



HM Revenue
& Customs

Tackling the hidden economy: Sanctions

Consultation document

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2016

Subject of this consultation:	The potential for new sanctions to tackle hidden economy activity including repeated non-compliance.
Scope of this consultation:	HMRC is exploring the potential for new penalties and sanctions to tackle those operating in the hidden economy, including those who have already been penalised for non-compliance, but have not changed their behaviour.
Who should read this:	We would like to hear from businesses, individuals, tax advisers, professional bodies and other interested parties.
Duration:	8 weeks, starting from 26 th August 2016 and closing 21 st October 2016.
Lead official:	Sarah Harris: HMRC Hidden Economy Policy and Strategy Team.
How to respond or enquire about this consultation:	Please send responses via email to: isbc.compliancepolicy@hmrc.gsi.gov.uk or via post to: Sarah Harris HMRC Room G/73 100 Parliament Street London SW1A 2BQ
Additional ways to be involved:	If you would like to meet to discuss this consultation please send an email to: isbc.compliancepolicy@hmrc.gsi.gov.uk
After the consultation:	Responses will be taken into account in developing these proposals and a response document will be published.
Getting to this stage:	This is the first consultation on these proposals, first announced at Budget 2016.

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Foreword

The vast majority of UK taxpayers pay what they owe, but a small minority seek to evade or avoid paying their fair share. The hidden economy consists of those businesses who fail to register for tax, and individuals who fail to declare a source of income that should be taxed.

By hiding their activity from HMRC, those operating in the hidden economy deprive the government of much needed funds to run public services and invest in the UK's future. In 2013/14, the hidden economy tax gap was £6.2bn. This places an unfair burden on the vast majority of people and businesses who pay their fair share of tax.

Hidden economic activity also disadvantages compliant businesses. Competition between businesses is distorted when a small minority seek to hide under the radar from their tax obligations.

This government will continue in its efforts to ensure that the UK remains a great place to set up and grow a business. We're making paying tax quicker, easier and more convenient for the compliant majority through moving to a largely digital tax system, providing businesses with their own digital tax account and enabling them to register for taxes online at a time that suits them.

Today, we are asking for your views on new proposals to tackle the hidden economy. At Budget 2016, the government announced the consultations that are being published by HMRC today. These cover:

- Proposals to extend HMRC's bulk data gathering powers to Money Service Businesses (MSBs). This will allow HMRC to identify and take action against those who misuse cash services offered by MSBs to hide sources of income from HMRC and operate in the hidden economy.
- Tougher sanctions for those who participate in hidden economy activity including repeated non-compliance.
- The principle of making access to licenses or services for businesses conditional on them being registered for tax.

Changes arising from these consultations will help us to support the majority of UK businesses by levelling the playing field between the compliant and non-compliant.

This builds on progress that the government has already made to tackle the online hidden economy, and through investment in HMRC to fund more frontline investigators to step up their response to the hidden economy.

Our message to those operating in the hidden economy is clear – it is getting harder to hide your activities, come forward before HMRC catches up with you and join the vast majority of businesses that pay their fair share of tax.

Jane Ellison
Financial Secretary to the Treasury

1. Introduction

Tackling the Hidden Economy

- 1.1 The majority of UK taxpayers pay what they owe, but a small minority seek to evade or avoid paying their fair share. The hidden economy consists of those who fail to register for tax, and those who fail to declare a source of income. HM Revenue and Customs (HMRC) estimates that the 2013/14 tax gap due to the hidden economy stood at £6.2bn, which equates to 18% of the total tax gap. The tax gap is the difference between the receipts HMRC actually collects and the amount of tax that should be collected if all taxpayers complied with the letter and spirit of the law.
- 1.2 The UK has one of the smallest reported tax gaps in the world. HMRC remains committed to reducing it further, and as part of this, achieving a significant and sustained narrowing of the hidden economy tax gap. To accomplish this, we must make compliance the easy option for our customers. Our compliance strategy is based on three principles:
- **promote** good compliance, making it easier for people to get things right;
 - **prevent** non-compliance, preventing mistakes and stopping things from going wrong; and
 - **respond** to non-compliance, targeting our approach to tackling complex cases and deliberate cheats.
- 1.3 Hidden economy activity disadvantages compliant businesses. Tackling the hidden economy will ensure a level playing field for those who comply with their tax obligations. This means working to improve the ways in which our customers register for tax and report their income, helping them to get things right the first time. We will also make it increasingly difficult for businesses and individuals to enter the hidden economy, and robustly tackle those who continue not to pay the right amount of tax.
- 1.4 Those who operate in the hidden economy may also demonstrate non-compliance in areas of their business besides tax, which might include health and safety violations, failure to comply with employment rights for workers, and immigration offences. By tackling the hidden economy we can help to shrink the space for wider criminality and non-compliance to flourish. This reduces opportunities for businesses to profit from illegal workers and criminal activity, and so delivers wider benefits for society.

HMRC's approach

- 1.5 The nature of business and employment is changing. Greater numbers of individuals now have multiple or flexible sources of income throughout their working lives. Technology supports these changes, with people using smart phones to access products and services and to make payments. Reflecting this, in recent years, we have increased our focus on tackling the hidden economy using new data and smarter compliance work.

- 1.6 HMRC wants to support those starting in business to get their tax affairs in order early. Behavioural evidence and operational experience indicate that the greatest impact on the hidden economy tax gap stems from stopping our customers entering the hidden economy in the first place, and we are seeking to develop new “promote” interventions to address this. This includes guidance and tools for new and pre-start-up businesses, and working with schools to teach young people about the importance of paying tax.
- 1.7 To ensure that it becomes increasingly difficult for businesses to hide their income, the government has introduced new targeted data gathering powers, supporting interventions to prevent and respond to non-compliance. The government has also invested in HMRC to recruit additional hidden economy investigators to make use of these new data streams and to combat this risk effectively. These policy changes and HMRC investment, both announced at Budget 2015, are expected to contribute total additional revenues of £860m to 2020-21.
- 1.8 These approaches are putting more and more pressure on those operating in the hidden economy. One strand of HMRC’s response to hidden economy activity is the deployment of targeted compliance teams. In 2015/16, those teams settled 11,000 cases and generated yield of £174m, an increase from £146m in 2014/15.
- 1.9 This consultation, and others published alongside it, set out the government’s next steps in tackling the hidden economy. That action is an important part of the government’s stance on supporting compliant businesses – by levelling the playing field so that those playing by the rules do not face unfair competition from those not paying their fair share.

HMRC’s approach to penalties

- 1.10 Penalties in the UK tax system are designed to encourage taxpayers to comply with their obligations; to deter those who would otherwise not comply; and to reassure the compliant majority that they will not be disadvantaged by rule breakers. Penalties are not designed to raise revenue.
- 1.11 HMRC’s 2015 penalties discussion document set out five key principles that underpin HMRC’s approach to penalties. These are:
- The penalty regime should be designed from the customer perspective, primarily to encourage compliance and prevent non-compliance. Penalties are not to be applied with the objective of raising revenues.
 - Penalties should be proportionate to the failure and may take into account past behaviour.
 - Penalties must be applied fairly, ensuring that compliant customers are (and are seen to be) in a better position than the non-compliant.
 - Penalties must provide a credible threat. If there is a penalty, we must have the operational capability and capacity to raise it accurately, and if we raise it, we must be able to collect it in a cost-efficient manner.

- Customers should see a consistent and standardised approach. Variations will be those necessary to take into account customer behaviours and particular taxes.
- 1.12 The 2015 publication "HMRC penalties: a Discussion Document" advised that HMRC is looking at the way that penalties are applied when people fail to meet their tax or entitlement obligations. The Summary of Responses to the discussion document said that, alongside wider transformational work, HMRC would develop options in respect of the review of penalties and consult further when that had been done.
- 1.13 This consultation has a narrower focus on the penalty models that apply to hidden economy activity – for example failure to notify HMRC of a tax liability. Any penalty changes for hidden economy activity will be developed so as to be consistent with the direction of travel of the wider penalties review.
- 1.14 The changes explored in this consultation should not be read as a prediction for the design of any future, wider model for HMRC penalties. As those wider changes to penalties for inaccuracies and notification failures develop, they may in fact absorb or alter the narrower proposals set out in this consultation.
- 1.15 We are consulting now to ensure that the design of any penalty changes for hidden economy activity will be fully informed by expert opinions from interested parties. Responses to this consultation will therefore be invaluable in reaching the most effective and appropriate proposals for any future changes.

Future options to tackle the hidden economy

- 1.16 HMRC is committed to tackling the hidden economy in new and innovative ways. At Budget 2016, the Government announced consultations on three proposals to cover the full range of promote, prevent and respond activity.
- 1.17 This consultation is on sanctions to deter hidden economy activity including repeated non-compliance. Two parallel consultations on hidden economy measures will be launched alongside this one, on the following topics:
- **Access to data held by Money Service Businesses (MSBs)** – new powers to gather customer data held by MSBs for tax compliance purposes, ahead of potential legislation in Finance Bill 2017 <https://www.gov.uk/government/consultations/tackling-the-hidden-economy-extension-of-data-gathering-powers-to-money-service-businesses>
 - **Conditionality**, defined as the principle of making access to licenses or services for businesses conditional on them being registered for tax <https://www.gov.uk/government/consultations/tackling-the-hidden-economy-conditionality>
- 1.18 This consultation focuses on our approach to those who fail to declare all of their income. We want to make sure penalties are applied fairly, so that those who deliberately participate in the hidden economy face tougher sanctions

from those largely compliant customers, who may make the occasional mistake.

- **Chapter 2** sets out existing penalty provisions and their application;
- **Chapter 3** presents options for stronger sanctions for hidden economy activity including repeated non-compliance;
- **Chapter 4** sets out potential non-financial deterrents for hidden economy activity including repeated non-compliance;
- **Chapter 5** sets out other options we are considering for tackling the hidden economy.

2. Existing penalty provisions and their application

- 2.1 The law requires individuals and businesses to take appropriate steps to understand the correct tax treatment of the transactions to which they are party, to register with HMRC for the appropriate tax regimes and to fully declare their tax liabilities.
- 2.2 The law provides for penalties to be applied where customers fail to meet their tax obligations. They break down into three broad types:
- **Penalties for failing to meet an obligation** such as notifying a liability to tax or a taxable status or not complying with a regulatory regime. These are largely contained in Schedule 41 to the 2008 Finance Act (“**Schedule 41**”).
 - **Penalties for submitting inaccurate returns and documents.** These are largely contained in Schedule 24 to the 2007 Finance Act (“**Schedule 24**”).
 - **Penalties for late filing or payment,** such as submitting a return or making a payment by a deadline specified in law. These are largely contained in Schedule 55 to the 2009 Finance Act (“**Schedule 55**”).
- 2.3 Further information about when and how each of these penalties are applied is included at Annex A.
- 2.4 The existing penalty models provide strong penalties and sanctions that are geared to the taxpayer’s behaviour. Where a taxpayer fails to comply with a tax obligation, they face paying the tax that is due, plus interest, plus any penalty due.

Schedule 41: ‘failure to notify’

- 2.5 Schedule 41 sets out penalties for failing to meet an obligation such as notifying a liability to tax. This is the most relevant penalty provision to tackling the hidden economy because it penalises those who fail to come forward and declare a tax liability to HMRC. In 2015/16, HMRC issued non-compliant businesses with just over 7,000 Schedule 41 penalties relating to domestic matters¹.
- 2.6 When HMRC catches up with an individual operating in the hidden economy who has deliberately failed to register for the appropriate tax regime and has sought to conceal their tax liability, under Schedule 41; that individual will face a minimum additional penalty of 35% of the potential revenue loss resulting from their non-compliance. More detail is available at Annex A. Where the behaviour of that individual is judged to be fraudulent, HMRC can and does pursue criminal investigation where appropriate.

¹ Higher penalty ranges apply for offshore matters. An offshore matter results in a potential loss of revenue that is charged on or by reference to income arising from a source in a territory outside the UK, or assets held in a territory outside the UK.

Table 2.1: Non-compliant businesses, Schedule 41, ‘failure to notify’ penalties, (domestic matters), 2015/16

Behaviour	Penalty range	Sch 41 penalties charged	% of penalties charged by behaviour	% of penalties where penalty % rate was reduced for disclosure	Average % penalty rate charged (after adjustment)	Average penalty amount after adjustment
Non deliberate	0% to 30%	1500	21%	99%	19%	£2000
Deliberate	20% to 70%	5500	77%	86%	46%	£3,600
Deliberate and concealed	30% to 100%	100	2%	80%	81%	£26,700
Total:		7100				

2.7 This data about HMRC’s application of Schedule 41 penalties suggests that:

- A substantial number of penalties are issued to businesses who fail to notify a tax liability;
- Of those, the majority relate to deliberate failures, suggesting that those penalised have deliberately engaged in hidden economy activity;
- Nearly all non-deliberate, and most deliberate penalties are reduced for disclosure (see Annex A for disclosure rules);
- As a result, the average penalty rates charged are below the maximum percentages (of potential lost revenue), that could apply for each behaviour;
- The average penalty amount for deliberate failures is larger. That’s because the percentages that apply for deliberate failures are higher;
- The average penalty amount for deliberate and concealed failures is larger again. That’s because the percentages that apply are higher, but also because the starting point of potential lost revenue in those cases is also higher.

2.8 Despite the sanctions that apply, HMRC’s operational experience is that a small number of businesses continue to operate in the hidden economy after receiving a penalty. They return to a ‘failure to notify’ position after being penalised. This suggests that some hidden economy businesses see that occasional penalty as a cost of doing business. They may conclude that it is worth running the risk of being caught again and absorbing the cost of a second penalty. HMRC will undertake more detailed data analysis to further quantify this observed repeat hidden economy activity.

2.9 Illustrative examples are used throughout this consultation and the first are below. These are not based on real taxpayer cases but instead illustrate scenarios of the sort uncovered by HMRC’s hidden economy investigations.

Illustrative example 2.1

Mr Smith has traded from home for several years. He knew that he ought to be registered for self-assessment but he never has. HMRC identified Mr Smith's business activity through third party data – he had been accepting card payments. HMRC investigated Mr Smith, recouped the tax that was due, and charged him a failure to notify penalty under Schedule 41. His behaviour was deliberate. That penalty maximum started at 70% of the potential lost revenue from Mr Smith's hidden economy activity. The final penalty was reduced to 35% because he made a full prompted disclosure. As a result of the investigation and penalty, Mr Smith registered with HMRC for the appropriate tax regimes and stopped operating in the hidden economy. He was no longer failing to notify.

After a year, Mr Smith dropped out of the self-assessment system. He continued to trade in the hidden economy. Business picked up and he built up a sizeable unpaid tax liability because he was not registered. Mr Smith was not deterred by the prospect of a further sanction and was again failing to notify.

Schedule 55: late returns from employers

- 2.10 Some hidden economy businesses employ staff but fail to operate PAYE when that obligation applies. Those businesses fail in their obligation to collect and pay relevant income tax and NICs to HMRC and the exchequer. In these cases, because the business fails to hand over sums that should have been collected from employees, that non-compliance has a broader impact than failures just relating to the tax affairs of the businesses.
- 2.11 From March 2015 onwards, Schedule 55 applies a penalty to all businesses who fail in their obligation to file one or more monthly PAYE returns, on time, through the Real Time Information (RTI) system.

Illustrative example 2.2

A business ("NE-Biz123") employed nine staff for five months and deliberately did not notify HMRC of its PAYE liability despite understanding its obligation to do so. Following a tip off, HMRC investigated NE-Biz123 and demonstrated its obligation to notify its liability and operate PAYE. HMRC assessed the tax and NICs due and issued a penalty. NE-Biz123 notified its liability, was brought into PAYE and started making regular returns. It submitted late returns for the months that it had missed.

The tax and NICs at stake because of the failure to operate PAYE associated with the employment of nine staff for five months was estimated at £12,150.

Under Schedule 55 NE-Biz123 paid a penalty of £400 for the late returns it submitted for the missing five months (there is no penalty for the first month). That penalty equated to 3% of the potential tax and NICs lost.

Hiding a second source of income from HMRC

- 2.12 A hidden economy individual or business might be compliant with some of their tax obligations but not all. For example, some are registered and compliant for the obligations that apply to one source of their income, but not for a second or third source. Penalties that apply for these failures fall under two categories; failure to notify (Schedule 41), discussed earlier in this chapter; and submitting an inaccurate return (Schedule 24).
- 2.13 When HMRC identifies an individual operating in the hidden economy who has deliberately failed to record one or more sources of income on the relevant tax return, and has sought to conceal their tax liability, under Schedule 24, that individual will face a minimum additional penalty of 35% of the potential revenue loss resulting from their non-compliance. More detail is available at Annex A. Where the behaviour of that individual is judged to be fraudulent, HMRC can and does pursue criminal investigation where appropriate.

Illustrative example 2.3

Ms Jones paid tax and NICs on her primary source of income via her employer and PAYE. She also had a second source of income from freelance work. She did not pay tax and NICs on that second source of income and kept it hidden from HMRC. She did not notify HMRC of her second job, which she should have done as part of the self-assessment process. Ms Jones was ultimately liable for a behavioural, tax-geared, 'failure to notify' penalty under Schedule 41.

Illustrative example 2.4

Mr Shah, a self-employed handyman, was registered for self-assessment and submitted a return covering his primary self-employment. Mr Shah had a second, less regular source of income as a driver. He understood the rules that applied but did not declare this source of income as part of the self-assessment process. In hiding that source of income, he submitted an inaccurate self-assessment return. When HMRC identified the error, he was charged for the tax lost and a behavioural, tax-geared penalty under Schedule 24.

3. Options for stronger sanctions for hidden economy activity including repeated non-compliance

Stronger sanctions for hidden economy activity including repeated non-compliance

- 3.1 There is more that can be done to tackle hidden economy participants who see an occasional penalty as a cost of doing business. The aim is to ensure penalties are a credible threat in line with HMRC's penalty principles and that past non-compliant taxpayer behaviour is taken into account.
- 3.2 The next two chapters include proposals for stronger penalties and sanctions. As set out, the three main penalty regimes that apply to hidden economy failures are designed in different ways to address different failures. This consultation recognises the clear distinction between those three main penalty regimes and takes a different approach to each:
- It proposes potential changes to the specific hidden economy failure of 'failure to notify' (Schedule 41).
 - It does not propose changes to the failure of inaccuracies in returns (Schedule 24) because that failure is not specific to the hidden economy and has wider uses and implications. This is discussed further in this chapter.
 - It does not propose direct changes to the failure of PAYE late filing (Schedule 55), because that failure is not unique to the hidden economy and the legislation has wider uses and implications. This is discussed further in this chapter.

Proposal 1: Changes to 'failure to notify' penalties (Schedule 41) for repeat hidden economy failures

- 3.3 The previous chapter set out examples of hidden economy businesses that see penalties at the current rate as a cost of doing business. In these cases, the penalty does not sufficiently deter non-compliance. One option to address this is to amend the existing failure to notify penalty regime so that a second failure to notify attracts a higher penalty rate than a first failure. Introducing stronger penalties for hidden economy activity including repeated non-compliance aligns closely to HMRC's second penalty principle: ensuring that penalties are proportionate and take account of past behaviour. This option could also offer a stronger incentive for non-compliant taxpayers to get their affairs in order after a first failure, aligning with HMRC's first penalty principle that the primary purpose of penalties is to encourage compliance.

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

Q.2: 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?

3.4 There are at least two ways to approach changes to Schedule 41:

- **Option A:** A change could take the form of simple escalation. That could be increased penalty percentages for second and third failures by the same individual or business. Unprompted, non-deliberate failures might be exempt from escalation so as not to penalise those who make unintentional mistakes. Taxpayers who had a reasonable excuse for their failure would not receive a penalty. More information about this proposal is at Annex B.
- **Option B:** Alternatively, Schedule 41 could be changed so that second and subsequent failures attract the same penalty percentages as deliberate failures on the grounds that a second failure cannot be said to be non-deliberate. Taxpayers who had a reasonable excuse for their failure would not receive a penalty. One of the drawbacks of this option is that it would not raise the potential penalty rate for those whose first failure and penalty were already deliberate. That is the majority of Schedule 41 penalties that HMRC issues (see Table 3.1), so this option could only be expected to affect and deter a smaller subset of potential second failures. More information about this proposal is at Annex B.

3.5 This consultation does not set out firm proposals, but seeks views on the principle of changes to Schedule 41. The example below revisits the illustrative scenario of Mr Smith, discussed in the previous chapter. It explains how escalation of Schedule 41, as set out at Option A, might work in his case.

Illustrative example 3.1

Mr Smith traded from his home for several years. He knew that he ought to be registered for self-assessment but never did so. HMRC identified his business activity through third party data – he had been taking card payments. HMRC investigated Mr Smith, recouped the tax that was due, and charged him a failure to notify penalty under Schedule 41. His behaviour was deliberate. That penalty maximum started at 70% of potential lost tax but was reduced to 35% because he made a full prompted disclosure. As a result of the investigation and penalty, Mr Smith registered with HMRC for the appropriate tax regimes and stopped operating in the hidden economy.

After a year, Mr Smith dropped out of the self-assessment system. He continued to trade in the hidden economy. Business picked up and he built up a sizeable unpaid tax liability because he was not registered.

HMRC caught up with Mr Smith again and applied the same investigation, charging and penalties procedures that it had done before. His behaviour was the same but under changes to Schedule 41, the penalty percentages that applied to a second penalty were higher. The new penalty maximum started at 105% of potential lost tax but was reduced to 52% because he made a full prompted disclosure. Mr Smith was deterred by the prospect of, further, higher sanctions and continued to meet his tax obligations in future years.

3.6 This consultation does not set out firm proposals. However, in order to better obtain those views, Annex B illustrates how a regime might work under both Options A and B.

3.7 In designing any changes to ‘failure to notify’ penalties (Schedule 41) in more detail, consideration would have to be given to a number of detailed points, including:

- The most effective and proportionate rate of escalation.
- The period in which the repeat failure must take place.
- How the penalty could apply in cases of phoenixism. (This is where a company ceases trading, sometimes in a contrived manner, and disposes of assets to a successor company without paying accrued debts. Trading continues through the new company, often with the same director, premises, equipment and workforce).
- How incentives to disclose may be retained.
- Whether the escalation should apply across different taxes and obligations.
- Whether the penalty was proportionate and could be paid by those penalised.
- How the escalation would interact with the offshore penalties regime.

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?

Inaccuracies in returns (Schedule 24)

3.8 Individuals and businesses who choose to hide a source of income by not declaring it on an existing tax return contribute to the UK’s hidden economy tax gap. This is demonstrated by illustrative example 2.4 (Chapter 2). The penalty that applies in that situation (inaccuracies in returns - Schedule 24) is not specific to the hidden economy and has wider uses and implications. That makes it challenging to design changes to Schedule 24 that would catch the behaviour of individuals and businesses engaging in hidden economy activity, without also impacting other taxpayers who include other inaccuracies in their returns. For the purposes of this consultation, there at least three potential approaches to Schedule 24 and the hidden economy. The consultation could;

- Seek to define a specific hidden economy inaccuracy (say failure to declare an entire source of income), and then apply the proposed changes only to those Schedule 24 penalties for inaccuracies that meet that criterion.

- Omit Schedule 24 penalties for inaccuracies from the scope of the consultation and proposed changes on the grounds that the legislation applies too widely to avoid unintended consequences.
- Apply the proposed changes, for example the principle of escalation, to Schedule 24 penalties for inaccuracies as they exist, disregarding the risk of unintended consequences.

3.9 Schedule 24 has a broad application to many types of errors. Although Schedule 41 also has a broad application across different tax regime, it is focused on one type of failure quite specific to the hidden economy – the failure to notify HMRC of a tax liability. Any changes to Schedule 24 would have to be particularly mindful of HMRC’s wider programme of tax administration reform, including announced or potential changes to penalty models.

3.10 This consultation reflects early stages of policy development. For now, it does not propose changes to the penalties for inaccuracies in returns (Schedule 24) because that failure is not specific to the hidden economy and has wider uses and implications. The government will further consider the application of penalties for inaccuracies as part of the development of Making Tax Digital.

3.11 Putting aside this type of failure at this stage is not without problems. For example, making changes to failure to notify (Schedule 41) but not inaccuracies in returns (Schedule 24) could lead to imbalances in the way in which different types of hidden economy activity is sanctioned, even when the underlying behaviours are similar. For this reason, and to inform future reforms, we would welcome comments on this approach.

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?

Schedule 55: late returns from employers

3.12 The non-payment of PAYE income tax and NICs contribute to the hidden economy tax gap. Under existing penalty rules (Schedule 55), a fixed late filing penalty of between £100 and £400 is charged for each late RTI return that a hidden economy employer makes for the months it has missed, after it is brought into PAYE.

3.13 This fixed penalty applies most commonly to late RTI returns for each month after an employer has registered as an employer with HMRC and to previous months in the tax year before registration. The first month is excluded for the first failure in a tax year. HMRC thinks that deliberate failures to notify HMRC of a PAYE liability demonstrate similar taxpayer behaviours to failure to notify for other regimes. However, the model for what is in effect, failure to notify a PAYE liability, leads to much lower penalties. For comparison, a deliberate,

prompted failure to notify for another tax regime would prompt a minimum penalty of 35% of the liability under Schedule 41.

3.14 HMRC is considering changes to the penalties that apply to employers who fail to make or report PAYE deductions and therefore fail to operate PAYE correctly. Because Schedule 55 applies to late returns from any employer required to submit RTI returns, not just those operating in the hidden economy, it has a wider application than Schedule 41. It may therefore be inappropriate to propose changes to Schedule 55 in order to tackle hidden economy behaviour. Any new penalties or changes to existing penalty models, to tackle PAYE failures in the hidden economy, will need to be considered carefully with a view to minimising the impact on compliant employers and those who make mistakes.

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?

Safeguards

3.15 Safeguards ensure that taxpayers are treated fairly and in accordance to the law. HMRC is considering changes to the penalty model for failure to notify (Schedule 41). There are already existing safeguards for failure to notify under Schedule 41, including:

- The taxpayer may request a review or accept HMRC's offer to review the issue before the appeal is referred to the tribunal.
- A taxpayer can appeal to the relevant Tribunal against a decision that a penalty is payable.
- The amount of a penalty can be reduced depending on the timing, nature, and extent of any disclosures made by the taxpayer about the inaccuracy in point.

3.16 These are effective and important safeguards that we do not intend to change.

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?

4. Non-financial deterrents for hidden economy activity including repeated non-compliance

- 4.1 The government also wishes to consider whether non-financial deterrents could have a greater part to play in combatting the hidden economy. Non-financial deterrents can influence behaviour and approaches such as increased monitoring can also reduce the opportunity to hide sources of income from HMRC.
- 4.2 This chapter sets out a number of potential options for non-financial deterrents for those operating in the hidden economy. HMRC would welcome views on these proposals, and on how they might work alongside changes to existing penalty provisions in chapter 3 to reduce hidden economy non-compliance.

Proposal 2: Increased monitoring of individuals and businesses engaging in hidden economy activity

- 4.3 HMRC already has successful programmes in place which help deter and monitor repeated non-compliance in other contexts.
- 4.4 Under the **Managing Serious Defaulters (MSD) programme**, HMRC can monitor any individual or business considered to be a serious defaulter. One of the main qualifying criteria is the charging of a penalty because of deliberate behaviour under Schedules 24, 41 or 55 set out at earlier chapters. HMRC will continue to monitor the defaulter until it is satisfied that they are meeting their tax obligations and have changed their previous non-compliant behaviour – this includes putting right any inaccuracies identified. For most people this can last for two to five years.
- 4.5 Under the **Publishing Deliberate Defaulters** programme, HMRC can publish details of deliberate tax defaulters. HMRC may publish information about a deliberate tax defaulter where it has carried out an investigation and the person has been charged one or more penalties for deliberate defaults, where those penalties involve tax owed of more than £25,000.
- 4.6 Under the **Serial Avoiders regime**, HMRC can monitor and take action against taxpayers who persistently enter into tax avoidance schemes that are defeated by HMRC. The consequences of relevant single or multiple defeats include special reporting requirements, a surcharge, public naming and restriction to tax reliefs that have been used for avoidance purposes.
- 4.7 Those found to have been operating in the hidden economy may be eligible for the Managing Serious Defaulters or Publishing Deliberate Defaulters programmes. Because entry into those programmes is triggered by deliberate behaviour, they do not target those individuals or businesses engaging in non-deliberate hidden economy failures.

- 4.8 In 2014/15, 20% of Schedule 41 failure to notify penalties issued to non-compliant businesses were for non-deliberate failures. As set out in earlier chapters, operational evidence suggests that existing sanctions for first-time non-compliance are not deterring some hidden economy participants from further activity. As such, there may be a case for a complementary hidden economy monitoring regime as a tool to promote compliance after an initial hidden economy failure.
- 4.9 Hidden economy businesses seek to operate outside of formal registration processes and under the radar from HMRC. There is an argument that a different approach to monitoring is needed to keep those businesses compliant.
- 4.10 A supplementary regime or extension of MSD could help to ensure that those who repeatedly continue to operate in the hidden economy despite earlier sanctions and opportunities to get their affairs in order, are monitored more closely. This would function as a tailored approach to the enhanced risk they present in light of their ongoing non-compliant behaviour as they incur more failures.
- 4.11 This additional monitoring regime could also supplement the existing MSD provisions by applying also to hidden economy businesses and individuals who receive a non-deliberate Schedule 41 failure to notify penalty.
- 4.12 HMRC is considering additional tracking and potentially enhanced monitoring of taxpayers with a history of hidden economy non-compliance. This will allow any further non-compliance to be identified early and penalties escalated appropriately for repeat failures. This will add to the existing measures in place and will help implement the escalation of penalties such as referred to in proposal 1 (chapter 3).
- 4.13 A successful monitoring regime would also need to have the capability to take account of the risks posed by individuals involved in tax-motivated insolvencies. HMRC will also continue to make effective use of securities powers in cases of serious non-compliance, by asking for a deposit or bond in advance of payment.
- 4.14 Lastly, HMRC is considering the important role that tax agents and other advisors can play in supporting former hidden economy participants to be compliant and keeping them on the right track with their obligations.

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?

5. Further areas of interest

- 5.1 HMRC is determined to make it more difficult to operate in the hidden economy, and to clamp down on those who do not pay their fair share – especially where this behaviour is part of a pattern of non-compliance.
- 5.2 Chapters 3 and 4 outlined potential policy changes to strengthen HMRC's approach to hidden economy activity including repeated non-compliance. Thinking is not limited to these options and HMRC welcomes any alternative proposals for sanctions to address the specific challenges of hidden economy failures, whilst also meeting HMRC's penalty principles.

Illegal working in the Hidden Economy

- 5.3 The ability to work illegally – i.e. work which a migrant is not permitted to undertake as part of their conditions for being in the UK, or when they have no right to be in the UK – is a key driver for illegal immigration that requires a robust cross-government response. The government is taking forward a range of activity to strengthen its response to illegal working including the announcement at Budget 2016 of restrictions to the Employment Allowance for employers found to be employing illegal workers.
- 5.4 In addition to the immigration offence, HMRC's experience is that employing workers illegally is often associated with a range of tax failures including non-payment of personal and business taxes, and not registering with HMRC.
- 5.5 Those who employ illegal workers can be charged a penalty of up to £20,000 for each worker by the Home Office. Given that those who operate in the hidden economy may also demonstrate other forms of tax non-compliance, HMRC is considering the interactions between its penalties and the illegal working regime.
- 5.6 HMRC welcomes views on whether and how the penalty regimes for tax failures could be strengthened where an immigration offence has also been committed. Any proposals in this area will be considered to supplement the existing Home Office sanctions regime for illegal working.

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

Conclusions

- 5.7 Any suggestions for alternative proposals for sanctions to address the specific challenges of hidden economy non-compliance would be welcomed.
- 5.8 Financial penalties are not always the best way to change behaviour, and HMRC is keen to consider other sanctions to deter non-compliant behaviour in the hidden economy.

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?

6. Assessment of Impacts

Summary of Impacts

The consultation is to establish whether and how to introduce hidden economy penalties and sanctions for those who are not compliant with their tax obligations. This consultation does not include firm proposals for policy change although it is anticipated that any changes to HMRC penalties models in future will not have any impact on compliant businesses.

Exchequer impact (£m)	2016 -17	2017 -18	2018 -19	2019 -20	2020 - 2021
	The Exchequer Impact cannot be quantified at this stage.				
Economic impact	These measures are not expected to have any economic impacts.				
Impact on individuals, households and families	This consultation does not include firm proposals for policy change. It is anticipated that any changes to HMRC penalties models in future would not disproportionately affect legally protected equalities groups, families with children or have any detrimental impact on child poverty.				
Equalities impacts	This consultation does not include firm proposals for policy change. Equalities impacts will be considered at the next stage of policy consultation.				
Impact on businesses and Civil Society Organisations	This consultation does not include firm proposals for policy change. It is anticipated that any changes to HMRC penalties models in future will not have any impact on compliant businesses.				
Impact on HMRC or other public sector delivery organisations	This consultation does not include firm proposals for policy change. We will consider the potential impact on HMRC or other public sector delivery organisations at the next stage of policy consultation. In particular, changes to HMRC penalty models will be designed to meet HMRC's fourth principle for penalties - penalties must provide a credible threat. If there is a penalty, HMRC must have the operational capability and capacity to raise it accurately, and if it raises it, must be able to collect it in a cost-efficient manner.				
Other impacts	This consultation does not include firm proposals for policy change. We will consider other potential impacts at the next stage of policy consultation.				

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?

7. Summary of Consultation Questions

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

Q.2: 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?

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?

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?

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?

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?

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?

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

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?

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?

8. The Consultation Process

This consultation is being conducted in line with the Tax Consultation Framework. There are 5 stages to tax policy development:

- Stage 1 Setting out objectives and identifying options.
- Stage 2 Determining the best option and developing a framework for implementation including detailed policy design.
- Stage 3 Drafting legislation to effect the proposed change.
- Stage 4 Implementing and monitoring the change.
- Stage 5 Reviewing and evaluating the change.

This consultation is taking place during stage 1 of the process. The purpose of the consultation is to seek views on the policy design and any suitable possible alternatives, before consulting later on a specific proposal for reform.

How to respond

A summary of the questions in this consultation is included at chapter 7.

Responses should be sent by 21st October 2016 by e-mail to isbc.compliancepolicy@hmrc.gsi.gov.uk or by post to:

Sarah Harris
HMRC
Room G/73
100 Parliament Street
London
SW1A 2BQ

Telephone enquiries 03000 540 848 from a text phone prefix this number with 18001.

Please do not send consultation responses to the Consultation Coordinator.

Paper copies of this document or copies in Welsh and alternative formats (large print, audio and Braille) may be obtained free of charge from the above address. This document can also be accessed from [HMRC's GOV.UK pages](#). All responses will be acknowledged, but it will not be possible to give substantive replies to individual representations.

When responding please say if you are a business, individual or representative body. In the case of representative bodies please provide information on the number and nature of people you represent.

Confidentiality

Information provided in response to this consultation, including personal information, may be published or disclosed in accordance with the access to information regimes. These are primarily the Freedom of Information Act 2000 (FOIA), the Data Protection Act 1998 (DPA) and the Environmental Information Regulations 2004.

If you want the information that you provide to be treated as confidential, please be aware that, under the FOIA, there is a statutory Code of Practice with which public authorities must comply and which deals with, amongst other things, obligations of confidence. In view of this it would be helpful if you could explain to us why you regard the information you have provided as confidential. If we receive a request for disclosure of the information we will take full account of your explanation, but we cannot give an assurance that confidentiality can be maintained in all circumstances. An automatic confidentiality disclaimer generated by your IT system will not, of itself, be regarded as binding on HM Revenue and Customs (HMRC).

HMRC will process your personal data in accordance with the DPA and in the majority of circumstances this will mean that your personal data will not be disclosed to third parties.

Consultation Principles

This consultation is being run in accordance with the Government's Consultation Principles.

The Consultation Principles are available on the Cabinet Office website: <http://www.cabinetoffice.gov.uk/resource-library/consultation-principles-guidance>

If you have any comments or complaints about the consultation process please contact:

John Pay, Consultation Coordinator, Budget Team, HM Revenue & Customs, 100 Parliament Street, London, SW1A 2BQ.

Email: hmrc-consultation.co-ordinator@hmrc.gsi.gov.uk

Please do not send responses to the consultation to this address.

Annex A: Existing penalty provisions

The law provides for penalties to be applied where customers fail to meet their tax obligations. They break down into three broad types:

- penalties for failing to meet an obligation such as notifying a liability to tax or a taxable status or not complying with a regulatory regime (for instance by handling goods subject to unpaid excise duty), largely contained in Schedule 41 to the 2008 Finance Act (“Schedule 41”); and
- penalties for submitting inaccurate returns and documents, largely contained in Schedule 24 to the 2007 Finance Act (“Schedule 24”), these are often called behavioural-based penalties;
- penalties for failing to meet a deadline, such as submitting a return or making a payment by a deadline specified in law, largely contained in Schedule 55 to the 2009 Finance Act (“Schedule 55”).

Text Box A.1: Behavioural-based penalties for hidden economy non-compliance

Penalties for inaccuracies in returns, failure to notify and – in the case of a very late return – failure to file a return are based upon:

- the behaviour of the taxpayer, including whether the inaccuracy or failure was deliberate;
- the potential revenue lost as a result of the inaccuracy or failure; and
- the degree to which the taxpayer has disclosed the inaccuracy or failure to HMRC.

Schedule 41 – ‘failure to notify’

Schedule 41 provides for penalties where a taxpayer has failed to comply with a relevant tax obligation, including a failure to notify chargeability to income tax or capital gains tax, and failure to register for VAT when required to do so.

In the hidden economy context, a penalty is due under Schedule 41 when a business or individual fails to comply with registration obligations. There is no penalty if the taxpayer has a reasonable excuse for the failure.

The regime reserves the highest penalties for deliberate and concealed failures. It encourages taxpayers to report failures by reducing penalties for disclosure and encourages taxpayers to contact HMRC as soon as possible by further reducing penalties for disclosure unprompted by any HMRC action. For example, if a taxpayer makes a full unprompted disclosure of a non-deliberate failure to notify within 12 months after tax first becomes unpaid, the penalty may be reduced to zero.

The table below shows the penalty ranges for inaccuracies that involve a domestic matter.²

Behaviour	Unprompted or prompted disclosure	Penalty range
Not deliberate ³	Unprompted – within 12 months of tax being due	0% to 30%
	Unprompted – 12 months or more after the tax was due	10% to 30%
	Prompted – within 12 months of tax being due	10% to 30%
	Prompted – 12 months or more after tax was due	20% to 30%
Deliberate	Unprompted	20% to 70%
	Prompted	35% to 70%
Deliberate and concealed	Unprompted	30% to 100%
	Prompted	50% to 100%

For example, a taxpayer must notify HMRC of their income tax liability within six months of the tax year to which the tax liability arises.⁴ A 'failure to notify' penalty can be charged after October. If the failure was not deliberate, the taxpayer faces a maximum penalty of 30% of the revenue lost as a result of the failure, with reductions depending on disclosure.

Schedule 24 – Inaccuracies in returns

Some individuals and businesses operating in the hidden economy are registered with HMRC but fail to declare a second source of income. As these taxpayers are filing returns, they have not necessarily failed to notify HMRC of a liability to tax, but by omitting the second source of income, they have filed an inaccurate return. These persons are sometimes referred to as 'moonlighters'.

The table below shows the penalty ranges for inaccuracies that involve a domestic matter.⁵

Behaviour	Penalty max (%)	Penalty min (%) – prompted disclosure	Penalty min (%) – unprompted disclosure
Inaccurate but took reasonable care	0	0	0

² Higher penalty ranges apply for offshore matters. An offshore matter results in a potential loss of revenue that is charged on or by reference to income arising from a source in a territory outside the UK, or assets held in a territory outside the UK.

³ If there is a 'reasonable excuse' for the failure then no penalty is due.

⁴ To note, for other liabilities such as National Insurance Contributions (NICs), earlier notification rules apply.

⁵ As with Sch 41, higher penalty ranges apply for offshore matters. An offshore matter results in a potential loss of revenue that is charged on or by reference to income arising from a source in a territory outside the UK, or assets held in a territory outside the UK.

Careless	30	15	0
Deliberate	70	35	20
Deliberate and concealed	100	50	30

Some hidden economy businesses employ staff but fail to operate PAYE when that obligation applies. Those businesses fail in their obligation to collect and pay relevant income tax and NICs to HMRC and the exchequer. In these cases, because the business fails to hand over sums that should have been collected from employees, that non-compliance has a broader impact than failures just relating to the tax affairs of the businesses.

Text box 2.2: relevant PAYE obligations

HMRC only wants businesses to notify the Department of their PAYE liability when they have liable employees. The technical term for that liability is 'chargeability', but for ease of understanding, 'liability' is used throughout this document.

Businesses must notify HMRC of their PAYE liability when:

- they start paying staff over the lower earnings limit, or;
- are required to operate a tax code against their pay because they have another job or pension, or;
- use subcontractors for construction work.

Employers must notify HMRC before the first payday. This notification is on top of other registrations the business may have with HMRC or companies house as a limited company. It is an additional step they must undertake to make HMRC aware of their intention to employ staff and operate PAYE. Failure to notify HMRC can be considered an additional failure (under Schedule 55).

From March 2015 onwards, Schedule 55 applies a penalty to all businesses who fail in their obligation to file one or more monthly PAYE returns, on time, through the Real Time Information (RTI) system.

HMRC makes use of this penalty as a sanction for employers who have already notified HMRC of their liability. It has much more limited applicability to businesses operating as employers, but who are unknown to HMRC and have not notified their liability. In simple terms, it can apply when a hidden economy business is no longer hidden, but submits late returns that should have been submitted when it was hidden.

Text box 2.3: relevant PAYE penalties

Schedule 55 Finance Act 2009

The non-payment of PAYE income tax and NICs contribute to the hidden economy tax gap. Under existing penalty rules, a fixed late filing penalty of between £100 and £400 is chargeable for each late return that a hidden economy employer makes for the months it has missed, after it is brought into PAYE.

This fixed penalty applies to late returns for each month after an employer has notified HMRC of their liability and to months that they have missed before that notification. The first month is excluded for the first failure in a tax year.

Annex B: Theoretical models for potential changes to failure to notify (Schedule 41)

Tables A.1. and A.2. are for illustrative purposes only. They do not constitute a definite design for any future changes to Schedule 41.

See chapter 4 for more context, including the following points that would be considered in more detail for the purposes of designing changes:

- The most effective and proportionate rate of escalation.
- The period in which the repeat failure must take place.
- How the penalty could apply in cases of phoenixism. (This is where a company ceases trading, sometimes in a contrived manner, and disposes of assets to a successor company without paying accrued debts. Trading continues through the new company, often with the same director, premises, equipment and workforce).
- How incentives to disclose may be retained.
- Whether the escalation should apply across different taxes and obligations.
- Whether the penalty was proportionate and could be paid by those penalised.
- How the escalation would interact with the offshore penalties regime.

Option A, Table A.1.

A change could take the form of simple escalation. That could be increased penalty percentages for second and third failures by the same individual or business. The Sch 41 penalty for the second failure could be 1.5 times the penalty applicable for the first failure, and a penalty for the third failure which is twice that of the first failure.

Behaviour	Unprompted or prompted disclosure	1 st failure	2 nd failure	3 rd and subsequent failures
Not deliberate ⁶	Unprompted – within 12 months of tax being due	0% to 30%	0% to 45%	0% to 60%
	Unprompted – 12 months or more after the tax was due	10% to 30%	15% to 45%	20% to 60%
	Prompted – within 12 months of tax being due	10% to 30%	15% to 45%	20% to 60%
	Prompted – 12 months or more after tax was due	20% to 30%	30% to 45%	40% to 60%

⁶ If there is a 'reasonable excuse' for the failure then no penalty is due.

Deliberate	Unprompted	20% to 70%	30% to 105%	40% to 140%
	Prompted	35% to 70%	52% to 105%	70% to 140%
Deliberate and concealed	Unprompted	30% to 100%	45% to 150%	60% to 200%
	Prompted	50% to 100%	75% to 150%	100% to 200%

Option B, Table A.2.

Schedule 41 could be changed such that second and subsequent failures attract the same penalty percentages as deliberate failures on the grounds that a second failure cannot be said to be non-deliberate. Taxpayers who had a reasonable excuse for their failure would not receive a penalty.

Behaviour	Unprompted or prompted disclosure	1 st failure	2 nd and subsequent failures
Not deliberate ⁷	Unprompted – within 12 months of tax being due	0% to 30%	As per deliberate: 20% to 70%
	Unprompted – 12 months or more after the tax was due	10% to 30%	As per deliberate: 20% to 70%
	Prompted – within 12 months of tax being due	10% to 30%	As per deliberate: 35% to 70%
	Prompted – 12 months or more after tax was due	20% to 30%	As per deliberate: 35% to 70%
Deliberate	Unprompted	20% to 70%	20% to 70%
	Prompted	35% to 70%	35% to 70%
Deliberate and concealed	Unprompted	30% to 100%	30% to 100%
	Prompted	50% to 100%	50% to 100%

⁷ If there is a 'reasonable excuse' for the failure then no penalty is due.