Response from ICAS to the HMRC discussion document

‘HMRC penalties: a discussion document’

11 May 2015
About ICAS

1. The Institute of Chartered Accountants of Scotland (ICAS) is the first professional body of accountants. We represent over 20,000 members who advise and lead businesses. Around half our members are based in Scotland, the other half work in the rest of the UK and in almost 100 countries around the world. Nearly two thirds of our members work in business, whilst a third work in accountancy practices. ICAS members play leading roles in around 80% of FTSE 100 companies. ICAS is also a public interest body.

General comments

2. ICAS members welcome the opportunity to review the tax penalties and to contribute their views to ‘HMRC penalties: a discussion document’ issued by HMRC on 2 February 2015. Following the major Review of HMRC Powers from 2005 to 2012 (the “Powers Review”) it is sensible to review whether all penalties are working as intended.

3. Our comments are made in relation to tax compliance, rather than tax credits, and centre on penalties for late filing of income tax returns and associated payment of income tax, and for late filing and paying of VAT and PAYE.

4. The legislative powers around excise penalties have been in place for many years and were not a part of the programme of modernising HMRC powers that have taken place since Customs and Excise and the Inland Revenue were merged. ICAS recommends that excise duties be brought within the same overall regime as other HMRC penalties and powers. The general powers available to HMRC, for example, to consider special circumstances, or for a reasonable excuse to be considered and given effect to, need to be available in the management of excise penalties.

5. In an overall review of the existing tax penalties there are two major aspects that are worthy of consideration, which are:

   i. Whether the penalties operate as intended, with the balance correct between encouraging compliance and penalising non-compliance, or if there are improvements that could be introduced. The balance between compliance and non-compliance can be quite difficult; but ICAS members consider that the focus should be on encouraging taxpayers to be compliant wherever possible, and

   ii. Whether the existing penalties are appropriate for digital tax developments, or need to be revised. Also, if penalties are specifically designed to encourage the use of digital services, HMRC needs to make sure that those who are digitally disenfranchised for whatever reasons are not penalised unjustly for using traditional services. ICAS members do not support mandatory ‘online everything’.

6. In general, the “new” penalties introduced following the Powers Review, for example for late filing, late payment and errors in returns are appropriate, though in some cases the penalty is disproportionate and this should be addressed in the current review. “Proportionate” should not just have regard to the cost to the taxpayer, but should also have regard to the cost to the public purse and to the inconvenience to HMRC.

7. ICAS recommends that VAT penalties should be reduced and also recalibrated to take account of the degree of lateness.

8. The HMRC Debt Management Unit is in many instances in a difficult position: it is a debt collecting unit working amongst those taxpayers who cannot or will not pay and is tasked with collecting outstanding tax as promptly as possible. Generally, Debt Management Unit officers are considerate of taxpayer difficulties in paying but it would be of greater assistance to these taxpayers if there was both earlier intervention and support, to raise awareness of penalty exposure rather than just collect tax, and greater coordination with agents. This would help in particular with those traders who do not appreciate the cumulative cost of VAT non-compliance, and with those traders who have cash flow difficulties but do not understand the specifics of negotiating time-to-pay arrangements across both VAT and PAYE.
9. Time to pay ("TTP") terms and conditions are often unduly restrictive; taxpayers think they have an arrangement for payment but then it turns out not to be a formal TTP, or it has not been agreed before the payment date, or the taxpayer thinks there is a TTP but it only relates to PAYE and not VAT. Greater flexibility is required from HMRC in assisting those with cash flow problems in applying the terms and conditions to cases of genuine misunderstanding.

10. The agent will frequently not be aware of late payment issues because his terms of engagement will be to prepare annual accounts and a tax return, without being involved in ongoing PAYE and VAT compliance or tax payments. Nevertheless, the agent could usefully be brought in when payment difficulties arise or if the matters are outside the 64-8, HMRC could encourage the taxpayer to speak to their agent. This may help although if a trader is short of money they may not want to incur professional fees in these circumstances, in which case HMRC’s advice is more important.

11. It is suggested that ‘nudge’ procedures could be used to encourage compliance. For example, a penalty rating risk score on a digital tax account is likely to encourage compliance and focus the attention of the recalcitrant taxpayer. With the future digital accounts this may be across taxes so it would highlight overall tax behaviour.

12. ICAS endorses the recommendations put forward by the Office of Tax Simplification in its report ‘Tax Penalties’ issued in November 2014. In particular, a number of administrative steps could be taken to reduce the number of taxpayers who are issued with a notice to file a tax return but who do not really have enough tax at stake to make this sensible. One of the most telling parts of the Office of Tax Simplification’s November 2014 report was paragraph 2.15 which includes “Currently about 16% of those on the SA register are making zero liability returns with a further 8% returning a liability of less than £50.” Of course that does not mean 24% of those incurring a penalty for late filing are within those two categories, but it does suggest HMRC might look more closely at this area. That may not require any change of law.

Specific questions

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

The concerns expressed, in relation to the general issues of fairness and proportionality, automated penalties, income tax self-assessment and VAT default surcharge, are in our view typical of cases. Most represented taxpayers are very conscious of common and advertised penalties such as the £100 late filing penalty for their tax return. The worrying situations, however, arise where businesses are really struggling for cash flow and, rather than agreeing a payment plan with HMRC (if they even know this facility exists), they make payments to account, get behind and automatic penalties then roll up with alarming rapidity, exacerbating an already serious problem. Such cases can be seen regularly at the First-tier Tax Tribunal and particularly so amongst the unrepresented.

Penalties in relation to excise duties, which affect imports, can be extremely expensive and often appear disproportionate to the default or compliance failure.

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

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

The major areas of concern with HMRC penalty regimes, and hence the priority areas to address, are:

- Penalties applying for being a day or two late. These can often be disproportionate and even a £100 penalty may be considered rough justice for a return that is a day late. The imposition of a penalty should be reviewed when no tax is due.
- Automatic penalties which really do penalise situations where there is a large liability with a flat rate percentage applied to the liability; there needs to be regard to ability to pay and proportionality to the underlying error.
- VAT penalties that apply rapidly increasing percentages to liabilities, and do not take any account of the length of period of lateness.
- The management of debt in particular that leads to PAYE and VAT penalties, both of which can arise and rapidly accumulate when a business has cash flow problems.
- VAT penalties that are levied despite there being no overall loss of tax to the Treasury.

The areas of concern are as follows.

VAT penalties for late returns and late payment all too often seem disproportionate. The penalties are expensive and increasingly so at 2%, 5%, 10% and 15% of the VAT due. This is aggravated by two main problems. First, a default and hence a penalty, is triggered even if the lateness is by only one day. Secondly, and this is largely due to practicalities around non-compliance amongst smaller businesses, the penalty implications are not appreciated at the outset. So, for example, if the trader is focused on his business and not on HMRC matters, penalties may have been going on for a long time with the warning notice possibly misunderstood or ignored; the 2% penalty, and sometimes also the 5% penalty, being waived because it’s under £400 and therefore ignored again; and suddenly the trader will face an expensive 10% penalty.

Furthermore, due to the way in which VAT penalties fail to register with some taxpayers until they are at, often, the 10% penalty, it means that it is extremely unlikely that a ‘reasonable excuse’ will be relevant. A 10% penalty means that this is the fourth default, i.e. the late compliance has been continuing for at least a year. The original default may have started due to ill health or a one-off event which would constitute a reasonable excuse at the time, but there are exceptionally few cases where such an excuse will have gone on throughout this length of period. The taxpayer knew, or should have known, about the need to pay on time due to the steady receipt of notices and a reasonable excuse very rarely lasts for a year or more. A different preventative strategy needs to be considered.

Penalties can also be disproportionately harsh when non-compliance arises due to cash flow problems and, as commercial restitution is addressed by HMRC charging interest, the penalties could be less aggressive. This can be seen with VAT penalties, where their accumulation simply aggravates the trader’s problems. It is made worse if the taxes are dealt with in isolation. The penalty regime should take account of the position on all taxes for a taxpayer to build up a wider picture of the attitude towards compliance.

Some taxpayers accept that they have been late in making a return or a payment, and have rectified the position. They may also accept a penalty, but question the amount of the penalty which is viewed as disproportionate. However, having accepted that they were late in complying, there is no room for discretion or mitigation of the penalties.

For the unrepresented, particularly in smaller businesses, a significant proportion of the cases that come to tribunal are because the appellant feels the penalty is unfair and disproportionate and this has led to a sense of grievance.

There have been some instances of HMRC seeking to impose penalties where there is a nil tax position, with no tax loss to the exchequer as input and output tax are matched. An example of this may arise if a supplier applies the wrong VAT rate by applying standard rating instead of zero-rating on a supply to a fully taxable business and subsequently, when the mistake comes to light, all the records are amended and revised invoices are issued along with credit notes. Whilst in strict terms a penalty is due from the customer because there has been an over-recovery of input tax on the return, there is no real loss as both sides are fully taxable. ICAS members question whether a penalty should be charged in such situations and if it is whether this constitutes unjust enrichment on behalf of HMRC.

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

We agree with the principles set out at paragraph 5.3.

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

A more individual approach may be of assistance.
Such an approach may involve more HMRC time or system development to achieve, particularly to look at a taxpayer’s medium term history to establish whether he has historically been compliant and what has caused difficulty in terms of either late returns or late payments of tax.

Penalties and the appropriate approach to them should go hand in hand with the approach to dealing with debts. ICAS commented as follows in relation to the proposals for Direct Recovery of Debt:

‘In terms of principle, ICAS understands that HMRC needs the means to drive contact with those who ‘can pay, but won’t pay’. However, it is a very big assumption that all those with debt are in this category. HMRC should undertake, or publish, further analysis to identify the causes of tax debt and those who incur it. Based on the experience of ICAS members, the categories of people who do not reply to correspondence and who might have outstanding debt include:

- Those who can pay but will not - ‘the obstinate’
- Those who need help to understand or manage their tax affairs, including the elderly – ‘the vulnerable’
- Those who are chronically disorganised, or hapless – ‘the chaotic’.’

Different debt collection procedures are required for each of these groups and, equally, different approaches to penalties may also be needed.

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

Some penalties are unfair with a cliff edge of a single day. While not large, the £100 late filing penalty for a tax return is a case in point. The cliff edge needs to be somewhere but it may be beneficial to have a phasing of some penalties. However, there is always a concern that if penalties are not imposed for the first, say, seven days of non-compliance then this is simply an effective shift of the date of compliance.

It may be that, for example, the existing penalties might be applied but discounted by say, 75% if paid within a week; 50% if paid within a month; and 25% if paid within two months.

It may also be helpful to review what failures trigger a penalty, and the amount of the penalty. For example, some penalties feel particularly harsh where they relate to less familiar returns which are made late, such as an employer who has set up a share scheme but who has little background knowledge to the tax administration of these and the need for timely submission of a form 42.

**Q7: What do you think should trigger a penalty?**

To be as efficient as possible, HMRC needs to receive returns reasonably timeously and ICAS members accept that there need to be penalties for late returns. The issue is the proportionality of the penalties. For example, a taxpayer who gets a notice to file a tax return in April, has more than nine months to file the return or contact HMRC to say they do not think they should be required to make a return for the year. If they do not then a £100 penalty may be proportionate, subject to “reasonable excuse”, of course. However, if the return is still not filed a year after the deadline, the penalty for late filing will be at least £1,200. This will often be excessive, for example if the taxpayer has little or no income to report and/or HMRC has made no meaningful effort to find out why the return has not been filed.

We accept the current trigger points. However, late filing penalties might automatically be suspended for (say) two years, or perhaps limited to £100, if the return is filed within a certain period (say 30 days) after HMRC actually contact the taxpayer. This would cut the significant amount of unproductive work dealing with unfilled tax returns, and allow for more time to be spent helping taxpayers who cannot cope, for whatever reason, with filing a tax return on time, or preventing the return from being even later.
Q8: Are there incentives HMRC could consider to encourage compliance?

For business taxes, PAYE and VAT, the vast majority of businesses seek to be compliant. Non-compliance generally arises due to cash flow problems and trading difficulties therefore incentives are probably not relevant. It would help, however, if HMRC took into account a taxpayer’s history in determining their actions if a return is late or payment is made late. In other words, taxpayers with a good record would be treated less harshly than those with a poor record. As discussed under the general comments above, better support for taxpayers from the Debt Management Unit when there are cash flow difficulties, and with instigating time to pay arrangements, would be welcomed.

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

Behavioural science insight should suggest ways in which HMRC could more effectively explain about sanctions, and penalties and their role. However, whatever the proposal consists of, it needs to be an improvement on sending existing format letters, either by post or online. Those taxpayers who have difficulties complying and are therefore faced with penalties tend not to take on board the content of such correspondence until after the event or do not feel in a position to take steps to change matters. For represented taxpayers, probably the best way forward is for the agent community to be aware of HMRC penalties and pass this information on to their clients.

In due course, once the digital tax account is available, a penalty rating risk score on a digital tax account may encourage compliance and focus the attention of the recalcitrant taxpayer. This would be across taxes so it would highlight overall tax behaviour.

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

The charging of penalties does influence taxpayer behaviour. For example, the penalties for late payment have changed those cases where businesses paid PAYE one or two days late on a regular basis. This sometimes arose through misunderstanding in that the tax payer may have posted a cheque on the 18th of a month but HMRC was not receiving/processing this until the 21st and so, as far as HMRC was concerned, payment was made late. HMRC did eliminate or reduce penalties in a number of cases but the experience very definitely had an effect on those taxpayers who now ensure that payment is received by the 19th.

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

The existence of penalties does help in, for example, ensuring that many tax returns are lodged by the 31 January deadline. They also cause aggravation in other respects, such as the slightly late payment of PAYE noted at 10 above, where agents become embroiled in correspondence with HMRC and research of tribunal decisions to put a case to HMRC for mitigation of penalties.

Q12: Do you have any comments on the likely impact of any changes, or can you contribute to our evidence base?

In some cases where a business has had cash flow problems, but manages to work through these temporary problems and remains profitable, but has ended up with penalties on VAT, PAYE and perhaps also income tax or corporation tax returns, the penalties can become completely disproportionate. There may be a number of penalties on different taxes arising from the same basic problem of reduced cash flow in the business. This can result in a mixture of anger, frustration and demotivation as far as some taxpayers are concerned as, just when they think they are getting ahead in bringing arrears up to date, there are further penalties and, in the case of VAT, the rate of these rises with each default. Policies which support taxpayers in such circumstances across taxes, need to be adopted.
In terms of VAT compliance much of the criticism of the VAT default surcharge regime might be removed by adopting a flat rate penalty coupled with interest on late paid tax approach. That would remove most – possibly all – of the “proportionality” arguments and the level of the flat rate penalty could be set to “incentivise” compliance, and might be varied according to the size of the business, based on turnover or, perhaps, payment history, to ensure that it did not hit smaller businesses harder than larger ones.