concealed."

Businesses rather than accountants are the main target of the new rules. HMRC has said it's extremely unlikely that the penalty regime would affect accountants or tax agents. However, tax advisers are unlikely to be immune to the new rules. Advisers who make errors when completing tax returns could land their client with a penalty and could be sued by their clients for providing negligent advice.

Accountants should check that their clients are aware of the new penalty rules, and that the rules will affect all parts of their business. HMRC's website has a [section](#) explaining the implications of the new penalty system for tax agents and advisers.

Why is the taxman changing the penalty rules? HMRC says that the new rules for tax penalties are simpler, fairer and more consistent – replacing multiple rules at the old Customs and Excise and the Inland Revenue government departments.

In a section on its website about the new tax penalty rules, HMRC says businesses and accountants wanted the old system of tax penalties to be changed.

"During the consultation, customers and their agents said they wanted a fair system and told HMRC to do more to support those who tried to get their tax right, but come down hard on those who tried to get an unfair advantage by not complying," says HMRC.

Familiarise yourself with HMRC's five-point checklist on their definition of "reasonable care"

HMRC defines this slippery concept in a five-point checklist, including: making sure that accounting records and systems are accurate and complete; checking all the taxes you pay when filing returns; and documentation – being able to explain how you worked out figures in a tax return. For more information you can read a [Q&A](#) on the new penalty regime on HMRC's website.

Know the three levels of penalties for inaccurate company tax returns

- For "careless" errors the maximum penalty is 30% of the additional tax owed
- For deliberate mistakes, but when the taxpayer co-operates, the maximum penalty is 70%
- For "deliberate and concealed" inaccuracies, the maximum penalty is 100%

You can reduce penalties by telling HMRC about errors in a tax form before officials spot them, or by giving tax inspectors access to your figures.

Tax penalties can be challenged. Taxpayers can ask for a penalty decision to be reviewed or appeal to a tax tribunal. In addition, both the taxpayer and HMRC can seek leave to appeal to the upper tax tribunal if they don't disagree with the tax tribunal's decision.

Have a disciplined approach to record keeping

Graham Morgan, tax partner at accounting firm Kingston Smith LLP, predicts that there will be a significant increase in the number of penalties issued for errors in tax returns.

"Historically penalties were pretty freely negotiable," he says. "You could cut a deal with HMRC, or sometimes negotiate them away altogether. Penalties are much more automatic now – a normal charge for doing something wrong."

He advises small businesses to check their accounting procedures and systems for controlling risks. This could be as simple as checking that expenses are posted to the right ledger.

"[It's] about having a disciplined approach to record keeping and more importantly being able to demonstrate it," says Morgan.

Invest in good quality accounting software

[Leading accounting software](#) has built-in business rules, which can also help you spot errors before the tax return is sent. Crucially, software can also show tax inspectors that proper accounting procedures were being followed if an error is made in a tax return.

The new tax penalty rules haven't attracted much publicity, but they could cause major headaches for businesses with lax accounting procedures and systems.

As ever with tax, the devil will be in the detail. The grey areas of the new penalty regime will take years to emerge, and may not be well publicised initially.

Now is the time to advise clients to do a thorough review of accounting and tax processes and calculations. Errors will always slip through the spreadsheets, but if accounting procedures and systems are robust and transparent, the taxman is more likely to show some clemency.

“Careless inaccuracy” – an example, source HMRC

A&B Ltd, a large company with a substantial advertising budget, does not have procedures to identify the entertaining element of advertising costs. So any expenditure on advertising is included in full in the advertising account, with no way of crosschecking how much of the expense relates to disallowable entertaining.

This would at least indicate failure to take reasonable care and could be shown to be deliberate. A&B Ltd’s basic systems and procedures are inadequate to give appropriate levels of assurance.

How to help clients stay on the right side of the taxman

There are a few things that you can suggest to help clients prove that they took “reasonable care” when completing their tax return:

Make and preserve sufficient records to make a correct and complete return and to show their (and your) decision-making processes.

Ensure that they have adequate systems and processes in place and that these are followed
If they encounter something that they’re not familiar with, find out about the correct tax treatment or seek appropriate advice.

If they’re unsure about the right tax treatment you should draw attention to the entry and the uncertainty when you send the return or document to HMRC.

For further information visit hmrc.gov.uk

Alternatively, visit our
sagetax.co.uk website,
email us at sagetax@sage.com
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