



DRA/cf
Ref: Penalties18

HM Revenue & Customs and Penalties
Room 1/72
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Dear Sirs

**Modernising Powers, Deterrents and Safeguards
Meeting the Obligations to File Returns and Pay Tax on Time**

1. Introduction

- 1.1 The Institute of Chartered Accountants of Scotland welcomes the opportunity to comment on the HMRC consultation on 'Meeting the Obligation to File Returns and Pay Tax on Time'.
- 1.2 We are grateful to the HMRC Powers Team for meeting with ICAS members here in Edinburgh on 27 August and participating in a discussion of the detail of the consultation. The meeting was helpful and constructive. This is a complex area of considerable public interest and what emerged was that there is considerable diversity of opinion.
- 1.3 Nobody likes to pay tax but it is even more important to recognise that nobody likes to pay a penalty. It is therefore important that the regime is perceived by the general body of taxpayers as a fair one. To achieve this, the penalty regime should recognise that penalties are used to discourage certain forms of behaviour. It should not be used as an alternative to taking prompt enforcement action to recover debts or force the production of returns and it should not be used without consideration given to the economic effect of the interest regime. Therefore late payment of tax would face an interest regime but bad behaviour would face a spectrum of penalties depending on the nature of the poor behaviour.
- 1.4 We believe that past recent history of HMRC's conduct has devalued penalties. All too often, HMRC have issued penalty notices which are incorrect and where the issue of the notice reflected a failure on HMRC's part rather than the taxpayer. For penalties to be effective, they need to be used only where it is appropriate. Our current information indicates that each year approximately 1.7 million penalty notices are issued and nearly half of these are subsequently vacated as not having been appropriate. To be effective, penalty notices should only be served where there is a very high probability that a penalty is due.
- 1.5 We believe that compliance within the UK is comparatively at a very high level. We support the need for there to be an effective enforcement regime which would include penalties to punish those whose behaviour falls short of acceptable standards. But we are concerned that

there must be appropriate and strong safeguards to protect the majority of compliant taxpayers.

- 1.6 In principle, HMRC has confirmed its wish to help those taxpayers who are compliant or who are trying to be compliant. We support this objective. We also recognise that there are those who either cannot or will not be compliant and we recognise the need to have an enforcement regime which includes penalties to encourage such people to meet their fiscal obligations. We would however be concerned at additional burden being imposed on general taxpayers and we would urge HMRC to bear in mind the burden ensuring that the non compliant minority fall into the penalty regime as appropriate but that the compliant majority are protected. We also start from a point of principle that the current complex and diverse penalty regime actually works reasonably well and does not require radical change. Thus we believe that HMRC has, on past occasions, not used wisely the penalty regime. It has been irresponsible in issuing too many penalty notices to people who did not deserve to receive such a notice. We therefore do not accept that HMRC needs a wider range of tools but we recommend that HMRC staff need considerable training to ensure that the penalty regime is applied consistently and more effectively than it has been in the past.

2. General Comments

- 2.1 We recommend that any penalty regime must be acceptable to the majority of taxpayers. A penalty regime must be reasonable and proportionate. During our discussion, it was recognised that there is a difference between meeting compliance obligations which include filing a return and the payment of tax which is late. As a matter of principle, we recognise the additional cost and expense imposed on HMRC where a return is not filed. However we do believe the principle to be correct that a filing penalty should be the lower of a fixed penalty, whatever that may be and set at a reasonable amount and the tax which is due. Where tax is paid late, this should be dealt with by the interest regime. It is only where the behaviour giving rise to the late payment crosses a border that consideration of penalties should arise.
- 2.2 The document does not appear to recognise that a failure can have serious commercial repercussions. For example, a recurrent failure to make timeous payment could result in a sub contractor losing the right to receive payment gross from contractors. That can have disastrous cash flow consequences and may even cause the business to fail. Making a mistake in identifying what should be zero rated or standard rated can result in the business having to pay 14.9% of the consideration received without the opportunity of recovering this from its customers. Making a mistake or indeed failing to meet compliance obligations can therefore be commercially punitive without needing to impose additional penalties. Late registration for VAT and a failure to charge VAT at the point of sale can have catastrophic commercial repercussions.
- 2.3 From our discussion, it was clear that HMRC saw merit in dissociating filing and payment. HMRC are inconvenienced by those who file late even where no tax is due because HMRC has to devote resources to chasing the outstanding return before it can ascertain whether the figures are acceptable or correct. There was therefore some sympathy expressed that late filing should carry with it an automatic penalty although it was worth restating that some felt this was wrong in principle. For those who had sympathy with HMRC's recommendation to impose a filing penalty that was fixed, conditions were recommended. These included:

1. The present tax system is viewed as overly complex and the obligation to complete tax returns as they are currently drafted is seen as quite onerous. We therefore recommend that further effort should be made to remove from the annual obligation to file returns as many people as possible, especially those who are recurrently receiving repayments or whose deductions at source exceed their annual liability. In addition, the return needs to be simplified as far as possible.
2. If there is to be an automatic filing penalty, taxpayers need to be encouraged to use estimated figures to enable them to file a return.
3. We also recommend that there must be a reasonable excuse defence to a filing penalty and that this excuse be exercised leniently in the case of anybody who suffers from a disability.

4. Turning to the list of questions asked by the consultative document our response would be:

Q1: Do you agree with the analysis of filing and payment behaviour set out in Chapter 3? Do you have any further insight or evidence that you could share with HMRC?

A: We agree broadly with the analysis of filing and payment behaviour. We think it is a facet of human nature to delay until the last moment tasks which are unpleasant. As an observation, it is disappointing that HMRC have never tried to create an incentive for taxpayers to file early but instead have concentrated on penalties to discourage them from filing late. Most taxpayers wish their contact with HMRC to be kept to a minimum. They also wish certainty yet the UK system of taxation is recognised by all to be complex. Most people are frightened of making a mistake and this can cause some to delay completing their return. We therefore recommend that HMRC should offer more support and more guidance and that this should be more accessible.

Q2: What should the relationship between time to pay on penalties be? If a taxpayer enters into a time to pay arrangement after the due date, how should they be treated? If somebody fails to adhere to their time to pay arrangements how should they be treated with respect to penalties?

A: A taxpayer who otherwise complies but is late in making payment may require assistance with a time to pay arrangement. We believe that in such a case, the taxpayer should be required to pay interest on the amount outstanding from when the tax was due until it was finally settled. If the taxpayer has made the effort to come forward and seek a time to pay arrangement, there is an expectation that the taxpayer will respect whatever has been agreed. If they are in breach of contract, HMRC should consider whether they should enforce payment immediately on the full sum, re-negotiate the time to pay agreement in the light of changing circumstances or impose interest. But in essence, it seems that someone who has negotiated a time to pay arrangement is an otherwise compliant taxpayer who is honestly returning what is due to the Government. Therefore we doubt that a penalty regime is appropriate to this sort of person unless their behaviour verges into deceit or dishonesty.

It is important that someone who has entered into an arrangement to pay in instalments respects that agreement and we recognise that some additional pressure may be appropriate for HMRC. We suggest that this might be dealt with by the surcharge mechanism imposing surcharges of perhaps 5% after an agreed delay. The present surcharge regime uses a delay of one month but we recommend three months would be more appropriate. If a penalty regime was to be considered, this might be an area where suspended penalties would give the right incentive to taxpayers to respect the contractual agreements for time to pay. If they failed, the penalty would be chargeable but if they respected the

agreement then the suspended penalty might be forgiven either in part or in full.

Q3: Are the safeguards for taxpayers suggested in Chapter 5 adequate? What other safeguards would be appropriate?

A: We believe the range of safeguards suggested in Chapter 5 seems reasonable.

Q4: What are the advantages and disadvantages of capping (where a late filing penalty is capped to the amount of tax due)? Are there any other safeguards that could be put in place that would protect vulnerable taxpayers without reducing the effectiveness of the penalty?

A: We believe that the deterrent effect of late filing penalties has been eroded by HMRC issuing too many penalties in too many circumstances often reflecting a mistake made by HMRC. It is difficult to design a penalty which would fit all circumstances but an underlying principle must be that whatever penalty is imposed it must be proportionate. Thus a fixed filing penalty of £100 is trivial to a large multi national company making billions of profit but would be a very significant deterrent to an individual of limited means. Where a return is late and subsequently it emerges that no additional tax was due or that a repayment was due, the imposition of a fixed £100 penalty (or other amended amount), is quite disproportionate.

As our discussion with the HMRC Powers Review Team illustrated, there is considerable diversity of opinion on this matter. Some recognised that a fixed penalty has the advantage of simplicity and is therefore clearly understandable to taxpayers. It also punishes in the same way the same offence whatever the taxpayer's circumstances. Therefore, some felt that so long as there was a defence of reasonable excuse, a fixed penalty for filing was acceptable. Others felt that those not liable to tax or due a repayment need to be protected. It is difficult to imagine the behaviour that gave rise to them not filing a tax return in good time if they are not due to pay additional tax or indeed are due a repayment. We recommend that further research is conducted into why such taxpayers have delayed the submission of their return. We also recommend that HMRC must give better guidance and more assistance to taxpayers, particularly vulnerable taxpayers who may have struggled because of a disability.

This is a complex area and it is important that taxpayers submit returns which are as accurate, correct and complete as they can achieve. One consequence of imposing a fixed penalty would be to encourage taxpayers to use estimates if they are confused or the information which they hold is incomplete. In many ways, we believe that as a matter of principle it is wrong to encourage the use of provisional figures or estimates.

We therefore recommend that the burden of completing tax returns should be reduced to the minimum possible level and also that those taxpayers who are currently obliged to complete a return when they are normally entitled to a repayment or have no liability should, wherever possible, be removed from the annual obligation to file returns. A non statutory method such as issuing P810's or R40 type forms should be encouraged for such taxpayers with an annual review requiring a return to be completed where risks are identified.

In areas like VAT and PAYE we consider that capping is appropriate but we recognise that there is a difference between repeated and recurrent behaviour and a single isolated failure. Thus we recommend filing penalties should be capped but we could accept that fixed penalties escalate. So an isolated failure might result in a zero penalty if all the due tax has been paid but if the failure is repeated until eventually tax is due, the penalty imposed might be an order of magnitude larger than that for a single failure.

At page 42 of the consultation document, there is a proposal to impose a fixed filing penalty if a paper return is filed late. From past consultation documents, HMRC have published that the marginal cost of completing a paper return is £6 in the case of an SA100. We therefore think it is not proportionate and unacceptable for HMRC to contemplate imposing a fixed £100 penalty which exceeds by a considerable margin, the additional cost of chasing and processing a paper return compared to say an electronic return. To be effective, penalties need to be used with discrimination, they need to be easily understood and they need to be proportionate to be acceptable.

Q5: Do you agree that there are benefits to alignment of penalties for failing to file a return or pay the tax owed by the due date? Are there any benefits we have missed?

A: In reading Chapter 7, there was broad agreement on a number of areas including the recognition that a penalty regime is an appropriate measure to discourage the small minority of taxpayers who file a return late or pay the tax late that they are due on time (or at all). A clear and visible penalty has merit but it was equally clear that not everyone agreed that a penalty regime which aimed to have one size fitting all was appropriate. In particular, there was a recurrent comment that the nature of VAT and PAYE was significantly different and needed to be considered separately.

As a matter of principle, it is important that taxpayers are not penalised more than once for the same misdemeanour and it is important to establish that the payment of tax is an obligation. There should be no question of one tax having a greater priority over another. The paper outlines the benefits of a simple and aligned penalty structure but our broad conclusion was that we saw it as being difficult to arrive at this single simple regime that could be accepted as being both reasonable and proportionate in all cases. The paper concludes that suspended penalties for a failure to notify do not seem appropriate but we do not agree. We recommend that this area is revisited as we feel that suspended penalties would create a mechanism to encourage the non compliant to become compliant and remain so.

Q6: How should HMRC use the tools discussed in Chapter 7 to most effectively reinforce both obligations – to file a return and to pay the tax due?

A: Chapter 7 contains a number of options available to HMRC including taking enforcement action, determinations of assessments, fixed sum penalties, tax geared penalties, daily penalties and all of these must be considered against a background of an interest regime being in force to deal with late payment of tax. We suggested that for a filing failure, there should be a fixed penalty which is capped at the lower of a fixed penalty sum and the tax due. If that behaviour is repeated, the fixed penalty should escalate but there would remain a capping mechanism so that if no tax is due the penalty will be reduced to zero.

We recognise that if the taxpayer does not file a return, HMRC is unable to know how much tax should have been declared on that return. It is therefore sensible that HMRC should have the power to issue determinations and assessments. We consider daily penalties to be an appropriate tool for use in tackling late or non filing of returns but we recommend that these should be part of a strategy and only available for a fixed period. If the delay in filing a return becomes excessive, we agree there comes a point in time when a tax geared penalty for the seriously non compliant taxpayer is appropriate.

Paragraph 7.32 suggests that after 12 months a higher penalty might be imposed. We are concerned that HMRC should consider 12 months to be a very long time after the filing date and the imposition of a penalty of up to 30%.

Paragraph 7.33 suggests that delays beyond 12 months could be penalised up to 100% of the tax outstanding. We think this is wrong in principle. Mere delay is a less serious offence than deliberate understatement. If one sets a proposal of 100% penalty against the provisions to be found in Finance Act 2007 dealing with deliberate understatement, we believe paragraph 7.33 is too harsh.

We can accept the removal of pre-authorisation by the Commissioners or tribunal for the issue of daily penalties provided these are appealable and that there is recognition of a reasonable excuse escape. Our acceptance is conditional upon HMRC having a transparent internal approval procedure involving senior officers as well as a mechanism to notify the taxpayer in advance of daily penalties starting.

We believe that in answering Question 6, we have suggested an answer simultaneously to Question 7.

Q8: If the requirement for pre-approval of daily penalties was removed, would the other safeguards suggested in this Chapter including a right of appeal against the penalty, internal review and a possible limit on how large daily penalties can get be adequate to protect the taxpayer?

A: We believe what has been outlined is reasonable and contains sufficient tax safeguards to protect taxpayers. Daily penalties must be preceded by a clear warning so that taxpayers understand that they have a last opportunity to submit the outstanding information before becoming liable to a regime. Daily penalties would not be the lesser of the tax due but would reflect the fact that costs were now being incurred in a process for which the taxpayer was responsible and would need to bear the costs. It follows that we recommend daily penalties should be used with discretion and only after they have been authorised by a senior officer.

Q9: How could HMRC ensure that the package when considered as a whole does not get disproportionate?

A: This question is fundamental to the package being acceptable. There is a spectrum of behaviour and time is a necessary consideration in deciding what level of penalty would be proportionate to the behaviour giving rise to a delay. HMRC has available to it a range of powers which can range from taking action to assess or estimate the tax due and enforcing collection to the imposition of penalties.

Taxpayers who are late in paying their tax should be dealt with largely under the interest regime but there should be a mechanism to register and recognise those who are persistent. Setting the level of penalty is always going to be difficult because it needs to be sufficiently high to deter the undesirable behaviour but not so high as to be viewed as punitive. The penalty also needs to be reasonable but cannot be so low as to be seen as ineffective.

Earlier in our response, we recommended a mechanism of filing penalty which would be a penalty set at a commercial amount sufficient to deter bad behaviour and sufficient to be effective. However that penalty would be capped at the lesser of the tax due and the fixed sum whatever that might be. Where all tax was paid, a recurrence of the behaviour would give rise to a higher penalty but similarly capped and taxpayers should be advised that there was a growing potential penalty should at any time they find themselves owing tax.

HMRC was concerned that if the fixed penalty fails to influence behaviour, particularly where the taxpayer knows all tax has been paid but refuses to submit a return, a further suite of penalties is appropriate. We have agreed to this on the basis of giving the taxpayer adequate warning that a set of fixed daily penalties were going to be sought.

It is important that the taxpayer is looked at on a holistic basis taking into account all tax due and paid from all sources of liability. We do however recognise that there may become a point in time when a tax geared penalty should be available to HMRC to deal with more serious delays both in filing and in payment. It is however important that this tax geared penalty is not as serious as the penalty regime proposed to deal with incorrect returns. We think that in this respect, the paper proposed tax geared penalties which are too high, too early.

Q10: Should those who pay or file shortly after the due date be treated differently from those who file their return or pay later?

A: This is a question of fact and degree. We recommend that consideration should be given for those who become liable to a penalty by filing or paying shortly after the due date might be encouraged to meet their compliance obligations in the future if a suspended penalty was imposed. If the taxpayer has returned their income but delays paying, the interest regime should be sufficient and there should be no difference. However if the taxpayer is a persistent late filer and later payer, repeated offences should have a cumulative augmentation of the penalty regime so that those who are persistent in failing will suffer higher penalties than those who fail in an isolated instance.

Q11: How should those who repeatedly file or pay later be treated?

A: We believe that we have already answered this point in Question 10. Our recommendation would be that those who are persistent and multiple in offences within say a defined period should become liable to a penalty or interest surcharge regime.

Q12: How well do the approaches suggested in Chapter 7 balance the elements of the design principle?

A: We struggle to answer this question because we have made recommendations to amend the proposed punishment regime in Chapter 7. We also recommend that compliant taxpayers who pay late should be dealt with under the interest regime except when such late payment becomes persistent and excessive. We have recommended that there should be capping to ensure that the penalty is proportionate to the tax at risk or due and we have commented that we believe the imposition of a penalty of up to 100% after 12 months delay is excessive. Accordingly, we are concerned that the approaches outlined in Chapter 7 are incomplete. In our view, in designing what is in Chapter 7 there is a failure to take into account the fact that, for example, late registration could result in a commercial penalty by a loss of profit margin. We are similarly concerned that compliance failures have other consequences which could be damaging to the business and therefore will, without reference to this penalty regime, act as a deterrent. Further, we recommend it is necessary to look at the taxpayer holistically taking into the account the existence of an interest regime and the administrative actions available to HMRC such as assessments and determinations and taking enforcement action.

Q13: How effective are the approaches suggested for frequent filing and payment obligations in Chapter 8 likely to be in encouraging timely payment and filing? Are there any alternative structures that may be more effective at encouraging on time filing and payment?

A: Those who are required to file frequently should be geared to achieve this objective. There is the potential for more frequent filers to move rapidly up an escalating filing penalty regime because of the need to file on shorter time periods. It is also likely that the larger the taxpayer and the more complex the underlying return, the likelihood of incurring a penalty will increase. So for a large organisation with many branches at different and remote locations throughout the United Kingdom offering diverse

services and liable, for example, to partial exemption, the possibility of delay being caused by a member of staff's absence through illness or unexpected circumstances is greater.

For this reason, during our discussion, we recommended that there should be an incentive and recognition for those who have complied in VAT quarterly returns, the default surcharge mechanism of a 12 month review has a lot of merit. In essence, this would mean that an isolated failure surrounded by a good record of compliance would not incur a penalty. We are not convinced that this could be dealt with adequately with the reasonable excuse mechanism and would like to see an attempt to build in a safeguard which would recognise good behaviour and provide a safeguard for isolated errors. We appreciate that this would be complex because an isolated error of one or two days delay in a single return of payment caused by exceptional circumstances such as staff illness or a system's failure is not the same as a prolonged delay where steps have not been taken to remedy what has caused the delay.

For those with multiple filing requirements in an in-year 12 month period, we realise what we propose is an additional complication. We also think it is important that where a trader is a repayment trader, consideration needs to be given about whether a penalty should be imposed and, according to the principles we have outlined above, we have concluded that the penalty should be capped at the lesser of the tax due and a fixed penalty but that recurrent failure should lead to an augmenting potential penalty which would be triggered at any time when VAT became payable.

We have refrained from addressing other taxes other than VAT.

Q14: HMRC would welcome views on the best way of encouraging employers to pay their in-year PAYE in full and on time without creating unreasonable burdens on employers.

A: As we discussed, we were opposed to increasing the filing requirement and we would be opposed to imposing a monthly (or more frequent) filing obligation on employers. Our recommendation would be that the end of year return should be accompanied by a breakdown showing the monthly payments made and reconciling these at the year end. HMRC should then use a risk assessment to check. Any attempt by an employer to back-end load the payment profile should therefore be detectable and dealt with by a punishment regime that would involve tax geared penalties.

Q15: How well do the approaches suggested in Chapter 8 balance the elements of the design principles?

A: A penalty regime cannot be viewed in isolation and there is a responsibility on the part of HMRC to publicise to taxpayers and businesses their obligations and responsibilities. It is normal commercial practice for organisations to issue reminders in advance of payment becoming due and this is something that HMRC should undertake. There must also be a clear mechanism of advising taxpayers that they are potentially becoming liable to a penalty giving them the opportunity to take action to avoid becoming liable to a penalty. In addition, the past practice of HMRC to allow penalties to accumulate to a substantial sum before the taxpayer is notified is unacceptable and there needs to be a mechanism if a monthly penalty is potentially accruing of notifying taxpayers quickly. Subject to these caveats, we believe that the approaches suggested in Chapter 8 incorporate many of the desirable principles in the design.

This is a complex area and our discussions with the HMRC Powers Review Team enabled a lot more detail to be discussed and promoted than is possible in a written document. We believe that further consultation is going to be necessary and members of the Institute's Taxation Committee would welcome the opportunity in participating in the future necessary discussions.

Yours faithfully

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