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# POSSIBLE PENALTIES FOR OVER CLAIMING CAPITAL ALLOWANCES

## Introduction

A new system of penalties has been introduced by the Finance Act 2007 (FA 2007), Schedule 24, as amended by the Finance Act 2008, Schedule 40. The system covers the different types of inaccuracies (errors) that might be made within a document that leads to an understatement of tax, an inflated loss, or an inflated claim for repayment of tax. It also covers situations where HM Revenue and Customs (HMRC) raise an understated assessment.

The new rules apply for income tax and corporation tax from 1 April 2008 for chargeable periods commencing after that date, but only if the filing date for the return is on or after 1 April 2009, as specified by SI 2008/568 - Finance Act 2007, Schedule 24 (Commencement and Transitional Provisions) Order 2008.

The question that this paper sets out to consider is whether an excessive Capital Allowances claim could lead to a penalty under the new system.

## The pre-FA 2007 rules

Before we look at the new rules in some detail, it is appropriate to firstly consider the position as it stands pre-FA 2007. The relevant legislation can be found in Taxes Management Act 1970 (TMA 1970) for income tax and Finance Act 1998 for corporation tax. TMA 1970, Section 95(1)(b) states that a penalty will arise when a person fraudulently or negligently 'makes any incorrect return, statement or declaration in connection with any claim for any allowance.....'. Similar wording applies at FA 1998, Schedule 18, para 20 for corporation tax. In both cases, the maximum penalty is equal to the tax due, but can be reduced down to nil depending on factors such as disclosure, cooperation and seriousness.

In their Consultation Paper dated December 2006, HMRC stated that "in practice, the penalties charged for negligent and fraudulent conduct tend to be bunched in a narrow range at the bottom of the scale. This does not appear to represent a proportionate response to the potential range of behaviours from currently neglect to serious fraud". HMRC found that the small difference in the level of penalties applied between neglect and fraud was due to the ease of getting the maximum abatement for cooperation in cases of fraud.

It is also worth noting that under the pre-FA 2007 rules, there is no penalty for overstatement of a loss if the loss could not immediately be used. The new regime seeks to redress this issue, as well as graduating the level of penalties that are applied depending on the seriousness of the action leading to the inaccuracy.

## The new rules

The following different types of inaccuracy are covered:

- (1) An inaccuracy made despite the person taking reasonable care.
- (2) A careless inaccuracy.
- (3) A deliberate inaccuracy that is not concealed.
- (4) A deliberate inaccuracy that is concealed.
- (5) An understated assessment is raised by HMRC and the taxpayer does not notify HMRC within 30 days of the date of the assessment.

Type 1 above will not lead to a penalty unless it is discovered by the taxpayer and the taxpayer then fails to notify HMRC, in which case it will be treated as a type 2 (careless) inaccuracy. Type 5 is also treated in the same way as type 2. The penalty types of inaccuracy, therefore, can be categorised as careless, deliberate but not concealed, or deliberate and concealed.

The maximum penalty for each type of inaccuracy (or for failure to disclose an under-assessment within 30 days) can be reduced. The amount of the reduction will depend upon how the inaccuracy or understatement is disclosed. If the person making the disclosure has no reason to believe that HMRC has discovered, or is about to discover the inaccuracy or under assessment, then the disclosure will be treated as unprompted, otherwise it is treated as prompted.

The table below sets out the minimum and maximum penalties for each type of inaccuracy. The percentages apply to the additional tax liability (or potential tax liability) that will arise on the correction of the inaccuracy.

	Type of disclosure			
	Unprompted		Prompted	
<b>Careless</b>	Min	0%	Min	15%
	Max	30%	Max	30%
<b>Deliberate</b>	Min	20%	Min	35%
	Max	70%	Max	70%
<b>Deliberate and concealed</b>	Min	30%	Min	50%
	Max	100%	Max	100%

If the inaccuracy results in an increased loss that cannot be utilised in the year of loss, but it is reasonable to assume that the loss will be utilised at some future date, then a discounted penalty of 10% applies. If there is no likelihood that the increase in the

loss due to the inaccuracy will ever be utilised (e.g. the trade has ceased), then no penalty will be applicable. If an inaccuracy leads to the delay of tax being paid (rather than a reduction in tax), then the penalty will be 5% for each year of delay.

A penalty can be suspended by HMRC for two years to give the taxpayer time to rectify the causes of the inaccuracy, such as poor record keeping. If, at the end of the two year period, the taxpayer has met the conditions of the suspension, then the penalty will be cancelled. A penalty can only be suspended if it is careless, not if it is deliberate.

## Excessive Capital Allowances claims

It is true that HMRC has not generally applied penalties under the pre-FA 2007 rules for over claims of Capital Allowances. HMRC have been known, however, to modify their stance on many issues in the past and it would, therefore, be naïve to assume that the same approach will continue under the new rules.

Perhaps the first question to consider is whether an excessive claim for Capital Allowances can be regarded as an error or inaccuracy at all? Perhaps the Capital Allowances claimed were too high simply because of the basis of valuation used? If that was the case, then it seems difficult to regard a Capital Allowances claim as inaccurate just because it is reduced by HMRC. Even if the claim is regarded as inaccurate, provided that reasonable judgement is adopted and the basis on which the valuation made is disclosed, then it will be treated as a 'mistake', which does not attract a penalty.

The above conclusion would seem to rule out the possibility of penalties arising where the claim is based on an apportionment that has been prepared under the Valuation Office Agency's (VOA) approved apportionment formula. Other methods of valuation could likewise be considered to have been made after taking reasonable care, or making a reasonable judgement. But what about methods of valuation that have no reasonable basis for being adopted?

A Capital Allowances claim for plant and machinery that is made on the basis of a percentage of the price paid for a property, or a percentage of the construction cost, is unlikely to involve reasonable care or reasonable judgement. The taxpayer, or the taxpayer's adviser, must have known (or should reasonably be expected to have known) that Capital Allowances are based on cost incurred. A claim made on the basis of a percentage of the construction cost of a property, therefore, shows a disregard of the facts and could, therefore, be considered unreasonable or negligent. Likewise (but maybe to a slightly lesser degree), in the case of a claim based on a percentage of the price paid for a property, no reasonable attempt

would have been made to reach a 'just apportionment' that is 'reasonably attributable' to the qualifying expenditure as required by Capital Allowances Act 2001, Section 562.

The taxpayer might also be held to be careless in the over claiming of Capital Allowances if there is no legal basis for any claim at all, or there are previous claims or other legal restrictions that have not been taken into account. The following text taken from HMRC's Compliance Handbook in respect of 'marginal cases' is worth noting:

*"It will be inappropriate to spend time trying to push marginal cases into the category of 'failure to take reasonable care'. The objective of securing better compliance in future may be achieved just as effectively and more economically, by treating the matter as a 'mistake, pointing it out, putting it right, reminding the taxpayer of what is needed in future and moving on. If there is any repetition of this understatement, or if there is another understatement in future, the case will obviously be less marginal on that occasion".*

We may conclude from the above, therefore, that the first time an over claim of Capital Allowances arises, for whatever reason, it is very unlikely that HMRC will consider applying a penalty. If, however, the taxpayer persists in failing to adopt reasonable care, then HMRC may consider the situation differently. It is also worth considering whether persistent errors in Capital Allowances claims arising after HMRC has drawn the matter to the taxpayer's attention could be considered to be deliberate, rather than just careless. If that is the case then the penalty would be higher and it cannot be suspended. It is more likely, however, that HMRC would first apply a penalty on the basis of carelessness (with possible suspension), rather than jump to deliberate intention. Note also the position of the taxpayer and the tax agent as set out under the next heading.

### Third parties acting for taxpayer

The taxpayer will be held responsible for any inaccuracies in his tax return or other document, irrespective of whether it was completed by the taxpayer or his agent. It is the responsibility of the taxpayer to make sure he is satisfied with the work of the agent. The taxpayer will be liable for a careless inaccuracy in the tax return if he failed to take reasonable care to check the work performed by the agent, did not give the agent all the necessary information, or failed to take the agent's advice. A taxpayer, therefore, cannot absolve himself of all errors on the basis that they arose due to the actions of his agent.

Furthermore, if the agent should have known about an under assessment, or discovers an inaccuracy and does not notify HMRC then it is the taxpayer that is liable to a penalty. HMRC can, however, only charge the taxpayer a penalty for careless and not deliberate inaccuracy by an agent. But if the taxpayer satisfies HMRC that he took reasonable care to avoid the inaccuracy or failure, there will not be a penalty.

Notwithstanding the above, the agent will be subject to a penalty for any inaccuracy arising due to the agent deliberately supplying false information to the taxpayer, or deliberately withholding information from the taxpayer with the intention of the tax return or other document containing the inaccuracy. The penalty will apply to the agent irrespective of whether the taxpayer is also subject to a penalty for the same inaccuracy. (FA 2007, Schedule 24, para 1A).

### Conclusions

Under the pre-FA 2007 rules, it would not be expected that HMRC would impose a penalty because of a careless error in a Capital Allowances claim leading to an under assessment of tax. Under the new rules it also seems unlikely that any penalty would arise for a negligently prepared Capital Allowances claim for the following reasons:

- 1) When an over-claim of Capital Allowances is made it is usually a matter of valuation, which will be dealt with by the Valuation Office Agency, rather than an Inspector of Taxes. This is certainly the case for apportionment claims and disposal value calculations, where the Inspector is required by HMRC internal guidance to refer the claim to the Valuation Office Agency. If the Capital Allowances claim is reduced through a process of negotiation, then it seems very unlikely that such overvaluation (or undervaluation in the case of disposal values) can be treated as an inaccuracy or error.
- 2) If the Capital Allowances claim was made in such a way as to be regarded as careless, such as applying a percentage claim to a construction contract, or failing to check legal entitlement or restrictions, (none of which are really issues of valuation), it is likely that HMRC would consider the case to be marginal. Where HMRC consider the inaccuracy to be marginal, then it will be treated as a mistake and no penalty will apply.
- 3) Unless the taxpayer prepared the Capital Allowances claim himself, or could be expected to have sufficient knowledge of the subject to have checked the claim prepared by the agent or other adviser, it seems unlikely that the taxpayer will be liable for any inaccuracy due to lack of reasonable care. An exception to this might be where the

taxpayer fails to provide the agent with all the necessary information and therefore, the agent makes do with what he has. For example, applying a percentage claim where the taxpayer only provided total costs, after repeated requests from the agent. That said, HMRC would probably treat the case as marginal unless the same careless approach was used again and again.

So it is unlikely in the vast majority of cases that over claiming Capital Allowances will result in a penalty under the new system. That should not be of any comfort to the taxpayer, however, because any penalty should be the least of the taxpayer's worries. Penalties can be significantly reduced, or even suspended and then cancelled. The tax due as a result of the over-claim, on the other hand, will always be 100% due, plus interest. As an example, consider a Capital Allowances claim of £1 million that has no legal basis of entitlement, or a reduction of £1 million to a Capital Allowances claim that has been recklessly prepared. As the inaccuracy is almost certainly to have been prompted by HMRC, let us say that the minimum penalty of 15% applies to a corporate taxpayer. In that case the penalty would be £42,000, but the tax due would be £280,000 plus interest!



### Final thought

The main message is that the whole issue of penalties rather clouds the real issue at hand, which is tax risk mitigation. The cost of getting a Capital Allowances claim seriously wrong will always attract a penalty of sorts, whether it is interest, the cost of negotiation, the increased level of HMRC enquiries and agent's fees in the future, or simply the unexpected expense of a higher tax bill. Irrespective of penalties, therefore, the focus of the taxpayer and his advisers should be on getting the claim right in the first place.



It should be appreciated that HMRC operates a system of risk appraisal, so that enquiries are concentrated in areas where the risk of tax leakage is high. Claims for Capital Allowances involve extremely complex legislation, often coupled with valuation issues for which HMRC seeks specialist advice from the Valuation Office Agency. It is, therefore, only logical for HMRC to view Capital Allowances claims as an area where tax risk could be high, particularly in cases where the Capital Allowances claims made by a tax payer have been repeatedly proven to be excessive. In this respect, it is worth considering the following quote from a HMRC document dealing with Compliance Risk Management dated March 2007: *"Higher risk customers can expect to be the focus of more intensive scrutiny,...."*



On the other hand, getting Capital Allowances claims right means a lower risk profile for the tax payer, resulting in fewer enquiries from HMRC, more tax certainty and reduced compliance costs.

For further advice concerning any of the issues raised in this briefing, please contact one of our key individuals detailed overpage, or alternatively call our helpline on 0800 526262. Information on other property tax related topics can also be found on our website at <http://bankingtaxfinance.davislangdon.com>.

