Analysis

Section 103: expanding the scope of automated decisions by HMRC?

Speed read

HMRC aspires to fully digitise the UK tax system. As the number of digitised taxes expands, there is increased scope for the use of artificial intelligence by HMRC. Finance Act 2020 legislates retrospectively for HMRC to use artificial intelligence to carry out its functions. Whilst HMRC has said this is simply putting its existing accepted practice beyond doubt, it is likely to reflect HMRC's intention to increase its use of automation. The non-exhaustive list of functions that HMRC may carry out 'using a computer or otherwise' suggests at a potentially very broad utilisation of technology which may not always be in the taxpayer's favour.

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New legislation in FA 2020 provides that any function capable of being done by an individual HMRC officer may be done by HMRC using a computer or otherwise. In other words, HMRC may use automated processes to carry out any of its operations with the same legal effect.

This measure comes at a time of an increasingly visible push from HMRC to meet its vision of a fully digital tax system. In July 2020, HMRC published a report, *Building a trusted, modern tax administration system*, which set out how this goal is intended to be achieved over the next ten years.

The first phase is a progressive extension to 'making tax digital' (MTD). MTD is the transformation from a system of paper tax returns and supporting data to a fully digitised system, requiring taxpayers to keep digital records, file digital tax returns and automatically share data with HMRC. MTD is in its initial roll-out phase and currently only applies to VAT registered businesses with taxable turnovers exceeding £85,000, although businesses with turnovers under the threshold can opt in. HMRC has lauded its initial performance as a great success with businesses 'already reporting wider productivity gains and reductions in input errors'. MTD provides HMRC with more up-to-date information about the financial position of taxpayers due to more frequent reporting. HMRC also says it will be able to perform 'real-time' risk assessments, which should prevent unintentional errors in returns much earlier in the process, assess the use of tax planning, and lead to a more straightforward resolution of long-running disputes.

MTD requires certain records and accounts to be kept digitally and submitted to HMRC via an application programming interface (API). An API is a set of rules which allows software interfaces to interact. In the case of MTD, the API allows data to flow out of the taxpayer's internal system and translate across to HMRC's system. Taxpayers currently within the scope of MTD for VAT are required to replace legacy systems, put in place functional compatible software and build 'digital links' (a digital automatic output from one part of a business's software to another) between relevant business data points. Bridging software can be used to submit the final VAT return to HMRC through an API, or the final data set which prepares the VAT return could have API functionality built into it. In light of the challenge Covid-19 poses for businesses, HMRC extended the 'soft landing period' for businesses to put the necessary digital links in place between all parts of their compatible software until the first VAT return period starting on or after 1 April 2021. All VAT registered businesses will be subject to the MTD regime from April 2022.

From April 2023, MTD will be extended to income tax. Self-employed businesses and landlords with income exceeding £10,000 per annum will be required to keep digital records and report quarterly in relation to income tax for accounting periods starting on or after 6 April 2023. HMRC intends to consult later this year on the application of MTD to corporation tax.

HMRC's Automation Delivery Centre, established in 2016, also forms an important part of HMRC's digital strategy. The centre delivers robotic solutions to time-consuming clerical tasks, such that HMRC staff have greater resource for dealing with customers. So far, automated dashboards for HMRC staff and employer registrations have been highlighted as particular areas of success.

This article considers how HMRC may use its new legislative power to automate certain functions, both in light of where HMRC is already using artificial intelligence and where it may seek to use it more extensively in line with an expanding digitalisation programme.

Background to the measures

In 2017 and 2018, HMRC suffered several defeats in the First-tier Tribunal by taxpayers seeking to challenge penalty notices issued by HMRC in circumstances where the notice was issued automatically by computer. Judgments including *Khan Properties Ltd v HMRC* [2017] UKFTT 830 held that provisions such as TMA 1970 s 100 require a decision by a human being who is an officer of HMRC, and they noted that the specific officer should be named in the penalty notice.

As a result of these cases, the UK government announced its intention to legislate to formalise the use of artificial intelligence by HMRC, and to confirm that notices issued automatically were valid.

The Upper Tribunal (UT) has since considered the position in *HMRC v Rogers and Shaw* [2019] UKUT 406 (TCC), which concerned the validity of a notice issued under TMA 1970 s 8. Section 8(1) requires that the notice should be issued 'by an officer of the Board'. The UT held that it is not necessary for the notice to be issued by a 'flesh and blood' officer of HMRC; instead, it was sufficient if HMRC officers determined the general criteria to identify taxpayers to whom the notices should be sent, even if that criteria are then applied by a computer.

Despite this ruling, the UK government pressed ahead with its intention to legislate to place the position beyond doubt. According to statements in Parliament, the new legislation would be 'merely confirming the validity of HMRC's longstanding and widely accepted operational practice'. Whilst this is a helpful indication of the government's current intention, the breadth of the legislation makes it possible for HMRC to expand its use of artificial intelligence in the future.

The wide scope of s 103

The legislation has been enacted as FA 2020 s 103. It provides that anything capable of being done by an officer of HMRC under tax legislation may be done by HMRC, whether by use of a computer or otherwise. This would appear to effectively give HMRC the ability to automate any function it is entitled by legislation to perform.

Section 103 gives a list of examples of functions that can be carried out in this way. However, this list is non-exhaustive, so it does not limit the potentially broad application of the legislation. The examples given cover functions where HMRC already uses automation, such as giving notices to file returns and issuing fixed penalty notices. But they also cover some areas where, as far as we are aware, HMRC does not currently use automation, such as the issuing of penalties of a discretionary amount under TMA 1970 s 100.

There is no statutory requirement for HMRC to consult before automating additional functions, so no further scrutiny will necessarily be given to an expansion of the use of automated intelligence.

Furthermore, s 103 has retrospective effect and is therefore to be treated as having always been in force. A written Parliamentary statement explains that this is to protect the significant tax and penalties already paid. There is an exception for cases where a judgment was received before 11 March 2020 (provided it has not been overturned, but regardless of whether that decision is currently under appeal). However, any ongoing litigation where no decision has been given is now redundant, even if brought on similar facts to an already decided case.

The enactment of retrospective legislation is generally thought to be harmful to the rule of law. The desire to preserve tax revenues is understandable and, given the judgment in *Rogers,* the practical impact of this retrospective application is perhaps limited. Nevertheless, it seems to be a draconian step to deny taxpayers the ability to pursue certain appeals through the courts which they made prior to the date when the government announced its intention to legislate.

Increased automation: some areas of potential concern

Assessment of penalties

The assessment of penalties and issue of penalty notices is an area where HMRC already relies heavily on automated decisions by computers. However, thus far, this appears to have been limited to fixed penalties, where no exercise of discretion is required, such as the issue of fixed penalty notices in relation to late filed returns. The use of computers in such circumstances is uncontroversial and unlikely to cause difficulties or injustice towards taxpayers in most cases.

Worryingly, s 103 is broad enough to permit HMRC to expand the use of automated decision making and artificial intelligence into areas where penalties can be of varying amounts, requiring the exercise of discretion and consideration of mitigating circumstances. Whilst it may well be possible to programme computers to consider different factual scenarios and to apply criteria set by HMRC officers to determine the amount of a penalty, such criteria are unlikely to address every conceivable scenario and the absence of a human decision maker will inevitably impact the ability to fully take account of the nuances of each taxpayer's situation and to judge the fair level of penalty (if any) in every case.

It is particularly concerning that decisions taken under TMA 1970 s 30A are specifically included in the examples given for s 103. Section 30A requires assessments to tax other than by self-assessment to be made by an 'officer of the Board'. Such assessments can clearly require the exercise of a high degree of discretion, and we therefore question whether the inclusion of s 30A as a specific example is indicative of an intention by HMRC to expand the use of automated decision making in this area. The impact of this on the enquiry and assessment process is discussed in more detail below. Any such expansion is likely only to increase the number of appeals against assessments made by HMRC, adding to the administrative burden for both taxpayers and HMRC.

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During the committee stage debates on this clause in the House of Commons, the financial secretary to the Treasury noted that as a rule of law society 'we want as little discretion as possible to be exercised'. This is true in a general sense; however, it is vital to the fairness of our tax system that the assessment of penalties is able to take into account the full range of a taxpayer's individual circumstances in order to incentivise and enforce compliance with tax legislation, while not unfairly prejudicing taxpayers who have made unintentional errors in difficult circumstances.

Discovery assessments

As referenced above, while s 30A simply sets out the procedure by which an assessment is made and served by an officer of the Board, its specific inclusion raises a number of further questions about how HMRC intends to automate this procedure, in particular in relation to discovery assessments.

The discovery assessment is one of HMRC's most important powers and allows HMRC to override the finality that the end of an enquiry window would otherwise bring for a taxpayer. It is therefore rightly subject to certain limitations. For example, TMA 1970 s 34 limits HMRC's assessment powers to four years after the year of the assessment to which it relates if the taxpayer has acted with reasonable care and pursuant to TMA 1970 s 36 HMRC is only able to issue an assessment within extended time periods if the taxpayer has behaved deliberately or carelessly. The burden of proof lies with HMRC to show that the taxpayer has behaved deliberately or carelessly with regard to the loss of tax that has been discovered. In *Burgess and Brimheath Developments Ltd* *v HMRC* [2015] UKUT 578 (TCC) and *HMRC v Household Estate Agents Ltd* [2007] EWHC 1684 (Ch), HMRC was found to have failed to discharge its burden of proof of demonstrating that there was careless or deliberate behaviour. This burden of proof is unlikely to be successfully discharged by artificial intelligence available to HMRC, given the complications in establishing 'carelessness' or 'deliberate' behaviour brought about by any professional advice provided to a taxpayer in completing its return, whether the actions of the taxpayer were consistent with 'generally prevailing practice at the time' and the considerations given to the taxpayer's knowledge, experience and abilities.

That said, HMRC has not been deterred by the outcome of *Burgess* or *Household Estate Agents Ltd,* as it continues to issue 'protective assessments' where the statutory time limitations in TMA 1970 ss 34 and 36 are about to expire. When doing so, HMRC is arguably motivated by the time limitations to improperly override the other limitations on its powers. This practice suggests that HMRC might not hesitate to use artificial intelligence to issue protective assessments, which could result in significant administrative inconvenience and cost for taxpayers in appealing assessments that stand a significant chance of being found to be invalid.

Furthermore, a discovery assessment is not valid if HMRC could have reasonably been expected to be aware, on the basis of information available to the HMRC officer before the enquiry window closed, that there was an insufficiency of tax paid with respect to the taxpayer's return. If, for example, the taxpayer has disclosed certain information in the white space of its tax return where, perhaps, a finely-judged view has had to be taken because of a lack of clarity in the application of certain tax legislation, HMRC should raise any queries with regards to that view of the correct tax treatment during the enquiry window. As HMRC's artificial intelligence processes become more sophisticated (as is to be expected during the progression of MTD), the bar that HMRC will have to meet, as regards what it could have been reasonably expected to be aware of, may be higher. HMRC will have access to information sooner in the course of MTD and should therefore raise informal queries sooner in order to give taxpayers greater certainty. Alongside MTD, HMRC is looking at reviewing the deadlines for certain tax payments which should have a knock-on effect for the time-limitations that HMRC is subject to when raising an enquiry or assessment.

The interaction of the very concept of a 'discovery' with the use of artificial intelligence is difficult to square. *HMRC v R Tooth* [2019] EWCA Civ 826 (61) found that the requirement for the conclusion of HMRC to have 'newly appeared' is implicit in the statutory language 'discover'. This may suggest that artificial intelligence may only make a discovery on the day that the relevant data is processed by it. Any further discovery with respect to the same data should have to be made by an individual HMRC officer, coming to a new conclusion with respect to the same data.

It is clear that the increased use of automation and artificial intelligence may bring certain efficiencies for HMRC and, in particular, could be used to open enquiries and raise assessments where HMRC's powers would otherwise be fettered by time. However, there is also a risk for both HMRC and the taxpayer of yet more procedural issues to battle over given the complexities potentially created by the use of artificial intelligence in the discovery assessment procedure. Given HMRC's relative lack of success in the courts on such procedural matters, HMRC should carefully consider how it may use its new powers under s 103.

Business risk reviews

As pointed out earlier in this article, HMRC has highlighted 'real-time' risk assessment of businesses as something that will eventually be made possible through its tax digitalisation reforms, such as MTD. It is not clear whether HMRC are directly referring to the business risk review (BRR) process here, which is in place for large businesses that will have a customer compliance manager (CCM) at HMRC. The idea is that the BRR involves the CCM periodically making a rounded assessment, in what should be a collaborative process between the business and the CCM, of how the business approaches its tax affairs. The BRR involves assessing the taxpayer against three factors: the taxpayer's ability to deliver the correct tax; the taxpayer's transparency and cooperation with HMRC and internal accountability for managing tax risk; and the taxpayer's tax strategy and involvement in tax planning. The BRR process was reviewed following the 2017 Spring Budget, and new guidance was introduced in October 2019. In the updated guidance, the direction of travel has been towards greater flexibility in outcomes, rather than narrowing the process to become a more rigid regime.

It therefore seems extremely unlikely that the BRR process could become entirely automated, given the central role of the CCM and the discursive nature of the process. That said, as HMRC increasingly utilises automation to preserve resource, it is not beyond the realms of possibility for HMRC to attempt to automate certain aspects of the BRR. The use of automated functions in this regard could result in some arbitrary outcomes, especially as HMRC's current guidance provides that a taxpayer must not fail any of the low risk criteria in any material respect in order to be regarded as low risk. The fact that, for example, a taxpayer is the subject of an ongoing enquiry with HMRC or corrects a return due to an error made by third party auditors does not inherently mean that they are a higher risk; and currently such events can be reasonably explained to an individual HMRC officer. An automated system may not allow for nuanced consideration of what might be a 'material respect' in this context, and so the taxpayer's risk rating could be adversely affected.

Section 103 does not include any aspect of the BRR in the non-exhaustive list of functions that HMRC may carry out by use of a computer or otherwise. We would expect that the government would be required to consult with taxpayers before revising the BRR guidance to allow for increased use of automation. However, in view of HMRC's assertion that it has always been permitted to use computers or otherwise to carry out any of its functions, taxpayers should ensure that they continue to receive the expected level of service and care from their CCM during the BRR process.

What next?

Section 103 itself is unlikely to give rise to a significant immediate change in HMRC's practices with regard to its use of automation. However, it is a strong indicator of the direction of travel. The next ten years will constitute a significant transition period as potentially radical changes to the tax system are made in line with HMRC's aspiration to introduce further digitalisation and use of real time reporting. Such radical change inevitably leaves scope for not only teething problems but also the possibility for less nuanced and taxpayer-focused practices to be adopted. HMRC's consultation with taxpayers during this period will be critical if it is to ensure that certain established taxpayer rights and protections are not eroded through increased use of automation. ■

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