THE CHARTERED INSTITUTE OF TAXATION

LOW INCOMES TAX REFORM GROUP

HM Revenue and Customs and the Taxpayer
Modernising Powers, Deterrents and Safeguards
Penalties Reform: The Next Stage

RESPONSE TO CONSULTATION DOCUMENT OF 10 JANUARY 2008

Executive Summary

We are pleased to respond to this consultation from the perspective of the unrepresented taxpayer on a low income.

We broadly agree with the design principles set out in para 2.4, but would add two further principles. First, that legislation and guidance on penalties should be accessible, clear and easily understood. Secondly, that the obligations to be reinforced by the new penalties system must be clear and comprehensible, otherwise bad law results.

Extension of FA 2007 penalty regime to other taxes

In general we agree with the proposal to extend the penalty regime legislated in Finance Act 2007 to incorrect returns for other taxes. We are in discussion with tax credits compliance policy officials about how far those principles should be extended to tax credits. We have reservations about linking the amount of tax credits penalties to the size of overpayments, as the differences between penalties geared to relatively small amounts of tax, as against relatively large overpayments, could become disproportionate. We are also concerned that the same thinking and guidance should be adopted by both tax and tax credits enforcers when applying the principles underpinning innocent mistake and failure to take reasonable care.

Extended guidance on reasonable care will be needed particularly where there is reliance on others. We discuss that in the context of the inheritance tax example in para 4.18ff.

Failure to notify

We agree, on the whole, that the suggested new penalty regime for failure to notify does meet the design principles set out in chapter 2, and that the legislation achieves its aim, subject to the following points.

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- As the penalty model is so similar to that for incorrect returns, the draft legislation should provide for full abatement for non-deliberate failure to notify.

- A prompted notification, where notification would have been unprompted had the taxpayer known of their obligation to notify, may be of no lesser quality than an unprompted notification and would merit the same mitigation.

- We very much welcome the repeal of the £100 fixed penalty for non-registration for Class 2 NICs. We agree that the obligation to notify HMRC of the start of a business should remain, but hope that further work can make greater progress towards aligning the statutory notification dates.

- We agree with the principle (para 5.13) that there should be no penalty for failure to notify unless there is unpaid tax as a result, but it is important that no more than one tax-geared penalty is imposed in respect of the same amount of tax.

- We note that para 9 of the illustrative Schedule allows a special reduction 'if HMRC think it right because of special circumstances'. **We would strongly urge HMRC use this 'special circumstances' reduction in order to encourage people to start participating in the formal economy**.

- Once somebody has voluntarily left the informal economy, it is vital to ensure that they do not backslide. Accordingly, **we recommend that suspending a late notification penalty could do much to encourage a person, once in the formal economy, to stay there.**

- In principle, we agree that a late disclosure within a permitted period might merit abatement of the penalty for non-deliberate failure to notify below 10%. However care should be taken to avoid the cliff-edge situation where a person who disclosed just before the end of the permitted period would benefit from the extra abatement, but not a person who disclosed just after the end of that period but whose circumstances were otherwise similar. **We recommend that additional words such as 'or such longer period as HMRC might allow' following '[PERIOD]' would build some desirable flexibility into the legislation**.

- **We also recommend that the draft legislation should provide for time to start to run when the obligation to notify arose, or when the person first became aware of it, whichever is the later**.

In principle, a single legislative provision for reasonable excuse across HMRC is sensible, but the accumulated body of case law, and the role of the courts, should continue to be pivotal. To be harmonious with the penalties model for incorrect returns, the zero penalty where there is no loss of tax or the taxpayer has a reasonable excuse needs to embrace the situation where the taxpayer has made a genuine mistake despite taking reasonable care.

1. Introduction

1.1.1. The Low Incomes Tax Reform Group is an initiative of the Chartered Institute of Taxation to give a voice to the unrepresented in the tax system. We welcome the opportunity to comment on these proposals to extend the penalty framework in FA

2007, Sch 24 to other taxes and duties, and on a new penalty regime for failures to notify HMRC of a liability to tax. We approach this consultation from the perspective of the unrepresented taxpayer on a low income, and have answered those questions in the condoc which seem to us to be within that focus. That accounts for the fact that we have not answered all of the questions.

2. Extension of existing framework to other taxes

2.1. ***The design principles in 2.4***

2.1.1. The design principles set out in para 2.4 seem reasonable. We would like however to see a further principle added: that legislation and guidance on penalties should be accessible, clear and easily understood.

2.1.2. It should be easy for people to find out, in whatever communication medium best suits them (print as well as internet), what the consequences of non-compliance are likely to be. It is important also for people to know the likely amount of a penalty so they can tailor their behaviour accordingly; guidance on enforcement should therefore be made public as well as the legislation, and should be widely disseminated, not sent just to people at risk of a penalty.

2.1.3. Also, whatever is published must be in a form which the lay public can easily understand. Simply publishing internal guidance, replete with arcane statutory references and technical jargon, will not meet this test.

2.1.4. Most importantly, the obligations to be reinforced by the new penalties system must be clear and comprehensible, otherwise bad law results. An example is the obligation in tax credits to report changes in normal weekly working hours outside certain limits. The practical difficulty, in a flexible labour market, that many workers have in detecting a normal pattern to their working hours has led on occasion to their being given certain advice by the tax credits helpline, then investigated by compliance teams for following that advice, because HMRC itself is confused about the nature of the obligation.

2.1.5. Imposition of penalties for supposed failure to comply with badly formulated legal obligations can only result in injustice and absurdity.

2.1.6. Finally, penalties are of limited use unless they can function as an incentive as well as a deterrent. This principle is touched on in the first design principle, to ‘reinforce legal obligations thereby encouraging compliance’, and stated in terms in para 4.4. There is sometimes a fine balance to be struck between encouraging compliance and deterring non-compliance, deterrence being served by the penalty itself, encouragement by its mitigation; and this response will in part consider whether the mitigations proposed are enough to encourage the non-compliant to become – and to remain – compliant.

2.2. ***HMRC would welcome views on whether extending the penalty regime legislated in Finance Act 2007 to other incorrect returns for other taxes would meet the aims and design principles in chapter 2.***

2.2.1. On the whole we agree that the list in chapter 4 is sensible, as is the principle that the penalties framework should be similar across the taxes.

2.2.2. Two omissions from the list are the national minimum wage (NMW) and tax credits. The exclusion of the NMW is reasonable as the offence is against the employee, not HMRC. As for tax credits, we are in consultation with HMRC on revisions to the scheme of tax credits penalties. There, we have expressed our concern about proposals to tailor penalties to the amount of tax credits overpaid. Tax credits overpayments commonly reach significantly higher levels than the majority of ordinary tax debts, and gearing penalties to them will lead to disproportionately higher penalties. It will also blur the differential between the behaviour-related categories because of the need to keep within the statutory maximum of £3,000.

2.2.3. We are concerned that tax credits penalties should mirror the proposals for the main taxes at least to the extent that the dividing lines between innocent mistake and failure to take reasonable care should follow the same basic guidance; and that there should be the same facility for reducing penalties for the latter to nil in appropriate circumstances. It would be wrong for different parts of HMRC to adopt different thinking and different guidelines when applying the same basic principles.

2.3. ***Are there other areas where guidance on reasonable care will need to be expanded if the penalties for incorrect returns are extended to other taxes?***

2.3.1. Extended guidance will be needed particularly where there is reliance on others, as discussed at para 4.17 and para 1A of the illustrative Schedule. We are interested in the situation described in para 4.18, where a beneficiary who might benefit from an understatement of inheritance tax by the personal representative deliberately withholds from the personal representative information about the deceased's assets. At a time and in a geographical area where house values can take an otherwise modest estate above the inheritance tax threshold, the personal representative will sometimes be unrepresented.

2.3.2. In such cases, extended guidance would have to deal with a situation where a personal representative, despite taking all reasonable care, was misled by a beneficiary in the manner described; also to deal with the peculiar difficulty of giving a full and accurate account of all of a deceased person's assets and any gifts within the seven years before death.

2.4. ***HMRC would welcome views on whether a provision to charge a penalty on a third party for deliberately inaccurate information meets the aims and design principles in chapter 2. Does the proposed legislation achieve its aim?***

2.4.1. Yes, we believe that a provision such as outlined in para 4.18 would meet the aims and design principles in chapter 2. The question whether the proposed new Schedule, para 1A should apply will inevitably become, or even start as, an issue between P (the personal representative) and T (the beneficiary to be charged with the penalty). In those circumstances, it would be equitable to give a right of appeal to P against any refusal by HMRC to pursue T for a penalty it was seeking from P; as well as to T against the imposition of the penalty. The proposed amendments to para 15 seem to achieve this, but maybe para 17 needs to be amended to give the appellate tribunal power to join T in any appeal proceedings brought by P, and vice versa.

2.4.2. There also needs to be a limitation on HMRC recovering more than 100% of a penalty by penalising both P and T.

3. Failure to notify

3.1. ***HMRC would welcome views on whether the suggested new penalty regime for failure to notify would meet the aims and principles outlined in chapter 2. Does the proposed legislation achieve its aim?***

3.1.1. We agree, on the whole, that the suggested new penalty regime for failure to notify does meet the design principles set out in chapter 2, and that the legislation achieves its aim, subject to the points made in the paragraphs which follow and in the answers to the questions below.

Level of maximum abatements

3.1.2. We do not understand why, when the penalty model is so similar to that for incorrect returns, the draft legislation differs in the one respect that it does not provide for full abatement for non-deliberate failure to notify.

Prompted vs unprompted disclosure.

3.1.3. A person may make a prompted disclosure in a case where their disclosure would have been unprompted had they known of their obligation to notify. Because they were not aware of any obligation to notify (and would be able to show that their ignorance was not unreasonable), they would only ever notify if prompted to do so. A prompted notification, in such circumstances, may be of no lesser quality than an unprompted notification and would merit the same mitigation.

3.2. ***Does relating the penalty to tax unpaid as a result of failing to notify (and repealing the £100 fixed penalty for Class 2 NICs) provide sufficient reinforcement of the obligation for new businesses to notify?***

3.2.1. We very much welcome the repeal of the £100 fixed penalty for non-registration for Class 2 NICs. We have heard of many wholly honest people falling foul of this arbitrary impost, often not knowing how to get the penalty vacated once it had been automatically imposed, and resenting the fact that their first contact with HMRC had been of this nature.

3.2.2. We agree that the obligation to notify HMRC of the start of a business should remain. But we share the view of many members of the public that to impose two separate notification requirements, with different deadlines for self-assessment income tax and for Class 2 NICs, seems perverse.

3.2.3. We are disappointed that it is thought ‘impractical’ to align the statutory deadlines when good work has already been done, and more is clearly planned, on aligning their practical effect (para 5.3). We hope that further work can make greater progress towards aligning the statutory notification dates.

3.2.4. We agree with the principle (para 5.13) that there should be no penalty for failure to notify unless there is unpaid tax as a result, but it is important that no more than one tax-geared penalty is imposed in respect of the same amount of tax. The illustrative draft legislation (para 10 of the Schedule) seems to achieve this. It is also important (as mentioned at 3.4.2 below) that the size of a penalty should not become disproportionate to the behaviour which gave rise to it simply because it is based upon more tax accruing over a longer period.

3.3. ***Do the reductions for disclosure strike the right balance between encouraging people to come forward and not disadvantaging the compliant?***

3.3.1. We said at the beginning of this submission that there was a difficult balance to be struck between deterring non-compliance and encouraging a previously non-compliant person to become, and remain, compliant. We are concerned that a person who has been deliberately non-compliant, eg worked in the informal economy for a number of years, but who now genuinely wants to straighten out their tax affairs, would face a penalty of at least 20% of any unpaid tax or duty.

3.3.2. There are many reasons why people work in the informal economy, most of them economic and social rather than simple desire to cheat the system[1]. Often people are substantially worse off when they lose benefits due to starting work, unless they are fortunate enough to fulfil all the qualifying conditions for working tax credit[2]. This is often related to the extraordinarily low level of earnings disregards in the benefits system, first introduced in 1982 and kept at the same rate since then despite regular upratings of other economic and fiscal instruments such as the national minimum wage, tax, NIC and benefits rates.

3.3.3. We believe there is a strong case for challenging the widespread perception that there are disincentives to entering the formal economy by making it easier to do so. While we recognise the need to maintain a deterrent for those who are caught out, we believe that for those who come forward voluntarily, a minimum penalty of 20% of unpaid tax, in addition to accumulated interest perhaps over many years, is likely to strengthen disincentives rather than dismantle them. Paying the tax plus interest due will, to them, seem a considerable penalty and incentive to stay in the informal economy. At the same time we recognise that they have committed an offence. But there is a balance to be struck.

3.3.4. We note that para 9 of the illustrative Schedule allows a special reduction 'if HMRC think it right because of special circumstances'. **We would strongly urge HMRC to recognise cases such as those described above as 'special circumstances' in order to encourage people to start participating in the formal economy**. Any penalty imposed in addition to interest should be kept to a minimum, or even stayed altogether.

3.3.5. Once somebody has voluntarily left the informal economy, it is vital to ensure that they do not backslide. Accordingly, **we recommend that suspending a late notification penalty could do much to encourage a person, once in the formal economy, to stay there.**

3.4. ***HMRC would welcome views on whether there should be still greater reductions for disclosure than shown in the chart at paragraph 5.24, where disclosure is within a short period of the date required for notification.***

3.4.1. In principle, we agree there are circumstances in which the penalty for non-deliberate failure to notify should be abated below the minimum 10% normally permissible. A disclosure that is made late, but not too long after the date on which it should have been made, may be one such circumstance. However we feel the illustrative drafting (Schedule, para 8(5)(a) and (b), (6)(a) and (b)) would produce a cliff-edge situation

[1] See *Need not Greed – People in Informal Work* (Katungi, Neale and Barbour, JRF June 2006)

[2] See *Interact: benefits, tax credits and moving into work* (Community Links, Low Incomes Tax Reform Group, Child Poverty Action Group, December 2007)

where a person who disclosed just before the end of the permitted period would benefit from the extra abatement, but not a person who disclosed just after the end of that period but whose circumstances were otherwise similar. That could lead to unfairness. **We recommend that additional words such as 'or such longer period as HMRC might allow' following '[PERIOD]' would build some desirable flexibility into the legislation**.

3.4.2. It is not necessarily the case that the seriousness of the offence increases in proportion with the length of the period of non-disclosure, particularly where a person does not know of the obligation to notify (especially where their lack of knowledge proves to be 'reasonable'). It would be perverse, in such cases, to penalise A more than B because A happened to find out about his or her obligation after (say) two years, while B knew about it within (say) six months. The criterion there should be not how long it took A or B to find out about their obligation, but how promptly they acted once they were aware of the facts. **We therefore recommend that the draft legislation should provide for time to start to run when the obligation to notify arose, or when the person first became aware of it, whichever is the later**.

3.5. ***HMRC would welcome views on whether a single legislative provision for reasonable excuse across HMRC would strengthen this safeguard and also comments on whether the illustrative drafting would be appropriate across all of the current taxes.***

3.5.1. In principle, a single legislative provision for reasonable excuse across HMRC is sensible, but there is a considerable body of case law on reasonable excuse and we trust that any proposed definition will (a) faithfully take into account all extant decisions to date, and (b) not fetter the jurisdiction of the courts in any future appeals.

3.5.2. The proposal to apply reasonable excuse in cases where a person has reasonable grounds for believing that no obligation existed is welcome. The question will arise as to what are taken to be reasonable grounds, and here the characteristics and capabilities of the individual taxpayer will be crucial. The fact that a taxpayer does not have and cannot afford professional advice, for example, should normally constitute reasonable grounds. Other characteristics of the individual taxpayer – for example levels of educational attainment, literacy or numeracy, or any special needs such as disability or language issues – will also be important factors.

3.5.3. HMRC should also take full account of the quality of its own information sources, particularly at a time when general cutbacks are leading the department to economise both on the availability of printed guidance, and on the extent of the information given to the taxpayer. The recognition, in para 5.3, that 'there is still a lot of work to do to improve the overall notification processes', is welcome in this context.

3.6. ***HMRC would welcome views on whether the proposed reasonable excuse provision affords the appropriate level of protection to those taxpayers who have reasonable grounds for believing that no obligation existed. Is the illustrative drafting effective?***

3.6.1. To be harmonious with the penalties model for incorrect returns, the zero penalty where there is no loss of tax or the taxpayer has a reasonable excuse needs to embrace the situation where the taxpayer has made a genuine mistake despite taking reasonable care. On the whole we agree that the example in para 5.27 does this.

3.6.2. There will be other examples of genuine mistake that led the taxpayer to believe there was no obligation to notify, or not to think that there was any obligation. For example, foster carers and adult placement carers are treated as 'self-employed' for tax purposes. Therefore, they may be obliged to register for Class 2 NICs, even though in practice few earn above the SEE limit. It is not uncommon for such carers to find out, many years after starting their caring activities, that they should register for Class 2, whereupon they do so and are charged a penalty. Sometimes the penalty is vacated later on, depending on whether the carer knows that they can appeal. It would clearly be disastrous if such people were to be charged a tax-geared penalty under the new model, given that the generous tax exemptions now available were not introduced until 2003/04; and we sincerely hope that it would always be accepted that they had a reasonable excuse for late registration in such cases.

3.7. ***Illustrative drafting***

3.7.1. Our only comment on the drafting of para 15 relates to sub-para (2)(b):

'where P relies on any other person to do anything, that is not a reasonable excuse unless P took reasonable care to avoid the failure to comply with the relevant obligation . . . '

3.7.2. It should be acknowledged that if P has taken reasonable care to appoint a reputable agent or intermediary, including a voluntary sector adviser, and genuinely believes them to be capable, that should in itself be enough to establish reasonable excuse.

LITRG
6 March 2008