Correcting the tax gap

Large Corporate | OMB



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Annis Lampard and *Mike Pape* on how HMRC investigates failure to comply with UK tax obligations

Key Points

What is the issue?

It's anticipated that HMRC's role in collecting unpaid tax will become of increasing importance to help fund the much-needed but costly Covid-19 government initiatives supporting individuals and businesses during the pandemic.

What does it mean for me?

Events of the recent past give us some insight into how HMRC might look to recover funds for the Exchequer and methods for investigating those who do not fully comply with their UK tax obligations, including using the most serious powers at its disposal for investigating fraud.

What can I take away?

With an anticipated increased focus from HMRC in mind, taxpayers should remain aware of their tax compliance responsibilities and, if necessary, act promptly to correct any non-compliance.

In these unprecedented times, Covid-19 has had a myriad impact on all of our lives. The UK government acknowledged the additional stresses on taxpayers early on in the pandemic when it acted swiftly to ease their burdens. For example, HMRC offered to suspend many enquiries, defer certain tax payments and extend certain statutory appeal deadlines.

HMRC also implemented costly but necessary support schemes to help those businesses and individual taxpayers most acutely impacted. These measures have been a lifeline for many, but it will come as no surprise that the vast sums required to fund them will ultimately have to be recovered, with HMRC acting as collector. It is currently unclear what, if any, measures the government will take to help recoup the Covid-19 related shortfall. However, prior to Covid-19, HMRC was already under ever increasing pressure to increase the recovery of underpaid tax and this is only likely to increase.

HMRC focus

Despite the Covid-19 pandemic being very different from the 2008 financial crisis, certain parallels can be drawn in the government's need to raise additional funds to help rebalance the books. In the wake of the previous crisis, additional scrutiny was placed on tax transparency both in the UK and worldwide, largely driven by public

discourse. The new tax responsibility agenda led to a renewed HMRC focus on tackling tax evasion and avoidance, particularly on 'offshore' matters, as in HMRC's 'No Safe Havens' strategy, published in 2014 and refreshed in 2019. New approaches, including the Liechtenstein and Crown Dependency 'disclosure facilities', were introduced to put the onus back on the taxpayer to correct historic non-compliance. International cooperation in this area led to bilateral and multilateral automatic exchange of information agreements, culminating in the common reporting standard (CRS), which came onstream in 2017.

Additionally, since 2008 successive governments have regularly legislated to increase HMRC's powers, including further information gathering powers, the ability to assess historic tax, and levy increased penalties. We may well see further legislative measures to bolster these powers even further.

Wealthy individuals and large businesses have been subject to greater levels of scrutiny by HMRC in recent years in addition to those where avoidance or evasion is suspected. It would come as no great surprise if HMRC was to continue to push greater resources towards these areas and further still in identifying the small percentage of taxpayers that deliberately seek to underreport their taxable income and gains to HMRC. Focusing on those who deliberately underreport tax, through investigations under its Code of Practice 9 (COP9) in cases of suspected fraud, could have a significant revenue impact for HMRC, not least due to the greater penalties that can be levied.

Contractual Disclosure Facility

Where HMRC suspects tax fraud, it will first consider pursuing a criminal investigation. In many cases, it is determined that a criminal investigation is not appropriate and investigations then proceed on a civil basis through a specialist HMRC team, the Fraud Investigation Service (FIS).

Civil investigations of fraud are carried out under HMRC's Code of Practice 9, and you may hear the term COP9 used as a shorthand for these cases. However, since 2012 HMRC has also used the Contractual Disclosure Facility (CDF), which operates within COP9. We will refer to CDF rather than COP9 in this article. The first step is that HMRC writes to the taxpayer, offering the opportunity to admit to deliberate conduct resulting in a loss of tax and to commit to making a full disclosure via the CDF of all past tax irregularities. HMRC will not divulge the reasons for its suspicions

which gave rise to the CDF offer. The taxpayer has 60 days to respond and if they accept HMRC's offer they will enter the CDF in order to make a full disclosure. In return, HMRC will not pursue criminal prosecution of matters included in this disclosure.

If the taxpayer accepts HMRC's CDF offer, an outline disclosure of past tax irregularities must also be submitted within the initial 60 day period with the view to submitting a more detailed, full disclosure report later. Should the CDF offer be rejected by the taxpayer, or indeed if the outline disclosure does not address the issues that gave rise to HMRC's CDF offer, the case will again be considered for criminal investigation or HMRC may commence its own civil investigation.

The process

HMRC will likely wish to meet with the taxpayer after the CDF outline disclosure has been submitted. These meetings can last many hours and in our experience the questions asked are wide-ranging and detailed. Taxpayers are not obliged to attend but HMRC may take this into account when considering penalty levels upon conclusion of the process. HMRC will then ask the taxpayer to produce a detailed disclosure report, which will be thoroughly reviewed and must satisfy all HMRC's concerns before any settlement agreement is made. A timetable will be discussed and agreed with HMRC for the disclosure report to be completed. This timetable will depend on the circumstances of the particular case and its complexity.

The CDF process is often lengthy and detailed, commonly extending to the taxpayer's personal tax affairs and the affairs of businesses with which they are associated. It is therefore important to agree a clear scope with HMRC and keep HMRC informed of the progress at all stages during the preparation of the report.

Typically, in civil fraud matters, HMRC can assess historic tax liabilities for the past 20 years, providing the loss of tax relates to deliberate behaviour by the taxpayer. Certain errors may be subject to reduced assessment time limits, depending on the behaviour which led to the error.

Once HMRC has reviewed the final CDF disclosure, a financial settlement of the total additional tax, late payment interest and penalties will be agreed. Tax liabilities arising in these cases are frequently for significant amounts and therefore the tax-geared penalties can also be significant. The 'standard' penalty range for a

deliberate inaccuracy is 20% to 70% of the tax liability, although the maximum penalty can be 200% of the tax liability where it relates to an offshore matter and where the 'Failure to Correct' provisions of Finance (No.2) Act 2017 Schedule 18 apply. In addition, where penalties arise as a result of deliberate behaviour and the tax exceeds £25,000, it may also result in the publication of the taxpayer's details on HMRC's website.

Whilst CDF disclosures are usually instigated by HMRC, taxpayers are able to approach HMRC to request to enter into the CDF in order to make a full voluntary disclosure of historic tax irregularities. Given the serious nature of the process, specialist advice should be sought before making any approach to HMRC relating to CDF and it should be reserved for cases relating to serious, deliberate irregularities. Other disclosure routes are referenced below.

The CDF process allows HMRC to collect tax over a period of up to 20 years and to challenge the most severe behaviour of a small number of taxpayers. As the taxpayer bears the burden of preparing a detailed and lengthy disclosure report, the process is relatively cost effective for HMRC. For these reasons, the CDF is an attractive route for HMRC in tackling a population that has a significant impact on the UK tax gap and we might anticipate more CDF offers in the near future.

Conclusions

Notwithstanding that HMRC has sought to temporarily ease the burden on taxpayers given current circumstances, this 'reprieve' of sorts is likely to be temporary. With responsibility to refill the Exchequer's coffers, it is anticipated that there will be a renewed focus from HMRC to ensure taxpayers are complying with their tax compliance obligations, and in pursuing those who do not.

Whilst this article focuses on HMRC's approach to those who deliberately seek to underpay tax, a large proportion of the 'tax gap' results from innocent errors, or errors resulting from careless behaviour. Taxpayers should keep on top of their tax affairs, to ensure all is up to date and nothing has been underreported to HMRC. If an error has occurred in the taxpayer's affairs, any delay in disclosing errors to HMRC could come at a greater cost to the taxpayer in the long run. If the disclosure of an error is prompted by HMRC, for example, the taxpayer will suffer higher penalty rates as a result.

Different routes are available to taxpayers who wish to make a voluntary disclosure to HMRC, ditepending on the severity and complexity of the error. As well as a voluntary disclosure under the CDF, the Worldwide Disclosure Facility (WDF) and the Digital Disclosure Service (DDS) are available. Taxpayers should discuss the most appropriate route with their tax adviser and, where needed, seek specialist advice, particularly where a CDF offer has been issued by HMRC.