

Summary: Intervention & Options

Department /Agency:
HMRC

Title: **Impact Assessment of Meeting The Obligations to File Returns and Pay Tax on Time**

Stage: Consultation

Version: 1.0

Date: November 2008

Related Publications: Consultation Document - Meeting the obligations to file returns and pay tax on time - June 2008 and November 2008.

Available to view or download at:

<http://www.hmrc.gov.uk/consultations>

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What is the problem under consideration? Why is government intervention necessary?

The vast majority of people send in returns and pay the right tax at the right time. However some do not. Existing legislation provides for a number of different penalty structures across the different tax regimes for a failure to deliver returns and make payments by statutory deadlines. These differences can be complicated for taxpayers to understand, particularly for those interacting with HMRC across more than one tax regime and make it hard for HMRC to present clear messages about the consequences of late filing and late payment.

What are the policy objectives and the intended effects?

The policy objectives are: to modernise and align (where sensible) the penalty and safeguard structures to make them easier for taxpayers to understand. The intended effects are:

- to influence behaviour through fair and effective penalties and safeguards so more returns are filed on time and more tax is paid on time;
- to encourage taxpayers to come forward as early as possible when they are having difficulty meeting tax bills and provide support when they do so; and,
- to reassure compliant taxpayers that failure to meet obligations is dealt with seriously by HMRC.

What policy options have been considered? Please justify any preferred option.

1) Do nothing - continue with varied and inconsistent penalties across taxes with inconsistent safeguards for those who do not file/pay on time, including some which have significant weaknesses.

2) Legislate to modernise and align (where sensible) penalty structures and safeguards.

Option 2 is preferred. A number of different penalty structures have been considered, but in consultation with stakeholders preferred models have emerged which are separate for late filing and late payment. For late filing: a fixed sum penalty to reinforce obligations followed by the option of daily penalties and escalating tax geared penalties for prolonged failure. This model could be applied, with small modifications, for those taxes with more frequent obligations. For late payment, the proposal is for tax geared penalties at 1, 6, and 12 months. The aim is for an aligned penalty regime that is fair, effective and influences behaviour balanced by aligned taxpayer safeguards.

When will the policy be reviewed to establish the actual costs and benefits and the achievement of the desired effects? Post implementation review would take place around three years after the full implementation of any option.

Ministerial Sign-off For Consultation Stage Impact Assessments:

I have read the Impact Assessment and I am satisfied that, given the available evidence, it represents a reasonable view of the likely costs, benefits and impact of the leading options.



Signed by the responsible Minister:

Stephen Timms MPDate: 3 November 2008

Summary: Analysis & Evidence

Policy Option: 1

Description: Do Nothing

COSTS	ANNUAL COSTS		Description and scale of key monetised costs by 'main affected groups' Current penalties will continue to apply differently across different taxes and duties, including some that can be ineffective and some that can produce disproportionate results in some circumstances.	
	One-off (Transition)	Yrs		
	£ nil			
	Average Annual Cost (excluding one-off)			
	£ nil		Total Cost (PV)	£ nil
Other key non-monetised costs by 'main affected groups'				

BENEFITS	ANNUAL BENEFITS		Description and scale of key monetised benefits by 'main affected groups' There will be no effect for compliant taxpayers as the obligations remain the same.	
	One-off	Yrs		
	£ nil			
	Average Annual Benefit (excluding one-off)			
	£ nil		Total Benefit (PV)	£ nil
Other key non-monetised benefits by 'main affected groups'				

Key Assumptions/Sensitivities/Risks Taking this option would mean that HMRC continues to have disparate penalty systems, sending out contradictory messages about how HMRC views non compliance leading to confusion for taxpayers.

Price Base Year	Time Period Years	Net Benefit Range (NPV) £ nil	NET BENEFIT (NPV Best estimate) £ nil
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What is the geographic coverage of the policy/option?			United Kingdom		
On what date will the policy be implemented?			Already in force		
Which organisation(s) will enforce the policy?			HMRC		
What is the total annual cost of enforcement for these organisations?			£ N/A		
Does enforcement comply with Hampton principles?			Yes		
Will implementation go beyond minimum EU requirements?			No		
What is the value of the proposed offsetting measure per year?			£ NA		
What is the value of changes in greenhouse gas emissions?			£ NA		
Will the proposal have a significant impact on competition?			No		
Annual cost (£-£) per organisation (excluding one-off)		Micro	Small	Medium	Large
Are any of these organisations exempt?		No	No	No	No

Impact on Admin Burdens Baseline (2005 Prices)				(Increase - Decrease)
Increase of	£ nil	Decrease of	£ nil	Net Impact
				£ nil

Key: Annual costs and benefits: Constant Prices (Net) Present Value

Summary: Analysis & Evidence

Policy Option: 2

Description: Legislative change for a new late filing and late payment penalty model

COSTS	ANNUAL COSTS		Description and scale of key monetised costs by 'main affected groups' There may be a small initial cost to taxpayers and their representatives as they familiarise themselves with the new regime. Thereafter, all employers will need to complete the new boxes on the P35 return. This cost will vary according to the payroll systems used, but is unlikely to exceed 5-10 minutes and may be less. HMRC will incur information system upgrade and/or development costs, and HMRC is investigating the likely scale of these.
	One-off (Transition)	Yrs	
	£ To be determined		
	Average Annual Cost (excluding one-off)		
	£ 3- 6 million		Total Cost (PV) £ To be determined
Other key non-monetised costs by 'main affected groups' The costs for compliant businesses will be minimal. Those that deliberately do not comply may incur penalties.			

BENEFITS	ANNUAL BENEFITS		Description and scale of key monetised benefits by 'main affected groups' Taxpayers, particularly those who interact with HMRC in more than one tax, will find it easier to understand one penalty structure rather than several. Burdens will fall because of the improved clarity, simplicity and alignment.
	One-off	Yrs	
	£ Nil		
	Average Annual Benefit (excluding one-off)		
	£ To be determined		Total Benefit (PV) £ To be determined
Other key non-monetised benefits by 'main affected groups' Compliance and payment rates will improve. The new regime will prevent the non-compliant gaining an unfair advantage.			

Key Assumptions/Sensitivities/Risks A more aligned (and predominantly automated) system will be easier for taxpayers to understand and simpler for HMRC to administer. The reform is not expected to affect the amount due.

Price Base Year 2008	Time Period Years p.a.	Net Benefit Range (NPV) £ To be determined	NET BENEFIT (NPV Best estimate) £ To be determined
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What is the geographic coverage of the policy/option?		United Kingdom		
On what date will the policy be implemented?		Not yet known		
Which organisation(s) will enforce the policy?		HMRC		
What is the total annual cost of enforcement for these organisations?		£ N/A		
Does enforcement comply with Hampton principles?		Yes		
Will implementation go beyond minimum EU requirements?		No		
What is the value of the proposed offsetting measure per year?		£ NA		
What is the value of changes in greenhouse gas emissions?		£ NA		
Will the proposal have a significant impact on competition?		No		
Annual cost (£-£) per organisation (excluding one-off)	Micro Negligible	Small Negligible	Medium Negligible	Large Negligible
Are any of these organisations exempt?	No	No	No	No

Impact on Admin Burdens Baseline (2005 Prices) (Increase - Decrease)
 Increase of £2-5 million Decrease of £ Nil **Net Impact** £2-5 million increase

Key: Annual costs and benefits: Constant Prices (Net) Present Value

Evidence Base (for summary sheets)

Introduction

1.1 Between June and September 2008, HMRC consulted on the case for aligning and modernising HMRC's penalties for late filing of tax returns and late payment of tax. The consultation considered how penalties could be structured in different ways to influence behaviour. The penalties HMRC currently uses are generally either:

- fixed penalties; or,
- tax geared penalties; or,
- daily penalties.

1.2 These different penalties can be combined in a number of different ways. In order to assist with the development of penalty structures, three guiding design principles were developed. These were to:

be effective – clear, easily understood and applied consistently;
influence behaviour – reinforcing legal obligations thereby encouraging compliance; and,
be fair – proportionate, customer focused and subject to appeal.

1.3 Through the consultation process, a preferred approach to penalties has emerged. The preferred approach involves:

- recognising that the obligations to file a return and pay tax are separate and therefore separating the penalty structure to reinforce both obligations;
- a fixed sum penalty immediately after the due date to reinforce the obligation to file;
- escalating tax geared penalties to deter repeated or prolonged failures; and,
- a more structured approach to daily penalties with a limit to how many days they can be charged.

Second stage of consultation

1.4 HMRC is now consulting for a second time on penalties for late filing and late payment including HMRC's preferred approach. This impact assessment is part of the consultation process and presents the potential impact of the preferred penalty models.

While the aim is, as far as possible, to align the penalty structure across the taxes, adaptations are suggested to reflect the different structures of the taxes, most notably the frequency of the filing and payment obligations. HMRC has therefore developed a number of generic models which are variations of the preferred approach and apply to the various taxes and duties it administers.

These are:

1. a standard model for all taxes with annual and one off return and payment obligations;
2. a rolling default window model for taxes with quarterly obligations (with possible adaptation for those with monthly obligations); and,
3. a model for in-year payments of PAYE. This involves modification of the end of year P35 to include the amounts due to have been remitted each month. These would then be reconciled at the end of the year with payments made and repeated or prolonged late payments would result in penalties based on the amount of tax unpaid.

This impact assessment also describes the options which have been considered but have been excluded.

Policy objectives and intended effects

- 1.5 The aim of this work is to provide HMRC with a modernised, effective and aligned set of penalties across the taxes. This will make it easier for HMRC to explain to taxpayers the consequences of failing to file their tax returns and pay the tax they owe on time.

Existing penalty structures for late or non-filing and payment

- 1.6 There are currently many different ways across the tax regimes to reinforce the obligation to deliver a return or make a tax payment on time. While few if any taxpayers deal with HMRC over the whole range of tax regimes and duties, many do for at least two or three but the penalty regimes may vary considerably. Some of these variances arise from the different structure of the tax regimes such as the frequency of filing obligations, and many are simply due to the way tax legislation has evolved over the years particularly between two separate Government departments. Some are not as effective as they might be and others can sometimes produce disproportionate results. The available research suggests taxpayers find it difficult to understand the consequences of not meeting their obligations and the differing approaches provided in the legislation to address failures to file or pay on time only adds to this confusion.
- 1.7 Most tax regimes have separate sanctions for late filing and late payment although some such as VAT roll the penalty for late payment and late filing into one sanction.

Summary of the changes since the June consultation

- 1.8 Through the consultation process, the penalty models have been refined to ensure they best meet the design principles. Some of the key changes that have been made to the models are:
- for late payment, there will be no penalty immediately after the due date. It is proposed that the first penalty will be tax geared and will be charged one month after the due date;
 - for late filing, where the delay in submitting a return continues, it is suggested that HMRC should be able to charge modest ***daily penalties***. These are designed to encourage people to focus on completing the return and to provide a progressive response to delay. Significant restrictions on the use of this power would be set out in legislation. See Para 4.38 of the consultation document for what these restrictions should be; and,
 - for frequent obligations (such as VAT, CIS, PAYE), the first late payment in a rolling 12 month period would not attract a penalty, responding to stakeholders' concerns.

In-year payment of PAYE

- 1.9 In-year payments of PAYE represent a significant challenge for HMRC in designing appropriate sanctions for late or non payment. This is because employers are required to make payments of tax and other deductions they have made from employees in year, usually on a monthly basis, but are not required to file returns until after the end of the tax year. This means that, although there is an obligation on the employer to pay in-year, HMRC does not know whether those amounts are correct. In the June consultation, three options were considered:
- ***Monthly statements***
Employers could be required to file a short monthly statement setting out how much tax and other deductions is due – HMRC has estimated that the administrative burden may be increased and would result in a major operational change for HMRC.
 - ***Charging a penalty at the end of the year based on the number of payment defaults***
Extending the existing surcharge for late payment from large employers to other employers. This would only influence behaviour at the end of the tax year whereas the obligation to pay arises each month throughout the year. There were also concerns about the design of the existing surcharge.
 - ***Charging penalties based on an estimate of the monthly tax due in year***
The estimate could be based on the previous payments and information from the taxpayer, for example from their previous end of year return. If the taxpayer paid less than the estimate then interest might be payable and sanctions for late payment may be considered in the same way as for other late payments.

- *Additional information on the end of year P35 return*
Early in the first consultation period, a fourth option was suggested by a representative body and echoed in a significant number of written responses. This proposal involves requiring employers to report some additional information on the end of year P35 return. This would be the amount due to be remitted to HMRC for each month of the year – 12 extra boxes.

This would enable HMRC to reconcile this expanded end of year return with the in-year payment record and to identify any discrepancies e.g. month 4 payment was received 3 weeks late. Late payment penalties would then be charged as appropriate, alongside recompense interest. The focus of this reconciliation would be on whether payments had been made on time.

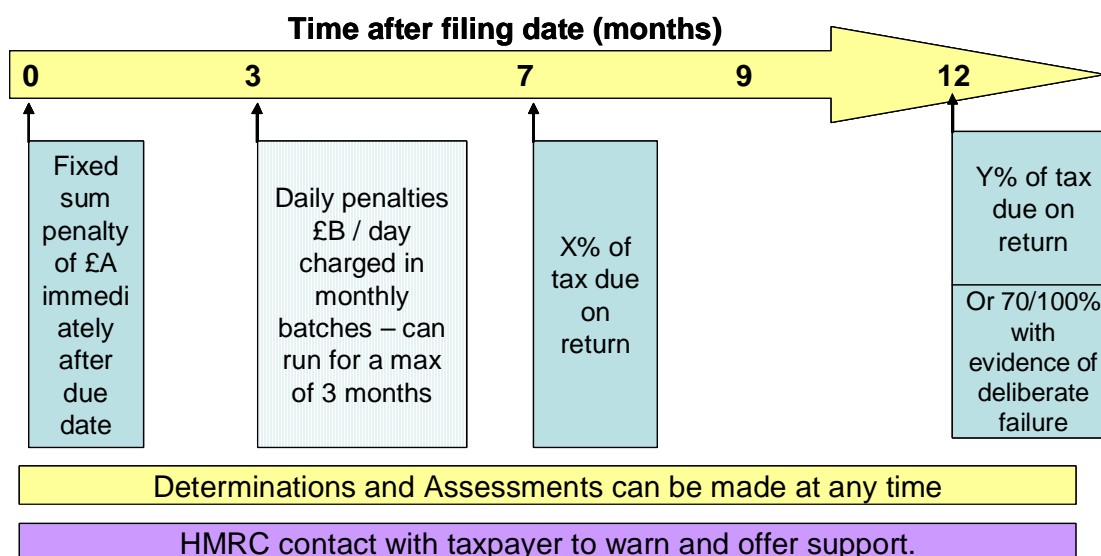
Proposals taken forward in November 2008 consultation

Late filing of returns

Late filing for taxes with annual or one-off filing obligations

- 2.1 The first response to a return not being received by the filing, or due, date would be a fixed sum penalty of £A, unrelated to the amount of tax due or paid. Where the delay in submitting continues, despite reminders, it is proposed that HMRC may be able to charge modest **daily penalties with certain restrictions: they could not be charged earlier than 3 months from the filing date; and not for longer than a 3 month period.** Daily penalties of £B per day would be charged in monthly batches at the end of each month. In cases of prolonged failure to file a return, it is proposed that there should be at month 7 a tax geared penalty of X% rising to Y% at month 12. The month 12 penalty would be 70% of the tax due on a return where HMRC has evidence of deliberate failure and 100% where there is also concealment. These higher penalties could be reduced if the taxpayer disclosed to HMRC, more so if this was unprompted.

Late filing (annual and “one-off” obligations)



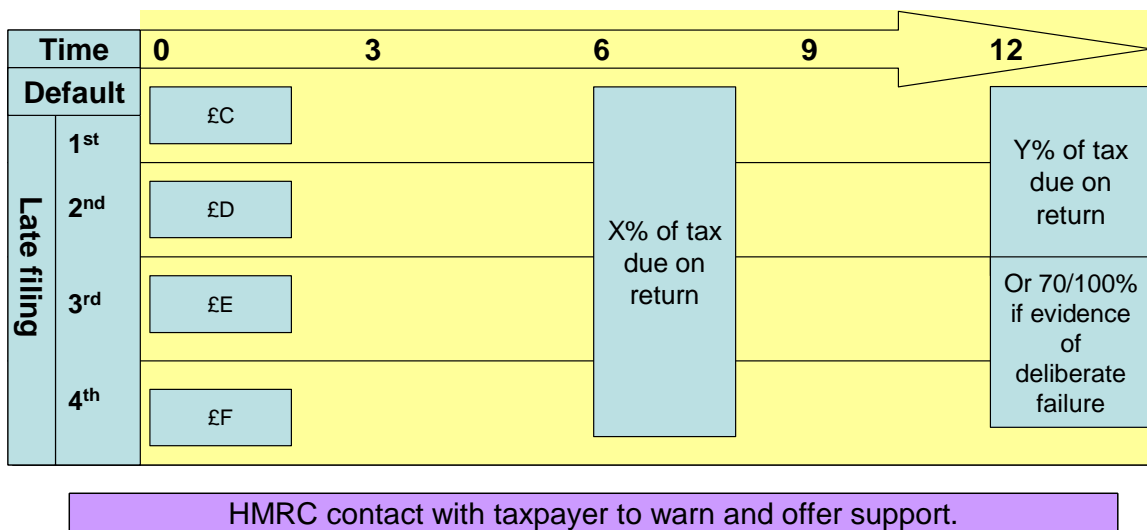
Annual taxes - late payment

2.2 There will be no penalty immediately after the due date for late payment. However if the tax due is not paid in full one month after the due date the taxpayer will become liable to a tax-gearred penalty of C%. If any tax is outstanding 6 months after the due date, the taxpayer will become liable to an additional penalty of X% of the tax unpaid rising to Y% of any tax unpaid at 12 months after the due date. Effectively the penalty level applied escalates as the period of late payment is extended.

Late filing - taxes with quarterly filing obligations (VAT, Environmental Taxes, IPT)

2.3 For quarterly taxes, the first time the taxpayer defaults (fails to submit a return by the due date) they enter the default window which ends on the anniversary of the default and receive a penalty of £C. Any further defaults in the default window result in a penalty of £D rising to £F. In addition any return outstanding more than 6 months after the due date would receive an additional penalty of X% rising to Y% at 12 months.

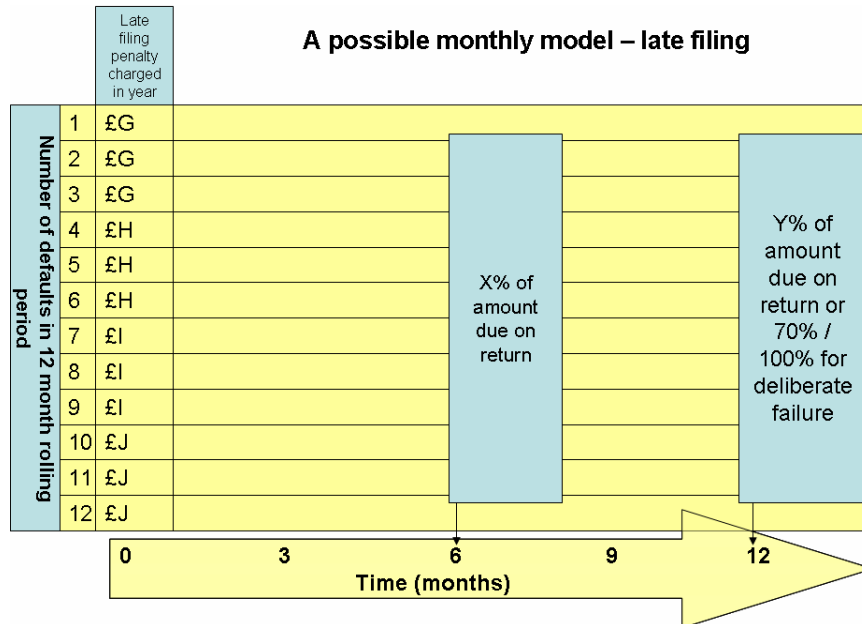
Late filing – quarterly obligations



Late filing – monthly obligations

2.4 Work is continuing to understand whether this is the most appropriate approach for those taxes and schemes that have monthly filing obligations – notably excise duties and the Construction Industry Scheme. The diagram below shows one way that the quarterly model could be modified for monthly obligations.

2.5 The first time the taxpayer defaults (fails to submit a return by the due date) they enter a default window. The first failure to file attracts a fixed penalty of £G immediately after the due date. Further defaults attract a penalty as described in the diagram below. In addition, any return outstanding 6 months after the filing date attracts an additional penalty of X% which would rise to Y% at 12 months. This can be increased up to 100% where there is evidence of deliberate failure. The default window ends on the anniversary of the latest default. In other words the taxpayer must submit returns on time each month for 12 months before they can leave the default window.

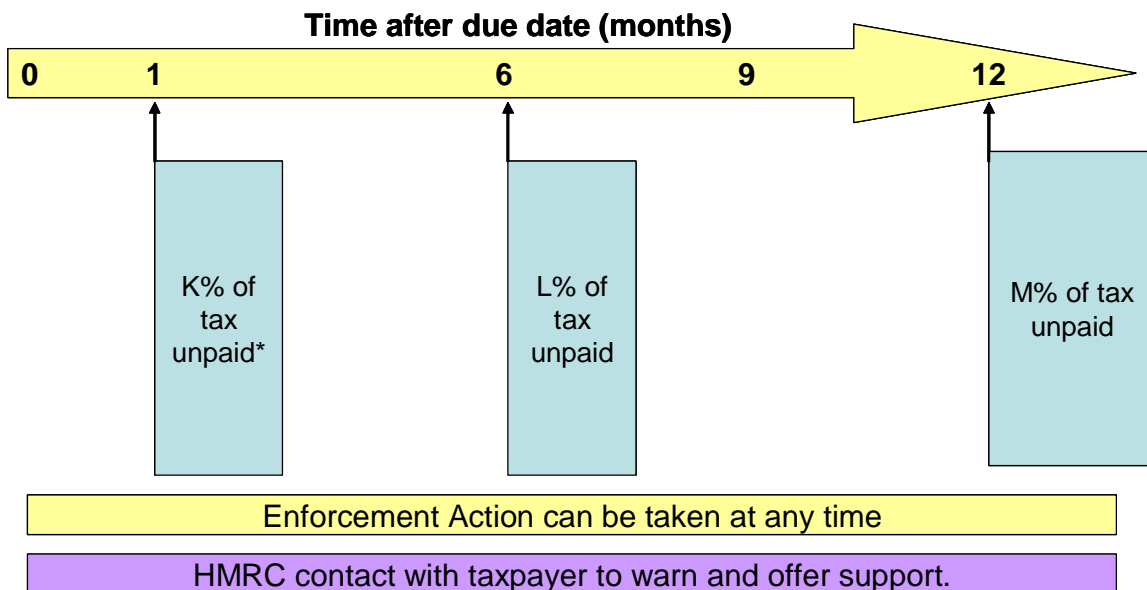


Late payment

Late payment of annual and one-off payment obligations

2.6 The suggestion is that at fixed points in time after the due date for payment, say 1 month, 6 months and 12 months, a taxpayer becomes liable to a penalty of a fixed percentage of any tax due but unpaid at that point in time.

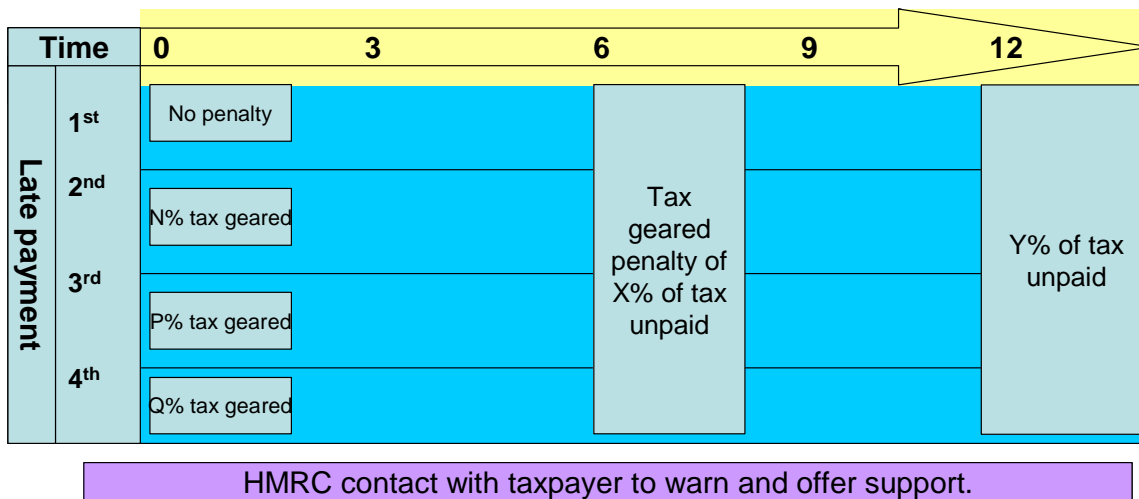
Late payment (annual and one-off obligations)



2.7 A modification would be necessary for Corporation Tax, where the first penalty would be chargeable 3 months after the due date, which would also be the filing date.

Late payment – taxes with quarterly payment requirements (VAT, Environmental Taxes, IPT)

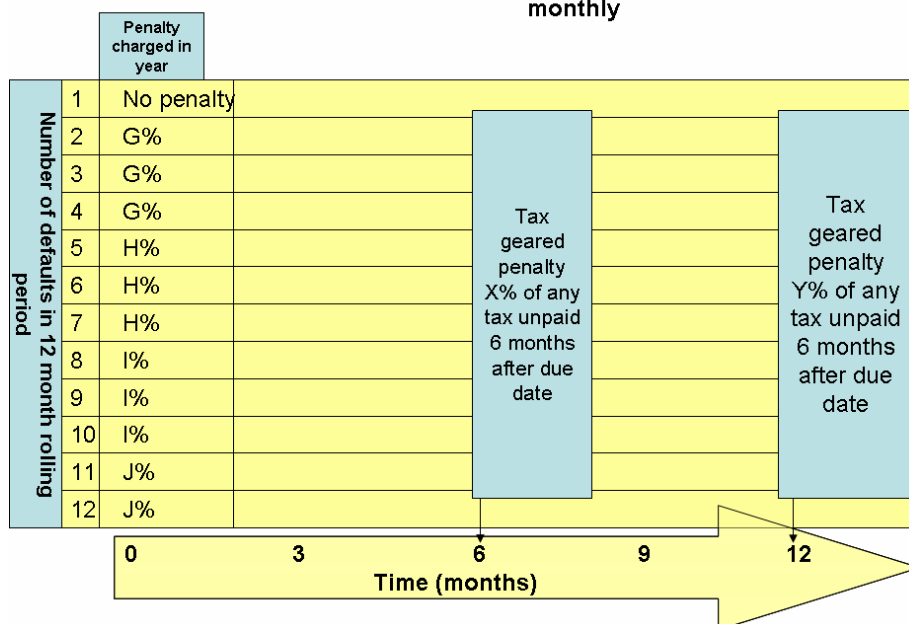
2.8 For quarterly taxes, the first time the taxpayer defaults (fails to pay in full) they enter the default window which ends on the anniversary of the default but receives no penalty. Any further defaults in the default window result in a penalty of B% rising to D%. In addition any payment outstanding more than 6 or 12 months after the due date would receive additional penalties of X% and rising to Y% respectively.



Late payment of taxes with monthly payment obligations (APD, some VAT traders)

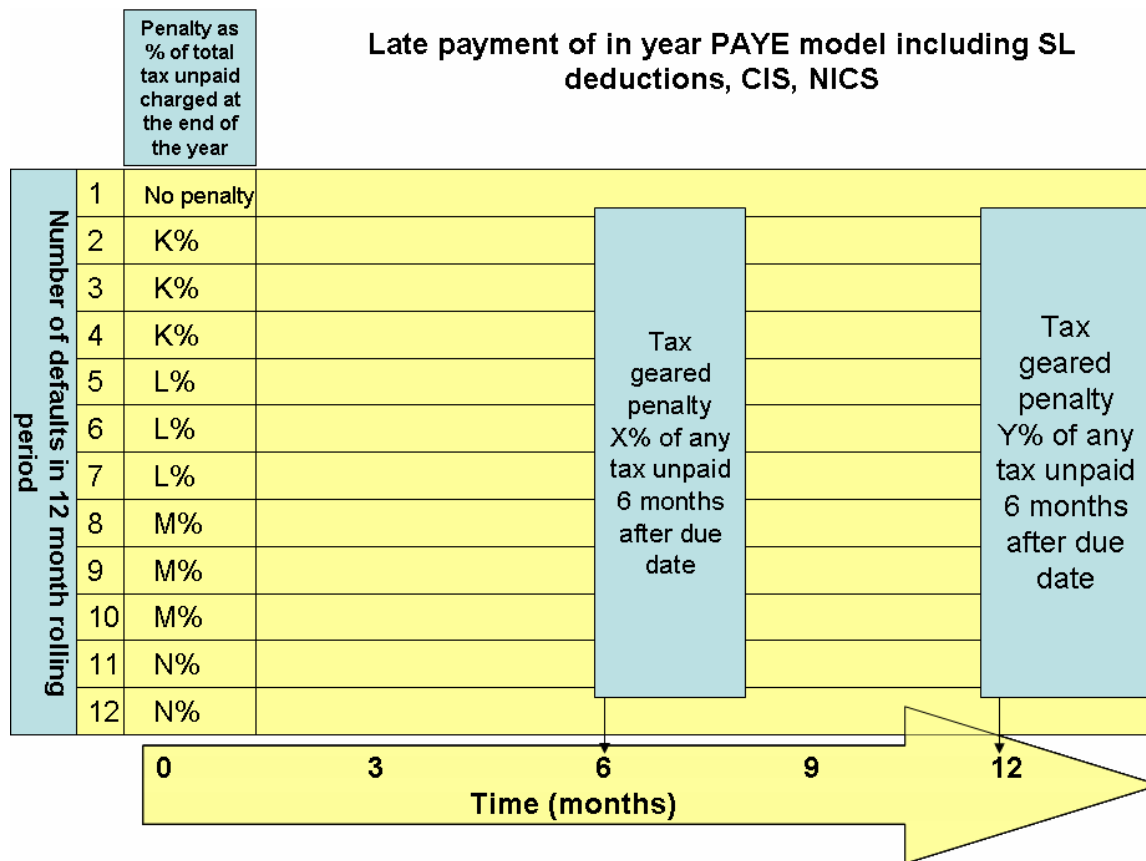
- 2.9 Again the penalty depends on the number of defaults (failures to pay in full) in a default period which lasts 12 months. The first time the taxpayer defaults they are not issued with a penalty but enter a default window. Any further defaults in the default window makes the taxpayer liable to a penalty of G% rising to J%.
- 2.10 In addition if any penalty is outstanding for more than 6 months, the taxpayer becomes liable to an additional X% of the tax unpaid. This rises to Y% of the tax unpaid if any payment is outstanding for more than 12 months.

Late payment of APD, and other quarterly taxes paid monthly



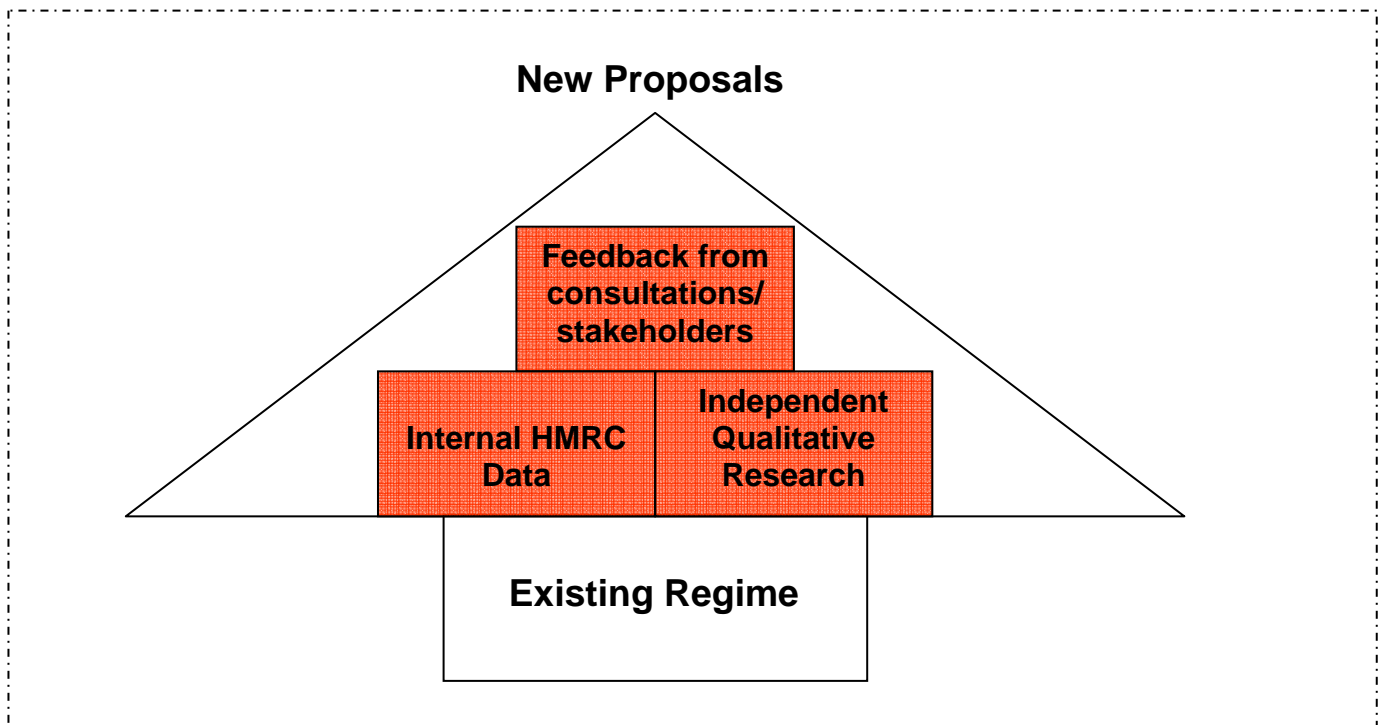
In year PAYE

- 2.11 The end of year return is modified with 12 boxes added to show the total amount due to have been remitted to HMRC each month. After the year end, HMRC would reconcile the payments actually received in year with the amounts declared as due to be remitted. Any amounts unpaid are added up (so if a taxpayer defaults £100 in month 1, £200 in month 5 and £300 in month 8, the total default pot contains £600). The first default would attract no penalty so the first £100 is subtracted. The remaining pot of £500 is subject to a tax geared penalty depending on the number of defaults in the diagram below. In this case there have been 3 defaults so the penalty is K% multiplied by £500. In addition, any payment outstanding 6 and 12 months after the due date are subject to a penalty of X% and rising to Y% respectively of the tax unpaid.



Understanding the current regimes

3.1 The block diagram below describes the evidence base construction for this impact assessment:



There have been three main strands to building the evidence base for the proposed changes as shown in this diagram.

Consultation responses

- 3.2 Responses to earlier consultations are explained in some detail in Chapter 3 of the accompanying consultation document.

Independent qualitative research

- 3.3 The second strand has been qualitative research into attitudes to debt.
- 3.4 Ipsos MORI was commissioned this year by HMRC to undertake research with customers that had been in tax debt during the past two years. The aim of the project was to develop a better understanding of late paying customers and the effect of different enforcement and support regimes.
- 3.5 Fifty-two in-depth interviews¹ were conducted with individuals or representatives of businesses that, based on HMRC records, had a tax debt in the recent past. The research was carried out only with tax debtors and the findings do not apply to compliant tax payers².

Key findings

- 3.6 Some tax debtors had unfavourable perceptions of HMRC. In most cases, past debtors perceived that it was difficult to get advice and guidance from HMRC when needed. From the viewpoint of many of the participants, this made it difficult for them to both explain the circumstances of their tax debt and, also, arrange to pay what was due.
- 3.7 The main reason why individuals and business get into debt is because of problems with cash flow. In nearly all cases, participants wanted to pay but, at a given point in time, could not do so because the funds were not available.
- 3.8 Cash flow problems interact with tax payment schedules. Many debtors described how the misalignment between tax due dates and business invoicing dates caused short-term problems.
- 3.9 The above issues meant that for those already in debt, penalties and interest were unlikely to be effective tools for tackling the debt.
- 3.10 For those who are already in debt and therefore where the existing penalty structures have failed to influence them, their reaction to the new penalty and interest structures were muted. The participants found it difficult to understand the differences between the new structures and the old structures. This suggests that HMRC must carefully communicate how the new penalty structures operate and tailor communications to different taxpayer groups.
- 3.11 Participants reacted positively to flexible measures that allow them to pay off a debt over time and to pay their taxes on a different basis going forward so debts are less likely to arise.
- 3.12 A shift towards paying tax on a monthly basis was warmly received by participants because it allowed them to pay smaller amounts more frequently and also reflected the way that other financial interactions are conducted, such as the payment of credit cards, utility bills and so on.
- 3.13 Customers said that HMRC lacked knowledge about the circumstances and structure of their businesses. They felt that HMRC operated a one-size-fits-all approach in communicating with businesses. This means that the nuances in tax issues between, for example, large and small businesses or different industrial sectors were not reflected in HMRC's approach to customer management.
- 3.14 Overall, this audience does not seek to avoid tax and understands their obligations. Incentives and processes that make tax easier to pay in the first place for an individual or business (which

¹ Interviews carried out across the UK between 1st July and 2nd October 2008

² The focus of the research was to consider new methods of recouping a debt with those that have missed payments in the past, and no "control group" of compliant tax payers was therefore included. All of the interviews were conducted with people or businesses known to the Department (as the sample was drawn from HMRC's data).

can include the *status quo*) are, according to participants, more effective than measures to recover a debt that has occurred. When a debt has occurred, flexibility in repayment which matches an individuals or businesses circumstances was welcomed.

Focus groups

- 3.15 In addition to the work by Ipsos Mori, and as part of HMRC's efforts to better understand its customers, two focus groups were held to discuss some of the proposals being worked on in relation to debt, penalties and interest. One was with individual non-business customers and the other with business customers, from a mix of ages (including pensioners), gender and ethnicity. Some had suffered from debt problems in the past, whilst others had never been in debt. Whilst this is not empirical research, it has provided valuable insights.
- 3.16 These groups confirmed the view expressed in the qualitative research that a fixed sum penalty for late payment was likely to cause more damage to relations between taxpayers and HMRC than the behaviour benefit (in reinforcing the due date) warranted. Respondents preferred late payment penalties to be related to the tax unpaid, and thought these should be applied sooner than 3 months after the due date. They acknowledged that these were required in addition to interest.
- 3.17 Flexible payment schemes were considered to be a good thing for those entering the tax system for the first time and perhaps the disorganised, but of less value to those with long term payment difficulties. Direct Debit was welcomed by some, but not universally. Incentives such as a percentage discount were suggested as a tool to encourage early or timely payment.
- 3.18 The groups were asked to comment on how HMRC is perceived and how HMRC might do more to help its customers. Some found HMRC very helpful whilst others were fearful of making contact. Some suggested that HMRC should make more regular contact with taxpayers and take into account previous compliant behaviour when considering issuing a penalty.

Internal HMRC data

- 3.19 Analysis of HMRC data on the different penalty regimes currently operating provides some helpful insights into whether they meet the design principles and helps to quantify the likely impacts of the proposed changes.
- 3.20 It is important to understand the scale of HMRC's operations when considering both the design of penalty regimes and the likely impact of changes.
- 3.21 On the payment front, in 2006-07 HMRC around £64bn³ (or 15% of the £423bn net tax receipts) was paid late. In addition, HMRC made repayments of £72bn. HMRC processed 55 million payments in 2006-07⁴.
- 3.22 On the filing front, HMRC expected⁵ to receive almost 23 million returns in 2006-07, however almost 3 million (13%) were filed late or not at all⁶.

Current filing patterns

- 3.23 The following data gives some an indication of the current filing and payment rates for different regimes. It is provided not for the purposes of comparison between the taxes (the different nature of the taxes and taxpayer groups make this of little value). Instead it is provided as one measure (but not the only measure) of the effectiveness of current penalty regimes. As said before, penalties are by no means the only influencing factor as to why people pay and file on time.

³ Source: Internal HMRC data (including some estimated figures) for ITSA, CTSA, PAYE and VAT debts.

⁴ HMRC cannot quantify how many payslips were issued or payments were made late.

⁵ Expected returns are not the same as number of returns due.

⁶ Source: HMRC internal data.

Income tax self assessment (ITSA) - In 2006-07 9.3 million ITSA returns were issued, and 8.3 million (89%) were filed on time⁷.

Corporation tax self assessment (CTSA) - 1.3 million (79%) of the 1.6 million returns expected in 2005-06 were filed on time⁸.

VAT - 6.5 million (85%) out of 7.6 million 2005-06 returns issued⁸ were filed on time. Again the lack of any sanction for prolonged late filing has been identified as a weakness in the current default surcharge regime.

PAYE - 1.5 million (89%) of the 1.7 million expected returns for 2006-07 were filed on time⁶.

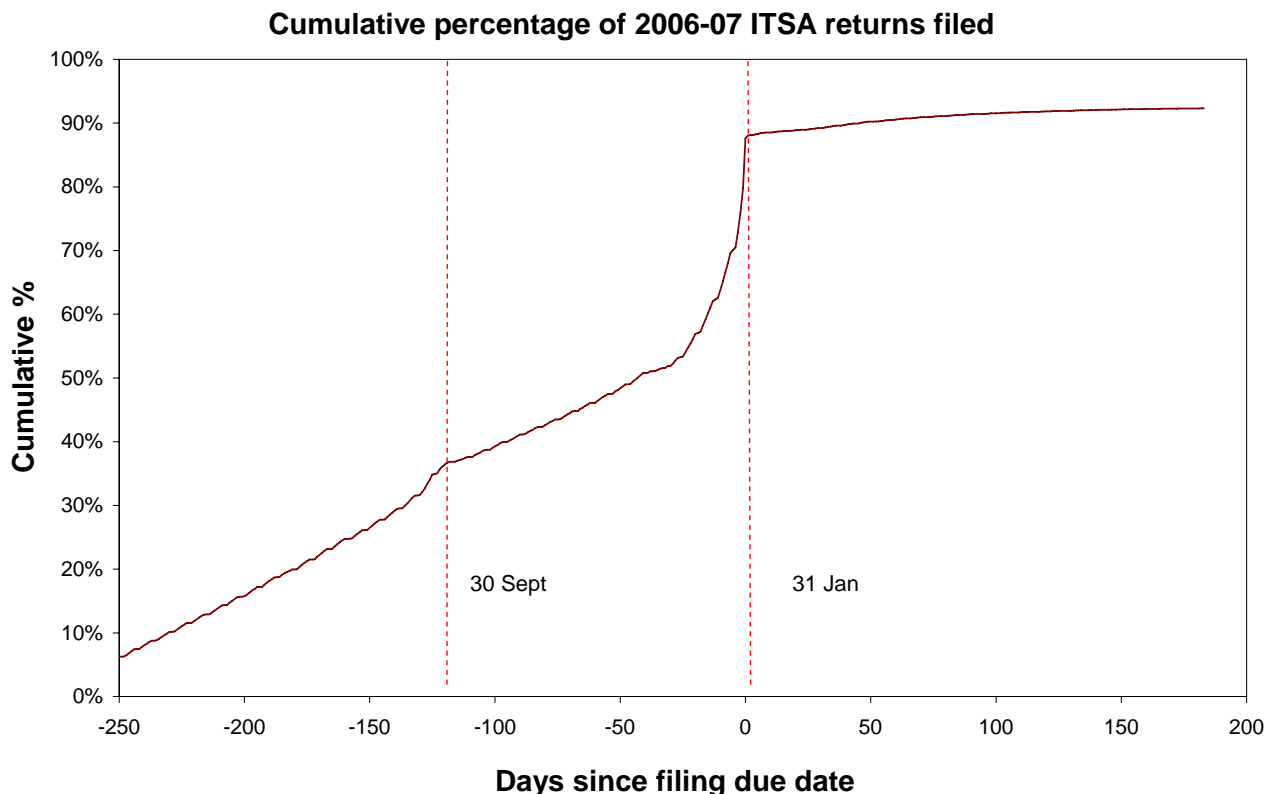
Stamp Duty Land Tax - 1.7 million (94%) of the 1.8 million returns for 2005-06 were filed on time⁶.

Excise Duties - 40,000 (88%) of the 50,000 returns issued in 2006-07 were filed on time⁶.

Inheritance Tax - 68,000 (92%) of the 75,000 returns filed in 2007-08 were filed on time⁹.

3.24 What is also clear is that once people miss the main filing deadline, many go on to become very late or non-filers. For example, for ITSA in 2005-06 887,864 returns (9.5%) were still outstanding 3 months after the due date, and 774,772 (8.3%)⁹ had still not been filed 6 months after the due date.

3.25 The following chart shows the cumulative total percentage of ITSA returns filed by date. It illustrates that the vast majority of ITSA taxpayers do comply with their filing obligations – many filing well in advance of the 31 January due date. This suggests that despite the current penalty regime, a number of returns are still not filed a considerable period after the due date.



⁷ Source: HMRC Departmental Report for 2008 <http://www.hmrc.gov.uk/about/dept-report-2008.pdf> and internal data

⁸ Source: NAO Value for Money study report into CT&VAT filing http://www.nao.org.uk/publications/nao_reports/06-07/0607102.pdf

⁹ Source: HMRC internal data.

In year PAYE payment patterns

3.26 The lack of a requirement to report the amount due each month for in year PAYE means data about late payment of in year PAYE necessarily involves estimation. Estimates may be particularly unreliable for new employers, where HMRC will not have sufficient information to accurately estimate the likely tax due. But there are some broad indicators that may help explain the payment patterns for in-year PAYE. PAYE receipts (including Class 1 and 1A National Insurance Contributions) were around £210bn in 2006-07 from 1.7million employers (excluding the 300,000 or so small employers who pay quarterly or annually). HMRC estimates that around a quarter of this was not paid on time. Around two-thirds was subsequently paid within 2 weeks (some at the end of the calendar month to fit in with business invoicing cycles) but this still left over £1bn outstanding each month. Around 40% of employers with up to 250 employers do not pay on time. The large employers surcharge for those within the mandatory electronic payment arrangements (over 250 employers) has made a significant difference to the payment patterns for the approximately 10,500 employers within that segment.

The number and value of current penalties issued

3.27 Another relevant factor in considering the impact of any changes to penalties is to understand how many are currently charged and for what value. The aim of these reforms is to encourage more people to file and pay on time and therefore a measure of success would be for **fewer** penalties to be charged.

Income tax self assessment

3.28 One of the issues explored in the consultation is the way that capping the fixed sum £100 penalty for late filing of the income tax self assessment to the amount of tax unpaid at the filing date has had unintended consequences. A total of 1,629,845 fixed sum penalties were issued in relation to late 2005-06 returns. Of these 46,690 (3%) were subsequently cancelled because there was a reasonable excuse, an appeal was upheld or they were incorrectly issued. But a further 213,935 (13%) were subsequently capped because the amount unpaid at the due date was less than £100. A penalty may be capped for one of three reasons; there is a repayment due to the customer, the amount due has been paid by the due date, or the amount payable is less than £100 (the penalty will in these circumstances be capped to the amount due). As recognised in consultation responses, the greater majority relate to those who are not on low incomes, but who simply pay an estimated sum by the due date or know they are due a repayment when their return is processed. They know they will escape a late filing penalty if they do not file on time.

3.29 In the numbers of daily penalties for late ITSA returns charged were 37,449 for 2004-2005, 59,131 for 2005-2006, 46,136 for 2006-07, and, 41,988 in 2007-2008¹⁰. Internal analysis suggests that warnings of impending daily penalties are very effective in persuading people to file returns that are overdue.

Corporation tax self assessment

3.30 The figures below from the NAO Value for Money Report on CT&VAT Filing¹¹ show the number of penalties issued for CT late filing in 2005-2006:

CT Late Filing Penalty	Issued in 2005-06	Value	Timing
First fixed sum	250,000	£100	Day following statutory filing date
Second fixed sum	140,000	£100	Day following three months after statutory filing date

¹⁰ Source: HMRC internal data

¹¹ NAO Value for Money study report into CT&VAT filing http://www.nao.org.uk/publications/nao_reports/06-07/0607102.pdf

First tax-related	45,000	10% of unpaid tax at the date liability to the first tax-related penalty arises	Day following 18 months after the end of the accounting period
Second tax-related	22,000	10% of the unpaid tax at the date liability to first tax related penalty arose	Day following two years after the end of the accounting period

VAT

3.31 In 2005-06 the total value of VAT surcharges issued was £258 million (this amounted to 767,347 surcharge notices including 250,811 surcharge assessments). In 2006-07 the total value of VAT surcharges issued was £240 million and 173,988 Help Letters and 678,183 surcharge notices including 275,709 surcharge assessments were issued. In 2007-2008 the numbers of VAT surcharges issued were £344 million and 172,258 Help Letters and 766,639 Surcharge Notices including 329,996 surcharge assessments¹².

Deliberate non filing of returns

3.32 Teams within HMRC dealing with serious non-compliance have confirmed that there are incidences of taxpayers deliberately not filing returns to hide information from HMRC as part of a pattern of fraudulent behaviour, including in VAT missing trader frauds. The tribunals and courts have accepted evidence that non-filing can be a deliberate act.

Conclusions from analysis of current penalty regimes

3.33 There are some important lessons to be learned from the current variety of penalty regimes that HMRC operate, including:

- small fixed sum penalties at filing date do appear to positively affect filing patterns;
- the current late filing penalty regimes are not very effective in addressing prolonged late filing (if people miss the deadline they often go on to be very late filers);
- late payment penalties do positively affect payment patterns – most notably the income tax self-assessment surcharge;
- where there are neither interest nor late payment penalties, payment rates are significantly lower, for example in-year PAYE;
- warnings of daily penalties for late filing can be effective; and,
- some of the current regimes are perceived as producing disproportionate results and so are regarded as unfair.

New proposals: likely impact

4.1 It is difficult to predict what the effect of the proposed new regimes will be on taxpayer behaviour and therefore it is hard to quantify/estimate how many penalties would be charged compared to current regimes. The whole rationale for having civil penalties for failing to meet tax obligations is to deter. Late filing and late payment penalties reinforce filing and payment deadlines. Where the deadlines are not met, the penalties proposed in this document are deterrence milestones, providing a clear downside, at fixed points in time, to continuing delay. A successful penalty regime charges no penalties at all because it is fully effective in influencing behaviour.

¹² Source: HMRC internal data

Late filing

- 4.2 It is perhaps helpful to set out for the main taxes, how the new models proposed differ from current regimes.
- 4.3 For **income tax self assessment** and **PAYE** end of year returns, the main changes will be to how daily penalties can be administered and the provision for a tax geared penalty 7 months after the due date.
- 4.4 For **corporation tax self assessment**, the proposed late filing regime is fairly similar, with the exception of the facility to charge daily penalties in restricted circumstances.
- 4.5 Responses to previous penalties consultations have questioned whether the level of the fixed £100 penalty for late filing of ITSA and corporation tax returns is sufficient to be effective. The amount has remained the same for over 10 years and therefore may have less influence on behaviour than it had in the past. But the overall structure of support, sanctions and safeguards is likely to be more important in determining effectiveness than the rates and levels. HMRC's current view is that there appears little reason to increase the level of the first response penalty.
- 4.6 For **VAT**, the changes are to move from the situation where filing a return late exposes a trader to the risk of a tax geared penalty if payment is also late, to fixed sum penalties with tax geared for prolonged delay.

Late payment

- 4.7 For **income tax self assessment** the late payment penalties are very similar to the current surcharges except to include an extra one at 12 months.
- 4.8 For **corporation tax** late payment penalties are new, but evidence suggests that certainly for the larger companies, most already pay on time, if not early and therefore the impact is likely to be limited for them. But for the minority who do not this seeks to remove the advantage gained.
- 4.9 For **VAT** the proposed late payment penalties are similar in design to the current default surcharge regime. They need to be considered in conjunction with the proposed introduction of recompense interest for late payment. As a result, the levels of the new late payment penalties are expected to be lower than the current highest default surcharge levels.

In Year PAYE

- 4.10 The biggest impact will be for employers with less than 250 employees who currently pay their in year PAYE late and are not charged interest or late payment penalties. It will be particularly important that ample time and effort is given to ensuring that this group are made aware of any change, so that they can take steps to improve their payment patterns and thus avoid the penalties. This must include publicising HMRC's time to pay facilities for those having difficulty meeting their liabilities.

Compliance costs

- 5.1 These reforms to late filing and payment penalties will have most impact on the non-compliant. For those that comply, the costs will be low, and in many cases negligible.
- 5.2 All taxpayers and their tax representatives will need to familiarise themselves with the new rules.
- 5.3 From a compliance cost perspective the main change is to the annual P35 end-of-year return. Some employers may need to make one-off changes to systems to help them produce the precise figures required, although all have to calculate and verify monthly payments already and any modification is likely to be minimal. The addition of 12 monthly total boxes will increase the time taken to complete the form, but the information requested (i.e. the total tax charge per month) will already be known to the businesses themselves. The increase is likely to be negligible for those (typically larger) businesses using automated payroll software. For those using

spreadsheet or paper based systems, we estimate the additional time to be around 5-10 minutes maximum. HMRC do not expect accounting fees to be significantly affected.

- 5.4 Early discussions with payroll professionals, payroll software providers and other interested parties support this view, although HMRC will continue working with employers' representatives to see how this burden can be kept as low as possible and whether there are any groups of employers who might be disproportionately affected.
- 5.5 For those employers who currently pay quarterly the expectation is that they would only need to complete four additional boxes on the end of year return.

Administrative burdens ¹³

- 5.6 HMRC tracks one aspect of compliance costs in particular. The administrative burden on business is defined as the time and cost necessarily incurred by compliant businesses in retaining information and/or sending information to HMRC or a third party. This burden is assessed through the 'Standard Cost Model', an activity based costing model which identifies what activities a business has to do to comply with HMRC administered obligations, and which estimates the cost of these activities, including agent fees and software costs. By convention, the administrative burden is always quoted in 2005 terms.
- 5.7 The cost of completing the new boxes on the P35 falls within this heading and we estimate the associated burden to be between £2 and £5 million per year. However, this is spread over nearly 2 million businesses and the average cost per business is about £2. The calculation is based on a maximum of 5-10 minutes being required, at an hourly wage rate of £23 (in 2005 terms).
- 5.8 The equivalent figure in today's terms is slightly higher: a rounded £3-6 million is quoted towards the top of page 3 accordingly.

¹³ The methodology is contained in the Standard Cost Model available at <http://www.hmrc.gov.uk/better-regulation/admin-burdens.htm>

HMRC costs

- 5.9 The changes proposed in this consultation, when taken with the proposed changes to interest charged and paid, will require modification to a significant number of HMRC's business processes, including information systems. HMRC are currently assessing what needs to be done and will provide an updated analysis in a final impact assessment. The aim is to have sufficient information available for ministers to make informed decisions before committing to any legislative change.

Benefits

Effect of behaviour

- 6.1 There are many factors that affect whether a person files returns or pays tax on time, so it is very difficult to measure the likely benefit of new penalties in terms of effect on behaviour. However the on time payment and filing rates vary across the taxes from around 60% to over 90% and it is reasonable to assume that the penalty structures have some impact on behaviour.
- 6.2 What is clear as the majority of respondents to the consultation re-emphasised, is that alignment across taxes where it makes sense, is likely to increase the effectiveness of the penalties and therefore the positive behavioural effect. This is because respondents recognised that alignment promises the benefits of:
- clearly-reinforced obligations;
 - easily-understood consequences;
 - readily accessible safeguards;
 - a sense of equity; and,
 - simpler administration for all (after the initial IT investment by HMRC).
- 6.3 For example, the one penalty that appears to be widely understood and recognised as influencing behaviour is the £100 penalty for late filing of an ITSA return partly due to a sustained advertising campaign. With more streamlined penalty regimes the opportunity for more generic publicity reinforcing deadlines is increased and therefore the deterrent effect should be enhanced.
- 6.4 The intention of the changes is to influence behaviour and improve the proportion of returns filed on time and payments made on time. It is recognised that there will always be reasons why some returns and payments will not be made on time, hence the reasonable excuse provisions and for suspension of penalties where a person enters into a time to pay arrangement. As said earlier, it is difficult to distinguish the affect of penalties from other factors effecting filing and payment patterns and so measuring the likely behavioural impact is problematic.
- 6.5 However from the independent research, focus groups and analysis of internal data it is reasonable to assume that a clearly communicated, well designed penalty regime, applied fairly and consistently, will have a positive effect on taxpayer behaviour.

Incidence and levels of penalties

- 6.6 As discussed, it is hard to assess the full impact in advance of any new regime on behaviour and therefore to quantify the likely incidence of the new penalties. The greater the behavioural change, the more the policy intention is achieved and the fewer penalties are charged. More work will be done in this area during the consultation period. What this emphasises is the importance of good communication about any penalty changes in plenty of time for taxpayers to meet their obligations and avoid penalties. This involves both generic communications and individual warnings and offers of support.

Recognition of the importance of both filing and payment

- 6.7 One of the benefits that is anticipated from these changes is to ensure that both the filing and payment obligations are separately and equally reinforced, and some of the unintended

consequences of the current regimes that cause people to pay but not file (or vice versa) will be reversed.

More accessible safeguards and support

- 6.8 One of the expected benefits of these changes is to move to a clearer and more accessible safeguards and support, particularly a consistent approach across taxes to reasonable excuse and to the interaction between penalties and time to pay. In this way the new regimes should encourage people to come forward to HMRC to seek help, better than the predecessor regimes.

Specific impact tests

Competition assessment

- 7.1 The proposed new penalty framework for late payment of tax and late filing of returns would provide businesses with more certainty about how HMRC views the way in which they manage and conduct their tax affairs. Those businesses that HMRC does not view as low risk can expect to spend more time dealing with HMRC and those classified as low risk will usually spend less. But this will not impact on any business's capacity to enter markets or compete rigorously within them.

Small firms impact test

- 7.2 Penalties will not apply to compliant businesses. The aim is for reduced compliance costs for small businesses. The overall alignment and simplification of penalties will make matters less confusing and lead to some reduction in administration costs.
- 7.3 The impact on small businesses has been considered, with small businesses and their representatives being consulted. The fact that the penalties do not apply to compliant taxpayers and the risks of having a different treatment for small businesses, including disaggregation, mean it is proposed that the new penalties should apply to all taxpayers.
- 7.4 The measure assists those small businesses who comply with their tax obligations by promoting a level playing field with those who do not.
- 7.5 The failure to file has to be a fixed penalty because we do not know the amount of tax due until the return is filed. In order to ensure that it is proportionate for small businesses with lower tax liabilities, the fixed penalty is set at a low level. Failure to pay is a penalty based on the tax due and so it is proportionately fair to small businesses.
- 7.6 HMRC consulted directly with small businesses to discuss whether the proposed changes could lead to additional associated costs such as increased agent fees or unanticipated changes in business processes - See paragraphs 3.4 to 3.18.
Businesses with cash flow difficulties would no longer need to consider which of potentially several different tax liabilities to pay first because the consequences of non payment would be the same for each tax.
- 7.7 HMRC are planning to set in statute that if, as a result of financial difficulty, taxpayers enter into a time to pay arrangement with HMRC they will not incur penalties as long as they comply with their arrangement. This is currently not the case for certain taxes.
The considerations from small businesses, as a result of consultations, were that there should be some flexibility if people come forward with cash flow difficulties, for example, HMRC to offer time to pay arrangements. It was also considered that if, however, taxpayers fail to contact HMRC and repeatedly pay very late then taxpayers should not be immune from the penalties system.
- 7.8 We have carefully considered whether these proposals will have any impact on:
- Legal Aid
 - Sustainable Development
 - Carbon Assessment
 - Other Environment
 - Health

- Racial Equality
- Disability
- Gender
- Human Rights, and
- Rural issues

and conclude that they do not impact.

Specific Impact Tests: Checklist

Use the table below to demonstrate how broadly you have considered the potential impacts of your policy options.

Ensure that the results of any tests that impact on the cost-benefit analysis are contained within the main evidence base; other results may be annexed.

Type of testing undertaken	<i>Results in Evidence Base?</i>	<i>Results annexed?</i>
Competition Assessment	Yes	No
Small Firms Impact Test	Yes	No
Legal Aid	Yes	No
Sustainable Development	Yes	No
Carbon Assessment	Yes	No
Other Environment	Yes	No
Health Impact Assessment	Yes	No
Race Equality	Yes	No
Disability Equality	Yes	No
Gender Equality	Yes	No
Human Rights	Yes	No
Rural Proofing	Yes	No