

Office of  
Tax Simplification

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**Tax penalties:  
final report**

November 2014



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# Foreword

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The OTS gets a regular flow of suggestions for areas of the tax system we should study and penalties is a topic that often crops up. Many such suggestions are sparked by a feeling that an aspect is operating unfairly, but at the hub of almost all is that the extensive changes that followed the lengthy review of HMRC Powers & Penalties consequent on the formation of HMRC in 2005 would benefit from a 'post implementation review'.

Penalties are clearly necessary in any tax system. There are numerous civil penalties within tax legislation, with one penalty dating back to 1842<sup>1</sup> and unchanged since then! The more recent penalties, introduced in Finance Acts 2007, 2008 and 2009, are aimed to change the behaviour of the customers by applying more severe penalties to those who:

- provide incorrect information<sup>2</sup>
- do not notify chargeability to tax<sup>3</sup>
- do not submit returns<sup>4</sup> or
- do not pay the tax due on time<sup>5</sup>

We have undertaken a short exploratory project, in many ways to prove the case for a fuller review and establish the main areas of concern. Due to the short time span available for this project, the review focusses on addressing inconsistencies in the application of these 'new' penalties and does not consider the legislative framework. Nor have the multitude of earlier penalties (which were not covered by the post-2005 review) been considered. These could be made the subject of a longer project with the aim of recommending ways to simplify and rationalise the rest of the penalty system.

People we spoke to generally considered the legislation for the 'new' penalties to be sound and there was no wish to recommend changes to the principles within the legislation. The issues and concerns raised were mainly around the application of the penalties by HMRC staff. External bodies and representatives recognised that there was a need to impose more severe sanctions on those who deliberately try to evade paying the tax that is due but felt that some penalties are being imposed either on the wrong people, or for the wrong reasons.

## Our findings

The basic question we have asked is: are the new penalties working in line with their objectives. We think the answer to that is a cautious 'yes', but whether they are promoting the behavioural change intended is not proven. It is also debateable whether the system is fully appropriate for the increasingly digitised nature of the tax system.

We have made some 14 immediate recommendations, all aimed at improving the workings of the penalties system. They are not legislative simplifications: the scope of our project and the time available did not permit us to develop such potential changes. It is a fair challenge that the

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<sup>1</sup> S103 Income Tax Act 1842

<sup>2</sup> Schedule 24 Finance Act 2007 – Penalties for Errors

<sup>3</sup> Schedule 41 Finance Act 2008 – Penalties: Failure to Notify and Certain VAT and Excise Wrongdoings

<sup>4</sup> Schedule 55 Finance Act 2009 – Penalty for Failure to Make Returns etc

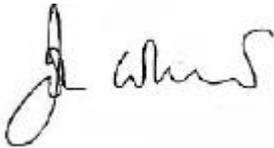
<sup>5</sup> Schedule 56 Finance Act 2009 – Penalty for Failure to Make Payments on Time

OTS have not really come up with the sort of simplification recommendations to change the system in the way we have done on previous reports. Our response is that in the limited time and scope we have had available for this project, it has not been appropriate for us to suggest such changes: instead we have concentrated on ways that the current system can be made to work better – and therefore seem simpler for all concerned.

The main conclusion is that there needs to be the full post implementation review we have alluded to, together with a completion of the aspects of the general review that remain unfinished. This should test whether the design features of the system are appropriate in an increasingly automated world. There are aspects that require judgements by HMRC staff and achieving consistency is clearly difficult at times. Such a review would potentially deliver the sort of changes that may seem lacking in this report.

We are pleased that the HMRC penalties team are carrying out some work of their own. We, and no doubt many of the external people we have spoken to, would welcome the opportunity to work with the HMRC team on improving the penalties system.

The project work has been led by Sally Munnings, on a short secondment to the OTS from HMRC. We are very grateful to her for her efforts and for the time everyone has given us and the way people have been so willing to discuss issues and concerns.

A handwritten signature in black ink, appearing to read 'John Whiting', with a stylized initial 'J'.

John Whiting

OTS Tax Director

# Executive summary

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The remit for this review was to concentrate on civil penalties, including the operation of suspension, reasonable excuse and special reduction.

The key issues emerging from the work carried out during this review are around the areas of the impact of the automated penalties for late filing on the more vulnerable members of society and consistency of application of the behavioural penalties including suspension of careless penalties.

There are various recommendations around the number of erroneous entries on the Income Tax Self Assessment (ITSA) register of people who should not be registered. These registrations compound the problem of the automated penalties which are issued to people who should not be on the register.

HMRC recognised that the introduction of behavioural penalties was a cultural change for the staff, which has been difficult to implement. HMRC are still considering methods to increase the understanding of these penalties to gain consistency in their application and carry out regular assurance activity to assess the accuracy of the penalties issued. There are a number of recommendations covering this area.

There are also specific recommendations covering VAT as Schedules 55 and 56 Finance Act 2009 do not currently apply to VAT.

## Recommendations

### ITSA

- 1 People receiving pensions from overseas are automatically in Self Assessment (SA) regardless of the amount and they often have very little other income so are consistently below the tax threshold. It is **recommended** that where people are consistently below the tax threshold, over retirement age and can confirm that their circumstances will not change, they are removed from the SA register; para 2.7.
- 2 ITSA on-line returns – these are often completed, payment made and a payment submission number generated but the form is not actually submitted, resulting in a late filing penalty. It is **recommended** that an on-screen warning to advise taxpayers that, if they leave the application at this point, they will not have submitted the return so need to ensure this is done or they could incur a penalty; para 2.12.
- 3 Customers ring the contact centres when struggling with returns but late filing penalties do not appear to be routinely mentioned so customers are not aware that these could be imposed. It is **recommended** that staff training is provided for contact centre staff regarding late filing penalties and that information on these penalties is added to the scripts used by the call centre staff; para 2.14.
- 4 If zero income SA returns are submitted for two or more consecutive years, it is **recommended** that an automated letter is generated asking if the taxpayer still need to be on the SA register. This should include the conditions required if they still need to be in SA. Letter to also state how to notify HMRC if no longer required to be registered for SA; para 2.16.

- 5 A reminder for SA is issued at the beginning of January each year. It is **recommended** that this emphasises the late filing penalty if taxpayers do not submit their return on time and, again, how to notify HMRC if no longer required to submit a return; but also to remind taxpayers that they do still need to submit the current return; para 2.17.
- 6 Summaries produced by the SA system are issued to give information on the tax, interest and penalties owed which are very confusing. It is **recommended** that HMRC issue a covering letter to go out with these statements to give a summary of the total tax and penalties owed for each tax year to provide a simple explanation and clarification; para 2.18.
- 7 People leaving the PAYE system owing tax are put into SA if the tax is not paid. Currently the only way to pay overdue PAYE/NICs is by a cheque in UK sterling but not everyone has a UK bank account. It is **recommended** that HMRC set up a system for taxpayers to pay the tax due by an alternative method such as credit card or bank transfer, options that do, after all, exist in many tax areas already; para 2.19.

## General

- 8 With regard to the lack of consistency on the application of penalties, it is **recommended** that HMRC provide further training for managers to emphasise their role in how penalties are applied and to get more consistency amongst their staff; para 3.6.
- 9 HMRC staff confirmed that they found it difficult to put conditions in place to ensure that one-off errors did not recur, in order to access the rules allowing suspension of the penalty. It is **recommended** that HMRC includes some more examples in the guidance to assist staff; para 3.10.
- 10 There is a lack of consistency across HMRC with regard to suspension of 'careless' penalties. It is **recommended** that HMRC carry out assurance work in this area to investigate the reasons why careless penalties are not being suspended where it would be appropriate to do so and, conversely, suspended where it is not appropriate to do so; para 3.13.
- 11 All HMRC staff use the Compliance Handbook guidance for penalties and complete the Penalty Decision and Action Checklist (PDAC). However, this has not been sufficient in itself to ensure consistency across HMRC so it is **recommended** that HMRC investigates alternative methods of publicising the behaviours and suspension criteria so that staff gain a better understanding of how to apply these; para 3.21.
- 12 Special reduction is very rarely used within HMRC and is not covered in any detail in the training. The expectation was that the special reduction would be used very rarely but Tax Tribunal cases suggest it should be used more widely. It is **recommended** (a) that HMRC review their guidance in the light of Tribunal decisions and then (b) that more emphasis is put onto this in the HMRC penalties training material; para 3.27.

## VAT

- 13 The VAT register also has some VAT registrations for businesses who are no longer trading (if they submit a nil return a business will not get a penalty as Default Surcharge applies where no return/payment is submitted). It is **recommended** that

this is looked at in order to de-register those businesses who are no longer required to be registered; para 4.15.

- 14 The VAT system for late filing/late payment is different from other taxes. To bring this in line with other taxes it is **recommended** that Schedules 55 (penalties for late filing) and 56 (penalties for late payment) FA09 regimes are implemented for VAT rather than default surcharge – after the VAT register has been cleared of those no longer required to be registered; para 4.16.

## Further areas for the OTS to explore

There was insufficient time during this review to look at simplifying the overall penalty system in order to reduce the numbers of different penalties and bring the different taxes into the same penalty regimes, getting rid of outdated penalties and those that are never used. Nor was there time to look at the complex legislative framework within which the new behavioural penalties operate to see where this could be simplified. The OTS would like to look into these areas in a future project.



# 1

## Introduction

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**1.1** This is the report for the OTS project on penalties. It is a summary of evidence that we have heard from people, organisations, representative bodies and HMRC staff. What follows is their views and experiences collated by OTS, balanced and validated by our own research.

**1.2** Our remit for the review was to concentrate on civil penalties, including the operation of suspension, reasonable excuse and special reduction. We have highlighted some possible quick fixes. We have made these suggestions where we think they could make things simpler without legislative intervention or changes. For the longer term, the sheer volume of penalties needs to be looked at with a view to simplifying and rationalising the overall system.

**1.3** The OTS itself can only make recommendations; it is up to Ministers to decide what to take forward.

**1.4** The main aims of this report are:

- to report back on what we have heard and found; and
- to prompt further thought and discussion

**1.5** Although we have held a number of meetings and have already heard from a number of stakeholders, we always welcome feedback on our reports and further input for our (or HMRC's) next steps.

### Main conclusions

**1.6** The main concerns raised by external bodies and representatives were around the behavioural and automated civil penalties introduced in the Finance Acts 2007, 2008 and 2009. We have therefore focussed on these aspects of the system.

**1.7** It is accepted that a system of penalties is needed: tax systems cannot operate without some sanctions. The concern is that the penalties should operate fairly, be seen to do so and be proportionate to the degree of non-compliance.

**1.8** There is evidence that the penalties are not always operating well in terms of their impact on the elderly and more vulnerable members of society in the Income Tax Self-Assessment (ITSA) regime.

**1.9** We have noted concerns around a lack of consistency both in the application of the behavioural penalties by HMRC staff and in the suspension of failure to take reasonable care (careless) penalties.

**1.10** In general, the penalty system is operating well, but we have not been able to conclude whether it is delivering the behavioural changes intended by its designers. This area needs a fuller study.

**1.11** The sheer volume of late filing penalties under ITSA is a cause for concern, not least because of the strain it puts on HMRC's debt management and banking (DMB) teams who are responsible for collecting the penalties.

**1.12** There is also a need to do more work on the ‘other penalties’, particularly those that the main post-2005 review did not consider.

**1.13** We are aware that HMRC are currently looking at penalties and we hope that their policy team will take a formal review exercise forward. We would encourage them to make this a comprehensive exercise and to include external (and independent) input.

## **Our remit**

**1.14** The terms of reference for the review proposed that we should undertake a short review of civil penalties. In particular our terms of reference asked us to:

- Consider areas of particular difficulty for businesses and individual taxpayers and areas where HMRC find difficulties in administering the penalty rules;
- HMRC guidance and advice;
- Examine the number and range of HMRC financial penalties issued to consider if they are proportional and have been targeted correctly;
- Examination of the number and range of financial penalties issued to consider if they have been successful in deterring non-compliance;
- Consider if the total number of different penalties could be reduced;
- Consider if there is a need for revalorisation of penalties and on what basis;
- Consider if there is another way to drive compliant behaviour that is more effective, cheaper and better targeted.

## **Our approach to gathering evidence**

**1.15** The report is based on work carried out by the OTS from June to October 2014 and incorporates feedback from a number of meetings with individuals, organisations, representative bodies and HMRC staff.

**1.16** We have also conducted research into penalty and other approaches relating to tax compliance taken by some overseas jurisdictions.

**1.17** We are very grateful to HMRC’s analytical team who responded to our request for statistics on issued and suspended penalties with some very useful data and information taken from HMRC’s computer systems.

**1.18** This report is based on representations made to the OTS, supplemented by our own research. We have not carried out any formal survey of individual or company taxpayers or their advisers but we are confident that what we are reporting is well founded and represents the views of a number of people with experience in this field. This includes the views of HMRC operational staff. We are very grateful for the time people have given us and the way they have been so willing to discuss matters.

## **Structure of the report**

**1.19** Due to the short life span of this project, we therefore concentrated on the following areas:

- Numbers on the Self-Assessment (SA) register who need not be on the register as their income is below the tax threshold and who are receiving late filing penalties

- People on SA as they receive benefits which are not taxed at source as well as a pension; and
- People who receive small overseas pensions
- Proportionality around the amount of the late filing penalties for SA and the Construction Industry Scheme (CIS)
- Lack of consistency around the application of behavioural penalties by HMRC staff
- Lack of consistency in the use of the suspension process for 'careless' errors
- Different penalty used for late filing of VAT returns, i.e. the default surcharge

**1.20** The penalties arising around these areas are:

- FA07 Schedule 24 – error penalty;
- FA09 Schedule 55 – late filing penalty; and
- VAT Act 1994 s59 – VAT default surcharge (for late filing and/or late payment)

**1.21** We looked at the above penalties across all taxes, looking at the consistency of the application of the penalties. There is a different system for late filing and/or late payment of VAT returns whereby a VAT default surcharge is automatically raised by the VAT system which has a different regime to the Schedule 55 late filing penalties and the Schedule 56 penalties for failure to make payments on time.

**1.22** The proportionality issue around CIS is currently being looked at by HMRC so this area has not been considered any further.

**1.23** The rest of this report includes sections on each of:

- Income Tax Self-Assessment (ITSA)
- Behavioural penalties
- Other aspects, including some VAT issues



# 2

## Income Tax Self-Assessment (ITSA)

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**2.1** People, from external organisations, representative bodies and HMRC, consistently told us that there are a large number of individuals who are registered for ITSA but are either not submitting returns or submitting returns late for a variety of reasons and therefore incurring the automated late filing penalties. This impacts particularly on the elderly and more vulnerable members of society.

**2.2** A £100 penalty is automatically issued by HMRC's computer system as soon as a return is considered to be late i.e. after the on-line filing date of 31 January. If a paper return is received after 31 October, this also generates the penalty. This penalty is not reduced if the subsequent return, when submitted, has no tax due.<sup>1</sup>

**2.3** If the return is still not received after 3 months, daily penalties are then issued of £10 per day for 90 days (maximum £900). A further 5% of tax due or £300 is due after 6 months and a further 5% or £300 after 12 months. This can be disproportionate for those on low incomes or pensions.

**2.4** The volume of £100 penalties is causing collection problems for HMRC. It can be a great deal of work to explain to the taxpayer why the penalty is due. This has certainly been a problem in the first year after the 'cap' of the tax outstanding disappeared.

### Partnerships

**2.5** There are a number of issues around the late filing penalties for partnerships which were identified in the OTS report on Partnerships.<sup>2</sup> These included:

- The £100 penalty is on each partner rather than the whole partnership – as only one partner normally deals with the tax affairs, other partners could receive a penalty without knowing why.
- As the penalty is on the partnership return, only the representative partner is able to appeal – individual partners cannot appeal even if they believe that have a reasonable excuse in their own circumstances.

### Issues with the more vulnerable members of society

**2.6** There is a disproportionate impact on the elderly and the more vulnerable members of society as a result of the new automated late filing penalties. The previous penalty was reduced to nil if there was no tax due. However, this is no longer the case and, from case studies provided by external bodies, HMRC appear loath to reduce the penalties on appeals even where there appears to be a reasonable excuse. At one organisation, which mainly assists the elderly,

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<sup>1</sup> This 'capping' of the penalty in terms of tax outstanding was much used and led to considerable numbers of penalty notices subsequently being vacated. The cap was dropped in April 2011 for ITSA as part of the implementation of Schedule 55, primarily to emphasise that HMRC needed the return. It will undoubtedly save HMRC considerable time in sending out and then cancelling returns, and in explaining why no penalty is due to taxpayers and their agents. But one consequence of the new system is the volume of people who presumably have continued in a familiar vein of paying their tax but being late with the return – and who are now faced with a penalty.

<sup>2</sup> OTS Partnerships Interim Report paragraphs 5.14-5.18 - <https://www.gov.uk/government/publications/partnerships-review>

phone calls regarding appeals for late filing penalties increased from about 100 to 650 calls per week when the new automated penalties were introduced.

**2.7** External organisations stated that some individuals who receive a small pension from overseas, which is not taxed at source, automatically go into the self-assessment (SA) regime. This is the case even if they are retired and only receive a small second pension so, as they are often well below the tax threshold, they will therefore never pay any tax. It is **recommended** that there is a limit below which such individuals could come out of SA where it is certain that their circumstances will not change.

**2.8** There is another group of individuals who have been advised to go onto Jobseekers Allowance or Employment Seekers Allowance by Department of Works and Pension (DWP) advisers which puts them into the SA regime. When they get a job, the allowance ceases and they do not inform HMRC as they believe this is automatic because they are going onto PAYE. Late filing penalties are subsequently issued. This can be compounded where benefits, which were previously non-taxable, change to being taxable.

**2.9** The ideal solution would be for benefits to be taxed at source, within PAYE or possibly in the same way as for bank/building society interest. This would remove a significant number from the SA register and prevent the issue of late filing penalties when they become employed. However, we know from our pensioners project that such moves are highly unlikely on many grounds, primarily cost.

**2.10** A practical solution is to improve information flow to affected taxpayers. Our pensioners project recommended the introduction of a 'DWP60' which would be the equivalent of a P60 issued by the DWP detailing benefits paid and analysing which were and were not taxable. Although framed in terms of pensioners (our remit for the project) the DWP60 was seen as something that would benefit all claimants. The pressures of work on Universal Credit have meant that there has been no progress on our idea, but HMRC's work on taxpayer statements has incorporated our principles and could in due course deliver what we had in mind. Thus we think that the taxpayer statements project should encompass the taxpayers and issues identified in para 2.9.

## General points

**2.11** External organisations have found that a significant number of individuals who contacted them regarding a late filing penalty received had filed on-line but had not completed the process properly. They had entered all the relevant details, the tax due had been calculated, they paid the tax, received a submission number and then closed the application. There is a small bar at the top of the screen to show completion progress – this is at 95% when they exit but many people do not notice this bar. They have omitted to proceed to the final screen which is the submission of the return and, as a result, get a late filing penalty and they do not understand why as they think they have completed the process.

**2.12** It is **recommended** that a screen warning to say that the taxpayer is exiting the application without submitting the return and could therefore incur a penalty should be put on the system if a taxpayer is exiting the system at the '95%' screen.

**2.13** Three specific examples were provided to support this situation.

### Box 2.A: Cases provided by Tax Aid

- 1 A daughter submitted her parent's return online but did not click the final button to submit online but paid the tax due on time. HMRC reimbursed the penalty.
- 2 A self-employed customer had previously used an accountant but decided to use on-line filing himself. He got to the final calculation screen and paid his tax on time. Late filing penalties followed and despite numerous contacts HMRC was unable to adequately explain to the customer that his filing was not complete and daily penalties were added. Eventually filing was completed at an Enquiry Centre but penalties then stood at £1,200. Penalties eventually cancelled but this took up a lot of both his and HMRC's time.
- 3 A customer expecting a refund received a late filing penalty. She contacted HMRC and was advised that her return was only 95% completed. To file she needed to re-enter the code – she was not prompted to do this and, as she was able to print off a hard copy of the return, assumed it had been filed. Nothing appeared on the screen to state that this had not been completed.

**2.14** Where individuals call the contact centres for help with their SA returns, organisational bodies reported that they do not appear to receive any warning or information regarding late filing or late payment penalties. It is **recommended** that this is added to the HMRC call centre staff scripts so that individuals can be made more aware that they could incur a penalty if they are late submitting a return or paying the tax due. With the closure of the Enquiry Centres and the development of the Needs Enhanced Support (NES) processes, this is clearly a matter that needs to be included in NES materials.

**2.15** 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.<sup>3</sup> This will include those that have a low income, either below or just above the tax threshold, as well as those who are submitting a nil return as they do not have any ITSA income.

**2.16** Where there are two or more consecutive zero liability returns, showing no income, filed for SA, it is **recommended** that a standard letter is automatically issued which includes the SA registration conditions. This should advise the individuals that, if they are no longer required to be on the SA register, they should inform HMRC. This letter should also provide information on how they should do this. This could remove individuals from the register who are no longer required to provide returns and prevent late filing penalties being issued to these individuals who have no tax obligation.

**2.17** A reminder is issued at the beginning of January to all individuals in SA who have not yet submitted a return. It is **recommended** that this reminder emphasises the late filing penalty system and also tells individuals how to inform HMRC if they are no longer required to be on the SA register. At the same time, it needs to be made clear that even if the individuals are no longer required to be in SA, they need to complete the return in question.

**2.18** Summaries produced by the self-assessment system are issued to individuals to inform them of the outstanding tax, interest and penalties due. These summaries can be very confusing due to their layout and the number of lines of tax and interest for each tax year. Few people therefore understand them, which compounds the problem as the taxpayers do not know how much they are required to pay. It is **recommended** that either the SA summary is simplified or a

<sup>3</sup> This is based on information supplied by HMRC in meetings, based on their estimates rather than formal evaluation of a particular year's results.

covering letter with a short summary showing how much tax, interest and penalty is due each year is issued with the SA summary.

**2.19** Some individuals owe outstanding tax after they leave the PAYE system – P800 forms are issued which ask for payment. Payment of this outstanding tax can only be by a cheque in sterling. This is not always possible if taxpayers have left the UK and no longer have a UK bank account. Those individuals who do not pay are then put into the SA system in order that HMRC can get payment. It would prevent individuals going into the SA system for one payment only, then receiving late filing penalties for subsequent years as they are still in the SA system, if they could pay the P800 by an alternative method. The individuals often do not understand why they have been put into this system only to put figures which have been supplied by HMRC onto a return to be sent back to HMRC. It is therefore **recommended** that alternative systems of payment are set up for these taxpayers.

**2.20** The overall conclusion is that there are a number of individuals who should not be within the SA system for a variety of reasons. It is **recommended** that HMRC investigates this and designs a process that enables them to transact with the individuals without the risk of penalties.

**2.21** We looked at the systems of penalties for late filing and late payment from other countries including Canada, New Zealand and Hong Kong. All of these countries had penalties in place to encourage compliance. However, it was noted that in all these countries, the penalty was based on the tax owing rather than on a fixed amount.

# 3

## Behavioural penalties

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**3.1** A key principle of the new system of the behavioural penalties is that they should influence taxpayers' behaviour. That is exemplified by the design principle of:

- mistake – no penalty;
- careless – small penalty; and
- deliberate action – significant penalty

This is complemented by the possibility of suspending penalties for careless defaults, to encourage the taxpayer to change how they comply and thus get things right to the benefit of all concerned.

**3.2** The main area of concern raised by the representative bodies and individual agents around the behavioural penalties was the lack of consistency by HMRC staff in the application of these penalties. This is mainly around how HMRC staff reach the decision about behaviour and what criteria that decision is based on.

**3.3** One representative body stated that under the old system,<sup>1</sup> which covered both ITSA and CTSA, agents could generally predict what the penalty amount would be and the reasons behind the decision. This is no longer the case and currently agents have no idea how HMRC come to their decisions about penalties and therefore cannot predict the level of penalty. There should be no doubt as to how HMRC come to decisions about penalties as it is all set out in detailed guidance but this may not always be explained sufficiently clearly so any problem may be down to poor communication rather than poor decisions.

**3.4** With regard to the suspension of the penalty for careless errors, the representative bodies stated that there was a lack of consistency in the use of this by HMRC staff and that there were difficulties in getting suspensions agreed, especially for one-off errors.

**3.5** This lack of consistency is supported by the statistical data provided by HMRC with a significant variation in the percentages of the use of suspension by type of tax and by directorates.

**3.6** Managers in HMRC have to authorise all penalties so it is **recommended** that HMRC provide specific training to managers to ensure that they look at the penalties raised to ensure that staff have applied the rules correctly and are consistent in the application of the penalties. HMRC have recognised that managers/authorising officers need specific training but, as yet, there is no formal training available beyond the general courses for compliance staff.

**3.7** The initial training and guidance stated that HMRC staff could not suspend penalties for all instances of 'one-off' errors.

**3.8** There have been a number of Tribunal cases on this issue.

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<sup>1</sup> S95 Taxes Management Act 1970

### Box 3.A: Examples of Tribunal cases

The First-tier Tribunal (FTT) decision in the case of *David Testa v HMRC* (published on 1 March 2013) highlights the subject of suspended penalties and challenges the usual principles applied by HMRC when deciding whether such a penalty is appropriate. David Testa (DT) negotiated a severance payment with his employer and received a P45, which included his salary. After his employment ceased he received the severance payment and a payslip showing the gross payment and tax deducted at the basic rate. DT completed his own tax return and unfortunately missed off the severance payment from his 2009/10 tax return.

DT wrote to HMRC asking for the penalty to be suspended on the basis that he would appoint a qualified adviser to complete his tax return for the next two years in order to avoid any further errors in the future. HMRC rejected his proposal on the basis that the error related to a 'one-off' event such that they could not therefore set specific, time bound and measurable conditions, to prevent it occurring again in the future. The FTT highlighted this as being a general policy of HMRC, not just the view of the case officer reviewing DT's individual request.

DT appealed to the FTT stating that he was prepared to take steps to prevent the error occurring again (as detailed above) and that therefore the penalty should be suspended.

The FTT ruled that the penalty *should be* suspended on the basis that DT had proposed the 'positive' step of appointing a qualified adviser to prepare his tax return for the next two years – a request which could be viewed as being both time bound and measurable.

The FTT was critical of HMRC's application of the suspended penalty legislation – which appeared to exclude all cases involving 'one-off' events – and stated that HMRC's general policy in these cases 'sits uneasily'. The FTT described the logic applied by HMRC as being 'flawed' and that HMRC were 'in danger of taking too narrow a view of the legislation' – legislation which was deliberately drafted to ensure it covered a wide variety of cases.

A second case relating to suspension, *Boughey v Revenue & Customs [2012]* concerned an appeal against a redundancy payment. The taxpayer claimed exemption from tax on his self-assessment return in respect of a redundancy payment. However, relief had already been given through the PAYE system. The error was discovered, and HMRC imposed a 15% penalty. HMRC would not suspend the penalty, on the basis that a condition needed to be set that was specific to the careless inaccuracy (i.e., claiming the £30,000 relief for a redundancy payment in error). HMRC broadly decided that such a condition could not be set in respect of a redundancy payment.

However, the tribunal considered that HMRC's decision was flawed. It referred to a previous case, the **Fane** case, in which the judge pointed out that, on the face of the provisions on suspended penalties, there was no restriction in respect of a 'one-off event' that was unlikely to be repeated. The tribunal noted that Mr Boughey had proposed his own suspension condition, which was that during any period of suspension his tax returns should be prepared by a qualified accountant. The tribunal considered that this was a "borderline" case but agreed that there was a basis on which the penalty could be suspended. The tribunal therefore decided to suspend the penalty for two years.

**3.9** As a consequence of the Tribunal cases there has been a change in approach and the updated guidance states that it is possible to suspend penalties in instances where there have been one-off errors as long as it is possible to set appropriate suspension conditions. The updated guidance now states:

*'CH<sup>2</sup>: 405050: A penalty cannot be suspended where it is not possible to set specific conditions because the same type of inaccuracy is unlikely to happen in the future.'*

However, HMRC front-line staff do not appear to be aware of this change and during discussions with operational staff this lack of awareness was confirmed. This needs to be publicised internally to encourage staff to inform customers about suspension in all appropriate cases. HMRC agreed with this and agreed to publicise within Local Compliance for managers to cascade to all staff.

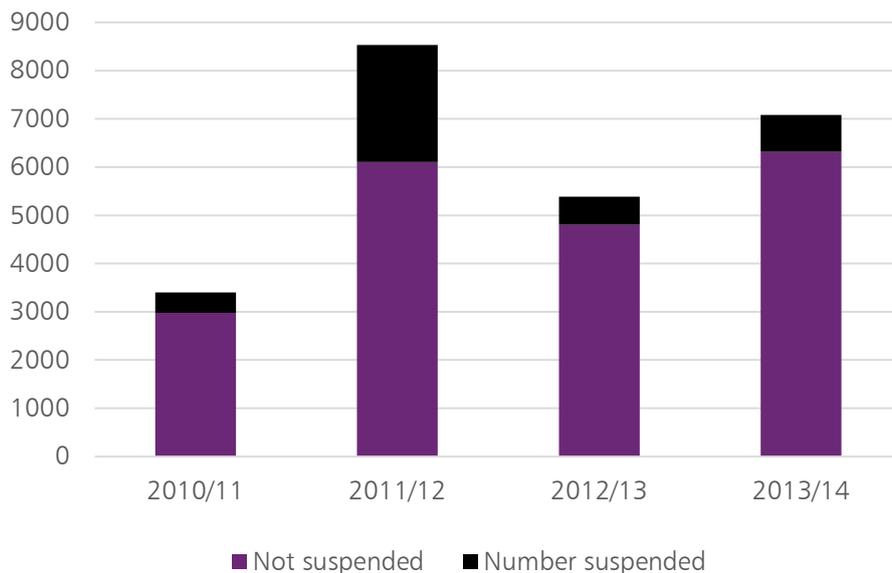
**3.10** A further problem was that HMRC staff could in some cases not see how they could suspend the penalty as it was difficult to put conditions in place to ensure that the type of error did not recur. Agents spoken to informed us that they have been asked to propose appropriate conditions which is one solution for HMRC staff. It is **recommended** that HMRC includes some more examples in the guidance to assist staff. It would also be sensible to make it clear that agents (where appointed) should be involved in the process of setting conditions for suspension.

**3.11** A representative body stated that there is a perception amongst agents that HMRC staff feel they have 'failed' if they suspend a penalty for careless behaviour.<sup>3</sup> The data provided by HMRC could be read as supporting this perception as the percentage of careless penalties suspended started at 12.3%, rose to 28.5% and then dropped back to 10.8%.

#### Box 3.B: Percentage of penalties suspended

- 1 10/11 FTRC penalties issued: 3399; Suspended: 417 = 12.3%
- 2 11/12 FTRC penalties issued: 8530; Suspended: 2427 = 28.5%
- 3 12/13 FTRC penalties issued: 5389; Suspended: 585 = 10.9%
- 4 13/14 FTRC penalties issued: 7083; Suspended: 765 = 10.8%

Chart 3.A: Percentage of suspensions



<sup>2</sup> HMRC's Compliance Handbook chapter 405050 <http://www.hmrc.gov.uk/manuals/chmanual/CH405050.htm>

<sup>3</sup> FTRC = failure to take reasonable care

**3.12** In contrast, in discussions with HMRC operational staff from one office across all taxes, they stated that they suspended about 90% of all careless penalties. This was confirmed by their manager.

**3.13** This area needs further investigation to find out why the penalties are not being suspended consistently across HMRC. Lessons need to be drawn for all concerned, especially to ensure advisers better understand the criteria. It is **recommended** that HMRC carry out assurance work in this area to investigate the reasons why careless penalties are not being suspended where it would be appropriate to do so and whether and why careless penalties are being suspended when it is not appropriate to do so.

## Consistency of application – HMRC guidance

**3.14** HMRC have carried out extensive face to face training to all front-line managers and staff on the application of Schedule 24 and Schedule 41 penalties. This is backed up by very detailed written guidance – the Compliance Handbook which contains both technical and operational guidance.

**3.15** As all HMRC compliance staff use the Compliance Handbook, this guidance should help to ensure consistency of application across HMRC. This is published on the HMRC internet site and is also available to agents.

**3.16** There is a tool used by all caseworkers to guide them through the entire penalty process – a Penalty Decision and Action Checklist (PDAC).<sup>4</sup> This is a step by step guide which also provides an audit trail for the penalty decisions and is the authorisation route for managers. It is mandatory for this to be completed in all cases where an error or failure to notify has been identified.<sup>5</sup>

**3.17** The operational guidance is controlled by a team responsible for operational policy and there is a prescribed system to ensure that this guidance is constantly updated if there is a change in policy resulting from case law, a specific project or a change in legislation. A full log is retained that lists every change that has been made to the manuals within the Compliance Handbook. Updates are communicated to staff by a variety of methods using HMRC's internal internet including publication on appropriate news sites for the various directorates and in managers' updates.

**3.18** The technical guidance is controlled by a team in HMRC's Central Policy who have a similar system for updating the guidance.

**3.19** The Central Policy and the Operational Policy teams work closely together to ensure that any changes are incorporated into both sets of guidance and that they are consistent.

**3.20** All HMRC staff spoken to confirmed that they did use the Compliance Handbook guidance for penalties and completed the PDAC although HMRC quality assurance checks show that the PDAC is not always completed.<sup>6</sup>

**3.21** The training, guidance and use of the PDAC has not been sufficient in itself to ensure consistency across HMRC so it is **recommended** that HMRC investigates alternative methods so that staff gain a better understanding of how to apply the behaviours and suspension criteria.<sup>7</sup>

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<sup>4</sup> Completion of the PDAC: <http://www.hmrc.gov.uk/manuals/chmanual/CH407100.htm>

<sup>5</sup> Mandatory for the new penalties under Schedules 24 and 41 only.

<sup>6</sup> It has been suggested that staff know what to do but find aspects of the penalty regimes overly complex and resource intensive to administer and apply and sometimes seek 'shortcuts' which result in inconsistencies. This results in some customers being treated less generously than they should be but others are treated more generously than they should be.

<sup>7</sup> It may be that further training is needed but in meetings it has also been said that a lack of understanding of the processes is not the problem – it is more likely to be a reluctance to engage fully with the penalty system that is the cause of the inconsistencies.

## Reasonable excuse

**3.22** There is no reasonable excuse within the Schedule 24 penalties (error penalties) legislation but it is included within the Schedule 41 FA 2008 Failure to Notify penalty and the Schedules 55 and 56 FA 2009 – late filing and late payment penalties. This was not raised as a specific concern although this is the main reason used in appeals against late filing penalties – see Chapter 2 of this report.

## Special reduction

**3.23** Special reduction is a discretionary reduction where it is established that there are special circumstances that are not considered under type of disclosure, type of behaviour or the quality of disclosure.

**3.24** This is an area of concern which was raised by external organisations but only to a limited extent. There have been a number of tribunal cases around this area where a special reduction has been granted by the Tribunal as HMRC staff had not considered the special circumstances in these cases.

**3.25** The initial expectation was that special reduction would be rare and that the circumstances in which it might be applied would indeed be ‘special’. However, the First Tier Tribunal appear to see this as applying more widely.

**3.26** There is a whole chapter within the Compliance Handbook which provides guidance for HMRC staff on Special Reduction: CH170000 – Special Reduction.<sup>8</sup> This covers all areas of this subject including when to use it, circumstances under which it is relevant, examples to assist staff and case law. This will presumably be updated in the light of Tribunal decisions as they emerge.

**3.27** Again this is an area which needs to be covered in more detail within the HMRC training on penalties to remind staff that it must be considered in all cases – it is in the training manuals but not covered on the face to face training event. There is no emphasis that staff need to consider this area when making penalty decisions although there is a section in the PDAC which staff have to complete to demonstrate that special reduction has been considered. It is **recommended** that this is included in the face to face HMRC penalty training as a reminder that Special Reduction must be considered in all cases.

## HMRC response

**3.28** HMRC recognise that the introduction of the behavioural penalties was a culture change and, as such, has taken time to bed in.

**3.29** Currently all staff, when starting compliance work, receive formal training including on-line manuals and a face-to-face event. The latter concentrates on the identification of behaviours, questioning skills and the factual evidence required to support the decisions made. However, it does not include suspension criteria or special reduction. This course is also available to compliance staff who want further training in this area.

**3.30** HMRC are currently carrying out a review of the penalties training material.

**3.31** There is an internal helpline for all staff which links to technical support for penalties. Feedback is published on the intranet where there are common areas of concern and where common questions arise.

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<sup>8</sup> Compliance Handbook: CH170000: <http://www.hmrc.gov.uk/manuals/chmanual/ch170000.htm>

**3.32** There is also a penalty roadshow which is available by request and a new DVD has recently been produced to ensure that the information provided is up to date. This follows on after the formal training and is aimed at compliance staff, although managers are also encouraged to attend and more managers are now attending this training.

# 4

## Other methods of gaining compliance including VAT aspects

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**4.1** We briefly considered methods other than the imposition of penalties in order to improve or encourage compliance. We looked at the theory behind penalties and behaviours and at methods other countries employ.

**4.2** Penalty regimes vary greatly from country to country with some countries having a far harsher system than the UK and some much more lenient. However, the common theme is that all countries use a penalty system in order to encourage compliance with regard to tax returns, payments and errors.

**4.3** Different methods may be particularly appropriate in Failure to Notify situations when taxpayers recognise that they are required to register (mainly for IT and VAT) but fail to do so partly because they are concerned at the amount of penalty they may incur. Perhaps an amnesty could be considered for a short period where businesses or individuals could notify HMRC of their requirement to be registered without incurring a penalty. The tax due and interest would still be payable.

**4.4** There is currently much interest in 'nudge' techniques. These have clear possibilities in the area of penalties because of the way they can encourage compliance and so prevent penalties being incurred. This merits further exploration. DMB have already adopted such techniques to great success. The use of nudge techniques in campaign letters brought forward an estimate of £210 million of tax revenue in the 2012/13 financial year. HMRC and the Behavioural Insights Team were awarded the 2013 Civil Service Award for Innovative Delivery for this work.

**4.5** We believe that there is more research to be carried out on *why* people incur penalties. The post-2005 review looked at some aspects and had regard to it in their design of the new system. But more data is needed on aspects such as the proportions of penalties that are due to:

- lack of knowledge (is there a need for more explanations/education or better targeting of what is currently being done?);
- carelessness (can suspension be made to do more here?); and
- confusion or genuine difficulties with compliance (which may have lessons for simplification of the tax system)

### A lesson from the charity sector?

**4.6** There was an article<sup>1</sup> produced in September 2012 by the Charity Commission where there had been found:

*'a curious lack of urgency towards meeting the requirements of charity law and complying with the principle of accountability. 39% of late filers had submitted their returns to*

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<sup>1</sup> Charity Commission article by Chief Executive Sam Younger 26 September 2012: <http://forms.charitycommission.gov.uk/about-the-commission/press-office/comment-and-speeches/signed-sealed-defaulted/>

*Companies House on time. Only a tiny proportion of the charities (5%) prioritised filing their accounts with the Commission over filing them with Companies House.'*

Their suspicion was that the Companies House system of fines was the crucial factor. Defaulting was also a habitual problem.

**4.7** The view of the Chief Executive was that the findings bolstered the case for introducing penalties for charities that are late in filing their accounts with the Charities Commission. In this instance, penalties do appear to encourage compliance with the legal requirement to file returns although it might be because Companies House is considered to be more 'official'.

**4.8** A further article in Accountancy Live<sup>2</sup> dated 13 February 2014 stated that the Charity Commission was to launch formal investigations into 12 charities that are in serious breach of reporting requirements following criticism that the watchdog was failing to take strong enough action on charities that bend the rules. This followed a rolling programme of class actions, which commenced towards the end of 2013, against charities considered 'double defaulters' as they failed to file their accounts on time for 2 out of the 5 previous years.

## VAT

**4.9** VAT is now mainly integrated into a common penalty system but there is still an element of transition. It is also a major area that needs full study, particularly as the OTS has been pointed to VAT penalty issues in a number of our projects.<sup>3</sup> In this current exercise there has not been time to do more than scratch the surface of VAT issues.

**4.10** There is a separate penalty system for late filing for VAT returns/late payment of VAT – a VAT default surcharge is issued which is based on the amount of VAT due. This starts at 2% and gradually increases for each instance the return is late up to a maximum of 15%. The calculation is based on the amount of VAT declared on previous returns. If there have not been any returns, a formula is applied based on the estimated turnover from the VAT 1, application to register for VAT, and the type of business.

**4.11** The representative bodies stated that this system is simpler, consistent and that the VAT representatives did not want to lose it. They stated that it acted as a deterrent and encouraged compliance.

**4.12** Large companies are concerned at the tax geared nature of this penalty. If a large organisation is just a couple of days late in submitting their VAT return, the resulting penalty is disproportionate to the error as it is based on a very large amount of tax.

**4.13** This dual system of penalties can be confusing for businesses and individual taxpayers who may be used to one system of penalties when then a different system is imposed for a different tax.

**4.14** However, it is recognised that there would be operational consequences of such a change and communication with the VAT businesses is vital.

**4.15** The VAT register also includes a portion of businesses who have ceased to trade. There is a risk that the same issues with regard to SA automated penalties would arise if these penalties were to be implemented on the VAT businesses – erroneous penalties charged to businesses who should no longer be liable and who should request deregistration. It is therefore also

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<sup>2</sup> <https://www.accountancylive.com/charity-commission-gets-tough-late-filing>

<sup>3</sup> See for example our Interim Report on Partnerships Paras 7.7-7.9 <https://www.gov.uk/government/publications/partnerships-review>

**recommended** that HMRC look at the VAT register to aim to de-register those who are no longer required to be registered.

**4.16** To simplify the system, it is **recommended** that, as part of further work on penalties, HMRC considers introducing the Schedule 55 late filing penalty and Schedule 56<sup>4</sup> late payment penalty into the VAT regime and abolishing the default surcharge penalty once the problems around the SA register have been resolved and the VAT register has been cleared of those who are no longer required to be registered.

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<sup>4</sup> Introduction of Schedule 55 and Schedule 56 penalties may have an impact on the s60 VAT Act 94 penalties for dishonest failure to render or displace a central assessment.



# A Data analysis

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**A.1** We received statistical data from HMRC on the behavioural penalties – the FA07 Schedule 24 error penalties and the FA08 Schedule 41 failure to notify penalties.

**A.2** The perception from agents is that these penalties are not being applied consistently and that suspension is not being used correctly. This is substantiated by the data where, overall, only a small percentage of failure to take reasonable care (careless) penalties are being suspended, para 3.9, and that this varies considerably between different taxes.

**A.3** The data was analysed to look at the percentage of suspended penalties across the four main taxes with an average over the 4 years:

VAT:	18.52%
IT:	7.00%
CT:	11.35%
EC:	46.63%

**A.4** The full penalty range was not initially used with few penalties being either at the top or lower end of the range. However, by the final year, 13/14, the full range of 0%-30% was being used by staff across all the taxes.

**A.5** During the first year after the new penalties regime was implemented, there were very few deliberate penalties but, as expected, this has gradually increased, see table below:

Year	Total deliberate	Total no penalties	Percentage deliberate
10/11	465	7,859	5.92%
11/12	1,045	14,191	7.36%
12/13	2,332	9,504	24.54%
13/14	5,477	15,135	36.19%

**A.6** This demonstrates that staff are now gaining a better understanding of the use of the penalties and the difference between prompted and unprompted disclosures.

**A.7** This is supported by assurance work carried out by HMRC Governance team in Local Compliance where the vast majority of penalties are raised. A project on a review of penalties charged has recently reported which checked whether the penalty provisions were correctly applied – this showed an increase of 27% with a total 82% accuracy rate over a 12 month period to April 2014.

**A.8** Where weaknesses were identified, recommendations have been made to improve the understanding of HMRC staff and an improvement plan drawn up. An assurance process is in place to ensure that the recommendations are actioned and working.



# B

## List of meetings held

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**B.1** A number of meetings were held with both external and HMRC staff. Others were corresponded with by email or over the telephone.

Baker Tilly

Bishop Fleming

Chartered Institute of Taxation (CIOT)

KPMG

Low Incomes Tax Reforms Group (LITRG)

Member of First Tier Tribunal

Tax Aid

Tax Help for Older People

**HMRC**

Penalties policy team

Various policy, administrative and operational staff





### **Office of Tax Simplification contacts**

This document can be found in full on our website at:

<https://www.gov.uk/government/organisations/office-of-tax-simplification>

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