Tax Representation

TAX FACULTY

TAXREP 24/08

PENALTIES REFORM: THE NEXT STAGE

Comments submitted on 11 March 2008 by the Tax Faculty of the Institute of Chartered Accountants in England & Wales to HM Revenue & Customs in response to the consultation document 'Modernising Powers, Deterrents and Safeguards: Penalties Reform: The Next Stage' issued on 10 January 2008.

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PENALTIES REFORM: THE NEXT STAGE

INTRODUCTION

1. In this document we present the comments of the Tax Faculty of the Institute of Chartered Accountants in England and Wales (ICAEW) on the consultation document *Modernising Powers, Deterrents and Safeguards: Penalties Reform: The Next Stage* (the Condoc) issued by HM Revenue & Customs (HMRC) on 10 January 2008.

2. We welcome the opportunity to comment on the detailed proposals set out in the Condoc. We would be happy to discuss any aspect of our comments and to take part in all further consultations on this area.

3. Information about the Tax Faculty and the ICAEW is given in Annex A. We have also set out, in Annex B, the Tax Faculty's ten tenets for a better tax system, by which we benchmark proposals to change the tax system.

KEY POINTS SUMMARY

4. The key points in our response are as follows:

- We think it would be sensible to have a single system of penalties for incorrect returns across the tax system.

- We doubt whether it is appropriate to adopt the same system for student loan repayments and for the recovery of statutory payments, because for these, HMRC is not acting as a taxing authority but merely carrying out the administrative functions for another Department.

- We are sceptical whether penalties based on underlying behaviour and which differentiate between prompted and unprompted disclosure are appropriate for one-off taxes such as IHT and stamp duties.

- We are not convinced of the need for a third party penalty for incorrect inheritance tax returns.

- We have a general concern that penalties for failure to notify will not achieve the objective of influencing behaviour but will deter a person operating in the shadow economy from regularising his or her position even if he or she would like to. While we accept that fairness might suggest a penalty we think that the national interest is best served by creating a situation in which the deliberate non-complier can become compliant.

- We welcome the proposal there should be no penalty for failure to notify where there is no loss of tax.

- We are pleased to note the abolition of the £100 fixed penalty for failure to notify self-employment within three months for Class 2 NIC purposes.

- We have no objection to the principle of penalties being charged as a percentage of the tax underpaid as a result of late notification, and also linked to the taxpayer's behaviour.

- However, we have a concern that for the purposes of penalising failure to notify, the stepped percentages are too high and may deter people from coming out of the informal economy.

- We suggest there should be a system of suspended penalties. To apply this, HMRC could monitor whether the taxpayer complies with his or her obligations after the notification has been dealt with.

- Where the failure to notify is not a deliberate attempt to evade tax, the reductions for disclosure shown do not seem unreasonable.

- Where the failure arises from tax evasion it might be more sensible to tie the penalties to the behaviour after the failure has been detected or disclosed rather than the behaviour that caused the failure.

- We would welcome a single legislative provision for reasonable excuse across HMRC.

EXTENSION OF PENALTIES FOR INCORRECT RETURNS TO OTHER TAXES

5. The paragraph numbers mentioned below relate to the paragraphs in the Condoc.

6. We think it would be sensible to have a single system of penalties for incorrect returns across the tax system.

7. However we are sceptical whether it is appropriate to adopt the same system for student loan repayments and for the recovery of statutory payments. These are areas where HMRC is not acting as a taxing authority; it has merely volunteered to carry out administrative functions for another Department. The appropriate penalties in relation to such matters ought to be a function of the loan or benefit system concerned. It should be irrelevant that HMRC happens to be administering the payments.

8. We are sceptical whether there is a benefit in aligning the penalty response to non-compliance by employers (para 4.15). The responsibilities of employers in relation to student loans and over-recovery of statutory payments are very different from those that apply to PAYE and NIC.

9. We are not convinced of the need for a third party penalty for incorrect inheritance tax returns (para 4.18). As it will be difficult to establish liability, we suspect that such a penalty would be rare. We cannot see any point in complicating the tax system to cater for a tiny number of possible cases. We doubt that many personal representatives either need or want HMRC to strengthen their hand.

10. We cannot see how a stepped penalty would help with 'red diesel' (para 4.20). We would have thought that misuse of such fuel would always constitute either a mistake or a deliberate action with concealment. Therefore, the steps in between these two extremes would not occur in practice.

11. Para 4.21 – the comment in relation to red diesel (para 4.20) again applies.

12. While we favour alignment where this can be sensibly done, we do not agree with alignment for the sake of alignment, particularly if it gives rise to other problems. We are sceptical whether penalties based on underlying behaviour and which differentiate between prompted and unprompted disclosure are appropriate for one-off taxes such as IHT and stamp duties.

13. In particular we think that they are inappropriate for personal representatives who are often unpaid laymen and who may have to try to piece together historical information from inadequate records which the deceased had responsibility for creating. In such circumstances the penalty will not necessarily reflect the behaviour of the personal representatives – and may not even reflect that of the deceased, as records might exist of which the personal representatives are unaware. We are pleased to note that HMRC recognises (para 4.6) that guidance on what represents 'reasonable care' will need to reflect the fact that IHT and SDLT are 'one-offs'.

CHANGES FOR PENALTIES FOR FAILURE TO NOTIFY

14. We are sceptical whether the aims and principles outlined in Chapter 2 of the Condoc are appropriate in relation to failure to notify. Such a penalty meets none of the objectives in influencing behaviour. Indeed it is questionable whether it is in the interests of the tax system to seek to influence behaviour at all in relation to the failure-to-notify penalty. A person will incur a penalty either through ignorance of his level of turnover or profits or because of deliberately not complying. In these circumstances the only object of a penalty can be punishment.

15. While we accept that fairness might suggest a penalty we think that the national interest is best served by creating a situation in which the deliberate non-complier can become compliant. If a person has functioned in the shadow economy for five years the tax liability alone may well be of such a magnitude that he cannot afford to become compliant. Adding interest and penalties in such circumstances is likely to ensure that the person continues to operate in the shadow economy even if he would like to regularise his position.

16. We welcome the proposal there should be no penalty where there is no loss of tax (para 5.13).

17. We are also pleased to note the abolition of the £100 fixed penalty for failure to notify self-employment within three months for Class 2 NIC purposes (para 5.14).

18. We have no objection to the principle of penalties being charged as a percentage of the tax underpaid as a result of late notification, and also linked to the taxpayer's behaviour.

19. However, we have a concern that for the purposes of penalising failure to notify, the stepped percentages (at para 5.24) are too high and may deter people from coming out of the shadow economy. This is because the penalty will be x% of 100% of the tax for the period whereas other penalties for incorrect returns are a percentage of the incremental tax only. Paying the tax plus interest plus a penalty may be just too much for some taxpayers who would otherwise come forward.

20. We suggest there should be a system of suspended penalties, similar to that under Sch 24, FA 2007. Since failure to notify a new source is a one-off, HMRC could instead monitor future behaviour such as whether the taxpayer submits returns on time and otherwise complies with his or her obligations, after the notification has been dealt with. This could apply to the 'non-deliberate failure' category.

21. Where the failure to notify is not a deliberate attempt to evade tax, the reductions for disclosure shown at para 5.24 do not seem unreasonable.

22. Where it arises from tax evasion we think it might be more sensible to tie the penalties to the behaviour after the failure has been detected or disclosed – such as the degree of co-operation in establishing the tax due and future compliance with tax obligations – rather than the behaviour that caused the failure.

23. We would welcome a single legislative provision for reasonable excuse across HMRC (para 5.26). However, we do not think that the tribunals should be constrained in determining what is reasonable in the circumstances of the case. In particular, reliance on professional advice and lack of funds ought both to be capable of constituting a reasonable excuse, albeit that we doubt that there would be many cases in which a tribunal would accept that a lack of funds on its own would provide such an excuse.

24. While we have no problem with there being an onus on the taxpayer to demonstrate that he or she had reasonable grounds for believing there was no obligation to notify (para 5.28), we do have a concern as to what a taxpayer is expected to do to show that. If a hobby is construed as having turned into a trade it is difficult to envisage what steps the taxpayer ought to have taken to confirm his belief that he was not trading. He could hardly be expected to seek advice when he had no reason to believe that he was in need of such advice.

25. In other cases we believe that taking advice from a properly qualified professional person who holds himself out as competent to give such advice should always constitute a reasonable excuse should that advice turn out to be incorrect, provided that the taxpayer can demonstrate that he had no reason to doubt the professional's competence and that he had disclosed to the professional the information that he could have reasonably believed to be necessary to generate that advice.

DRAFT LEGISLATION

26. We have no additional comments at this stage on the draft legislation.

ICAEW Tax Faculty
11 March 2008

ANNEX A

THE ICAEW AND THE TAX FACULTY: WHO WE ARE

1. The Institute of Chartered Accountants in England and Wales (ICAEW) is the largest accountancy body in Europe, with more than 128,000 members. Three thousand new members qualify each year. The prestigious qualifications offered by the Institute are recognised around the world and allow members to call themselves Chartered Accountants and to use the designatory letters ACA or FCA.

2. The Institute operates under a Royal Charter, working in the public interest. It is regulated by the Department for Business, Enterprise and Regulatory Reform through the Financial Reporting Council. Its primary objectives are to educate and train Chartered Accountants, to maintain high standards for professional conduct among members, to provide services to its members and students, and to advance the theory and practice of accountancy, including taxation.

3. The Tax Faculty is the focus for tax within the Institute. It is responsible for tax representations on behalf of the Institute as a whole and it also provides various tax services including the monthly newsletter TAXline to more than 11,000 members of the ICAEW who pay an additional subscription.

4. To find our more about the Tax Faculty and ICAEW including how to become a member, please call us on +44 (0)20 7920 8646 or email us at taxfac@icaew.com or write to us at Chartered Accountants' Hall, PO Box 433, Moorgate Place, London EC2P 2BJ.

ANNEX B

THE 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 http://www.icaew.com/index.cfm?route=128518).