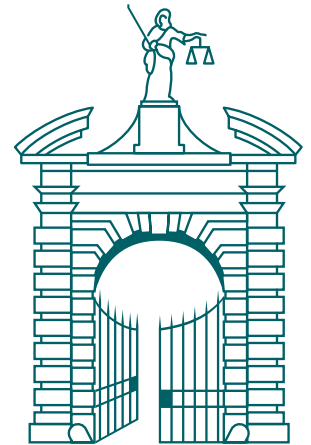


Revenue



Dealing with Revenue Audits in Practice

Cora O'Brien *Director, ITI*

Mary Healy *Tax Consultant, ITI*

Introduction

This is the third in a series of *Irish Tax Review* articles dealing with the new Revenue Audit regime after Finance (No. 2) Act 2008 (“the Act”). The first two articles in the series were published in January 2009 (“New Civil Penalty Regime”) and March 2009 (“Fixed Tax Penalties – Under the New Regime”). In this final article of the series we:

- › summarise the main changes in Finance (No. 2) Act 2008,
- › consider how the new legislation will impact on the 2002 Revenue Audit Code of Practice,

- › consider Revenue’s approach to audits, as set out for the moment in its supplement to the Code issued on 2 April 2009 (“the patch”), and
- › explore the practical implications for ITI members working on Revenue Audits.

There are a number of references below to the date 24 December 2008, which was the date that the Act was passed and is a significant transition date.

Main Changes Introduced in Finance (No. 2) Act 2008

The main legislative changes have been considered in some detail in previous articles, and this simply serves as a reminder of the key differences anticipated under the new regime:

- › disclosures
- › penalties applicable and categories of default
- › what happens when a settlement cannot be reached.

One important overall point to make is that the new penalty and disclosure regime is now enshrined in legislation and will be supported by a new Revenue Audit Code. Previously the matter of penalty mitigation and disclosure was dealt with under the Revenue “Care and Management” provisions by way of the 2002 Revenue Audit Code of Practice.

Disclosures

Old regime

In an audit situation, the taxpayer previously had the choice of making a voluntary disclosure under s1086(4) TCA 1997 or a “qualifying disclosure” under the 2002 Code. The voluntary disclosure could have been verbal or in writing and would generally have been made at the opening meeting prior to the commencement of the audit. The alternative was to make a prompted qualifying disclosure under the Code, which had to be notified to Revenue in advance of the audit commencing. The disclosure had to be in writing and should have been accompanied by a payment for tax, interest and penalties due, under the terms of the Code.

New regime

The facility for making a verbal s1086 voluntary disclosure is now gone.

Any disclosure made must now be in the form of a “qualifying disclosure” as defined in the new legislation. The qualifying disclosure must be made:

- › in writing and
- › accompanied by payment of tax and interest (but not penalties).

Qualifying disclosures made under the Act will benefit from the assurance of non-prosecution and non-publication.

The new regime and legislation raise some important disclosure issues.

The withdrawal of verbal voluntary disclosure is a very significant change with major practical implications. It has removed much of the scope for discussion of a matter before disclosure of the matter is made. Now the adviser must calculate the tax and interest at issue and make the disclosure, without the benefit of discussing the matter with the Revenue auditor.

There is also a significant funding issue for the taxpayer. It is now enshrined in the legislation that any qualifying disclosure must be accompanied by a cheque for the tax and interest upfront, thereby removing any flexibility in terms of payment.

Although a penalty element does not have to be included with this upfront payment, taxpayers may experience difficulties finding funds for the

tax and interest, which then raises the issue as to whether a valid qualifying disclosure has been made.

The regime for second and subsequent qualifying disclosures is also set out in the Act. One benefit of the new regime is the introduction of a qualifying disclosure “life” for the taxpayer. Now, where a qualifying disclosure is made in respect of a particular tax head and no further disclosure is made in respect of that tax head within five years, the qualifying disclosure “life” starts again. This means that a further disclosure in relation to that tax head will be treated as a first disclosure. It would appear that a qualifying disclosure made after 24 December 2008 will not be aggregated with a qualifying disclosure made before 24 December 2008 in ascertaining whether the disclosure is a first, second or subsequent disclosure. Again, this is something that we are seeking to clarify.

Penalties

Old regime

For defaults arising before 24 December 2008, penalties would be charged if there was “fraud” or “negligence” and the regime for penalty mitigation was set out in the 2002 Code. The extent of mitigation depended on whether the default fell into the category of:

- › deliberate default
- › gross carelessness or
- › insufficient care

and the levels of mitigation were set out in a table in the Code.

New regime

For defaults arising after 24 December 2008, the penalty and mitigation provisions are contained in Schedule 5, Finance (No. 2) Act 2008. A penalty is due under the Act if there has been:

- › deliberate behaviour
- › careless behaviour with significant consequences or
- › careless behaviour without significant consequences

and the levels of mitigation under each category are now set out in the legislation.

As carefully outlined in the March article of this series, fixed rate penalties have also been significantly increased. This will be a matter of particular concern where the error in question is of a recurring nature, affecting a number of tax returns. Clearly there is potential for very significant fixed penalties to build up in these circumstances.

Finally as regards penalties, the provisions of e-Brief No. 15/2008 have also been legislated for, i.e. the pursuit of penalties on deceased cases.

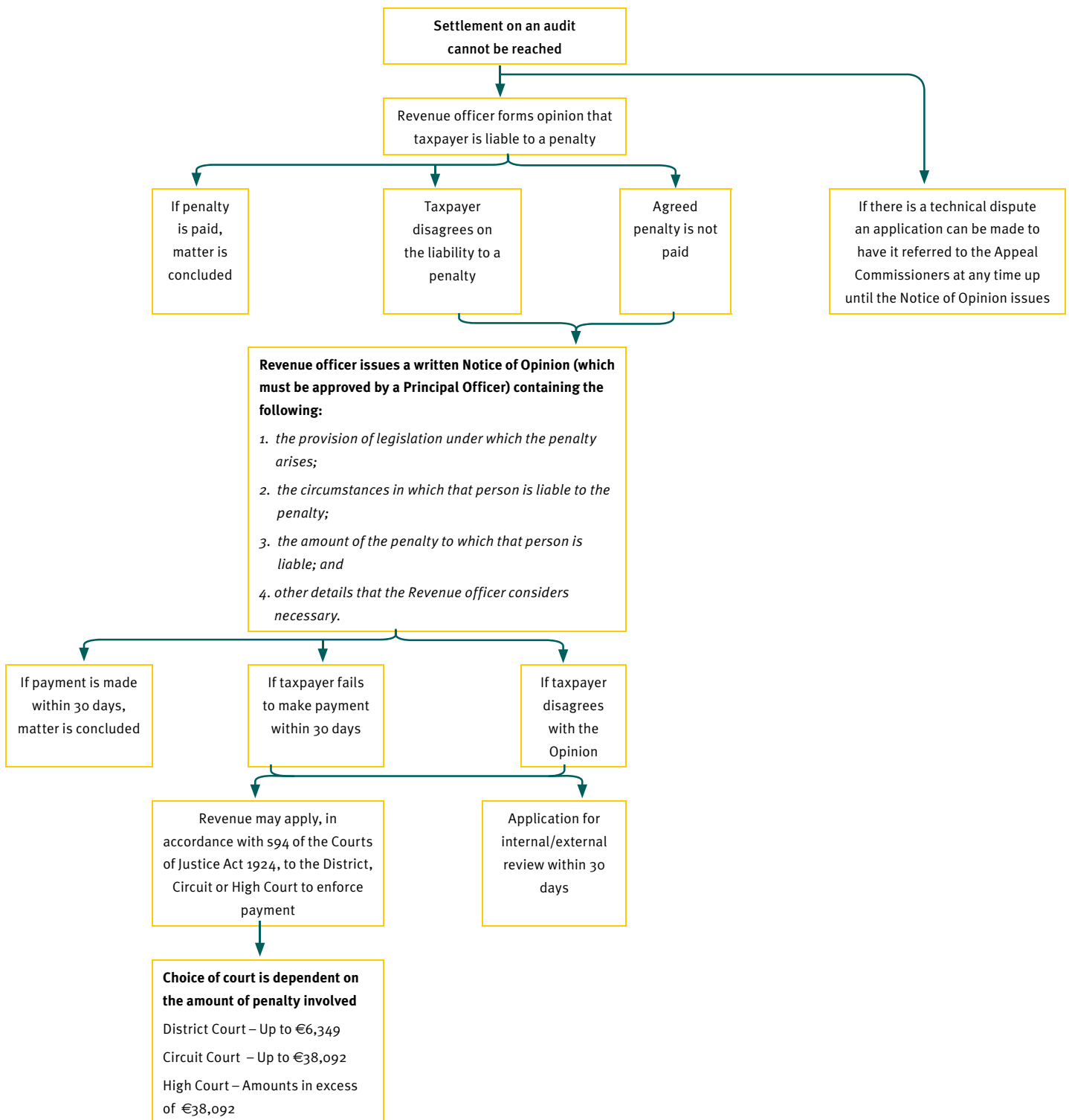
What Happens When a Settlement Cannot be Reached

The other significant change to the Revenue Audit regime introduced in the Act is that Revenue can now activate a new “closure” mechanism in cases where agreement on penalties cannot be reached. Revenue can now notify the taxpayer of its opinion on penalties due in the particular case, and if the penalty is not agreed and paid by the taxpayer within 30 days, Revenue may refer the matter to a “Court”. Under the Act, this referral will be to the District Court, Circuit Court or High Court depending on the quantum of penalty sought. The matter cannot be referred to the Appeal Commissioners, which would seem much more practical and inexpensive for the taxpayer. We have been advised that the use of the Appeal Commissioners would not be permitted under the European Convention of Human Rights. However, this is a matter of concern to ITI and is something we are considering further in the context of a legislative change.

The “patch” document issued by Revenue, which is discussed in further detail below, provides the taxpayer with the option of a review under the internal or external Revenue review process before this court referral is actually made.

Chart 1 overleaf is reproduced by kind permission of Julie Burke. It illustrates very well the course of events that will roll out now where agreement and payment of penalties cannot be finalised by negotiation.

Chart 1 – How do we deal with Revenue Audits now: where a settlement cannot be reached



Revenue will indicate the level of penalties it has sought from a taxpayer in the legal submission it makes to the court. This is not binding on the judge, who will take into account the facts of the case and the legislative provisions in coming to his/her determination. Where defaults have arisen before 24 December 2008, the court will likely decide on penalty mitigation as provided for under the 2002 Code, absent any legislation on

the matter at the time the default arose. However, there is no guarantee that this approach will be taken. Other difficulties that may arise on court referrals will become apparent only once a number of cases have been through the legal system.

In the event that the taxpayer disagrees with a court determination, appeal must be made to a higher court, with the associated costs and delay in resolution of disputes. As cases will not be held

in camera, the benefits of non-publication are limited.

Implications of the New Regime for the 2002 Code

When the Act was published late last year, it was not immediately apparent how this new legislative framework would operate alongside the existing 2002 Code. As outlined above, the legislation introduced new definitions for qualifying

disclosures and new criteria on which penalties are based that were not consistent with the Code as it stood. Furthermore, the legislation does not refer at all to the regime under the Code for self-correction, no loss of revenue, materiality and innocent error.

A general update of the Code was being discussed at TALC Audit when the new regime was published in the Bill last November. Practitioners were unaware that such an update would now have to include major penalty and regime change. The timetable for publication of the new Code is now mid-/late 2009.

The Patch as a Temporary Solution

Clearly, some guidance was required from Revenue regarding the conduct of audits under the new regime, pending the publication of the revised Code. Revenue published a supplement to the Code on 2 April 2009. In its “patch” document, it has confirmed that the general framework of the existing Code remains valid (subject to the penalty changes etc.) and that those practices set out in the Code are still effective. In particular, it has confirmed the continued availability of the procedures for self-correction, innocent error and no loss of revenue. The Code’s practices in relation to the application of interest charges and surcharges and materiality also remain.

The patch also addresses the practice and timing of making a “prompted qualifying disclosure”. Under the legislation, the disclosure must be made between the date of notification of an investigation or inquiry and **the date** the investigation or inquiry starts. This begs the question as to whether the disclosure can be made **on the day** of the audit, before the examination of the books and records begins. This is often the way that prompted disclosures are made, and the patch confirms that the practice of “on the day” disclosures will still be accepted – however, note the comments above that such disclosures must now be accompanied by a payment of tax and interest.

In regard to the new Notice of Opinion procedures, ITI has expressed concern over the circumstances in which a new Notice of Opinion could be issued or alluded to in the context of closing an audit.

This is an issue that we will be monitoring closely with members. The legislation allows any Revenue officer to issue the opinion – a policy that would be much too broad to operate in practice. ITI sought

confirmation from Revenue that prior authorisation would have to be obtained before any Notice of Opinion was issued and that this should take place at Assistant Secretary level. Clearance at this senior level would help to ensure that the rights of the taxpayer are properly safeguarded and that notices were issued only in very exceptional circumstances. The protection of the taxpayer is critical in this matter, as the taxpayer’s name will effectively be in the public arena if the issue goes to court. While the patch does provide for prior authorisation, it is at Principal Officer rather than Assistant Secretary level.

Revenue has stated that the legislative provisions in relation to the issue of Notices of Opinion and court referral are intended to apply only in exceptional and intractable cases. We would like to see a clear commitment in the Code that these provisions will be used as a last resort and not used in any way to influence settlements.

It is noted in the patch that a second qualifying disclosure will arise only where a qualifying disclosure is made under the same tax head as a previous disclosure, and gives rise to a liability to tax. Second and subsequent disclosures attract limited mitigation of penalties.

Other matters confirmed in the patch are:

- › Revenue will not seek to reduce a mitigated penalty given for co-operation or for a qualifying disclosure where subsequently an application to court for determination of a penalty was necessary.
- › The net tax-gear penalty will continue to be treated as including the fixed penalties for making an incorrect return.
- › A qualifying disclosure in the “careless behaviour without significant consequences” category will not be counted in calculating the number of qualifying disclosures made.

Issues in Practice – Dealing with Revenue Audits now

In this section of the article we aim to apply the principles of the new regime to practical audit situations. We felt that the most logical way to split the analysis was between:

- › audits commencing on or after the date the Act was passed, i.e. 24 December 2008, and
- › audits open at 24 December 2008.

We have summarised the issues arising under these two categories in Chart 2 overleaf i.e. the level of penalties to be applied and the way in which a disclosure must be made, in each case.

In terms of the penalty calculation, what is critical is the date that the default occurred and whether this is before, on or after 24 December 2008. Given that the majority of audits are driven by Revenue’s computerised risk-assessing system (REAP), which interrogates returns or claims filed, it is likely that the majority of audit notices issued at the current time will relate to transactions or periods before 24 December 2008.

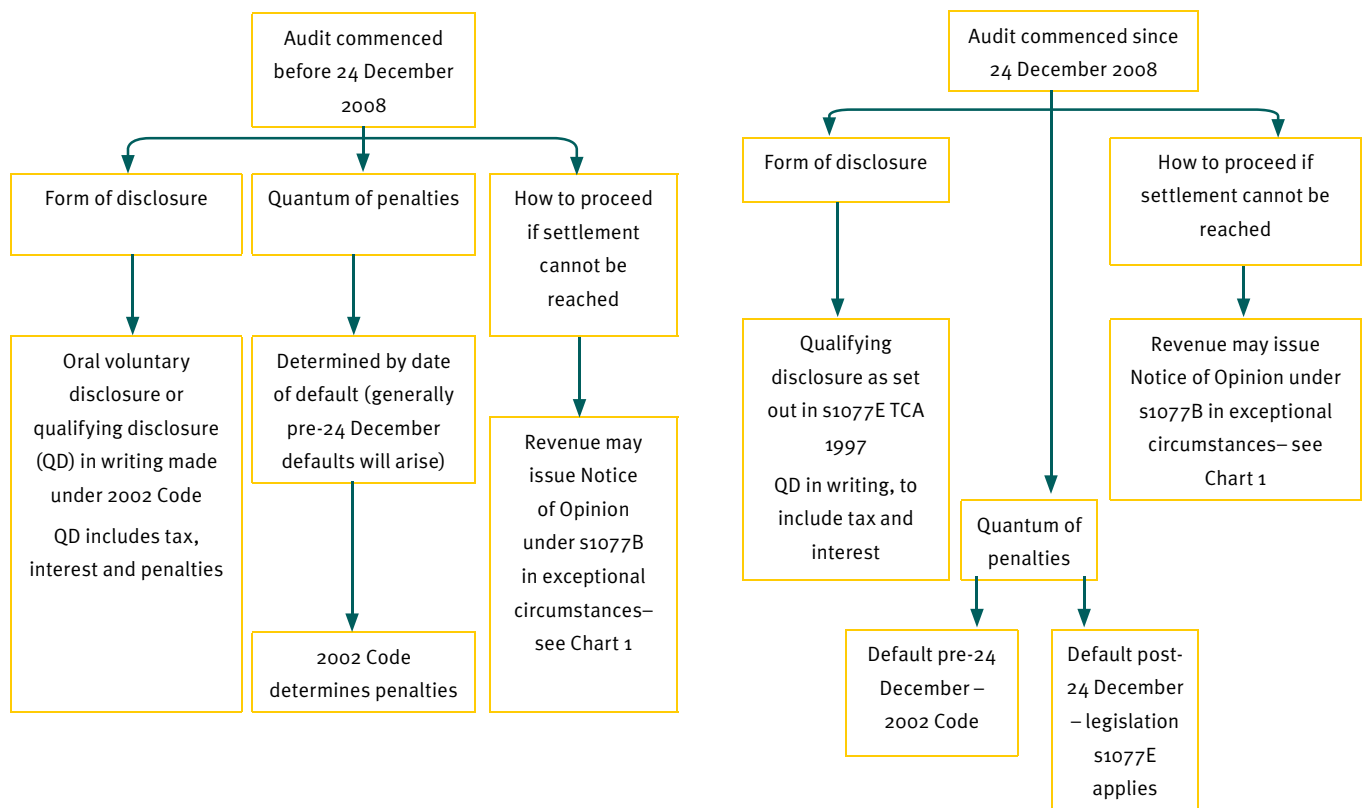
The way the new disclosure regime will operate, however, is not entirely free from doubt based on a reading of the new law. The Revenue view (as set out above) is that all disclosures made after 24 December 2008 must be made in the new format. This is reflected in its “patch” document and is also the view of many practitioners based on their reading of the law. However, the law is not clear on the matter, and some take the view that disclosures made after 24 December but which relate to defaults before 24 December are governed by the disclosure rules in the 2002 Code rather than the legislation. Please note, however, that verbal voluntary disclosures under s1086 are definitely gone.

Audits Commencing on or after 24 December 2008

How to make a qualifying disclosure

As set out above, there is some doubt in law regarding the trigger point for the new disclosure regime. It is certainly Revenue’s intention that the date that the disclosure is made is the determining factor for the form of the disclosure required rather than the date of the default that it relates to. Assuming this interpretation, for any disclosures made after 24 December 2008, the following apply:

- › The disclosure must be in writing – verbal voluntary disclosures are no longer acceptable.
- › The disclosure must be accompanied by payment of the tax and interest (see comments above). Revenue will be in contact with the taxpayer after its review of the disclosure to reach a conclusion on penalties.
- › The taxpayer still has 14 days from receipt of an audit notice to notify Revenue of an intention to make a qualifying disclosure, with

Chart 2 – How do we deal with Revenue Audits now: new audits and audits open at 24 December 2008

a subsequent 60-day period to prepare and submit it.

If a qualifying disclosure is not made, i.e. if no disclosure of a default is made or an invalid disclosure is made, the matter will be published if the settlement amount is more than €30,000 or if a penalty of more than 15% of the tax liability applies.

Calculating the penalties due

Although penalties do not actually have to be paid with the disclosure (assuming the interpretation above that all disclosures made after 24 December 2008 fall within the new regime), the penalties still need to be calculated.

The penalty calculation is determined by the date that the default arises. Where a default arises before 24 December, the liability to a penalty will depend on whether the default arises through “fraud” or “negligence”. The quantum of the penalty will be determined by the penalty table in the 2002 Code, with the relevant mitigation for co-operation and qualifying disclosure. This table is reproduced in penalty table 2, paragraph 23, of the patch.

Where a default arises on or after 24 December, the liability to a penalty will depend on whether

the default arises through “deliberate” or “careless behaviour” under the law. The penalties applicable are summarised in penalty table 1, paragraph 16, of the patch.

Where a qualifying disclosure is a second or subsequent disclosure, reference should be made to the Code or the legislation, depending on when the default occurs. Such disclosures will attract more limited mitigation of penalties.

Audits Open at 24 December 2008

How to make a qualifying disclosure

The disclosure is now a matter of historical fact. Where an audit commenced before the Act was passed, a qualifying disclosure will have been made already under the provisions of the 2002 Code.

Calculating the penalties due

The same system applies for penalty calculation as set out above, i.e. one looks to the date of the default. For open audits, the defaults in question will have arisen before 24 December 2008 and are therefore governed by the 2002 Code.

Inability to Pay

Given the current climate, taxpayers may find it difficult if not impossible to find the funds to pay the full audit settlement, or indeed the upfront

tax and interest. The Code contains guidance in paragraphs 13.1 and 13.2 regarding Revenue’s approach in such circumstances. These guidelines remain applicable. However, it has been noted in the patch that, in order for a qualifying disclosure to be made under the law, the tax and interest **must** be paid. It is arguable that Revenue could seek to withdraw the benefits of qualifying disclosure, i.e. non-publication, mitigation of penalties and non-prosecution, in the event that the liability goes unpaid or the taxpayer defaults on instalment arrangements. The current instalment arrangement in the Code envisages a 12-month period for payment, which is very restrictive given the cash-flow difficulties that many taxpayers face in the current climate.

It remains to be seen in practice how significant the impact of the new legislation will be. However, ITI will be monitoring the situation closely and will be in discussions with Revenue through TALC as we work towards the publication of a new Audit Code of Practice. For more information on changes to the audit and penalty regime, please see our dedicated webpage, <http://www.taxireland.ie/RevAudits.aspx>.