Investigating underpaid VAT: HMRC's best powers of judgment

Indirect Tax



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We consider how advisers should deal with assessments issued by HMRC when an officer thinks that a client has underpaid output tax on past VAT returns.

Key Points

What is the issue?

The legislation gives HMRC officers the power to issue an assessment using ‘best judgment’ if they consider that VAT has been underpaid on past returns. The assessments can only be a guestimate of the tax underpaid, so the officer’s conclusions and calculations should be properly checked and reviewed before they are accepted.

What does it mean for me?

If HMRC decides that output tax has been deliberately underpaid on past returns, it has the power to extend the assessment period from four to 20 years. Behavioural penalties are higher if errors are deliberate rather than careless.

What can I take away?

The increased use of card rather than cash payments has reduced the risk of total sales being understated by a business on its returns but it is important that advisers check the mix of standard and zero-rated sales and the accuracy of till procedures.

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Imagine the following situation: you trade in the High Street as a retail outlet – let's say, a restaurant – and have had a compliance visit from HMRC. Following his initial checks, the officer has decided that your business has understated its daily gross takings figures in your accounting records. He also thinks that you have over-recorded your zero-rated sales. You now have double trouble. What will the officer do in this situation and how should you react?

I will answer these two questions in this article, also referring to recent cases in the First-tier Tribunal to give a further steer.

What does best judgment mean?

The legislation gives officers the power to issue an assessment by using their 'best judgment' if they think that VAT returns have underpaid tax. See ***Best judgment: the legislation***.

A common misunderstanding is to think that officers are obliged to carry out detailed checks and calculations on every past return to establish what they consider to be the correct output tax figure for each period. This is not the case. So, for example, if an officer has calculated that a tobacconist should be achieving a 15% mark-up on the goods he buys by doing a detailed check of his purchase invoices in a representative period, he has the power to extrapolate this percentage to other periods and issue an assessment for the last four years.

Officers will usually discuss their concerns with taxpayers before issuing an assessment. This ensures that clients have a chance to review the calculations and

hopefully explain the difference by providing further evidence to support their declared figures. For example, many goods purchased by retailers are not sold at the full selling price due to, say, staff discounts, out-of-date stock being thrown away, obsolescence and wastage.

Best judgment: the legislation

Value Added Tax Act 1994 s 73(1):

1. Where a person has failed to make any returns … or where it appears to the Commissioners that such returns are incomplete or incorrect, they may assess the amount of VAT from him to the best of their judgment and notify it to him.

Author's note: HMRC might issue an assessment to disallow input tax if, for example, the officer decides that the evidence to support a claim is insufficient. However, most assessments will relate to underpaid output tax.

Two pieces of separate evidence

HMRC's internal manual on best judgment assessments suggests that officers should have two separate pieces of evidence to indicate that output tax has been understated. *HMRC VAT Assessments and Error Correction Manual* defines the 'best result' for HMRC officers when calculating a 'best judgment' assessment:

> 'It is important to remember that the best result does not mean the method which produces the highest arrears. By best, we mean the most reasonable method as it appears to the officer given the circumstances encountered and the information held. Assessments based on one method and confirmed or supported by means of another are to be preferred.'

For example, if an officer called into the premises of a restaurant unannounced – just before closing time – she might ask to see a till reading of the daily business. If this till reading indicates that total sales were £1,000 for that day but the business has only declared a maximum daily takings figure of £700 in its records for the last four years, this suggests there is a problem. If the officer has also carried out test purchases on different trading days, and observed that some of them have been omitted from the accounting records, she has further evidence of sales being under-recorded. She is in the driving seat, so to speak.

The potential challenge for a business faced with an output tax assessment is that HMRC might decide that the underpayment has been caused by deliberate actions rather than carelessness. An assessment can be raised going back up to 20 years, rather than being capped at four years for errors. The penalty regime applies rightly higher penalties for errors that are deliberate rather than careless.

See ***Recent tribunals: Neoterick UK*** and ***The Great British Takeaway.***

Recent tribunals

Neoterick UK Ltd

In the case of the Subway franchise restaurant *Neoterick UK Ltd* [2022] UKFTT 442, the officers had four pieces of evidence to indicate that standard rated sales had been understated, including two purchases of toasted subs (hot take-away food), which had been coded as zero-rated. They also carried out twelve hours of invigilation exercises over two separate trading days, which again indicated that output tax had been underpaid. The company failed to explain the discrepancies and the appeal was dismissed.

The Great British Takeaway Ltd

In the case of *The Great British Takeaway Ltd* [2022] UKFTT 315, the tribunal considered whether HMRC was correct to issue a penalty for ‘deliberate’ behaviour and whether the discount given on the maximum penalty rate by HMRC was fair and reasonable.

The company traded as a fish and chip shop and HMRC issued an assessment for £109,157 in October 2018, relating to suppressed sales on returns for the previous four years. The takings shortfall was identified by HMRC after carrying out extensive enquiries and checking Z-readings on tills. The tribunal agreed that the assessment had been raised using the officer's best judgment.

A penalty for £49,666 was issued for deliberate behaviour. The maximum penalty rate for a prompted disclosure is 70% of the tax owed and the minimum rate is 35%. HMRC reduced the maximum rate as follows:

- **Telling:** 10% (out of a maximum of 30%) because the taxpayer did not provide any information about the 'true basis or methodology of the suppression'.
- **Helping:** 30% (out of a maximum of 40%) because the taxpayer attended meetings and provided information when requested but did not help to quantify the arrears.
- **Giving:** the full 30% discount was given.

The judge commented that HMRC had been generous in allowing 10% discount for the 'telling' condition because the taxpayer's explanation that the shortfall was due to problems with 'training and telephone orders' was clearly incorrect. The penalty was upheld and the appeal was dismissed.

Credibility checks

Two major changes have happened in recent years, which have had a massive impact on the trading model of many businesses; namely, the increase in the volume of online sales and the reduction in the volume of cash takings because contactless payments by debit cards and mobile phones have increased.

Here are three important VAT questions that accountants should consider in the modern era when doing year-end accounts for a client:

1. Are online sales being recorded correctly?

I heard a great tale recently from an accountant about a client who owned a shop selling skin care products but also sold products online. The client said there was no

VAT to pay on his online sales because his wife dealt with them as a separate business – trading below the annual registration threshold of £85,000 – and she banked the money into her own account. ‘What about the input tax on these goods?’ asked the accountant. ‘That’s claimed by my business,’ he replied, ‘because the suppliers still issue all invoices to me.’ This is VAT utopia – claim input tax on your purchases but don’t pay output tax on your sales!

2. Has the mix of standard and zero-rated sales been declared correctly?

In the case of *Peppermint Foods Ltd* [2022] UKFTT 232, HMRC disputed the company’s VAT returns, which showed that 58% of sales were standard rated. The experienced officer decided that a figure of 90% was more realistic. The officer purchased a hot 12-inch tuna sub for £5.70 where VAT on the till receipt was shown as 43p instead of 95p, with a similar problem encountered on the purchase of a 12-inch chicken strips sub. The taxpayer’s appeal against an assessment of £144,383 was dismissed.

3. Do figures included on the VAT returns look sensible?

I always enjoy telling the tale about a visit I made to a kebab take-away business in my Customs and Excise days, where the owner’s VAT returns showed that 40% of his total sales were zero-rated. This percentage was ridiculous because the only zero-rated product he sold was a milkshake drink. A more realistic figure of 2% was agreed and I issued a big assessment plus a penalty.

In HMRC’s VAT Assessments and Error Correction manual (VAEC1510), there is a clear instruction that officers must consider whether an assessment is sensible: ‘Once you have calculated the arrears to best judgment, you should ask yourself: Is this figure credible? Could the business have actually under-declared this amount of tax.’

Alternative calculations

There are two stages for dealing with a best judgement assessment.

Firstly, you must check that the officer has considered all relevant trading factors about your client’s business. For example, has an allowance been made for draught beer lost through weekly pipe cleaning in the case of a pub? Has the projected sales

figure been adjusted to reflect ‘two for one’ meal deals on a Monday evening and the ‘happy hour’ sessions held during the week?

Secondly, if you think that the officer’s calculations are wrong, it is important to come up with your own calculations about what you consider to be the correct figures. This was a problem in the *Peppermint Food Ltd* case mentioned above, where the judge criticised the appellant for providing no ‘contrary number evidence’ of what the correct output tax figures should be.

Conclusion

HMRC has reallocated many staff from compliance work to Covid-19 and Brexit challenges in recent times. A renewed focus by the department on compliance activities and increasing the tax yield means that the number of best judgment assessments is likely to increase in the coming years. I hope this article has helped to prepare you for this possibility.

Finally, many VAT enthusiasts will recall the landmark case of *Pegasus Birds* [2004] EWCA Civ 1015, heard in the Court of Appeal many years ago. It related to a massive assessment issued by HMRC in relation to the alleged suppression of bird sales. The principles and analysis of the case have largely stood the test of time. See HMRC’s manual at VAEC1440 for more analysis – it’s worth a few minutes of your busy day.