PENALTY FOR PARTICIPATING IN VAT FRAUD

ICAEW welcomes the opportunity to comment on the consultation document *Penalty for participating in VAT fraud* published by HM Revenue & Customs on 28 September 2016.

This response of 10 November 2016 has been prepared on behalf of ICAEW by the Tax Faculty. Internationally recognised as a source of expertise, the Faculty is a leading authority on taxation. It is responsible for making submissions to tax authorities on behalf of ICAEW and does this with support from over 130 volunteers, many of whom are well-known names in the tax world. Appendix 1 sets out the ICAEW Tax Faculty's Ten Tenets for a Better Tax System, by which we benchmark proposals for changes to the tax system.

We should be happy to discuss any aspect of our comments and to take part in all further consultations on this area.

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MAJOR POINTS

Key point summary

1. We do not consider that there is a good case for a introducing a new penalty for participating in VAT fraud.

2. We understood that the FA 2007 changes were designed to harmonise the penalty regime across taxes and it was a 'once in a generation' change. HMRC is now seeking to change the basis for penalties, but there is no clear justification in the paper what has really prompted this change.

3. From the information in the impact assessments, it appears that the potential savings to be made by introducing the proposed penalty are insignificant. Indeed, it is likely to be several years before the costs of implementing the change would be recovered.

4. Whilst this may be because HMRC expects the new penalty to act primarily as a deterrent, we have concerns that the proposals as drafted are too widely targeted and that they have the potential to impact unfairly on taxpayers. In particular, we consider it unfair to impose a penalty against a person or company that genuinely had no knowledge of the fraud, even if HMRC believes they should have known. Such a penalty should only be imposed if the actual knowledge of the fraud could be proved in a court of law.

RESPONSES TO SPECIFIC QUESTIONS

Q1: Do you consider that there is a good case for introducing a new penalty for participating in VAT fraud and if so, do you agree that the new penalty is aligned with the 'knowledge principle' and does not distinguish between whether a business or individual knew OR should have known of the connection with VAT fraud?

5. No. Whilst we fully understand and support HMRC's efforts to tackle VAT fraud, we do not consider that there is a good case for a introducing a new penalty for participating in VAT fraud in the manner which has been proposed. It follows that we do not agree it should be aligned with the 'knowledge principle.'

Q2: Please outline your thoughts about the case for Option A? What do you see as the strengths and weaknesses of this option?

6. We believe that HMRC should set out in what circumstances a company secretary "should have known" that transactions were connected with VAT fraud (para 3.5). A company secretary will often have little knowledge of "transactions". He or she may sign the cheques as a second signatory but that gives little opportunity to "know" about what exactly the transaction was about.

7. It appears that the proposal is that if A Ltd is involved in a fraud, A Ltd can be penalised but its directors cannot be penalised personally. However, any director or other individual who was actually involved in the fraud can himself be penalised. If B Ltd, which is a customer of A Ltd, ought to have known that A Ltd was committing fraud, not only can B Ltd be penalised, but so can any director or company secretary of B Ltd who did not know of the fraud but ought to have done so. While there may be a case for a director or company secretary of B Ltd to be subject to a penalty if they knew of the fraud, this is much more problematic, and potentially unfair, where the test to be applied is whether the person 'ought to have known'. We would appreciate clarification that this understanding is correct.

8. As indicated above, the statement at 3.6 that the main benefit of the change would be to align the test for the penalty with the knowledge principle, ensuring that the two can be assessed together, is incorrect. The test for the knowledge principle is normally the adequacy or otherwise of due diligence when creating a business relationship. The test for the penalty is

behaviour in relation to a particular transaction. We believe that the two serve different purposes and cannot really be aligned.

9. The statement at 3.8 about "those that facilitate fraud" is also too sweeping a statement to be correct in all cases. A person who does not do adequate due diligence does not necessarily facilitate fraud, although they may have failed to help reduce the risk that the fraud will be exposed.

Q3: Is a 30% penalty an appropriate percentage to charge for this type of non-compliance?

10. A 30% penalty would not be appropriate in many cases. For example, if it was deemed to be due from a company officer of a large company where the amounts involved were substantial, a 30% penalty could bankrupt an officer who may have known nothing about the fraud, but was nevertheless considered that they should have known about it.

Q4: Please outline your thoughts about the case for Option B? What do you see as the strengths and weaknesses of this option?

11. Surely where the evidence against a person is overwhelming (para 4.8) HMRC already has the power to ask the FTT to strike out the appeal as having no likelihood of success. We do not see why HMRC allows such cases to go to a hearing.

12. If HMRC wants an "early payment" system (para 4.8) the obvious way would be to adopt the direct tax route of requiring payment at the time of the assessment unless the taxpayer asks for the tax to be postponed. A Tribunal could deal with a postponement applicant more quickly than a substantive appeal.

Q5: Do you think that having a higher penalty rate in cases where a tribunal finds actual knowledge would discourage legitimate appeals?

13. There would probably be some instances where this would be the case.

Q6: Do you think the proposed penalty percentages – of 25%, rising to 50% where a court finds actual knowledge of the fraud – are appropriate?

14. It is appropriate for a penalty to be higher if actual knowledge is proved.

Q7: Do you think the new penalty (under either Options A or B) should apply to company officers that should have known of the connection with VAT fraud?

15. We believe that a penalty should only apply to company officers if their personal knowledge of fraud is proved.

Q8: Are there any other design options that we should consider for a new penalty for participating in VAT fraud?

16. Although we believe that the problems the consultation seeks to address are exaggerated, a fairer solution to the perceived problem would be to give the First Tier and Upper Tribunals power to substitute a penalty for failure to take reasonable care if it considered that a penalty was appropriate but there was an insufficient level of proof to justify the deliberate behaviour penalty that had been assessed.

Q9: Do you prefer Option A or Option B or another design option?

17. We do not support either Option A or Option B. However, Option B would appear to be marginally fairer than Option A.

Q10: Should the new penalty feature reductions for disclosure and cooperation with HMRC?

18. Yes. This should be a feature of all penalties. However, this becomes difficult with a penalty for not knowing something that one ought to have known. If a person does not know something then he cannot disclose it to HMRC. This may be why HMRC is finding that such people rarely make meaningful disclosures.

19. It does not seem reasonable that a person who commits fraud should be able to reduce his penalty by disclosing information to HMRC whereas a person who was not involved in the fraud but should have known about it should be penalised more heavily because he is unable to disclose anything.

Q11: If so, what should the reductions be for and what level of reduction should be allowed?

20. The levels of reduction should be similar to those available for existing penalties.

Q12: Should those that participate in VAT fraud be named and shamed?

21. Given that we believe the whole proposal would lead to the risk of penalties being applied unfairly, we clearly believe that naming and shaming could exacerbate the unfairness.

Q13: In your view, is naming and shaming appropriate when a customer only should have known of a connection with VAT fraud?

22. No. It is inappropriate for anyone to be named and shamed for something about which they were unaware.

Q14: Do you have any further comments to make about the new penalty or this consultation exercise?

23. The title to the document is rather unhelpful, as the proposed penalty is not on the face of it for participating in VAT fraud. It is for not noticing that someone else has committed VAT fraud.

24. HMRC says that it has to choose whether to assess a penalty for deliberate behaviour or one for failure to take reasonable care (2.8) and that it does not know which is appropriate until the Tribunal has decided whether the taxpayer knew of the fraud or should have known of it. It is unclear why HMRC is unable assess both as alternatives (provided of course it does not seek to enforce both). Even though VAT is an EU tax, the penalties are up to the UK to determine. The UK has decided to have a common system of penalties for direct and indirect tax. The Court of Appeal has held that HMRC is entitled to raise two or more assessments on the same receipt provided that the two are alternatives (Lord Advocate v McKenna 61 TC 688). It is not clear why HMRC does not believe that this procedure holds as good for penalty assessments as for substantive tax assessments.

25. It was held by the First Tier Tribunal in Anthony Clynes v HMRC (TC 5123) that deliberately "turning a blind eye" to something is as deliberate as doing the thing itself. Accordingly, a person who ought to have known but turned a blind eye can already be penalised for deliberate conduct. If those who deliberately choose not to know are potentially liable for a deliberate conduct penalty, the only people to whom the new penalty will apply are those who genuinely did not know of the fraud but who might have become aware of it had they done better due diligence. It would then be a penalty for lax due diligence. It is not reasonable that such conduct should attract a penalty beyond that for not taking reasonable care, because a person should not be penalised unless he knew what the law required him to do and no-one can specify precisely what due diligence a person ought to do as that will vary from case to case.

26. There is no doubt that MTIC fraud is a major problem and that HMRC is largely powerless to prevent it because the opportunity for fraud is brought about by the VAT system (by enabling goods to cross borders free of VAT). Consequently, it might be appropriate for HMRC to introduce the penalty if it is limited to MTIC fraud, where the law already requires enhanced record-keeping and enhanced due diligence. Parliament has decided that people dealing in the types of goods that are used in MTIC fraud need to be vigilant to help HMRC to try to combat the fraud. Unfortunately, however, the proposal is that a new "failure to notice" penalty should apply to all VAT fraud.

27. The government made a policy decision in 2007 to have a common penalty system for VAT and direct tax. It is a needless complication to the tax system to seek to partially reverse that decision by treating VAT fraud as somehow different to direct tax fraud and thus deserving of higher penalties.

APPENDIX 1

ICAEW TAX FACULTY'S TEN TENETS FOR A BETTER TAX SYSTEM

The tax system should be:

1. Statutory: tax legislation should be enacted by statute and subject to proper democratic scrutiny by Parliament.

2. Certain: in virtually all circumstances the application of the tax rules should be certain. It should not normally be necessary for anyone to resort to the courts in order to resolve how the rules operate in relation to his or her tax affairs.

3. Simple: the tax rules should aim to be simple, understandable and clear in their objectives.

4. Easy to collect and to calculate: a person's tax liability should be easy to calculate and straightforward and cheap to collect.

5. Properly targeted: when anti-avoidance legislation is passed, due regard should be had to maintaining the simplicity and certainty of the tax system by targeting it to close specific loopholes.

6. Constant: Changes to the underlying rules should be kept to a minimum. There should be a justifiable economic and/or social basis for any change to the tax rules and this justification should be made public and the underlying policy made clear.

7. Subject to proper consultation: other than in exceptional circumstances, the Government should allow adequate time for both the drafting of tax legislation and full consultation on it.

8. Regularly reviewed: the tax rules should be subject to a regular public review to determine their continuing relevance and whether their original justification has been realised. If a tax rule is no longer relevant, then it should be repealed.

9. Fair and reasonable: the revenue authorities have a duty to exercise their powers reasonably. There should be a right of appeal to an independent tribunal against all their decisions.

10. Competitive: tax rules and rates should be framed so as to encourage investment, capital and trade in and with the UK.

These are explained in more detail in our discussion document published in October 1999 as TAXGUIDE 4/99 (see http://www.icaew.com/-/media/corporate/files/technical/tax/tax-news/taxguides/taxguide-0499.ashx).