

LOW INCOMES TAX REFORM GROUP

HM Revenue & Customs: Interest – Working Towards a Harmonised Regime RESPONSE TO CONSULTATIVE DOCUMENT

1. Executive Summary

- 1.1. As interest has the potential to be not only remedial but also penal, it is particularly important that changes to interest for late payment of tax and penalties for late filing of tax returns are looked at together, although consultations on the two issues have been published separately. The principle should be that late payment leads to an interest charge whereas late filing leads to a penalty. The two 'offences' are separate and need to be treated as such. There is no justification, for example, in both a penalty and interest on late payment (save possibly for a very late payment, discussed further below).
- 1.2. By linking the rate of interest added to overpayments of tax to savings, the consultation infers that a taxpayer would otherwise be holding the overpaid funds on deposit. In reality, statistics show that the majority in fact live on borrowings. We therefore recommend that this is taken into account when setting rates.
- 1.3. HMRC support for taxpayers – both in general terms and in facilitating payment – is vital to ensure timely payment and avoid interest charges. For certain cases, such as where the system deals with the taxpayer unfairly, we recommend that consideration be given to reducing, suspending or cancelling interest charges while a debt is being cleared via time to pay.
- 1.4. Time to pay could be complemented by flexible payment plans, allowing taxpayers to pay towards their tax liabilities in advance (and thereby avoid being caught in a downwards and potentially inescapable debt spiral). Interest and incentives to enter in to such arrangements would be important considerations in their design.
- 1.5. We note, and agree with, the document's use of 'recompense' rather than 'commercial restitution' as a guiding principle for the interest regime. But this cuts two ways: there are, unfortunately, many situations in practice where the taxpayer needs recompense and interest is the obvious route rather than a complex and uncertain claim for costs.
- 1.6. A distinction must also be made between those who choose to pay early and those who are forced to pay early. For those without a choice in the matter, the current system offers inadequate recompense, yet addressing this issue is, it seems, outside the scope of the present consultation. We discuss this further under the heading of

‘claims for repayment’ below.

- 1.7. HMRC errors and processing delays can result in further loss to the taxpayer in situations where interest is not accruing. Safeguards should therefore be revisited to compensate taxpayers automatically for HMRC failures where interest does not provide adequate, or any, restitution. This also links closely to the concurrent consultation on a new Taxpayers’ Charter in terms of HMRC’s service standards.
- 1.8. As with any consultation, equality is a factor and we are concerned that HMRC practices disadvantage some taxpayers. For example, those making claims for repayment are currently excluded from ‘Carter’ reforms as no online R40 is provided. Why should those claiming a repayment have to bear the processing delay of a paper claim while those in self assessment are offered the lauded service advantages of online filing? It may be that neither is entitled to interest on their repayment, but the SA online filer will obtain theirs that much quicker.
- 1.9. Whilst we appreciate that some of our points will be seen as outside the scope of the current consultation or simply outwith the ambit of the Powers team, we think they need to be considered to ensure that a fair and balanced package results. The Powers review is a fundamental exercise for HMRC as a whole; it would be wrong if the Powers team did not, for example, make strong internal representations that an on-line R40 is a necessary part of the reform package.
- 1.10. Finally, we agree with a number of the proposals, ie that:
 - simple interest is the easiest method of calculation;
 - the Bank of England base rate should be the starting point for the rate calculation;
 - alignment of rates across the taxes is generally acceptable, but there may be exceptional cases which require differing treatment;
 - the tax treatment of interest should be aligned – we recommend making it non-taxable and non-tax deductible in all cases.

2. Introduction

2.1. *About us*

- 2.1.1. The Low Incomes Tax Reform Group (LITRG) is an initiative of the Chartered Institute of Taxation (CIOT) to give a voice to the unrepresented. Since 1998 LITRG has been working to improve the policy and processes of the tax, tax credits and associated welfare systems for the benefit of those on low incomes.
- 2.1.2. The CIOT is a charity and the leading professional body in the United Kingdom concerned solely with taxation. The CIOT’s primary purpose is to promote education and study of the administration and practice of taxation. One of the key aims is to achieve a better, more efficient, tax system for all affected by it – taxpayers, advisers and the authorities.
- 2.1.3. Low-income taxpayers are likely to suffer the greatest disadvantage by being in debt, be it through private borrowings or struggling to meet liabilities such as tax. For them, credit is not a luxury but an unfortunate necessity and many can ill afford interest charges, particularly those levied at penal rates. This is therefore the background to our response.

3. General comments

3.1. *Links to other consultation*

- 3.1.1. We note that this consultation document was not published as part of the *Modernising Powers, Deterrents and Safeguards* series; yet interest charges are in many ways closely linked to the consultation on *Meeting the obligations to file returns and pay tax on time*, with particular regard to the timely payment of tax. Although we are submitting a separate response to that consultation, we stress that any changes to penalties and interest on late payment of tax should not be viewed discretely; not least because interest in itself has the potential to be not only remedial but also penal. We understand that HMRC also believe that the issues are closely linked.
- 3.1.2. For example, in our response to the penalties consultation, we comment on the issue of interest being charged on penalties. Given that HMRC's stated intention is for interest to be purely recompense, there is no justification for continuing the practice of charging interest on penalties which did not form part of the original tax liability.

3.2. *Alignment*

- 3.2.1. Before answering the questions summarised in Chapter 8, we firstly comment on the general principle of alignment. Whilst we support alignment where it results in a simpler, fairer tax system, each consultation should open with the question of whether alignment is appropriate.
- 3.2.2. The very large majority of individual taxpayers, including small and very small unincorporated businesses, will be concerned with only one or perhaps two taxes. This does not mean that alignment, in most cases, should not be pursued, but it is unlikely that most taxpayers will perceive differences in treatment under the current system. Consequently alignment in itself is not a significant issue and there are instances, such as with inheritance tax, where non-aligned rates could be justifiable.
- 3.2.3. It is interesting to note from para 2.3 that '(15%) of tax receipts are paid late, though a significant proportion of these are paid within a few days of the due date'. Whilst we understand the drivers to improve timely payment of tax, in comparison with the commercial sector HMRC already arguably achieve a high level of compliance. Further analysis of the types of tax paid late and by how long payment is delayed would have been useful to provide some indication of what influence the existing variance in rates has on promptness of settlement – or, indeed, whether they are a factor at all. Fundamentally, how much of a problem do HMRC really have?
- 3.2.4. Alignment here seems principally to have been discussed in the context of the way interest is calculated rather than on fundamental alignment of the system. Para 5.7 notes that there are inherent differences in the existing system regarding dates from which interest is charged and paid, but that changing these is outside the scope of this consultation. We think it is far more important to consider whether the principles of fairness, simplicity and recompense would not be better served by aligning interest on tax paid late and tax overpaid, than by simply aligning interest rates between one tax and another. There needs to be a complete review of the system – all areas need to be considered. If some aspects such as this are said to be outside the remit of the Powers review, then the review team needs to report that it cannot do a complete job.

3.3. **Commercial comparisons**

- 3.3.1. Para 3.3 states that HMRC are reluctant for taxpayers to be paid interest on tax paid 'early' (ie to be viewed as a 'bank') but have to compare the rates they charge and pay based upon commercial lending and deposit-taking. But, in reality, such a comparison is impossible – especially viewed in the context of alignment across all types of taxpayer and all taxes – as the commercial sector will vary interest rates and terms according to the customer's individual situation and risk profile. Banks also use different rates for lending and deposit-taking to reflect their need to make a profit, which is not HMRC's aim.
- 3.3.2. These considerations reflect back on the *Payments, Repayments and Debt* consultation, which suggested that taxpayers who wish to deposit funds with HMRC in anticipation of future liabilities should be encouraged to do so. Such sensible budgeting and planning ahead should not be discouraged through a failure to offer interest or some other 'incentive' to do so. Similarly, taxpayers with an open enquiry will often wish to make a precautionary payment to HMRC if there is a liability under dispute to ward off potential interest charges. But equally they should receive recompense if the tax is found not to be due on closure of the enquiry. In such circumstances, it is difficult to see how HMRC can avoid altogether acting as a deposit-taker.
- 3.3.3. We would also note in this context the need for HMRC to offer regular payment plans in the mode of utility companies. Such plans do not have interest implications but they would be an important payment option if offered by HMRC.

3.4. **Tax credits, child benefit**

- 3.4.1. We note from para 1.2 and footnote 3 that the review does not cover tax credits and child benefit.
- 3.4.2. Interest may charged on overpayments of tax credits only where fraud or neglect is involved, but we know of no case where HMRC have exercised their discretion in this way. Interest is chargeable on overdue penalties (S37 Tax Credits Act 2002), but again HMRC may mitigate or remit any interest which would otherwise be payable. We do not believe that any changes should be made to this.

3.5. **Claims for repayment**

- 3.5.1. One noticeable omission from the consultation document is the situation where the taxpayer is owed a repayment but has to submit a claim to HMRC for this to be issued, for example on tax deducted at source on bank interest or overpaid PAYE.
- 3.5.2. Some taxpayers are of course eligible for payment of gross interest on bank accounts, but others with a small tax liability routinely overpay tax throughout the year and have to make a reclaim. For instance, this will apply to those having to 'claim' the 10% savings rate introduced by Section 5 and Schedule 1 of FA 2008. Similarly, on some types of income interest has to be paid net (such as interest on pooled investment funds – unit trusts etc), in which case even non-taxpayers are forced to overpay and claim a refund.
- 3.5.3. This problem could, in part, be mitigated by expediting repayments to taxpayers through better matching of data held by HMRC. But – as illustrated by the recent

deferral of the new PAYE service implementation¹ – this seems far from being realised.

- 3.5.4. Section 824(3)(b) ICTA 1988 tells us that for income tax deducted at source, the 'relevant time' from which repayment supplement runs is 31 January following the end of the year of assessment in which tax has been overpaid.
- 3.5.5. Yet even those taxpayers who promptly submit a repayment claim can experience a delay of many weeks or even months before HMRC issue the refund. Unless this delay extends beyond 31 January, no compensatory interest is awarded to the taxpayer. This is particularly harsh in the following example, which is based on a recent case seen by a TaxHelp for Older People (TOP)² adviser.

Example 1

Ms M is 83. In 2007/08, she received pension income of £6,195. She also has some non-ISA savings which generated £2,105 gross interest, with tax of £421 deducted at source. On 17 April, she visited a TOP adviser who helped her complete the R40 to claim a repayment of £360, which she posted to HMRC immediately.

Ms M eventually received a cheque for her repayment on 27 June. This was after considerable confusion with moving her records between offices and Ms M being told on the telephone that the National Insurance number she has used since age 16 did not exist and she should go to her local JobCentre Plus to ask them to trace the correct number. Ms M commented that in the past she had always received her cheque within two or three weeks and could not understand what had happened.

- 3.5.6. If we assume that interest is credited to Ms M's accounts annually on 31 May each year, the Exchequer has already had use of the overpaid tax for 10 months before a claim can be submitted. For someone so prompt and organised in dealing with their affairs as Ms M, the reward was confusion, further delay in excess of two months, and – importantly – no compensatory interest. HMRC could achieve a higher degree of respect if their expectations of taxpayer compliance were matched by their own high standards of service.
- 3.5.7. This 'service delivery' issue links in to the consultation on a new Taxpayers' Charter and what standards can be expected from HMRC. Taxpayers need to be adequately compensated for an unreasonable delay in processing; something which does not currently happen as a matter of routine.
- 3.5.8. Under 'safeguards', para 2.8 says that HMRC will reduce or cancel an interest charge if the taxpayer contends that HMRC have made a mistake or delayed unreasonably and HMRC agree with this – but HMRC are judge and jury in their own cause (unless the taxpayer complains to the Adjudicator or Ombudsman). Also, this does not address the reverse situation outlined above of HMRC inadequately compensating taxpayers where they have held on to overpaid tax due to a mistake or unreasonable delay. How is it proposed that such complaints from the taxpayer will be dealt with? And how will the taxpayer be advised that they are able to query an interest charge or escalate their complaint?

¹ <http://www.hmrc.gov.uk/pay/deferral-new-service.htm>

² Tax Volunteers, Registered Charity No. 1102276

- 3.5.9. There is also a related issue of some workers, such as students, who regularly overpay tax via PAYE. It remains to be seen what the recent student tax code consultation¹ will produce. If the result is standard PAYE, students will continue to regularly overpay tax on their wages. This is again an injustice in the current system, which does not seem to be addressed – or even acknowledged – in this consultation.
- 3.5.10. Another area which is not covered in the consultation document is interest on claims by charities. This needs to be looked at separately.

‘Carter’ online developments and disadvantage for those claiming repayment

- 3.5.11. In terms of the delays highlighted above, those claiming repayment via the R40 system are currently disadvantaged due to the lack of an ‘online’ filing service. Whilst many low-income taxpayers may not find electronic means of interacting with HMRC readily accessible, there are those who would benefit from this. For instance, in 2002 Leonard Cheshire did a study which showed that 54% of disabled people considered internet access essential, indicating they might well make use of such online services.
- 3.5.12. Online filing of self assessment tax returns supplies an instantaneous tax calculation and expedites the repayment where one is due. R40 filers have no such opportunity; they have to continue to file on paper and in so doing are disadvantaged through exposure to manual processing delays.
- 3.5.13. We therefore urge HMRC to review the repayment claims process and ensure that taxpayers are put on an even footing no matter which system they fall into – self assessment, PAYE, or neither (R40). Although the Powers team may have no ability to change the R40 system, they need to make the point strongly within HMRC that improving the R40 is an important part of modernising the interest and payment system.

3.6. ***Time to pay***

- 3.6.1. In genuine cases of hardship, it seems unfair that interest keeps running on the amount outstanding while the taxpayer is trying to clear the balance. Certainly any penalties should be suspended whilst the taxpayer is clearing a debt through a time to pay agreement and continues to honour that agreement. We can accept that if the agreed payment pattern is broken, then interest should start to run again, apart from in exceptional cases where there are extenuating circumstances potentially causing extreme hardship.
- 3.6.2. For example, it is particularly harsh for the pensioner who unexpectedly finds they have a tax liability which has to be paid as a lump sum. Our reports on tax problems faced by older people² identify one such instance, where the only or main source of income is the state pension on which tax has to be collected via self assessment. When the pensioner first becomes aware of the liability, it is probable that they will not have set aside anything from their – already meagre – income to clear it. Even agreeing a time to pay arrangement, they can then end up in a vicious circle of debt for, as they are clearing their arrears, the current year’s liability continues to accrue.

¹ Consultation document - <http://tinyurl.com/686ppx>; and LITRG response - <http://www.litrg.org.uk/reports/submissions.cfm?id=544>

² LITRG pensioner reports - <http://www.litrg.org.uk/reports/reports.cfm?id=437> and <http://www.litrg.org.uk/reports/reports.cfm?id=67>

Charging interest while the arrears are being paid off compounds the problem. The root issue could be solved by DWP selectively operating PAYE on state pensions.

- 3.6.3. The following generalised example (but based in fact from everyday cases seen by TaxHelp for Older People) illustrates this point:

Example 2

Sheila retired on 6 April 2008 – her 60th birthday. Her only source of pension income is from the state, of £145 a week. She has no savings as she lives in a Victorian cottage and has been forced to take out a small mortgage to pay for repairs to the roof. Sheila, not uncommonly, does not understand that the state pension is taxable and is surprised to receive a tax return in April 2009. When she completes this, she finds she has a tax liability for 2008/09 of £301, which has to be paid on 31 January 2010. Not being able to pay this all at once, Sheila agrees a time to pay arrangement with HMRC. In the meantime, interest is running on the outstanding amount. Also, as she has no spare money to set aside for her 2009/10 tax liability, the problem is likely to persist year-on-year.

Sheila's twin sister, Annie, retired on the same day. Overall, both sisters are in a similar position financially. But Annie's pension income is made up differently – she receives £100 a week from the state and £45 a week from a company pension. Due to a mix up over PAYE codes, Annie pays no tax at source on the company pension until April 2009 when HMRC review her record. PAYE deduction then commences from April 2009 and the 2008/09 underpayment of £301 is 'coded out' in 2010/11. Although Annie will be paying back her arrears over a similar period to her sister, she will not suffer an interest charge.

- 3.6.4. So if you are within self assessment you are expected to make restitution to the Exchequer which you are not expected to make if you are taxed through PAYE. This makes for neither 'fairness' nor 'simplicity' in the interest regime. Moreover, if interest is supposed to be pure restitution, why is it that one taxpayer has to pay because they are in self assessment, while another whose circumstances are virtually identical does not, because she is taxed under PAYE?

3.7. ***Reasons for taxpayers paying late***

- 3.7.1. Para 2.2 does not seem to do justice to the myriad reasons a taxpayer may be late paying their tax. For instance, it refers to temporary cashflow problems but not longer term difficulties. There are many personal reasons such as separation, divorce, loss of employment/downturn in trade, death of a family member, health issues and so forth which all seem to be swept into a general comment about 'deeper problems', in which case taxpayers are encouraged to contact HMRC to discuss how to settle their liabilities. This fails to recognise that in certain difficult circumstances, taxpayers may not be in a position to contact HMRC, nor might tax be at the forefront of their mind.
- 3.7.2. In cases such as these, manual intervention may be required by HMRC to ensure that taxpayers are helped in resolving their problems and that tax compliance does not further compound whatever other difficulty it is they are experiencing. Tactful handling and sympathetic officers are needed to contact the taxpayer in the event of some unusual event. It is understood that flags or alerts are set in HMRC's computer

systems to identify potential issues of non-compliance, so it should be possible to create similar electronic identifiers of cases for review.

- 3.7.3. For instance, there may be a case where a taxpayer has hitherto been fully compliant in their dealings with the tax authorities, but on 31 January 2008 failed to pay their income tax self assessment tax liability. The system should be capable of identifying such cases so that an officer investigates the reasons behind non-payment rather than automatically taking penal action. It is difficult to suggest how this might be achieved without understanding the capabilities of HMRC systems, but perhaps a small sample of penalty cases could be reviewed or further data analysis undertaken to gauge the feasibility and cost of such an initiative.
- 3.7.4. If there is a case of hardship, should it not be the case that HMRC have some discretion to suspend or waive interest charges while the problems are resolved? This would engender a more cooperative spirit between authority and taxpayer. We also comment on the advantages of penalty suspension in response to the parallel consultation on filing and paying tax on time.
- 3.7.5. With changes in payment methods and an ever-greater push towards all things electronic, there is scope for non-payment due to confusion. The need for HMRC to support taxpayers is therefore emphasised. Para 3.7 says *'HMRC currently supports people to pay on time through:...support available when making a payment, for example, on the telephone...'*. Whilst it is true that telephone support is theoretically available, lines are frequently inaccessible and particularly so at busy times of the year such as payment deadlines. Face to face support has also dwindled and become less accessible through centralisation, making it difficult for those who used to obtain help by dropping into the local tax office to obtain the same levels of support as in the past. Again, there is an issue of service standards here to be considered in the context of the Taxpayers' Charter consultation.

3.8. ***Tax paid early***

- 3.8.1. In part, the issue of early tax payment comes back to the continuing developments in HMRC debt collection methods, particularly the potential to offer flexible payment plans.
- 3.8.2. Para 3.6 says *'Where tax is paid before it is due this is generally the decision of the taxpayer. The amount does not need to be paid until the date established in the legislation.'* We do not agree with this statement, as there are many reasons for overpaying tax or paying before the due date, for instance:
- Some people wish to pay early as a way of budgeting for tax liabilities, which comes back to having more flexible or regular instalment options under self assessment.
 - For the most part people may not realise they have overpaid and the SA system of payments on account inhibits you from incautiously underpaying. This generally means that most overpay even where a reduction later proves to have been possible. Also, taxpayers can unwittingly overpay when tax is deducted at source, for example where someone is ineligible to file an R85 on bank interest but is not fully liable at the basic rate.
 - The uncertain nature of paying by cheque or the banking system may lead people to pay at least a few days early – some up to a few weeks – due to 'fear of the authorities' and making sure they get their tax paid on time.

- 3.8.3. Exploring further the first bullet above, we can go back to the Sheila's case in Example 2 above.

Example 2 - continued

Supposing Sheila files her 2008/09 tax return as soon as she receives it in April 2009. Not having access to the internet, she sends back the paper form. Her tax calculation might arrive by post at the end of June advising of her tax liability in January 2010. Sheila panics, wondering how she will afford to settle this in full at the end of January.

- 3.8.4. What are Sheila's options under the current system? As at June 2009, it is difficult to see how Sheila can contact HMRC and agree time to pay arrangements, as her liability is not yet due and HMRC do not want her to pay early. She therefore decides to open a separate account and save a little each month towards the January bill. But this seems to produce a somewhat unfair result in that the money she manages to save before the end of January will generate interest which is taxable. For the remainder of the liability, she has to agree time to pay, yet this will accrue non-tax deductible interest. Further consultation on flexible payment arrangements addressing this point is needed.
- 3.8.5. Para 2.3 indicates that HMRC know how much is paid late (including how much is paid a few days after the deadline). It would be similarly interesting to know how much tax is paid early and how early it is paid. The former taxpayer bears an interest charge, but the latter receives no compensatory interest, therefore failing to meet the objective of 'fairness'.

4. Consultation Questions

Following on from the general comments above, we now give our thoughts on the specific questions summarised in Chapter 8.

- 4.1. ***Question one – Which of the options for a starting point for the interest rate formula best fits with the design principles of recompense, fairness and simplicity for the majority of taxpayers?***
- 4.1.1. Given that the Bank of England rate is now set independently, it seems sensible to make that the reference rate rather than a random consortium of High Street banks. It is a reasonable tracking device for the rates used by the High Street banks and is familiar to the general public, with Monetary Policy Committee decisions being immediately widely reported after their announcement.
- 4.2. ***Question two – How far should the difference between the rate of interest charged by HMRC and paid by HMRC reflect the difference between the borrowing and lending interest rates used commercially?***
- 4.2.1. This question presupposes that respondents agree a difference is necessary at all. For income tax, under the pre-self assessment regime, mirrored rates were in place. They were replaced by diverged rates when SI 1996/3187 (amending SI 1989/1927) came into effect on 31 January 1997. These changes were foreshadowed in the Inland Revenue booklet SAT2 *Self Assessment: The Legal Framework*. The contents of para 3.114 from SAT2 are interesting to note (emphasis added to last sentence):

‘SAT2 Self Assessment: The Legal Framework***Rate of interest******Section 178 FA 1989***

3.114 The rate of interest will be calculated using a formula to be set by regulations. Rates will change automatically when there is a change in the bank base rates. The rate charged on late tax will be in line with the average rate for borrowing. The rate paid on overpaid tax will be in line with the average return on profits.’

- 4.2.2. Para 4.10 of the consultation document confirms however that all interest rate *‘formulae have the same starting point... an average of the basic lending rates applied by six of the UK’s banks.’* So interest rates are used as the reference for ‘average return on profits’ but of course ‘profits’ may come in all manner of guises, not just interest.
- 4.2.3. Para 4.20 goes on to note that *‘Differential interest rates were then considered more appropriate to: encourage taxpayers to pay on time; provide appropriate recompense to both the Exchequer and taxpayers; and better reflect the differential in commercial rates for borrowing and saving.’* These points do not appear entirely consistent with SAT2 quoted above as it refers only to ‘saving’ rather than ‘profits’.
- 4.2.4. Paras 3.2 to 3.6 fail to differentiate between amounts ‘deposited’ for tax and amounts overpaid. Importantly, it is also inferred that any money a taxpayer has overpaid came out of savings whereas for most low-income people it would reflect funds that could be used for day to day living or improving their quality of life. Awaiting a refund might well mean a taxpayer has extended borrowing in the meantime, for example by way of an overdraft, credit card or loan – the worst possible of these being those with a poor credit rating who have to resort to a ‘loan shark’ for funds to tide them over.
- 4.2.5. In such circumstances as those outlined above, it is inappropriate to compare the rate of interest paid on the refund with the rate the taxpayer could have received had they held the funds on deposit. Indeed, for the ordinary taxpayer, it is far more likely that they will be living on borrowings than with spare savings. There is no shortage of alarming statistics confirming this. According to Credit Action’s 1 August 2008 figures¹, the average debt (excluding mortgages) of those households with some form of unsecured loan is £21,650.
- 4.2.6. In context of the above, we feel that mirrored rates have considerable merit.
- 4.2.7. As a separate but linked point, we think that dates should be mirrored so that the taxpayer receives interest from the same point as interest becomes payable.
- 4.2.8. If, however, the consultation concludes that some divergence in rates is inescapable, we would argue that this is currently too wide. Given the evidence of taxpayer average borrowing levels cited above, the interest added to tax repayments should much more closely reflect borrowing rates rather than savings rates.

HMRC error

- 4.2.9. The consultation document uses the term ‘recompense’ rather than the traditional ‘commercial restitution’. We agree with this change but it has not really been developed fully in the paper. A general concern is that the taxpayer who is disadvantaged by an HMRC error is often paid a low rate of interest compared to

¹ <http://www.creditaction.org.uk/assets/PDF/stats/2008/august.pdf>

their likely interest bill at the bank. To this end, there is a strong case for a differential interest rate between an 'HMRC fault' occasion and a situation where the taxpayer has simply overpaid or is perhaps claiming loss relief. This may be difficult to administer, but nevertheless in the interests of fairness the taxpayer should be properly compensated.

4.2.10. Accordingly, the safeguards discussed at paras 2.6 to 2.8 are somewhat unbalanced because they do not acknowledge the ways in which the taxpayer could be out of pocket. The recompense to HMRC is fair, but the design principles at para 3.1 should include provision for compensation for HMRC errors under the 'fairness' heading. In para 3.4, the word 'some' should also be deleted from the statement that *'where HMRC delays repaying overpayments of tax, then interest should be paid to the taxpayer to provide some compensation for the loss of use of the overpaid amount'*. In this regard, the dictionary definition¹ of recompense is 'compensation for loss, injury, etc'; we see no need for qualification of this.

4.2.11. In light of the above, in the event of HMRC error – or indeed excessive processing delay – which leaves the taxpayer out of pocket, a system needs to be in place to ensure that full compensation is offered. If the interest payable does not provide adequate recompense, then extra compensation should be given, albeit perhaps dealt with separately. Where HMRC acknowledge an error or delay has occurred, they should automatically offer the taxpayer means of seeking redress.

4.3. ***Question three – What do you consider is the best way to strike a balance between delivering simplicity through stability and achieving recompense in setting the rates of interest charged and paid by HMRC?***

4.3.1. Interest rates clearly need to move in line with what the market says. The Bank of England base rate fluctuated more before 1997 than it does now that it is set independently, with the Monetary Policy Committee meeting and making rate decisions once a month. But of course the rate does not necessarily change every month. Taxpayers may feel the 'fairest' solution is for the HMRC rate to track the base rate, in common with some mortgages.

4.3.2. If, however, HMRC believe, following analysis of the consultation responses, that there is a case for less frequent changes, one solution is for HMRC interest rates to be reviewed quarterly and changed only if there is a need to move by (say) at least 0.5%, with some scope in the legislation for extraordinary review in the event of a significant change in the base rate in the interim.

4.3.3. The method of interest calculation and rates applicable must be published and clear so that taxpayers are able to understand and check the amounts charged or paid. In the interests of simplicity and understanding by taxpayers, we would therefore tend to agree that simple interest is more straightforward, although it does not entirely achieve commercial restitution.

4.4. ***Question four – Which of these approaches for charging interest on late payments of in-year PAYE do you feel best deliver the design principles of recompense, fairness, and simplicity?***

4.4.1. We comment on PAYE under question 5 below.

¹ Collins English Dictionary

4.5. ***Question five – Are there other approaches that could be taken for charging interest on late payments of in-year PAYE that would fit with the design principles of recompense, fairness, and simplicity?***

- 4.5.1. In the interest of fairness for all taxpayers, a pragmatic solution regarding the problem of in-year PAYE paid late does need to be found. Unrepresented employees can find themselves in dispute with HMRC where they have suffered a PAYE deduction but the employer has not made the proper declarations or payments to HMRC. A more robust system of in-year and post-year-end checks on employers would therefore provide an additional safeguard.
- 4.5.2. One solution might be a declaration at the year end of not only the total PAYE liability for the year, but also giving a breakdown of how this was made up across the year. This could be achieved by modifying the P35 and would save employers the additional administrative burden of monthly or quarterly returns in-year, whilst still providing the data to calculate interest charges. HMRC could then retrospectively take action to review the employer's records and/or charge interest if the return does not tally with the spread of payments made in the year.

4.6. ***Question six – This chapter has considered the possible features of a new interest regime. Your views are invited on how the options discussed meet the principles of recompense, fairness, and simplicity (as described in chapter three).***

International comparisons

- 4.6.1. Para 6.3 refers to the UK adding 2% to 2.5% to the reference rate, being at the lower end of the 'scale' compared to the other countries examined. However, the limited sample of countries taken is not large enough to have established a 'scale' at all and a wider international comparison would be necessary to give a true indication. Those selected in this sample may, or may not, give a false indication. International comparisons can be misleading, unless you compare the whole system and the basis on which it was founded. In many ways, the method of interest calculation in other countries is irrelevant if that implemented by HMRC meets the objectives it sets out to achieve.

Comparison with commercial banking

- 4.6.2. Para 6.8 gives a graph of repayment interest rates comparing them favourably against what a taxpayer could have achieved in an 'average savings account'. However, this judgement is somewhat unfair, as a taxpayer who has the choice of where to deposit funds is unlikely to select an account paying an 'average' rate of interest. There is therefore an argument for saying that the comparison should be made against the **best** rates that could have been achieved in the market, or indeed with borrowing rates to reflect more accurately the heavily-borrowed status of most taxpayers as discussed under question 2 above.

Offsetting of debts

- 4.6.3. The new offsetting proposals contained in Chapter 5 FA 2008 would be easier to understand if there were not different implications for interest, surcharges etc of offsetting a tax repayment or overpayment against an underpayment. Alignment of rates is one step towards simplification for this purpose, but unless other inherent differences are also ironed out, offsetting will continue to produce variable results depending upon the order.

Tax deductibility / charging tax on repayment interest

- 4.6.4. Paras 4.22 to 4.24 refer to the tax treatment of interest and the current differences in the system, inferring that alignment of treatment would be favourable. It is not clear however from reading the document whether this means that alignment should result in all overpaid interest being taxable and late paid interest deductible on the one hand, or (respectively) non-taxable and non-deductible on the other.
- 4.6.5. If interest were not deductible and not taxable, it would both keep matters simple and in many ways preserving fairness between individuals and businesses.
- 4.6.6. Alignment in the other direction – in effect making repayment supplements for individuals taxable and interest charges tax-deductible – would produce an unnecessary complication. For unincorporated businesses, interest on income tax being non-tax deductible has some logic, as tax is paid out of business drawings – it is not a business expense.
- 4.6.7. The result could also be a vicious-circle situation where a non taxpayer gets back his 20% tax on bank deposit interest and receives a repayment supplement with tax deducted.
- 4.6.8. On balance, therefore, we prefer the simple non-taxable/non-deductible route for interest.
- 4.7. ***Question seven – This chapter has considered how a new interest regime could be harmonised across all taxes - are there any conditions that are specific to any of the taxes that create a case for different treatment?***

Inheritance tax on estates

- 4.7.1. Timely payment of inheritance tax is often a problem, particularly for smaller estates (for instance, where the major asset is a property), as funds have to be raised to settle the tax before grant of Probate. Assets cannot be sold in the meantime and some executors may have difficulty in gathering together information and raising funds in the timeframe allowed. In the current economic climate, this problem will no doubt be exacerbated by the so-called 'credit crunch' for those needing to borrow. Linked in with the 'file and pay' consultation, there is a strong argument for evaluating together the ability of executors to file accurate returns and settle tax liabilities on time; a particular problem for those dealing with smaller estates who may be unrepresented. Penalties in this situation seem unduly harsh and there is an argument for a more lenient penalty regime coupled with a commercial rate of interest on late paid IHT.
- 4.7.2. Longer term IHT liabilities are currently subject to a reduced rate of interest where tax is paid by instalments and some tax – for example on partially-relieved business assets – is payable over a ten-year period on an interest-free basis (Ss227 to 229 IHTA 1984). A lower interest rate here does seem befitting to reflect the longer-term nature of the borrowing and HMRC has the 'security' that if the asset is sold, the outstanding tax liability becomes due.

4.8. ***Question eight – What other factors should be taken into account in setting the formula to determine the interest rates HMRC charge and pay?***

- 4.8.1. One issue that needs to be factored into the consideration is that different taxpayers have different situations. A small business or individual may be charged a much higher rate of interest than a large multi-national if they go overdrawn or otherwise are forced to borrow whilst, say, awaiting a repayment. As noted under question 2 above, this should have some influence on the interest rate decision as 'one size will not fit all' in terms of providing compensation for the taxpayer left out of pocket.

Time to pay

- 4.8.2. Given our comments above (para 3.6), we feel there is a case for considering charging a lower (or even in some cases nil) rate of interest where the taxpayer has entered into and is abiding by a time to pay agreement. Although we do not think that HMRC should necessarily look to the commercial sector in making their own arrangements, this suggestion could be based upon the distinction made by banks in the interest rates applied on 'authorised' as against 'unauthorised' overdrafts. This could have benefits in encouraging taxpayers to approach HMRC at an early stage and help them to clear their debt more quickly whilst still providing some recompense to the Exchequer. However, if the agreement is not adhered to by the taxpayer, we accept that interest should restart, apart from in exceptional cases as noted above.

Very late payment

- 4.8.3. There is a suggestion that very late payment of tax should be penalised through a higher rate of interest. We do not agree with this, though we have some sympathy with the concept of a penalty for very late payment, along the lines of the surcharges in self assessment. We think this is a simple route as it allows interest rates to remain standard. However, consideration of this issue needs to bear in mind our earlier comments on taxpayers who have genuine difficulties in meeting payment deadlines.

LITRG

11 September 2008