Analysis

SAO reasonable steps: lessons from *Thathiah*

Speed read

We now have the first SAO main duty judgment and what have we learned? At first sight, there is a lot here for SAOs to be comforted by: the decision reflects a proportionate sense of reasonable steps; and an expectation of fairness in HMRC's own procedures when pursuing such a penalty. However, looking into the detail there are notes of caution, particularly for FDs of larger groups. The judge's comments confirm the expectation that organisations will not only have the right policies, controls and people to operate them but will also have an appropriately sophisticated programme of testing.

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In August, the First-tier Tribunal (FTT) heard the first case involving a senior accounting officer (SAO) main duty penalty assessment in *Thathiah v HMRC* [2017] UKFTT 601 (TC). The SAO was assessed for main duty penalties for two consecutive years by HMRC, after it came to light that the company had not applied its partial exemption special method (PESM) correctly, resulting in errors in its VAT calculations. See figure 1 for details of the SAO's main duty.

Figure 1: The SAO's main duties (FA 2009 Sch 46)

- The senior accounting officer of a qualifying company must take reasonable steps to ensure that the company establishes and maintains appropriate tax accounting arrangements.
- The senior accounting officer of a qualifying company must, in particular, take reasonable steps:
  - to monitor the accounting arrangements of the company; and
  - to identify any respects in which those arrangements are not appropriate tax accounting arrangements.

The SAO appealed this assessment and the tribunal decision provides invaluable insight into what reasonable steps comprise and how this should be specifically considered in the light of the size and nature of the business. However, certain key considerations, such as materiality and reasonable excuse, were not addressed; and this will be a source of disappointment for those hoping for greater clarity in these areas. The outcome of the decision will be watched with interest: as the judge commented in her final findings, there are some concerns regarding HMRC's handling of the matter and underlying issues of taxpayer confidentiality.

More broadly, some comments from the judge appear to have implications for large businesses, which may need to revisit their SAO testing procedures in light of the tribunal's observations. Furthermore, large businesses will also reflect on how this decision fits as part of a broader evolution of their tax management responsibilities towards self-assurance in relation to key tax controls.

Background and summary of case

The case centred around errors totalling £1.36m in the VAT returns of International Currency Exchange plc (ICE) during the period March 2010 and January 2014. ICE was a member of the Lenlyn group during the period in question, which operated in the financial services sector providing currency exchange, ATM and other cash handling services.

As with many businesses operating in the financial services sector, the VAT recovery position of the Lenlyn group was complicated by the provision of partially exempt supplies. The group entered into a PESM agreement with HMRC to determine the appropriate amount of input tax recovery; and a revised PESM calculation had been agreed with HMRC in June 2010.

Mr Thathiah left the group in March 2014. However, vendor tax due diligence commissioned by Mr Thathiah in the preceding period identified issues which ultimately led to an error correction notice (ECN) being submitted by the group's advisors in September 2014.

The ECN disclosed a number of issues relating to the application of PESM in the periods after the updated calculation had been agreed, together with a number of other errors associated with the application of the reverse charge and duplicated recoveries of input VAT. The errors spanned multiple accounting and SAO certificate periods and affected VAT returns made between March 2010 and January 2014. A summary of the errors by value, type and duration is shown in figure 2 (overleaf).

Mr Thathiah had submitted unqualified SAO certificates for the financial years 2012 and 2013. As a result of the ECN, HMRC met with the appellant in January 2015. During this meeting, the appellant provided to HMRC details in relation to the group's VAT processes and the team members who operated them. There was also a discussion on the type of testing that was undertaken internally and by external advisors. However, despite seeking to obtain a copy, the appellant was not provided with any details regarding the content of the ECN.

HMRC had reservations around several aspects of the steps taken by Mr Thathiah. It highlighted, in particular, the absence of selective testing of the PESM to support its position that 'appropriate tax accounting arrangements' were not in place, and that the SAO had not discharged his main duty. Mr Thathiah was subject to a penalty assessment for a main duty failure for the financial years 2012 and 2013, which he then appealed.

Figure 2: Summary of errors (March 2010–January 2014)

Nature of error	Period	Value (£)
PESM: 'Misallocation' of costs relating to 'ICE direct' service	Jan 12 – Jan 14	455,000
PESM: 'Misallocation' of costs relating to ATMs	Apr 13 – Jan 14	300,000
PESM: Impact of other disclosures on PESM recovery	Mar 10 – Jan 14	70,000
PESM: Misallocation of head office costs	Mar 10 – Jan 14	26,000
Reverse charge: Omission from specific group transactions	Mar 10 – Jan 14	334,000
Reverse charge: Omission from specific overseas suppliers	Feb 11 – Jan 14	55,000
Reverse charge: Raphael Bank omissions	Mar 10 – Jan 14	33,000
Duplication recovery on prepaid rent	Aug 11 – Jan 14	87,000
		1,360,000

Whilst agreeing that the accounting arrangements of the Lenlyn group were not 'appropriate tax accounting arrangements', the tribunal judge found that HMRC had not established that the SAO failed to meet his main duty and the appeal was upheld.

Key considerations

Reasonable steps expectation

The decision confirmed the position that just because a company does not have appropriate tax accounting arrangements, as was the case here, it does not automatically follow that the SAO has failed the main duty.

As the judge noted: 'The test in paragraph 1 is whether the appellant took "reasonable steps" to ensure that ICE established and maintained appropriate tax accounting arrangements, and in particular whether he took reasonable steps to monitor those arrangements and identify any respects in which they were not appropriate.'

Whilst we learned that selective testing was not a critical missing step in this case, this must be seen in the context of other clearly reasonable activity on the part of the SAO. As such, we should not take the judgment as meaning that some form of selective testing is always above and beyond reasonable steps, even for smaller businesses.

Other components of reasonable steps that can be identified from the details of the case include:

- a board approved tax policy;
- a tax risk register integrated into the broader commercial risk register;
- documentation of tax processes and procedures;
- the integration of the above into a broader finance manual and assessed for ongoing relevance by the SAO;
- delegation by the SAO of responsibilities to appropriately qualified and experienced staff;
- the provision of specialist external training to those involved in the calculation of tax liabilities;
- the provision of a retainer budget for access to specialist professional advice;
- variance checks on tax liabilities to the budget and to prior periods (which took as a basis for comparison, periods that had been subject to both HMRC review and external audit); and
- specific checks of the tax treatment of the largest transactions.

This broader context was either not fully considered by HMRC or, if it was, it was not considered sufficient to constitute reasonable steps. Its focus was on a narrower root cause for the circumstances which allowed the error to arise undetected; namely, the absence of selective testing. In this case, the broader context was taken into account and considered persuasive by the tribunal.

No one size fits all

The nature of the business operations, the size and the complexity of the business were considered to be relevant factors in coming to a decision on whether the steps taken were reasonable.

The judge confirmed that: 'The question of whether the appellant took "reasonable steps" is clearly an objective one, which in my view must be determined by reference to all the circumstances. As indicated in SAOG14320 there is no "one size fits all". The matters to take into account will include the size, complexity and nature of the business, but in my view must also include matters more closely related to the role of the individual in question, such as the resources available to that individual and his or her authority to bring about any required change (albeit taking account of the fact that, under paragraph 16 of Schedule 46, the SAO will by definition have a senior role in the business).'

This included a discussion on the SAO's access and control over resources to undertake activities within the organisation. The appellant evidence, accepted by the judge, was that the group's operations were not comparable to large financial institutions, mostly due to the nature of business operations and the resources available to him.

Materiality

The definition of materiality from an SAO perspective is of understandable interest to SAOs. The HMRC guidance in this area is non-prescriptive. As such, it will be disappointing for many SAOs that there was no discussion of materiality in the case.

In fact, HMRC specifically ruled out its case's dependence on 'the precise quantum or order of magnitude of the financial consequences that result from the errors'. Instead, the view was put forward that there were 'regular, consistent and systematic misattributions of input tax and errors in accounting for the reverse charge', which constituted the reasonable steps failure. This is consistent with the HMRC guidance at SAO14330, which provides that the reoccurrence of a systematic error could prove to be material.

In the absence of specific guidance, it is helpful to have sufficient detail to consider the sources and periods of error to form an overall view as to the appropriateness of the tax accounting arrangements in question. However, it is clear from this case that HMRC will seek to apply a broader interpretation of materiality where errors persist and recur.

Reasonable excuse

It should be noted that, even if it were accepted that that the SAO had not taken reasonable steps, he would still have had the potential defence of a 'reasonable excuse'. This would have been applicable if:

- the SAO had been subject to an unexpected or unusual event that is either unforeseeable or beyond the person's control, and which prevents the person from complying with an obligation under the SAO provisions for failure; and
- had remedied that failure without unreasonable delay after the excuse ended.

This point was not tested in this case but it is noted that HMRC, in its guidance, regards the circumstances in which this can arise, in relation to a main duty failure, as limited to bereavement and serious illness.

Taxpayer confidentiality

The government's policy objective for SAO was to provide a clear point of accountability within a company. The personal responsibility that the SAO legislation introduced has certainly been successful in achieving that. However, it has also potentially introduced an additional party or taxpayer to the assessment of compliance giving rise to confidentiality concerns.

HMRC clearly struggled to manage taxpayer confidentiality in this case; and the judge was critical of the decision not to provide the SAO with details of the ECN. In the opinion of the judge, the appellant was not given the chance to adequately prepare for the meeting with HMRC and understand or respond to the specific error within a reasonable time prior to the appeal. As the decision noted: 'It is not enough that HMRC is fair, but is seen to be fair.'

Taxpayer confidentiality can be difficult to manage when the SAO is still in role and the interests of the taxpayer and company are broadly aligned. However, the position is significantly more challenging when the SAO has left the company. It is clear that more effective protocols for sharing information will need to be established in future cases.

What this might mean for larger businesses

The CRM of the Lenlyn Group clearly anticipated that there would be a cycle of testing which would include selective testing of different areas at different times. However, as noted above, the tribunal was critical of HMRC's failure to draw any distinction between different sizes of businesses and indicated there was, in its view, a 'significant distinction between a company with a small finance team that is just over the qualifying company threshold and (say) a major financial institution with a large tax department, where the SAO may well have a more significant degree of control over resources'. There is implicit agreement that, for large businesses, a formalised programme of testing should form part of its SAO's 'reasonable steps'.

The process and technical complexity inherent in the tax affairs of any business large enough to be within the scope of the SAO has traditionally acted as something of a barrier to effective internal monitoring or assurance activities. This has been changing in recent years and the SAO has played a significant role in driving that change. Those businesses with an internal audit function now increasingly seek assurance support in respect of tax management activities. In our experience, when internal scrutiny is directed towards the tax department, the results are variable. This appears to work best where there is (or has been) a partnership to 'professionalise' the tax function and use the tools and methodologies of internal audit to introduce additional rigour to the standards of tax documentation, risk management and the broader governance framework.

Once this has taken place, the improved standards of process, control and governance documentation can then provide a platform for internal testing, as part of a business as usual approach to gain assurance that procedures are followed, controls are operated and the governance and reporting mechanisms are effective.

Internal monitoring is less effective where the barrier of process and technical complexity is not tackled; and the focus is solely on simpler test criteria, such as the timely submission of returns or pre-submission reviews. Whilst these metrics are important if they are the only test criteria, the monitoring will be superficial and their results potentially misleading. Our experience has shown that a cross specialism contribution of subject matter expertise is required to deliver effective assurance: the tax professional to identify the sources of complexity and technical risk; and the internal auditor or risk specialists to provide the risk management techniques to help introduce, control and subsequently deliver assurance.

The testing required in this case was not straightforward and it is by no means certain that a large business with internal monitoring focused on tax would target the implementation of the new process. This is particularly so where, as in this case, both HMRC and the external auditors had reviewed the returns from which variance analysis was performed. However, a tax department with a culture of risk management and assurance would be more likely to seek assurance over the implementation of the new process themselves. Even if they did not, they would be more likely to be in a position to persuade their CRM (or tribunal judge if it came to it) that it had taken reasonable steps.

The wider context

Since the introduction of the SAO rules in 2009, we have seen a steady shift in the UK and elsewhere for tax authorities to make taxpayers responsible for not only ensuring timely and accurate compliance, but also providing assurance around the quality of the processes used in achieving that compliance. In the UK, this has more recently included the introduction of the requirement to publish a tax strategy statement which goes beyond compliance processes into consideration of behaviours around planning and tax authority engagement.

Those involved in the management of tax will be acutely aware that compliance is not a given, it is an ongoing challenge. In parallel with the shift towards self-assurance, it has presented many organisations with difficulty in managing costs and we are seeing this in more and more organisations, whether through the effective use of technology or changes to the operating model (for example, through outsourcing and the use of shared service centres).

SAO now looks ahead of its time. In the past two years, Spain, Ireland and Germany have introduced measures which either explicitly or implicitly introduce similar expectations of tax risk management and control. In its guidance on the subject issued in December 2015, the OECD encouraged both tax administrations and the large businesses within their jurisdiction to place emphasis on tax control frameworks. This suggests the international direction of travel is likely to continue on its current trajectory.

However, the UK continues to take a lead. The tax strategy transparency legislation requires businesses to describe the approach to governance and risk management that they will also rely on for SAO; and the new corporate criminal offence (of failure to prevent facilitation of evasion) extends the focus to the tax affairs of others.

After an intense period of raising penalties relating to the administrative aspects of the SAO regime (e.g. penalties for late filings or missing dormant entities from the certificate or notification), it is worth noting that HMRC appears to be refocusing on the main duty and to be pursuing a high bar. SAOs may wish to consider whether they have all of the components of reasonable steps that are described above; and, if not, what plans they have to address it. ■

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- Cases: *K Thathiah v HMRC* (23.8.17)
- Review of HMRC's SAO guidance manual (Kimberley Macdonald, Mark Kennedy, Tim Branston, 30.5.12)
- SAO: managing the certification process (Ed Dwan, 16.9.11)
- The SAO regime in practice (Alan MacPherson, 1.3.10)