



HM Revenue
& Customs

A penalty for participating in VAT fraud

Summary of Responses
5 December 2016

Contents

1	Introduction	3
2	Responses	5
3	Government response	10
4	Next steps	13
Annex A	List of stakeholders consulted	14

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1. Introduction

The consultation

1.1. HMRC published the consultation on a penalty for participating in VAT fraud on 28 September 2016. It sought views on a range of options for a new penalty for those that knew or should have known that their transactions were connected with VAT fraud. The consultation closed on 11 November.

1.2. The consultation examined the case for a new penalty including how it should be structured. The consultation suggested two options: a fixed rate system (Option A) and an early payment system (Option B). Additionally, respondents were asked to consider:

- Should the new penalty apply to company officers?
- Should the new penalty feature reductions in the level of the penalty for cooperating with HMRC?
- Should those that participate in VAT fraud be named?

1.3. Chapters one and two of the consultation set out the wider problem of orchestrated VAT fraud, HMRC's penalty principles and the problem with the existing penalty regime in tackling those that participate in VAT fraud.

1.4. The consultation explained that there was a misalignment between the 'knowledge principle', which HMRC has used successfully to tackle serious VAT fraud, such as Missing Trader Intra Community Fraud, and the existing error penalty regime in Schedule 24 Finance Act 2007, which applies to these cases.

1.5. The consultation document explained that to mitigate this problem the current approach was to delay issuing the penalty until after the knowledge principle has been finalised.

1.6. This delay in issuing the penalty causes HMRC problems:

- It opens up the opportunity of a second round of litigation, against the penalty.
- It increases the risk that the penalty will be ineffective as it allows greater time for those involved in the fraud to disburse the monies.

1.7. The consultation proposed a new penalty for participating in VAT fraud as a way of solving this problem.

Consultation responses

1.8. We are grateful to everyone who took the time to respond to the consultation exercise. We received 130 responses from a wide variety of stakeholders across different sectors. We were pleased to see responses from small and large businesses, tax representatives and trade associations. The responses have been invaluable in understanding respondents' views and concerns.

1.9. HMRC hosted a webinar session for 170 stakeholders and also held some meetings with individual stakeholders. Those accessing the live webinar were asked polling questions on the pros and cons of introducing the penalty, and for their views regarding the various design options.

1.10. Chapter 2 of this document sets out the questions posed in the consultation document and summarises the responses given.

1.11. Chapter 3 of the document outlines the government's response to the consultation.

2. Responses

2.1. A majority of respondents were in favour of introducing a penalty for participating in VAT fraud at a ratio of around three to one. There were different views about the design options with no clear preference between Options A and B.

2.2. Most respondents favoured applying the new penalty to company officers whose companies participated in VAT fraud, although some wished to restrict this application to circumstances where the company officer could reasonably be held culpable. Others wished to restrict the application of the penalty to company officers to cases where they had actual knowledge of fraud.

2.3. Most respondents favoured naming businesses that knew or should have known that their transactions were connected with VAT fraud.

2.4. Fourteen questions were posed in the consultation document. Some respondents simply provided general comments about the proposed penalty, whilst other respondents answered all fourteen questions. In many cases respondents made the same points in respect of several questions.

2.5. A more detailed summary of the response to each question is set out below.

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?

2.6. A majority of respondents favoured introducing a new penalty for participating in VAT fraud. Others highlighted its cost effectiveness and the expected reduction in litigation.

2.7. One tax representative, in favour of the new penalty applying to both “knew” and “should have known” cases, stated:

“Ultimately, if the business ‘should have known’ there was VAT fraud, ignorance or poor systems should be no excuse and result in lower penalties than a business which had implemented robust systems but ignored the fraud.”

2.8. A minority of respondents opposed the new penalty, although amongst this group nearly all respondents stated that they were supportive of HMRC’s attempts to tackle serious VAT fraud, such as missing trader fraud.

2.9. The concerns of those that were sceptical of the proposed penalty focused on the lack of distinction between “knew” and “should have known”. Their view was generally that those who had actual knowledge of fraud should be punished more

severely. They also raised concerns that the new penalty would not be proportionate where a business or company officer only should have known that their transactions were connected with VAT fraud. Some felt that this was a move away from HMRC's wider penalties principles.

2.10. There were some questions asked about what actually constitutes "fraud" for the purpose of the penalty. This aspect has been widely considered and tightly defined by the UK courts. It does not include tax avoidance, error or late payment.

2.11. Some respondents commented that there could potentially be increased administrative burdens on business from the new penalty and could lead to less collaboration with HMRC. Some thought the penalty potentially risked increased litigation. In this regard suspension of the penalty until after an appeal has been dealt with was suggested.

2.12. A number of respondents suggested that the measure should be coupled with further education for customers, especially small businesses.

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

2.13. Some respondents liked the simplicity of this option. The ability of HMRC to levy a penalty alongside the tax decision was welcomed, as were the benefits of reducing the time and costs of taking separate appeals. Others highlighted the cost effectiveness of this option, especially for HMRC.

2.14. Some respondents thought it unfair to effectively penalise those facilitating fraud twice, once with a denial of the right to recover input tax or use of the zero rate for despatches using the knowledge principle, and then again with the new penalty.

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

2.15. There was no consensus on this point, with a range of views expressed. Some respondents were content with the level. Others suggested that it should be as high as 100% as it is in other Member States and can be for "deliberate and concealed" non-compliance for existing error penalties. Whilst other respondents said that it was too high particularly for smaller businesses dealing with high value goods and services.

2.16. Others felt that the 30% rate was too high for those businesses that "should have known" that their transactions were connected with VAT fraud.

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

2.17. Option B also generated a mixture of responses. Some respondents were clear that a business that has sought to defraud the VAT system deliberately should not be

shown any leniency for early payment of a VAT debt. Others highlighted that this option has the benefit of discouraging frivolous appeals.

2.18. Some respondents commented that this option is “better aligned” with the wider policy principles as it distinguishes between cases of “knew” and “should have known” whilst others highlighted that an early payment system could act as a disincentive to taxpayers to appeal.

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

2.19. There was a mixed reaction to this question. Six respondents felt that a higher penalty might deter legitimate appeals for businesses that had inadvertently become involved in the fraud. A small number of respondents felt that it “might” act as a barrier to justice.

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

2.20. There were a range of views in response to this question. Some respondents agreed with the penalty percentages, whilst others suggested alternatives. A few respondents proposed that the penalty could be reduced, to say 12.5% where the tribunal finds that the business should have known of the connection with fraud.

2.21. Some respondents raised concerns that the different rates could lengthen litigation whilst others disliked the lack of distinction between cases where the trader had actual knowledge and cases where they should have known, where the VAT decision is not appealed.

2.22. There was also a suggestion that a third level of penalty for taxpayers between 25% and 50%, following the exchange of witness evidence, where an appellant withdrew their appeal within 30 days of the exchange of evidence.

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?

2.23. The majority favoured the penalty applying to both the business and company officers. A minority of respondents opposed this in cases of negligence. Other respondents argued that the penalty should only apply to company officers where they have decision making power in entering into the transactions connected with fraud.

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

2.24. Most responses focused on Options A and B. Of the alternative design options, the most common one mentioned was for reductions for cooperation with HMRC, which is dealt with below.

2.25. Other alternative design options included giving the First Tier and Upper Tribunals power to substitute a penalty for failure to take reasonable care if it considered a penalty was appropriate but there was an insufficient level of proof to justify the deliberate behaviour penalty that had been assessed.

2.26. A few respondents suggested that the existing error penalty regime could be run in the alternative (i.e. deliberate or careless) as a way of solving the misalignment with the knowledge principle.

2.27. Other suggestions included: an initial 30% rate to begin with which could increase up to 70-100% if actual knowledge of fraud is established on appeal alongside reductions for cooperation with HMRC; harder punishments for those knowingly involved, such as jail, confiscation and winding up orders; and applying the hardship rules that apply to the VAT case also to the penalty.

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

2.28. There was no clear preference between these options. The fixed rate penalty was praised for its “simplicity”. However, others felt that it is a “blunt instrument”. The early payment option had some support because it impacts those that had actual knowledge of fraud harder when they appeal to tribunal with frivolous cases. Others felt that the higher sanction was either a barrier to justice or an unnecessary complication. Alternative design options were generally not favoured.

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

2.29. HMRC explained in the consultation document that we did not recommend reductions for this penalty because organised fraudsters rarely provide meaningful disclosures, but that we welcomed customer’s views on this point. The majority of those who responded favoured reductions in the level of the penalty for cooperation with HMRC.

2.30. Respondents commented that reductions will incentivise the right sort of behaviour. This is consistent with how the existing error penalty regime operates. Respondents felt that reductions would also be fairer to those businesses that had become embroiled in a fraudulent scheme due to negligence, who would perhaps assist HMRC once they had realised what they had done.

2.31. Conversely there were a minority of respondents who preferred no reductions to the penalty.

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

2.32. A variety of views were expressed on this point. Some favoured the possibility of reducing the penalty to zero for all cases.

2.33. The most popular view, amongst those that favoured reductions, was for the new penalty to be based along the same lines as the existing error penalty regime.

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

2.34. Most respondents favoured naming businesses and company officers that knew or should have known their transactions were connected with fraud. However, concerns were raised about applying this approach where businesses had inadvertently become involved in the fraud. There were also concerns about the potential for reputational impact from this measure and that HMRC should approach this cautiously.

2.35. Some highlighted that participants in VAT fraud are already named in litigation, but of course not all knowledge principle decisions are litigated.

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

2.36. There was a mixture of responses with some in favour of naming participants for “should have known cases” whilst others thought it was inappropriate and should be restricted to cases where there was evidence that a business had “actual knowledge.” Some advocated a full appeal process for this aspect of the proposal.

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

2.37. There were a number of responses to this question and many of them not directly relevant to the consultation. HMRC was encouraged to tackle more of these types of cases using criminal prosecutions. Responses also highlighted different ways in which HMRC might tackle VAT fraud, such as through securities, use of escrow accounts and even changing VAT into a simplified flat rate tax. A small number of respondents commented that the knowledge principle and the penalty should also apply to online platforms when businesses trading on their platforms are evading VAT.

3. Government response

3.1. This Chapter sets out the government's response to the points raised in the consultation.

A new penalty for participating in VAT fraud

3.2. Having carefully considered the responses to this consultation, the government has decided to proceed with the introduction of a penalty for participating in VAT fraud. It considers that there is a strong case for having a new penalty aligned with the knowledge principle. This will help streamline cases and strengthen HMRC's ability to tackle serious VAT fraud. The government also recognises the deterrent benefits of a strengthened penalty regime in this area.

3.3. The government recognises the concerns about the application of the penalty to cases where participants "should have known" that the transactions were connected with fraud. This concept is quite narrowly defined in case law. Some of the respondents, perhaps understandably, were unaware of the scope of the current knowledge principle and how this term has been defined by the courts. HMRC will be applying the penalty in the context of the existing case law and want to reassure respondents that the new penalty cannot apply to cases where businesses could not have known that their transactions were connected with fraud.

3.4. A few respondents suggested, as an alternative, that the existing error penalty regime could be run in the alternative (i.e. deliberate or careless) as a way of solving the misalignment with the knowledge principle. HMRC looked into this but came to the conclusion that it is not a practical policy solution or legally possible. It would not solve the current problem of misalignment between the two regimes. HMRC would still be required to state its preferred case for the error penalty, either at the point of issuing the penalty (in order to notify the business of the rate of the penalty), or alternatively once the case reached court (as the appellant would need to know the case they had to answer).

Penalty design

3.5. The government has decided to proceed with the fixed rate option with a 30% penalty. This option aligns more neatly with the "knowledge principle" and has the benefit of simplicity as acknowledged by respondents to the consultation. The "knowledge principle" as defined in UK case law does not distinguish between cases where traders had "actual knowledge" and where they "should have known" that their transactions were connected with VAT fraud.

3.6. The government has taken account of the particular concerns expressed in the consultation that the early payment system could act as a barrier to justice, discouraging legitimate appeals. This alternative option also aligns less well with the "knowledge principle" as it would still require the court in litigation cases to distinguish between "knew" and "should have known".

3.7. Some respondents commented on the level of the penalty with some wanting it higher than 30% and some wanting it lower. The government has decided to continue with the consultation proposal of a 30% rate as this strikes the right balance between the current penalty levels for careless and deliberate behaviour.

3.8. A key driver for the new penalty is to create a more effective way of penalising those facilitating fraud by ensuring that the penalty is levied more quickly than it can be currently and ensuring that litigation costs are reduced for HMRC, appellants and the courts. The government considers that it can achieve this most effectively through a fixed rate option with a 30% penalty.

Company officers

3.9. Most respondents favoured applying the penalty to company officers and the government agrees with this view. This aspect gives the penalty more bite and ensures that company offices cannot avoid responsibility in cases of serious VAT fraud when they meet the “knowledge principle” tests. HMRC can already apply penalties to company officers in cases where their behaviour is deliberately non-compliant.

3.10. We can reassure respondents that the new legislation will specify that HMRC must show that a company officer “knew or should have known” of the fraud for the penalty to apply. Draft legislation will specify that the penalty will apply to the business and will only be transferable to a company officer when they knew or should have known of the fraud.

Naming participants

3.11. Having carefully considered the responses to this question (with most respondents in favour) the government has decided to include the option of being able to name participants in the fraud, alongside the penalty. To address the concerns raised about applying naming to “should have known” cases the government has decided to limit the application of this provision to cases where there is persistent offending or clear evidence of wrong-doing.

3.12. Draft legislation will make clear that naming participants is only optional. The government has also decided to restrict the naming provision to cases where the VAT at issue is over £50,000. This should provide further safeguards for smaller businesses or usually compliant businesses that have inadvertently become involved in one-off or infrequent transactions connected with fraud. Any naming provision will also be subject to strict time limits, so participants in fraud will not be listed permanently.

3.13. The naming provision will be subject to a strict governance process within HMRC. Businesses and company officers that appeal the knowledge principle decision (including the penalty) will not be named as participants in the fraud until after any litigation has concluded. It is hoped that this will further alleviate any concerns regarding this measure.

3.14. A key benefit of naming participants is to notify other businesses of their involvement in facilitating fraud, which will hopefully ensure that compliant businesses do not become embroiled in the fraud.

Reductions for cooperation with HMRC

3.15. The government has very carefully considered the responses on whether or not the new penalty should offer reductions for cooperation with HMRC, such as disclosing relevant documents and information.

3.16. HMRC explained in the consultation document that it did not recommend reductions for disclosure because organised fraudsters rarely provide meaningful

disclosures, but welcomed views. The majority of those who responded favoured reductions in the level of the penalty for cooperation with HMRC to incentivise the right sort of behaviour. This is also consistent with how the existing error penalty regime operates.

3.17. Having carefully considered these views the government has decided not to have reductions for disclosure. This will make the penalty simpler and less prone to litigation challenges. Those participating in serious VAT fraud are mainly knowingly involved. They would be able to exploit any reductions. Experience shows that many provide HMRC with documentation to appear compliant but this is usually a veneer to disguise their involvement in the fraud. In these scenarios HMRC would have to demonstrate the businesses knowledge of the fraud in order to challenge reductions, which would defeat the main driver for the penalty. The government also considers that any further reduction in the level of the penalty may lead to an ineffective sanction.

4. Next steps

- 4.1. Draft legislation will be published alongside this document on 5 December with final legislation included in Finance Bill 2017.
- 4.2. HMRC will consult with stakeholders about the draft legislation to ensure it delivers the intended effect.
- 4.3. The penalty will be introduced following Royal Assent of Finance Bill 2017.

Annex A: List of stakeholders consulted

170 tax agents consulted via a live webinar -105 tax agents responded to polling questions

7 individuals and small businesses

Neumans LLP

The Wines and Spirits Trade Association

University of Parma

Institute of chartered accountants in England & Wales

Chartered Institute of Taxation

Vodafone Group Services Ltd

ICAS

NFU

RAVAS (Retailers Against VAT Abuse Schemes)

PricewaterhouseCoopers LLP

Association of Accounting Technicians

Association of Taxation Technicians

Charity Tax Group

CBI

Pinsent Masons LLP

AFME

Charity Tax Group

Grant Thornton