



TAXREP 30/15 (ICAEW REPRESENTATION 80/15)

HMRC PENALTIES: A DISCUSSION DOCUMENT

ICAEW welcomes the opportunity to comment on the consultation *HMRC Penalties: a Discussion Document* published by HM Revenue & Customs on 2 February 2015.

This response of 29 May 2015 has been prepared on behalf of ICAEW by the Tax Faculty. Internationally recognised as a source of expertise, the faculty is a leading authority on taxation. It is responsible for making submissions to tax authorities on behalf of ICAEW and does this with support from over 130 volunteers, many of whom are well-known names in the tax world.

Appendix 1 sets out the ICAEW Tax Faculty's *Ten Tenets for a Better Tax System*, by which we benchmark proposals for changes to the tax system.

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For more information, please contact ICAEW Tax Faculty: taxfac@icaew.com

icaew.com

HMRC PENALTIES: A DISCUSSION DOCUMENT

INTRODUCTION

1. ICAEW welcomes the opportunity to comment on the consultation *HMRC Penalties: a Discussion Document* published by HMRC on 2 February 2015.
2. We should be pleased to discuss any aspect of our comments and to take part in all further consultations on this area.
3. On 12 March 2015 we attended a workshop hosted by HMRC in which we were able to put forward some key comments and concerns and discuss aspects of the consultation document. Previously ICAEW has been actively involved in the review of HMRC's powers, deterrents and safeguards including the work-strands on penalties.

KEY POINT SUMMARY

4. Our key points in summary are:
 - ICAEW welcomes and supports this review of penalties. We agree that aspects of the current system are not working well. We welcome the fact that HMRC is starting this consultation at an early stage, to establish principles and seek views on policy design and possible options.
 - The development of the penalty regime is closely linked with HMRC's move to digital services and the personal tax account. For this to be effective, any new IT systems must work well, for the taxpayer as well as for HMRC, and contain accurate data. The 'Carter principle' of testing should be applied and provision made for the digitally excluded.
 - Some of the possible changes will require legislation, but many of the problems of the penalty system could be solved by administrative improvements; this review of penalties should consider both administrative and legislative changes.
 - We strongly recommend that HMRC carries out research into taxpayer behaviour and a post-implementation review of the Powers Review, to inform the current discussions. It is important to understand what has worked and what has not worked in the current system, before making changes.
 - We also think it is important that penalties are not considered in isolation but in the context of the other sanctions and deterrents for non-compliance.
 - We are in favour of aligning penalty rules across different tax regimes, so far as that is feasible.
 - We also recommend that the opportunity should be taken to consolidate and simplify the legislation on penalties, which is currently to be found spread across the tax statutes.
 - If penalties are to be effective as a deterrent and as a means to encourage compliance, it is important that taxpayers should know about and understand them. HMRC should do more to publicise the rules for penalties and other sanction, and also provide better information and support so that taxpayers can comply with their obligations.

- Penalties must be fair, and perceived as fair, in order to encourage compliance. Areas of unfairness include the inconsistency in applying penalties which hinge on taxpayer behaviour, especially those for inaccuracy.
- Penalties in some cases are not proportionate to the offence, for example, late filing penalties which can exceed the tax due. This could be mitigated by HMRC having more discretion to override penalties or to offer options such as suspended penalties.
- We agree that charging a penalty where a return is a day or too late can be unfair and disproportionate. However, we do not support the idea of a 'grace period'; filing deadlines should be clear and simple, and this would simply serve to confuse taxpayers and move the effective deadline back.

GENERAL COMMENTS

5. ICAEW welcomes and supports this review of penalties. We agree that aspects of the current system are not working well and a thorough and open review should be carried out.
6. Our comments on the individual consultation questions are given below. We also have some general points to make.
7. Paragraph references are to paragraphs in the consultation document.

The consultation process

8. It is important that this review is not rushed, and that there is full consultation at each stage. The current penalty rules were developed through detailed work and discussion in the HMRC Powers Review, and changes must be carefully considered before they are made.
9. We therefore welcome the fact that HMRC is starting this consultation at an early stage, to establish principles and seek views on policy design and possible options.

The move to digital

10. A major driver for this review of penalties is the continuing development of HMRC's digital services, including the personalised tax account.
11. The consultation appears to assume that increasing use of digital services will of itself lead to improved compliance. We would question that assumption: to be effective, any new IT systems must work well, for the taxpayer as well as for HMRC, and contain accurate data.
12. We strongly recommend that the 'Carter principle' be applied, ie that no new service should be launched until it has been tested for at least a year (this principle was established in the Carter project which changed the system for self assessment filing).
13. It is also vital that the data HMRC uses in its digital systems is accurate, especially if this is going to be used to prepopulate tax returns and to assess a taxpayer's compliance behaviour. Many of our members have expressed a lack of confidence in the accuracy of HMRC's data, particularly in the context of incorrect penalty notices.
14. The consultation makes no mention of those who are digitally excluded. There are many people who cannot make use of HMRC's services, for reasons such as mental or physical disability or the lack of access to good broadband services and IT equipment. It is difficult to see how they might benefit from a digital tax account which forms the basis for a new way of charging penalties. They will also not benefit from the full range of reminders and information

supplied digitally, and the lack of digital engagement may make it more difficult for HMRC to build a picture of the taxpayer for compliance purposes. HMRC must ensure that taxpayers in this position are provided with services which are comparable with, and not inferior to, the digital services.

Legislation versus administrative improvements

15. Some of the possible changes mentioned in this consultation will require legislation. The penalty rules developed by the Powers Review were intended to provide a simple and consistent regime. Although the resulting regime may not quite have achieved that, and there is room for improvement, we would sound a note of caution about 'bolting on' new rules which could make the system more complicated. Changes to legislation must be carefully considered in the context of the whole penalty system.
16. Many of the problems of the penalty system could be solved by administrative improvements rather than legislative changes. The report by the OTS in November 2014 *Tax penalties* identified a number of such problem areas and made recommendations which we would generally support. Our members have regularly identified similar problem areas, for example the lack of consistency in applying penalties for inaccuracies, the issue of incorrect penalty notices, and need for better HMRC staff training and better communication with taxpayers and agents.
17. Therefore, we trust that this review of penalties will look closely at administrative changes as well as legislation.
18. The OTS also noted that there is as yet no evidence that the current penalty regime has promoted the behavioural changes among taxpayers that was a key objective of the Powers Review. We strongly recommend that HMRC carries out research into this aspect of the current penalty system; we are pleased to note that HMRC has already begun this.
19. The OTS also recommended a full post-implementation review of the Powers Review work. This is alluded to at paragraph 4.12 but it is not clear if HMRC intends to undertake such a broader review. We strongly recommend that HMRC should carry out research and take a wider look at the outcome of the regime introduced by the Powers Review, to inform the current discussions. It is important to understand what has worked and what has not worked in the current system, and the reasons for that, before changing it.
20. We also think it is important that penalties are not considered in isolation but in the context of the other sanctions and deterrents for non-compliance.

Alignment of penalty rules

21. We recommend that the review considers how to simplify the penalty regime, across the tax system. Members have commented that it is too complicated and inconsistent. Particular issues are:
 - There are inconsistent methods of charging – some are based on a percentage of tax, others not, some take behaviour into account, others not.
 - Some allow a period of non-compliance before penalties kick in.
 - Suspension of penalties is available for careless errors in self assessment but not in other situations.
22. There are of course reasons why different penalty rules have been developed for different taxes or situations, and complete alignment may not be possible. For example, applying similar rules to different taxes could create its own inconsistencies and disproportionate penalties.

23. However, as far as possible, similar penalties for the same failure would be more readily understandable by taxpayers. We also think that alignment will assist in HMRC's aim of focusing on each taxpayer across all taxes, rather on individual taxes.
24. We also recommend that the opportunity should be taken to consolidate and simplify the legislation on penalties. At present the legislation is hard to understand and is all over the place, in different statutes. For example, penalties for errors are in Sch 24, Finance Act 2007, filing penalties are in Sch 55, FA 2009 and penalties for late payments are in Sch 56, FA 2009. Penalties in relation to information and inspection powers are in Sch 36, FA 2008, failure-to-notify penalties in Sch 41, FA 2008, and the latest set of penalties, those relating to intermediaries, in ss 98 and 98A, Taxes Management Act 1970. We suggest that the legislation on penalties be consolidated and re-drafted using Tax Law Rewrite principles.

Communication

25. If penalties are to be effective as a deterrent and as a means to encourage compliance, it is important that taxpayers should know about and understand them. Although the £100 self assessment late filing penalty, for example, is very well known to the public, other aspects of the system are not well understood or communicated by HMRC.
26. HMRC also needs to provide better information and support about how to comply with tax obligations. Some taxpayers who are struggling with the system may wish to comply and avoid a penalty but need help to complete their returns or other tasks.
27. As well as communication from HMRC to the taxpayer, there should be better routes for taxpayers and agents to communicate with HMRC. For example, the widely-reported delays in getting through on the telephone are a barrier to those who need help with their returns or want to explain the circumstances in which a return was late. Agents have long been requesting a secure email route, as the easiest and most effective way of contacting HMRC about clients' affairs.

RESPONSES TO THE CONSULTATION QUESTIONS

Q1: To what extent are the concerns expressed above typical of actual situations?

28. We agree that all the areas of concern listed in chapter 4 are valid ones, supported by feedback from our members. We comment on some of them below. There are also some additional areas which members have identified.

Fairness and proportionality

29. We agree that penalties must be fair, and perceived as fair, in order to encourage compliance. Areas of unfairness include the inconsistency in applying penalties, especially those for inaccuracy.
30. Penalties in some cases are not proportionate to the offence, particularly in the case of late filing penalties which can soon mount up and exceed the amount of tax due. For example, an RTI penalty could be £100 for each month and exceed liabilities due.

Automated penalties

31. There are both advantages and disadvantages with automatic penalties, and we agree with the comments set out at paragraph 4.3. The sometimes disproportionate effect of these penalties could be mitigated by HMRC having more discretion to override penalties in the context of the offence, the taxpayer and the tax at stake.

Income tax self assessment

32. It is fair to say that our members have a range of views on the automatic £100 self assessment late filing penalty. On the one hand, it is not high enough to deter well-off taxpayers who negligently or deliberately fail to file on time. On the other hand, increasing the penalty would have a disproportionate impact on those with low incomes and little or no tax to pay.
33. The disproportionate impact of self assessment penalties on those with little or no tax to pay is even greater once the further penalties including daily penalties start to mount up.
34. Members have differing views on the abolition of the rule which capped the initial late filing penalty at the actual liability due on 31 January. Some feel strongly that this should not have been scrapped and should be reinstated, as the current regime is disproportionate, with most effect on those who owe little or no tax and may be on low incomes. Other members feel that the capping rule may encourage people may make people less concerned about filing on time, if they know the penalty will be negligible.
35. This is clearly an area which requires further discussion, and would also benefit from research into reasons for late filing and whether capping the penalty is likely to make a difference.

Behavioural penalties for inaccuracies

36. The behavioural model developed by the Powers Review has its merits but in practice it has been hard to implement. This is because it can be difficult to categorise behaviour and, although HMRC's manuals attempt to provide objective guidelines, it often comes down to the judgement of the HMRC case officer. In addition to good judgement, the officer must have sufficient accurate information about the taxpayer and the reason for the error before making a decision, and this is not always obtained – sometimes emerging only when the case goes to the tribunal.
37. Members regular report inconsistencies in how the penalties are applied, and the failure of HMRC officer in some cases to follow their own guidelines. Examples include a tendency to regard an error as *prima facie* evidence of carelessness, though innocent errors should not give rise to a penalty. At the other end of the scale, HMRC officers may incorrectly categorise behaviour as deliberate, which (given that deliberate behaviour is, by another name, fraud) can have serious consequences for the taxpayer – not just in terms of higher penalties but other sanctions too, such as inclusion in the deliberate defaulters programme.
38. Suspended penalties are another area of inconsistency. HMRC does not consistently or routinely offer this option where it would be appropriate in cases of careless behaviour, or may be unwilling to allow suspension and set conditions where the failure is regarded as a one-off.
39. A further source of inconsistency and unfairness is that taxpayers with agents, who understand the penalty rules and can negotiate or challenge HMRC's decision, are likely to be at an advantage compared to unrepresented taxpayers.

Penalties for failure to notify chargeability

40. There is no mention in the document of failure to notify chargeability. Failure to notify is one of the greatest risks to revenue collection, because if HMRC is unaware that a taxpayer exists or needs to pay tax then tax is not going to be collected.
41. We should be interested to know how successful the penalty regime is in encouraging taxpayers and businesses to register. We should also be interested to know whether people are deterred from notifying by the likelihood of penalties under the current regime (where a penalty is more likely to arise than under the old rules). We do not have a great deal of

evidence on how this aspect of the penalty regime is working and suggest HMRC undertakes some research.

HMRC errors and services

42. The majority of taxpayers will always try and comply with deadlines set by HMRC regardless of the regime and the simplicity or complexity of penalties. However, in order to engage with taxpayers more successfully, HMRC needs to be seen to have a fair, enforceable system that is easily understood. To do this, HMRC must have systems that work, can be relied upon, and have the confidence of taxpayers, businesses and agents.
43. Many members have pointed out shortcomings in HMRC's systems and services which mean that sometimes penalties are charged incorrectly, based on incorrect data, or are charged inappropriately, for example where system problems have made filing difficult. We have had reports of such problems in connection with RTI, the VAT Mini One Stop Shop, and the new online system for reporting share scheme events.

Q2: What do you consider to be the major areas of concern with our penalty regimes?

44. Our comments above identify a number of areas of concern. Without repeating the detail, these include:
- Behavioural penalties
 - Inconsistency in applying penalties
 - Automatic late filing penalties
 - Administrative issues at HMRC, such as the issue of incorrect penalties, penalties or decisions based on incorrect data, the need for better staff training and guidance, and for better communication and information.

Q3: What do you view as being the priority areas for the initial focus of this work?

45. The topics noted above would be our priorities.
46. We recommend that administrative problems be looked at as soon as possible, to identify improvements which could be made quickly and without the need for legislation.
47. As noted, we think that an important task for this project at this early stage should be research and analysis into the current regime and its effectiveness, to inform future decisions for changes.

Q4: Do you agree the principles set out at paragraph 5.3 should govern the design of our penalty regimes? If not what other or additional principles should apply?

48. We agree broadly with the principles set out at paragraph 5.3.
49. We are not clear whether these principles are intended to supplement the principles established under the Powers Review, or replace them. In our view the Powers Review principles are still relevant and include some principles which are not explicitly included at 5.3.
50. In particular, it is important that penalties should be simple and easy to understand.
51. HMRC should also explicitly recognise in its approach that the vast majority of taxpayers are honest and want to be compliant.

Q5: Do you think that an approach which focused more on individual behaviour would help?

52. We can see the merits of an approach focused on individual behaviour, if this would result in fairer and more appropriate penalties: for example, lighter penalties for those who make the occasional mistake but tougher penalties for serial non-compliers.
53. However, the behavioural approach is already an integral part of many penalties under the current rules, and we have indicated, above, the problems that this can cause. If penalties are to be based on behaviour, it will still be the case that the HMRC must make a judgement and will need good information to do so. We do not see that the move to digital services will remove these requirements.
54. We would be concerned if the move to digital means that focus on behaviour was based primarily on the information in HMRC's new systems – at some stage there must be personal contact with the taxpayer, in order to check if the information is correct and complete and find out reasons for any non-compliance.
55. Basing penalties on past behaviour may be perceived as unfair, since it is treating different taxpayers differently. There also needs to be scope to 'wipe the slate clean' where a taxpayer with a poor compliance history succeeds in bringing their affairs up to date and remaining compliant.
56. We are not sure how the concept of focusing on individual behaviour would be applied to taxpayers such as partnerships, large businesses, or employers running a number of payrolls.
57. There will also be issues to be addressed where the taxpayer is engaged with a range of taxes. They may have a good track record of compliance with some taxes, but problems with others.

Q6: What would be the impact if we were to remove penalties for 'short' failures (a day or two late) and how would we incentivise compliance (would a higher interest rate work for example)?

58. We agree that charging a penalty where a return is a day or too late can be unfair and disproportionate depending on the circumstances.
59. However, we do not support the approach suggested. Filing deadlines should be clear and simple. Introducing a grace period will simply serve to confuse taxpayers and also to move the deadline back: if, say, three days' grace is allowed for a short failure, taxpayers will know they have 'deadline-plus-three' to file their documents. Fixed penalties with clear deadlines do appear to have influenced behaviour and moving back from this risks a return to the days when more taxpayers are behind with their affairs.
60. There would also be the difficulty of defining a 'short' failure – would it be the same for all taxes and compliance requirements? There will be added complexity and confusion if a grace period applies in some situations but not others.
61. Rather than remove the penalty trigger for short failures, other options would be to give HMRC more discretion to mitigate penalties in appropriate cases, or to suspend penalties subject to conditions (such as filing on time on the next occasion) in more situations than are currently available.
62. We do not support altering the interest rules so that higher rates would apply in certain situations. This would introduce unnecessary complexity to the interest rules and could be hard for taxpayers to understand. The higher interest rate would have to be very much higher than the basic one to have any effect on compliance. And unless the taxpayers understand in

advance how and when a higher rate will be charged, the higher interest will not be a deterrent but merely punitive.

63. The interest rules as they stand are simple. Interest is a different concept from penalties and has a different function, and introducing punitive interest rates would muddy the waters between interest and penalties.

Q7: What do you think should trigger a penalty?

64. It is difficult to give a definitive answer to this, since different penalties are designed to tackle different tasks and situations.

65. In general, penalties should apply to careless or deliberate failures or errors, with escalating penalties for the worst offenders.

66. Those who make innocent errors or need help with the system should not be penalised.

67. Having said that, where there is a filing deadline, taxpayers are more likely to take it seriously if there is a penalty for failing to meet it, as the £100 self assessment late filing penalty has shown. Penalties for late filing or payment will still be needed. HMRC could be given more discretion to mitigate or suspend penalties to avoid a disproportionate impact on some taxpayers.

Q8: Are there incentives HMRC could consider to encourage compliance?

68. It is difficult to envisage what financial incentives might be offered and we are not convinced they would be effective.

69. Moreover, we do not think financial incentives are appropriate to encourage people to fulfil their statutory obligations.

70. HMRC should make best use of the incentives it already has at its disposal, such as disclosure opportunities and the suspension of penalties.

71. It should also remove barriers to compliance, such as the disincentive effect of disproportionate penalties. For those who are hesitant to come forward and notify chargeability or bring their affairs up to date, HMRC should be clearer about what mitigation may be available for penalties and that time to pay arrangements are available.

72. Rather than incentives, better support and information may encourage people to comply. For example, for those struggling with a tax return, a face to face service at an Enquiry Centre is no longer available, but the problem may not easily be dealt with on the phone (and they may have difficulty getting through). HMRC has the Needs Extra Support Service but this is not well known or available to all.

73. HMRC is already working on better, targeted prompts to taxpayers – for example, the GNN system used for employers, the texts and emails used prior to the January 2015 self assessment filing deadline. Our view is that this is a useful approach provided properly targeted: messages can be firm but not threatening, and make clear what sources of help may be available for those who want to comply but are having difficulties.

Q9: What could HMRC do better to explain sanctions and the role penalties play within them?

74. As above.

Q10: If we were not to charge penalties in all the circumstances that we do currently, how could we still get a strong message across to our customers which they will take notice of?

75. This is a difficult issue because penalties do seem to focus attention on submitting documentation on time and on returning accurate information.

Q11: To what extent does the present penalty regime help agents and advisers to influence their clients' compliance, and how might this be different if we were not to charge penalties in all the circumstances that we do currently.

76. Our members report that penalties do influence taxpayer behaviour and assist the agent in influencing compliance. Explaining the likely financial cost of failure to comply does focus the client's mind and motivate them to meet deadlines. People are busy and need encouragement to prioritise tax obligations. This works particularly well in the context of filing deadlines.

77. However, in order for the penalty regime to drive compliance, both agents and clients must be confident that it is truly focused on the non-compliant and is being accurately applied, with allowances made for innocent errors or the occasional lapse, and the acceptance that HMRC's systems may sometimes be at fault. This point has been made particularly by members in the context of RTI.

78. It is not just penalty regimes that assist agents in encouraging compliance. For example, members who deal with serious investigations report that the risk of prosecution is a strong motivator. The penalty regime must be considered in the context of the full range of sanctions.

APPENDIX 1

ICAEW TAX FACULTY'S TEN TENETS FOR A BETTER TAX SYSTEM

The tax system should be:

1. Statutory: tax legislation should be enacted by statute and subject to proper democratic scrutiny by Parliament.
2. Certain: in virtually all circumstances the application of the tax rules should be certain. It should not normally be necessary for anyone to resort to the courts in order to resolve how the rules operate in relation to his or her tax affairs.
3. Simple: the tax rules should aim to be simple, understandable and clear in their objectives.
4. Easy to collect and to calculate: a person's tax liability should be easy to calculate and straightforward and cheap to collect.
5. Properly targeted: when anti-avoidance legislation is passed, due regard should be had to maintaining the simplicity and certainty of the tax system by targeting it to close specific loopholes.
6. Constant: changes to the underlying rules should be kept to a minimum. There should be a justifiable economic and/or social basis for any change to the tax rules and this justification should be made public and the underlying policy made clear.
7. Subject to proper consultation: other than in exceptional circumstances, the Government should allow adequate time for both the drafting of tax legislation and full consultation on it.
8. Regularly reviewed: the tax rules should be subject to a regular public review to determine their continuing relevance and whether their original justification has been realised. If a tax rule is no longer relevant, then it should be repealed.
9. Fair and reasonable: the revenue authorities have a duty to exercise their powers reasonably. There should be a right of appeal to an independent tribunal against all their decisions.
10. Competitive: tax rules and rates should be framed so as to encourage investment, capital and trade in and with the UK.

These are explained in more detail in our discussion document published in October 1999 as TAXGUIDE 4/99 (see via www.icaew.com/en/about-icaew/what-we-do/technical-releases/tax).