EXPLANATORY MEMORANDUM TO

THE FINANCE ACT 2008, SCHEDULE 40 (APPOINTED DAY, TRANSITIONAL PROVISION AND CONSEQUENTIAL AMENDMENTS) ORDER

2009 No. 571 (c.39)

1. This explanatory memorandum has been prepared by HM Revenue & Customs ("HMRC") and is laid before the House of Commons by Command of Her Majesty.

This memorandum contains information for the Select Committee on Statutory Instruments.

2. Purpose of the instrument

The purpose of this order is to bring into force the provisions of Schedule 40 to the Finance Act 2008 which extend the new penalty regime for incorrect returns (introduced by Schedule 24 to the Finance Act 2007) to cover additional taxes and duties. The order also introduces a new penalty where an error in a taxpayer's document is attributable to a third party.

3. Matters of special interest to the Select Committee on Statutory Instruments

3.1 The order is made under section 122 of the Finance Act 2008. Section 122(4) of that Act provides that the Treasury may by order make any incidental, supplemental, consequential, transitional, transitory or saving provision which may appear appropriate in consequence of, or otherwise in connection with, Schedule 24 to the Finance Act 2007 or Schedule 40 to the Finance Act 2008. Section 122(8) of the Finance Act 2008 requires that an order made under section 122(4) referred to above, which includes provision amending or repealing any provision of an Act, is subject is subject to an annulment in pursuance of a resolution of the House of Commons. Article 8 and Schedule 1 to this order make amendments to primary legislation, thus the negative resolution procedure is required.

3.2. During the course of debate of the Finance Act 2008 (Committee of the Whole House stage), a commitment was made to publish an advance draft of this order to demonstrate the nature of the consequential changes. Accordingly, a draft order including those consequential changes was exposed for public comment on 29 January 2009. No responses were received.

4. Legislative Context

4.1 The new penalty regime for inaccuracies in returns and other documents was introduced by Schedule 24 Finance Act 2007, and initially applied to Income Tax, Capital Gains Tax, Corporation Tax and VAT. The penalty regime for these taxes was commenced on 1 April 2008 by Treasury Order (S.I.2008/568).

4.2 Schedule 40 to the Finance Act 2008 ("Schedule 40") was enacted to bring the following taxes and duties into the same regime by incorporating them into the Schedule 24 provisions: Insurance Premium Tax, Inheritance Tax, Stamp Duty Land Tax, Stamp Duty Reserve Tax, Petroleum Revenue Tax, Aggregates Levy, Climate Change Levy, Landfill Tax and Excise Duties. Section 122(2) of Finance Act 2008 stipulated that Schedule 40 would come into force on such day as appointed by the Treasury.

4.3 From 1 April 2009, the same penalty structure in respect of behaviours, safeguards, levels and reductions will apply to the new taxes as they do currently to the original taxes.

4.4 The order will also bring into effect on that date a new penalty across all the taxes and duties where an error in a taxpayer's document is attributable to a third party. This penalty will apply

in only very limited circumstances where the inaccuracy is attributable to the third party deliberately supplying false information to the person giving a document to HMRC. Additionally, the order provides for transitional issues and makes consequential amendments.

5. Territorial Extent and Application

5.1 This instrument applies to all of the United Kingdom.

6. European Convention on Human Rights

The Financial Secretary to the Treasury, Mr Stephen Timms has made the following statement regarding Human Rights:

In my view, the provisions of the Finance Act 2008, Schedule 40 (Appointed Day, Transitional Provision and Consequential Amendments Order are compatible with the Convention rights.

7. Policy background

- ***What is being done and why***

7.1 The HMRC Review of Powers, Deterrents and Safeguards began in 2005, following the merger of the Inland Revenue and HM Customs and Excise. The objective of the Review is to provide a framework of law and practice for HMRC that supports the Government's objectives of a tax system that is fair and better adapted to the needs of our customers. One of the first legislative outputs of the Review was a new penalty regime for incorrect returns and other documents aligned across HMRC taxes, contained in Finance Act 2007.

7.2 The underlying principle of the Review is to support those who seek to comply, whilst dealing firmly with those seeking an unfair advantage by not complying. The behaviourally-based penalty regime supports this approach. Aligning penalties across taxes enables clearer deterrent messages and facilitates cross-tax compliance checks.

7.3 This instrument brings into force Schedule 40 which introduces more taxes and duties within this new single penalty regime, where previously there was a whole range of different regimes and rules. A penalty becomes chargeable only when a return has not been completed without taking reasonable care or if an error was deliberate. The amount of penalty is determined by reference to the amount of tax involved, the nature of the underlying behaviour giving rise to the failure and the extent of disclosure by the taxpayer. Rights of appeal and other safeguards will operate in a similar way across the taxes.

7.4 This policy has been the subject of wide consultation with the public and interested bodies, and the intended start date for the new taxes and duties has been broadly publicised. Systems and processes both within and outside HMRC have been adapted for the order to take effect on the date stated.

- ***Consolidation***

7.5 Schedule 1 to the order makes comparatively minor consequential amendments to a wide range of primary legislation, which is very large and complex. The objective of these amendments is to preserve the intention and meaning of the references in that legislation and does not change its meaning. There are no plans to consolidate this legislation.

8. Consultation outcome

8.1 A consultation document "Modernising Powers, Deterrents and Safeguards: Penalties Reform: The Next Stage" was published by HMRC on 10 January 2008. A draft Schedule 40 was attached to that consultation.

8.2 The consultation ran until 6 March 2008 and the "Summary of Responses" was published in March 2008. Both documents are available on the HMRC website. HMRC received 24 written response to the January consultation and held 18 meetings with representative bodies and professional firms during the consultation period. Throughout this period, HMRC clearly indicated its intention to bring these provisions into effect on 1 April 2009.

8.3 Following the consultation, Ministers decided to include the draft legislation in the 2008 Finance Bill, and it was subsequently legislated as Section 122 of, and Schedule 40 to, the Finance Act 2008.

9. Guidance

9.1 Although the order comes into effect on 1 April 2009, returns and other documents affected by the new regime will normally not be received until after 1 April 2010. The changes have received a great deal of publicity, and professional firms and other intermediaries have been preparing on the assumption that the new rules will commence on the basis set out in the order.

9.2 HMRC has a major programme of guidance, communication and training about changes to error penalties, as well as a review of business processes including management information systems. This programme now incorporates the provisions commenced by this order, including revised staff guidance and customer communications.

10. Impact

10.1 The direct financial impact on business, charities or voluntary bodies is nil for those taxpayers who continue to pay the right amount of tax at the right time, as they will not be subject to the new regime. Although it is expected the penalties for the deliberately non-compliant will be larger than currently, there is no expectation of a significant increase in the amount of overall total penalties charged.

10.2 The benefits of alignment include simplicity (facilitating publicity and understanding, as well as reducing compliance costs) and integration (allowing for a single HMRC intervention and action to cover several taxes). Therefore, a single penalty regime reduces costs for taxpayers and HMRC.

10.3 The impact on the public sector is nil.

10.4 An Impact Assessment on the wider penalties reform was published by HMRC on 27 March 2008 and is attached to this memorandum. The figures in the Impact Assessment are still up to date.

11. Regulating small business

11.1 The legislation applies to small business. Small business will benefit from having a single aligned set of rules in relation to the forms and returns it is required to complete for HMRC, rather than the broad range of possible penalty regimes that apply up to the date of the order.

11.2 HMRC has sought views on the impact on small business during its consultation. The structure of the new penalty regime took into account consultation responses and meetings with a range of bodies including Community Links, the Federation of Small Businesses, the Low Income Tax Reform Group and Tax Aid.

To exempt small businesses with less than twenty employees would deny them the benefits of simplification that results from aligning the penalty regimes across all the taxes

and duties administered by HMRC. The very low number of small businesses who may need further advice on time limits can access this advice through our website or by seeking advice from our contact centres.

12. Monitoring & review

12.1 HMRC is introducing systems which will allow it to track the number and value of penalties charged across taxes under the new penalty regime compared to the amount of tax involved. There will be guidance and governance procedures in place to ensure that the new penalty regime is applied in a consistent manner.

12.2 There will be an Implementation Oversight Forum made up from external stakeholders and relevant HMRC directors which will report to ministers. The initial meeting of this forum is scheduled for 30 March 2009. A Post Implementation Review will take place within three years of implementation.

13. Contact

David Lewis at the HM Revenue & Customs Tel: 020 7147 2403 or email: david.e.lewis@hmrc.gsi.gov.uk can answer any queries regarding the instrument.

Summary: Intervention & Options

Department /Agency: HMRC	**Title:** Impact Assessment of Penalties Reform: The Next Stage	
Stage: Final/Implementation	**Version:** 1.0	**Date:** 27th March 2008
Related Publications: Consultation Document: Penalties Reform: The Next Stage: (10 January 2008) Draft Legislation and Commentary (10 January 2008): Responses to Consultation and Proposals (27 March 2008):		

Available to view or download at: www. hmrc.gov.uk/better-regulation/ia.htm

Contact for enquiries: powers.review-of-hmrc@hmrc.gsi.gov.uk **Telephone:** 020 7147 3223

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

Most people pay their taxes on time and give information and returns to HMRC at the right times. However, it is necessary to have the power to charge financial penalties for those who do not, both in order to be fair to those who pay on time and to deter those who do not. The problem is that the penalties inherited from predecessor departments are inconsistent and not fully effective. Penalties for incorrect returns for Income Tax, Corporation Tax, PAYE, NIC and VAT (the main taxes) were modernised and aligned through Schedule 24 Finance Act 2007, but not those for the other taxes and duties administered by HMRC. Penalties for failing to notify new taxable activities to HMRC are also varied and inconsistent. Creating a single penalty framework for incorrect returns for all taxes and for failures to notify new taxable activities will simplify and reinforce the deterrent effect of penalties.

What are the policy objectives and the intended effects?

The policy objectives are simplification and alignment, with the added benefit of targeting penalties more effectively at taxpayer behaviour, reinforcing the effect on compliance.

The intended effects are: to reassure those who pay the right tax at the right time, to support those who take care but make mistakes, to deter those who do not comply, and to encourage people to come forward when they think there is a problem with their tax affairs.

What policy is being taken forward?

Extend the new penalty regime to cover:

- incorrect returns for the remaining taxes and
- failure to notify/register a new activity

bringing with it the benefits of alignment – simplicity (facilitating publicity and understanding, reducing compliance costs) and integration (facilitating single HMRC intervention or action covering several taxes). A single penalty regime reduces costs for taxpayers and HMRC. This obviates the need for HMRC to understand a variety of penalty regimes and enables reform to relate the penalties more closely to taxpayer behaviour. This is the preferred option.

When will the policy be reviewed to establish the actual costs and benefits and the achievement of the desired effects? HMRC has started a major programme of guidance, communication and training about changes to penalties, as well as a review of business processes including management information systems. Post implementation review will take place within 3 years of implementation.

Ministerial Sign-off For Final Impact Assessments:

I have read the Impact Assessment and I am satisfied that (a) it represents a fair and reasonable view of the expected costs, benefits and impact of the policy, and (b) the benefits justify the costs.

Signed by the responsible Minister: Jane Kennedy

.... Date:27 March 2008

Summary: Analysis & Evidence

Policy Option: 1	Description: Extend the new penalty regime to cover incorrect returns for other taxes and failure to notify/register a new taxable activity

COSTS

ANNUAL COSTS		Description and scale of **key monetised costs** by 'main affected groups' There will be some initial cost to taxpayers and their representatives while they familiarise themselves with the new penalty regime. HMRC will incur costs implementing the 2007 penalty changes (around £10m for IT, training, guidance and communication). There will be further costs to HMRC implementing the 2008 changes but these are expected to be substantially less.
One-off (Transition)	**Yrs**	
£ 10m		
Average Annual Cost (excluding one-off)		
£ Nil		**Total Cost** (PV) **£ 10m**

Other **key non-monetised costs** by 'main affected groups' It is expected that penalties for the deliberately non-compliant would be larger than currently. However, we do not expect that there will be significant increases in total penalties charged.

BENEFITS

ANNUAL BENEFITS		Description and scale of **key monetised benefits** by 'main affected groups' There will be no effect for those taxpayers who continue to pay the right amount of tax at the right time as they will not be penalised. The obligations remain the same, only the penalties would change. Simplification will lead to some reduction in compliance costs.
One-off	**Yrs**	
£ Nil		
Average Annual Benefit (excluding one-off)		
£ Unquantified		**Total Benefit** (PV) **£ Unquantified**

Other **key non-monetised benefits** by 'main affected groups'

The key benefits arising are: simplification of the penalty regime to ease understanding across taxes. It is anticipated this will lead to potential improvement in overall rates of voluntary compliance, as the penalties align more with behaviours and encourage co-operation and positive engagement with HMRC.

Key Assumptions/Sensitivities/Risks It is assumed that the proposed new penalty model will encourage behavioural change in those taxpayers who deliberately get their tax affairs wrong. If their behaviour does not change, they will suffer penalties of between 20 and 100 percent of the tax understated.

Price Base Year	Time Period Years	**Net Benefit Range** (NPV) **£**	**NET BENEFIT** (NPV Best estimate)

What is the geographic coverage of the policy/option?	United Kingdom
On what date will the policy be implemented?	Not before 1/4/09
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?	£ N/a
What is the value of changes in greenhouse gas emissions?	£ N/a
Will the proposal have a significant impact on competition?	No

	Micro	Small	Medium	Large
Annual cost (£-£) per organisation (excluding one-off)				
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**

Introduction

Following the changes introduced in Finance Act 2007 to the way penalties are charged for incorrect returns for the main taxes (Income Tax, Corporation Tax, PAYE, NIC and VAT), HMRC is seeking to continue the alignment by extending this to incorrect returns for all other taxes and failure to notify a new taxable activity. This will ensure a single framework for penalties across taxes that leads to simplification and lower costs for taxpayers. Furthermore it will encourage positive taxpayer behaviour and voluntary compliance through a targeted and fair regime.

Basing penalties on behaviour is considered fairer, benefiting those making mistakes despite taking reasonable care with their tax affairs, while penalising those seeking to gain an unfair advantage by deliberately not meeting their tax obligations. This will encourage positive interaction and engagement with HMRC. As a result of the alignment of penalties for incorrect returns for all taxes and failure to notify a new taxable activity, taxpayers will only have to deal with one penalty regime across all taxes. This will make matters less confusing for the customer and facilitate cross-tax compliance checks in the future.

The proposed new penalty model will have no effect on those who comply with their obligations. In cases where a mistake has been made despite taking reasonable care, there will be no penalty chargeable. For those individuals and businesses not meeting their obligations as a result of a failure to take reasonable care, the level of penalty will be broadly similar to that under the current system. Where the new penalties will be higher is for those cases of deliberate non-compliance. Initially there may be an increase in appeals as the new regime beds in but this will be monitored.

HMRC have conducted a wide ranging review of civil penalties to consider how best to modernise and align the different penalty regimes inherited from the two former departments (Inland Revenue and Customs and Excise). The first stage of this review resulted in a new penalty regime for incorrect returns for the main taxes legislated in Schedule 24 Finance Act 2007.

Although the benefits of the new model will be difficult to measure, early indications from discussions with accountancy bodies and taxpayers about the penalty measures introduced in Finance Act 2007 would suggest that businesses are already considering whether they need to take more care with their systems and procedures to reduce the possibility of non-compliance.

A consultation document – Penalties Reform: The Next Stage, published on 10 January 2008 – sought views on the proposals to extend the provisions of Schedule 24 Finance Act 2007 for penalties for incorrect returns for the other taxes and duties HMRC administer and for failures to notify a new taxable activity. The response to the consultation has been overwhelmingly positive: “We are pleased to note the proposals to extend to other taxes, which is in line with our comments in earlier consultation.” This positive message is echoed by more specialist bodies representing particular groups affected. A full summary of responses to the January consultation has also been published today.

There will be some costs to taxpayers to familiarise themselves with the new penalty regime. HMRC will incur costs implementing the 2007 penalty changes (around £10m for IT, training, guidance and communication). There will be further costs to HMRC implementing the 2008 changes but these are expected to be substantially less.

Penalties Regime for Incorrect Returns

Taxes covered

The policy will extend the changes to penalties introduced in Finance Act 2007 to incorrect returns submitted for the following taxes and duties:

- environmental taxes (aggregates levy, climate change levy, landfill tax);
- excise duties (alcohols, tobacco, oils, gambling and air passenger duty);
- inheritance tax;
- insurance premium tax;
- pension schemes (the "accounting for tax" form);
- petroleum revenue tax;
- stamp duties (stamp duty land tax, stamp duty reserve tax); and
- accounting to HMRC for repayment of student loans.

Outline

A summary of the **current** penalties for other taxes can be found in Chapter 4, paragraphs 4.7-4.15 of the consultation document – Penalties Reform: The Next Stage, published on 10 January 2008.

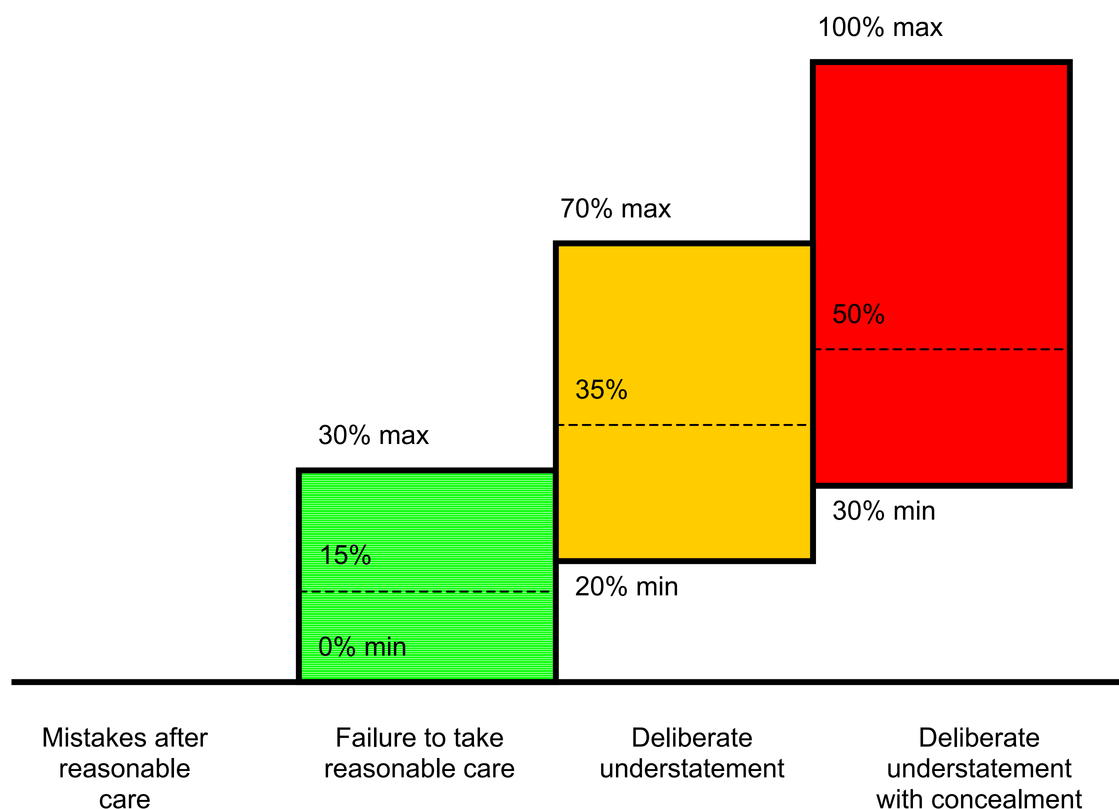
The new penalty regime for the main taxes, enacted in Schedule 24 Finance Act 2007, enables HMRC to determine a penalty for an incorrect return based on:

- the amount of tax understated;
- the nature of the behaviour that gives rise to the understatement; and
- the extent of disclosure of the irregularity by the taxpayer

Penalties will apply in a stepped structure depending on behaviour. There will be no penalty where the taxpayer makes a mistake or misinterprets the law despite taking reasonable care.

The law provides for significant reductions to penalties where a taxpayer makes a disclosure, more so if it is unprompted. For example, a taxpayer making a deliberate understatement of their tax obligation would incur a penalty of between 20 and 70% of the tax understated. The precise level would depend on whether the taxpayer made a full disclosure to HMRC and on whether that disclosure was prompted or unprompted.

The chart on page 5 shows the maximum penalties, the maximum reductions for "prompted" disclosure (dotted lines) and the minimum penalty after "unprompted" disclosure for each of the different behaviours:



HMRC also proposes to seek a penalty on third parties who deliberately withhold information or provide false information intending to cause a tax return to be inaccurate. This would apply in excise and inheritance tax cases where those benefiting are not responsible for submitting the return.

Expected Impacts

Excise and environmental taxes

At least 2,000 assessments totalling over £200 million were made by HMRC in 2006/2007 for excise and environmental taxes   These were to recover additional tax due as a result of incorrect returns by registered traders or misuse of duty relieved goods, e.g. red diesel the proposed penalties for which are covered in a later section.

As with other taxes, research suggests that a significant proportion of assessments for excise and environmental taxes are made to correct mistakes made by the taxpayer despite them taking reasonable care. Where currently a £250 penalty would be charged, no penalty would be due on these under the new regime.

Just over half of assessments were for relatively small amounts (less than £1,500) where, even if a penalty of 15% of the undeclared tax was due, it would be lower than the current penalty charged (£250).

A relatively small proportion of assessments involved significant amounts (more than £1 million). Where these understatements are due to a failure to take reasonable care or deliberate understatement, a tax-geared penalty would be larger than the current penalty and considered a more proportionate and effective response.

HMRC carried out a review of excise cases to test whether behaviour could effectively be assessed from information available. The research indicated that HMRC officers are able to

make the distinction between different types of behaviour. Under the new model the higher penalties will be targeted to understatements which are deemed deliberate or deliberate with concealment, as well as cases where there is greater tax at risk. The effect of this will be fairer penalties, coming down hard on those seeking an unfair advantage while at the same time benefiting those individuals and businesses that make genuine mistakes despite taking reasonable care. There will also be a greater incentive for disclosure and cooperation with HMRC.

Tobacco, alcohol and oils which are subject to excise duties may be held in excise warehouses. The warehouse-keeper is responsible for making returns. Sometimes those who may benefit from an understatement of excise duty deliberately misinform or withhold information (with the intention to cause tax to be understated) from the warehouse-keeper causing the return to be incorrect. The owner, consignee or haulier of the goods can gain an economic advantage by giving false information to the warehouse-keeper (for example about the destination of goods). The option to charge a penalty directly on the third party will strengthen the deterrent effect of the penalty regime.

Inheritance Tax (IHT)

Generally, the level of IHT penalty under the proposed new model will remain the same as the current penalty. Penalties for incorrect inheritance tax returns (known as accounts) are payable by the personal representative who is responsible for completing the return correctly. Evidence from previous investigations suggests that sometimes those who may benefit from an understatement of inheritance tax (the beneficiaries of the estate or the recipients of lifetime gifts) deliberately withhold information (with the intention to cause tax to be understated) about the deceased's assets from the personal representative, causing the inheritance tax return to be incorrect. The possibility of a penalty payable directly by the third party will strengthen the deterrent effect. It would align the penalty more closely with the unfair advantage gained by deliberate action.

Insurance Premium Tax (IPT)

The introduction of the new penalty regime fills a gap in existing IPT penalties. This will introduce a deterrent effect where currently there is none, reinforcing this relatively compliant area where it is expected that few insurance premium tax penalties would need to be charged.

Other Taxes and schemes

The penalty framework covers a further three duties, schemes and arrangements including:

- petroleum revenue tax and stamp duties (stamp duty land tax, stamp duty reserve tax)
- pension schemes (accounting for tax)
- accounting for student loan repayments

For these areas it is not expected that the number or level of penalties charged will change significantly. Aligning penalties for the above taxes will provide traders, businesses and employers with a clearer and more consistent approach to penalties across different taxes.

Failure to Notify a New Taxable Activity

Taxes Covered

The proposals for failure to notify a new taxable activity cover:

- income tax;
- national insurance contributions;

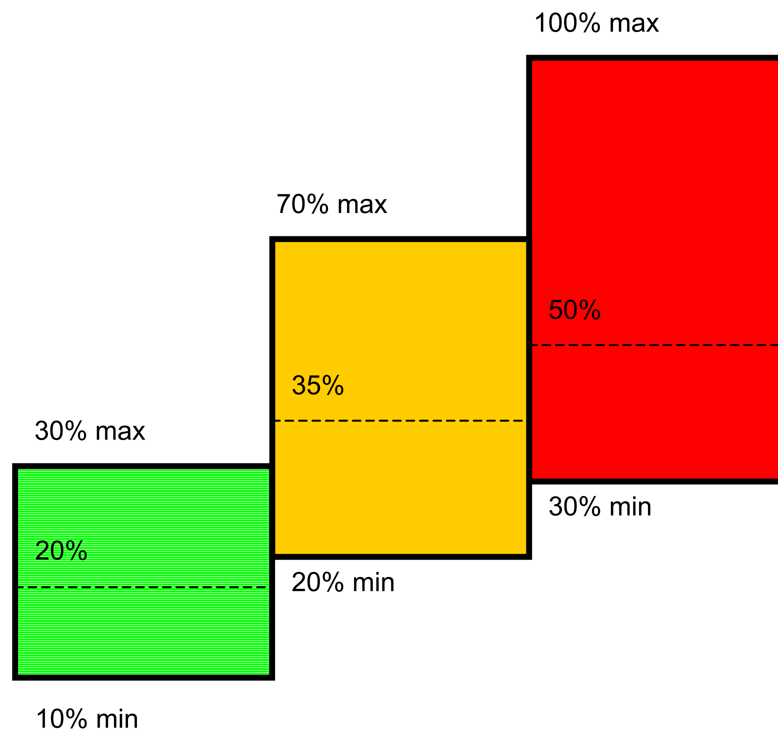
- corporation tax;
- VAT;
- excise duties;
- insurance premium tax; and
- environmental taxes.

<u>Outline</u>

Details of the strengths and weaknesses of **current** provisions can be found in chapter 5 paragraphs 5.5-5.11 of the consultation document – Penalties Reform: The Next Stage, published on 10 January 2008.

The new penalty model for failure to notify a new taxable activity is based on the model for incorrect returns with some adaptation.

The chart below shows for each of the different behaviours the maximum penalties, the maximum reductions for "prompted" disclosure (dotted lines) and the minimum penalty for "unprompted" disclosures.



No tax yet due or reasonable excuse including a reasonable belief no obligation existed	Non-deliberate failure to notify – notification received more than 12 months after tax became unpaid (see below)	Deliberate failure to notify without concealment	Deliberate failure to notify with concealment

To reduce the disincentive to come forward once a person has become liable to a penalty, it is proposed that there would be significant reductions for disclosure. Where a person who would otherwise be liable to a 30% penalty makes a full unprompted disclosure ***within 12 months of when tax first became unpaid as a result of the failure***, the penalty will be reduced further to nil. A full prompted disclosure within 12 months will be reduced to no less than 10% of the tax that is due.

This represents a policy change as a result of consultation. It aims to further encourage people to move from the hidden to the formal economy. It introduces a further reduction for early disclosure and instead of measuring the 12 months from when the failure occurred, it measures it from when tax first becomes unpaid as a result. This makes the benefits of coming forward earlier clearer.

It is proposed that the £100 Class 2 NIC fixed penalty for failing to notify self-employment within three months will be abolished. Where Class 2 NICs are overdue, a penalty geared to the amount of both income tax and NIC unpaid as a result of late notification would be charged when income tax became overdue.

Expected Impact

Failure to Notify – income tax and NIC

Of all the cases identified as failure to notify in 2006/2007, a quarter were voluntary notifications by the taxpayer (as opposed to being identified by HMRC's actions).

50% of voluntary notifications were made during the first year in which there had been a failure to notify (compared to 33% that were non voluntary). These represent the least serious cases, and taxpayers that come forward early will benefit from the reduction to nil where they may have been penalised under the current system.

In a significant number of cases where a person fails to notify, the amount of tax undeclared was under £500 and a small number of these cases (around 10%) led to a failure to notify penalty or surcharge. It is expected that none of these penalties will be charged under the new system.

Of the cases involving a liability over £500, just under 45% incurred a penalty or surcharge under current provisions. Under the new system this is expected to increase to just over 65%.

Failure to notify – VAT

As with direct taxes, the new model is not expected to result in significantly different levels of penalties being charged for non deliberate failures, but it is likely that the level of penalty will increase for deliberate failures. Aligning the VAT penalty for failure to notify a new taxable activity with the penalty for direct taxes will provide greater clarity, especially for those individuals and businesses who deal with both regimes.

Removal of fixed £100 Class 2 NIC penalty for failing to notify self employment

Consultation has supported the view that the £100 fixed penalty for failing to notify self employment within three months for Class 2 NIC is counter-productive. It is proposed that this penalty be removed and with it a significant irritant which damages relations between taxpayers and HMRC at a crucial stage of their relationship with HMRC.

Currently around 13,000 of these penalties are charged per year, bringing in approximately £1.3million to the Exchequer. Abolishing the £100 penalty will have relatively little financial impact to the Exchequer.

General

It is envisaged that the level of penalty charged for non deliberate failure to notify will be similar to that currently charged. This accounts for the vast majority of cases. Although research suggests that there are relatively few cases where a taxpayer has taken deliberate steps to evade tax by not notifying HMRC, enquiries have revealed individuals who have not notified businesses for more than fifteen years with offshore bank accounts used to avoid detection and offshore companies used to conceal the business from HMRC. The fact that the new system is better defined will make it easier for HMRC to apply higher, more appropriate levels of penalties, up to 100% of the tax for the most serious cases.

The new penalty system for failure to notify a new taxable activity will be fairer as it means lower or no penalties for those individuals notifying HMRC quickly and voluntarily, while penalising those who deliberately seek to gain an unfair advantage by continuing to operate in the informal economy.

By introducing a provision to reduce the penalty to nil, the new penalty model provides a greater incentive for taxpayers to come forward earlier and make a full unprompted disclosure.

Excise Wrongdoings

Outline

A product may be duty relieved (no excise duty paid) or duty rebated (a lower rate of duty paid) if it is to be used for a specific purpose e.g. agricultural use of red diesel. HMRC may already assess unpaid excise duty on a person who misuses such product. The current penalty regime enables HMRC to charge fixed penalties of £250 where misuse is identified. Provision is now made for a penalty to be charged on the person misusing the product, or on a person supplying the product knowing it is to be misused. The penalty will be calculated in the same way as for a failure to notify a new taxable activity.

A similar penalty will be applicable where a person handles goods at a time where the payment of excise duties on those goods is unpaid and has not been deferred. The penalty will be calculated in the same way as for a failure to notify a new taxable activity.

Expected Impact

It is estimated that £350m is lost to the Exchequer each year from the illicit market in petrol and diesel. The proposed changes will allow HMRC to charge more proportionate tax geared penalties which will be fairer and act as a more effective deterrent.

Competition assessment

The penalty framework will directly affect those who do not pay the correct amount of tax deliberately or due to lack of care and those who fail to notify HMRC of a new taxable activity. It should further indirectly affect all taxpayers by giving an incentive to take reasonable care in calculating the tax due and a stronger incentive not to deliberately underpay.

Overall, it is expected that the proposed new penalty framework for incorrect returns and for failure to notify a new taxable activity would improve competition by reducing the unfair advantage gained by those taxpayers who deliberately do not comply with their tax obligations or who fail to take reasonable care. This will benefit all compliant taxpayers by providing a more level playing field.

Small firms impact test

The proposals are quite explicit, more so than currently, that penalties will not apply to compliant businesses including those who make mistakes or misinterpret the law after taking reasonable care. The aim is for reduced compliance costs for small businesses. The overall alignment and simplification of penalties will facilitate integrated compliance checks reducing costs for small businesses.

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	***Results in Evidence Base?***	***Results annexed?***
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

The above impact tests have been considered and none of them is likely to be significantly affected in this particular case.