

Tackling the hidden economy: Sanctions
HM Revenue & Customs (HMRC) consultation document
Response from the Low Incomes Tax Reform Group (LITRG)

1 Executive Summary

- 1.1 We welcome the opportunity to respond to the HMRC consultation document on ‘tackling the hidden economy: sanctions’.
- 1.2 We acknowledge the important role that sanctions play in tackling the hidden economy, but we are pleased to note that HMRC are also looking at ‘promote’ interventions to create a complementary approach.
- 1.3 The hidden economy encompasses a broad spectrum of taxpayers, from larger, self-sufficient employers, who evade their Pay As You Earn (PAYE) responsibilities, to those engaged by such businesses, who are essentially victims too. We think this consultation should draw more of a distinction between different groups of taxpayers within the hidden economy, in particular we think some further consideration ought to be given to the imposition of harsher sanctions for those employers who do not operate PAYE on the earnings of those whom they employ.
- 1.4 We agree with the principle of penalties taking account of past behaviour. The idea of penalty escalation is therefore well worth exploring, but it is important that the design takes account of a variety of situations, such as occasions when what appears to be a repeat failure to notify is not, because it relates to a different source and type of income.
- 1.5 There must also be safeguards, including for failures that are a result of the taxpayer’s vulnerability. An additional safeguard, which might also assist in encouraging those who wish to be compliant to come forward, might be the use of suspended penalties.

- 1.6 Finally, although sanctions can be an effective deterrent, research suggests that there is a strong link between tax morality and compliance. We would therefore strongly encourage the use of educational activity and taxpayer support by HMRC, as well as publicity demonstrating the effectiveness of compliance activity rather than a heavy-handed approach.

2 About Us

- 2.1 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. Everything we do is aimed at improving the tax and benefits experience of low income workers, pensioners, migrants, students, disabled people and carers.
- 2.2 LITRG works extensively with HM Revenue & Customs (HMRC) and other government departments, commenting on proposals and putting forward our own ideas for improving the system. Too often the tax and related welfare laws and administrative systems are not designed with the low-income user in mind and this often makes life difficult for those we try to help.
- 2.3 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.

3 Introduction and General Comments

- 3.1 We previously responded to HMRC's 2015 paper, 'HMRC penalties – a discussion document'.¹ We think the penalty system should differentiate between those who deliberately and persistently fail to comply and those who occasionally fail to comply.
- 3.2 While we acknowledge the benefits that a digital tax system can bring to many, we note that there is a risk of some taxpayers, who feel unable to engage digitally, entering the hidden economy by default. This means the impact of the speed with which it is being proposed to roll out the Making Tax Digital (MTD) strategy on risk in relation to the hidden economy needs to be considered carefully. Care must be taken to recognise when sanctions are not

¹ <http://www.litrg.org.uk/latest-news/submissions/150512-hmrc-penalties-%E2%80%93-discussion-document>

the appropriate approach, and when support will be the right way forward, not just for the taxpayer, but also for HMRC, to ensure future compliance.

- 3.3 HMRC's principle about promoting good compliance (and making it easier for people to get things right) is one that we agree with. We are concerned that there is a mismatch between this message and policies such as the trading allowance of £1,000 and the rental allowance of £1,000 announced in Budget 2016. We understand that there is confusion about the start date for these allowances;² the lack of detail currently available about how they will operate also means there is a risk that some individuals will not notify new sources of rental or trading income to HMRC, mistakenly believing that they do not have to. So, unless good communications and educational messages surround the launch of these allowances, we think that there could be a risk of them leading to 'failure to notify' failures by taxpayers.
- 3.4 We welcome the fact that HMRC are seeking to develop new 'promote' interventions, including guidance and tools for new businesses and those about to start-up, and also work with schools. We would encourage the use of such programmes as education is key to enabling people to comply with their responsibilities. Historically there has not been any tax education in the school curriculum; even now, tax education is patchy. Since the tax system is complicated and the PAYE system encountered by most individuals discourages engagement with the tax system, it cannot be assumed that the average member of the public understands the tax system or their responsibilities within it.
- 3.5 Just as the taxpayer has responsibilities, so too do HMRC. In particular, we think HMRC have a responsibility to advise and educate taxpayers. This will help to ensure that those who wish to comply, can, and that they do not receive the same treatment as those who are deliberately non-compliant. We also think HMRC can assist those whose failure to comply is a result of being unable to cope with the system – we think compliance teams should work with the NES service, to ensure taxpayers in this position are guided towards compliance in the most customer-friendly way possible.
- 3.6 We note that this consultation document does not really distinguish between those who operate in the hidden economy as engagers of labour (the exploiters), and those whose labour is engaged by others who are unlikely to account for PAYE or National Insurance contributions (NIC) on the earnings of those whom they engage (the exploited). Arguably, a distinction should be made between the two when setting penalties, which should be more severe for the exploiters as primary agents, and more lenient for those who are exploited to

² The allowances are due to take effect from April 2017, but we understand that there is a wide held misconception that these were available from April 2016.

reflect their lack of choice.³ Our comments in relation to tax education (paras 3.4 and 3.5 above) are particularly pertinent to this latter group of hidden economy participants.

4 Q1. What are your views on the principle of an escalating financial penalties regime associated with repeat failure to notify failures?

Q2. Do you think increasing financial penalties for repeat failures will deter repeat failures? If not, why not? What more do you think could be done?

- 4.1 We agree with the five principles set out in the 2015 penalties discussion document and repeated at 1.11 of the current consultation. These include that penalties may take account of past behaviour. We understand the rationale for an escalating financial penalties regime associated with repeat 'failure to notify' failures.
- 4.2 However, if the repeated failure to notify relates to different sources of income, say in the first place, self-employment income, and then at a later date, rental property income (while remaining compliant in relation to self-employment income), this (escalation) would seem to be a less reasonable approach.
- 4.3 Increasing financial penalties for repeat failures might deter some repeat failures, where the taxpayer is aware that they are dealing with the same type of tax responsibility, so in the case where they have a previous failure to notify a self-employment and then start a new, separate self-employment. It seems unlikely, however, that this approach would deter some of those described at para 3.3 of the consultation.
- 4.4 If a taxpayer has 'failure to notify' failures in respect of different sources of income (see para 4.2 above), it might be inappropriate to charge an increased penalty for the second failure. In the case of a different source of income (whether or not the tax charged on it is different), an increased financial penalty may have no deterrent effect, simply because the taxpayer is unaware that they are repeating a failure.

5 Q3. What are your views on the design proposals for escalating financial penalties regime associated with repeat failure to notify failures set out here and in Annex B?

Q4. Do you have initial views on the detailed design points in paragraph 3.7?

Q5. What other design points should be taken into consideration?

³ Joseph Rowntree Foundation/Community Links report '*People in low-paid informal work: 'Need not Greed'*' (Katungi, Neale and Barbour, June 2006): <http://www.community-links.org/images/uploads/0346.pdf>.

- 5.1 If a model of escalating penalties were adopted, we think Option A would be more appropriate than Option B.
- 5.2 We think it is important that there are safeguards for those who have a reasonable excuse for their failure. In addition, we think it is important to distinguish between those who are deliberately non-compliant and those who have been careless or made an oversight.
- 5.3 We do not think the escalation should apply across different taxes and obligations, or even within the same tax where say one failure relates to self-employment and one relates to rental income.
- 5.4 In addition, it might be appropriate for there to be some sort of timescale within which a repeat failure must occur in order for escalation to apply. Inevitably, ordinary taxpayers may forget what to do or how to do something if it is only an obligation that occurs infrequently. Equally, the fact that the tax system changes may also affect a taxpayer's ability to recognise whether or not they have a responsibility to notify a particular source of income.

6 Q6. What are your views on excluding changes to Schedule 24 from the wider package of proposed sanctions to deter hidden economy activity including repeated non-compliance?

Q7. Would such an exclusion create any imbalances in the way in which hidden economy activity is penalised by HMRC?

- 6.1 We think it is difficult to reconcile the differences between Schedule 41 and Schedule 24. It will be important not to create any additional inconsistencies.
- 6.2 Nevertheless, we believe that the penalty regimes under Schedule 24 and Schedule 41 should be consistent. Rather than amending Schedule 24, we believe that Schedule 41 should be amended so that it is consistent with Schedule 24 – in particular, allowing for suspension of penalties in non-deliberate cases (see paragraph 8.5 below), and the possibility of a reduction to zero for full unprompted disclosure and maximum co-operation. Neither of those features exists in Schedule 41 and its divergence from Schedule 24 dismayed many of us who responded to the consultation at the time.⁴
- 6.3 We are pleased to note that HMRC now believe the two regimes should be consistent; we said so at the time, and Schedule 24 – as the superior of the two regimes – should be the model for the aligned set of rules.

⁴ <http://www.litrg.org.uk/sites/default/files/files/080306-LITRG-response-penalties-reform-FINAL.pdf>.

7 Q8. Do you think that there is an inconsistency between the strength of penalties for hidden economy employers that fail to operate PAYE, and penalties for other hidden economy failures like failure to notify?

Q9. What options should HMRC consider for strengthening penalties for hidden economy employers that fail to operate PAYE?

- 7.1 As we note in paragraph 3.6 above, this consultation does not really distinguish between exploiters and those who are exploited. Arguably, a distinction should be made between the two when setting penalties. We think it would be appropriate for there to be more severe penalties for exploiters (who are committing a twin crime, against both the state and the “employee”), and more lenient penalties for those who are exploited.
- 7.2 By way of example, we suggest that account should be taken of the effect on low-income employees of not having PAYE accounted for in the proper way, or not having NIC accounted for with consequent adverse effects on their accumulated NIC record. Given the potential severity of consequences for employees of such hidden economy employers, serious consideration should be given to imposing more severe penalties for non-operation of PAYE.

8 Q10. Do you think there should be any additional safeguards put in place to ensure the fair application of changes associated with repeat failure to notify failures?

- 8.1 In order to try to prevent such repeat failures, when the first failure occurs, clear information must be provided to the taxpayer, not only explaining the failure, but also explaining other sources of income that must be declared to HMRC, such that the taxpayer has the opportunity to learn for the future. This will hopefully prompt the taxpayer to check the position, if they start to receive a different source of income in the future. It is important that taxpayers are not lulled into relying on old guidance, however. Such educational information must point taxpayers to where they can find up-to-date information, and also tell them the importance of checking that the guidance they are using is up-to-date.
- 8.2 It must be made clear to taxpayers why, if relevant, they are receiving an increased penalty, such that they are able to explain properly why the repeated failure has occurred. In particular, an appeal form should be sent with each penalty notice, drawing attention to the possibility of reasonable excuse, and drawing a distinction between a deliberate failure, a failure to take reasonable care and a failure despite taking reasonable care.
- 8.3 Additional safeguards will be required to reflect the changes to the tax system, such as MTD and the £1,000 allowances for trading and property income (see paragraph 3.3 above).
- 8.4 More should also be done to cater for those whose failure is due to vulnerability, whether because of the onset of illness, disability or old age; the individual who suffers periodic episodes of mental ill-health; the taxpayer who suffers a bereavement or family breakdown; the PAYE employee who is self-employed for a few weeks and fails to meet obligations, even

though they are on PAYE throughout. We would include in this care and support employers.⁵ Consequently, hidden economy penalties should not be applied in such cases of one-off 'vulnerability' even if the offence is repeated when regular compliance is demanded (e.g. two or more instances of non-submission of a quarterly report).

- 8.5 We think consideration should be given to a further safeguard as follows – suspended penalties, to encourage an individual who has previously operated in the hidden economy to remain compliant for a period. For example, if a hidden economy trader wishes to make a full disclosure, he could be offered a reduced penalty (to reflect the quality of the disclosure and level of co-operation), part or all of which could be suspended for a period of two or three years, during which he will have to remain compliant. If the trader fails to comply throughout the suspension period the full amount of the penalty will automatically become due and payable. Such an approach may be appropriate in particular for non-deliberate failures or those who lack choice – the 'exploited' mentioned in paragraph 3.6 above. We think such an approach might also help to encourage people back into the formal economy, who otherwise would find it difficult to leave the hidden economy – because they would not be able to afford to pay the penalties or underpaid tax.

9 Q11. What are your views on increased monitoring of individuals and businesses engaging in hidden economy activity?

Q12. How could increased monitoring be designed to effectively target hidden economy individuals and businesses and motivate future compliance?

Q13. What safeguards do you think would be necessary and proportionate to ensure the fair application of increased monitoring?

- 9.1 We have no comments.

10 Q14. Where illegal working is found alongside tax non-compliance, could the penalty regime for tax failures be strengthened or changed?

- 10.1 Given that there are already severe penalties for those employing illegal workers, there is no need for an additional tax penalty geared to illegal working. The tax system *per se* does not take account of whether a trade is legal or illegal, or legal with elements of illegality.⁶

- 10.2 In addition, we understand that a lot of illegal working is through criminal gangmasters or in relation to particular trades. Enforcement in these areas is difficult and expensive (for

⁵ Care and support employers are 'accidental' employers, who are often vulnerable themselves due to disability or illness.

⁶ *IR Commissioners v Aken* [1990] STC 497.

example, cross-departmental working is needed), but a bigger investment in enforcement might be more successful than increased penalties.

11 Q15. Do you have any other suggestions for financial or non-financial sanctions that could be effective in responding to hidden economy non-compliance and promoting good compliance?

- 11.1 We think that rather than other sanctions, better education and support would help to promote good compliance.
- 11.2 We held a roundtable in February 2016,⁷ at which Professor Colin Williams of the Sheffield University Management School gave a presentation. This referred to research conducted across the EU to examine the association between participation in the hidden economy and views on sanctions, risks of detection and 'tax morality'. The results of the research suggest that views of sanctions do not necessarily correlate with propensity to participate in hidden economy; likewise, perceived risk of detection does not necessarily correlate with propensity to participate either. On the other hand, the results suggest that there is a strong correlation between propensity to participate in the hidden economy and tax morality. The conclusion to be drawn from the results is that the key to tackling the hidden economy is to improve tax morality.
- 11.3 Tax morality can be improved by changing societal attitudes through tax education and tax campaigns to underline that registering for tax and paying tax are the norm. For example, currently, due to media publicity, a not uncommon attitude might be "Everyone is doing it" or "What about [X]?" where X could be any one of a number of multi-national companies. More publicity highlighting the effectiveness of HMRC's compliance activity might assist in dealing with the former attitude; a broader programme of education, over a longer period of time will be needed to deal with the latter. Tax morality can also be improved by changing rules to enhance support and advice available to taxpayers, and also by making it easier to comply.
- 11.4 Suspension of penalties might also assist in encouraging those currently operating in the hidden economy to come forward. If adopted this were adopted, closer monitoring of compliance behaviour could take place during the period of suspension.

⁷ Can tax education tackle the hidden economy? – Low Incomes Tax Reform Group Roundtable (16 February 2016).

12 Q16. Do you have any suggestions or comments on the most effective way to understand and measure the likely impacts arising from potential policy changes set out in this consultation?

12.1 We have no comments.

LITRG
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