EXPLANATORY MEMORANDUM TO

THE FINANCE ACT 2009, SECTIONS 101 TO 103 (INCOME TAX SELF ASSESSMENT) (APPOINTED DAYS AND TRANSITIONAL AND CONSEQUENTIAL PROVISIONS) ORDER 2011

2011 No. 701 (C. 26)

AND

THE FINANCE ACT 2009, SCHEDULES 55 AND 56 (INCOME TAX SELF ASSESSMENT AND PENSION SCHEMES) (APPOINTED DAYS AND CONSEQUENTIAL AND SAVINGS PROVISIONS) ORDER 2011

2011 No. 702 (C. 27)

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 instruments

2.1 These instruments bring the new harmonised interest regime and the new penalty regimes for late filing of returns and late payment of tax, introduced by sections 101 to 103 and by Schedules 55 & 56 to the Finance Act 2009 respectively, into force in relation to payments due to be made to or by HMRC and returns due to be made to HMRC in connection with Income Tax Self Assessment. They also bring the late filing penalty regime into effect for Pension Scheme returns.

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

3.1 Amendments that are consequential to the penalties order come into force on 1st April 2011 for filing and payment obligations relating to the tax year 2010-11 and those that are consequential to the interest order come into force on 31st October 2011. Notwithstanding this, the existing interest provisions will have no effect during the period of 6th April to 30th October 2011 in respect of obligations for the tax year 2010-11 as the first date that payment obligations can arise for that tax year is 31st October 2011.

4. Legislative Context

4.1 The new harmonised interest regime was introduced by sections 101 to 105 of the Finance Act 2009. This new interest regime aligns the rules for the charging and paying of late payment interest and repayment interest for all taxes and duties administered by HMRC.

4.2 Section 104 of the Finance Act 2009 provides that sections 101 to 103 of that Act come into force on a day appointed by Treasury Order either generally or for specified purposes. It is the intention of HMRC that the new interest regime will be phased in for each existing tax and duty, and where possible with all new taxes and duties, over a number of years. The legislation allows for this approach.

4.3 The new penalty regime for late filing of returns was introduced by Schedule 55 to the Finance Act 2009, and the new penalty regime for late payment of tax was introduced by Schedule 56 to the Finance Act 2009. Sections 106 and 107 of the Finance Act 2009 provide that Schedule 55 and 56 respectively will come into force on a day appointed by Treasury Order either generally or for specified purposes. It is the intention of HMRC to implement these new penalties on a staged basis, and the legislation allows for this approach on an individual tax basis.

4.4 Some amendments to Schedules 55 and 56 are brought into force in April 2011 by the Finance (No. 3) Act 2010, Schedules 10 and 11 (Income Tax Self Assessment and Pension Schemes) (Appointed Days) Order 2011. Schedule 55 is also amended by Schedule 10 to the Finance Act 2010; these amendments will be brought into force on a day to be appointed by Treasury Order.

4.5 These orders continue the process of implementation of new penalties, started with SI 2010/466, which made the new regime effective for late payments under the PAYE Regulations and Pension Schemes payments from 6 April 2010.

5. Territorial Extent and Application

5.1 These instruments apply to all of the United Kingdom.

6. European Convention on Human Rights

6.1 The Exchequer Secretary to the Treasury, David Gauke MP, has made the following statements regarding Human Rights:

In my view the provisions of the Finance Act 2009, sections 101 to 103 (Income Tax Self Assessment)(Appointed Day, Transitional and Consequential Provisions) Order 2011 are compatible with the Convention rights.

In my view the provisions of the Finance Act 2009, Schedules 55 and 56 (Income Tax Self Assessment and Pension Schemes) (Appointed Days and Consequential and Savings Provisions) Order 2011 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 & 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. The Review has already aligned the penalty regimes for incorrect returns and failures to notify, and this regime continues the work in relation to late filing and late payment penalties.

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 with their tax obligations. The escalating nature of the penalty levels and provisions for suspension of a late payment penalty where deferred payment of the tax has been agreed are part of this approach. Aligning penalties across taxes enables clearer deterrent messages and facilitates cross-tax compliance checks.

7.3 Alongside the Review of Powers, HMRC also reviewed the existing legal frameworks for charging and paying interest that the department inherited from the former Inland Revenue and HM Customs and Excise. There are a number of differences in the way interest is charged and paid across the heads of taxes. For some taxes, interest is charged as soon as payment is late whereas for others it is only charged where under-declarations are assessed. For some liabilities, there is no late payment interest charge at all.

7.4 Following extensive consultation, the Government introduced legislation in the Finance Act 2009 to harmonise the way that interest is charged and paid across all taxes and duties. This legislation will, however, take some time to come into force in its entirety as many of the changes will require substantial changes to HMRC IT systems.

7.5 The interest instrument brings into force the new harmonised interest regime for income tax self-assessment payment and repayment obligations from 31st October 2011. Where an amount is paid late to HMRC, late payment interest will be charged until that amount is paid. Where HMRC repay amounts, repayment interest will be paid from the later of the due date for payment or the date the amount was paid, until the date the amount is repaid.

7.6 The penalty instrument brings into force Schedule 55 on 6th April 2011 for late returns under Income Tax Self Assessment for the tax year 2010-11 onwards. When a return is late, the penalty is initially a fixed £100 penalty. If the failure continues for over three months, the penalty level escalates by a fixed £10 per day up to a maximum of 90 days. For more serious non-compliance where the failure is prolonged

beyond six or twelve months, there are further penalties of either £300 or 5% of the tax liability on the return (whichever is the greater).

7.7 From 6th April 2011, this instrument also applies Schedule 56 to late payments under Income Tax Self Assessment for the tax year 2010-11 onwards. If a payment is over 30 days late, then a penalty of 5% of the amount unpaid is due, with similar penalties if any amounts remain unpaid after a further five or eleven months. There are special rules that apply where HMRC make further assessments of tax.

7.8 The two penalty structures operate independently of each other, so the late filing penalty is not capped to the amount unpaid or due.

7.9 The penalty instrument also brings the late filing penalty regime into effect for late Pension Scheme returns from 1 April 2011. This will complete the alignment work to bring Pension Schemes into the same penalty rules across all other taxes and duties administered by HMRC.

7.10 All the penalties have a reasonable excuse defence, as well as other safeguards, which will operate in a similar way across all taxes when implementation is complete.

7.11 These policies have been the subject of wide consultation with the public and interested bodies, and the intended start date has been widely publicised. Systems and processes both within and outside HMRC have been adapted for the orders to take effect on the dates stated.

8. Consultation outcome

8.1 A consultation document “Meeting the obligations to file returns and pay tax on time” was published by HMRC on 24 November 2008. Drafts of what became Schedule 55 & 56 were attached to that consultation.

8.2 The consultation ran until 13 February 2009 and the “Summary of Responses” was published on 22 April 2009. Both documents are available through the National Archive website (with links from the HMRC website). Throughout the consultation and in the subsequent Budget announcement, HMRC clearly indicated its intention to bring these provisions into effect for ITSA filing and payment obligations on 6 April 2011.

8.3 Following the consultation, Ministers decided to include the draft legislation in the 2009 Finance Bill, and it was subsequently legislated as Schedules 55 & 56 to the Finance Act 2009.

8.4 Draft versions of the orders were published in advance on the HMRC website for public comment.

9. Guidance

9.1 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 is conducting a programme of guidance, communication and training to raise awareness of the new penalty regime, as well as a review of its own business processes. This programme now incorporates the provisions commenced by this order, including revised staff guidance and customer communication.

9.3 No additional guidance is required for interest.

10. Impact

10.1 The impact on business, charities or voluntary bodies is nil for the majority of taxpayers who continue to file their returns and pay their tax on time, so they will not be affected by the new regime. There is no expectation that the penalties will apply to a wider population than the regime that it replaces, although the intention is to reduce the number of taxpayers who fail to comply.

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

10.3 The impact on the public sector is nil.

10.4 An Impact Assessment for interest harmonisation and for the late filing and late payment penalties reform was published by HMRC on 14 April 2009 and is attached to this memorandum and available from the HMRC website at http://www.hmrc.gov.uk/better-regulation/ia.htm

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 filing and payment obligations it must meet with HMRC, rather than the broad range of possible penalty regimes that may currently apply.

11.2 HMRC sought views about the impact of these changes 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 the Federation of Small Business, Forum of Private Business and the Low Income Tax Reform Group.

11.3 To exempt small businesses with fewer 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. Small businesses that may need further advice on their obligations can access this advice through our website or 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 regimes. There will be guidance and governance procedures in place to ensure that the new penalty regimes are applied in a consistent manner.

12.2 A Post Implementation Review of the interest and penalty regimes will take place within three years of full implementation.

13. Contact

13.1 Don Morley at HM Revenue and Customs can answer any questions regarding the instrument for interest. Telephone: 020 7147 2407 or email: don.morley@hmrc.gsi.gov.uk

13.2 David Lewis at HM Revenue & Customs can answer any questions regarding the instruments for penalties. Telephone: 020 7147 2403 or email: david.e.lewis@hmrc.gsi.gov.uk

Summary: Intervention & Options

Department /Agency: HMRC	Title: Combined Impact Assessment of Working Towards a Harmonised Regime for Interest and Meeting The Obligations to File Returns and Pay Tax on Time	
Stage: Final	**Version:** 2.0	**Date:** 14 April 2009
Related Publications: **Consultation documents -** Meeting the obligations to file returns and pay tax on time. Interest – Working towards a harmonised regime – June 2008 and November 2008		

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

Contact for enquiries: **Vivienne Webb / Robert Horwill** **Telephone:** 020 7147 3223/2447

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

There are currently differences in the way that penalties and interest are applied across the various taxes and duties that HM Revenue and Customs administers and this can be complicated for taxpayers, their advisers and HMRC.

What are the policy objectives and the intended effects?

To harmonise and align (where sensible) the interest regime, penalty structures and safeguards to make them better reflect the following design principles:

- New penalties should: Influence behaviour, be effective and be proportionate,
- A new interest regime should: be simple, fair and provide recompense for HMRC and any taxpayer not having the right money at the right time.

The intended effect is for more people to file returns and pay tax due on time, with a more robust approach to prolonged and repeated delay.

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

1) Do nothing – continue with the inconsistent approach across all taxes.
2) Align rates for charging and paying interest only for those taxes and duties where HMRC currently charge and pay interest.
3) Legislate to modernise and align penalty structures and safeguards, and to charge and pay interest consistently on all taxes and duties.

Option 3 is the preferred option. In consultation with stakeholders preferred models have emerged which include separate penalties for late filing and late payment and a simplified but extended interest regime. The aim is for a penalty regime that is fair, effective and influences behaviour balanced by aligned taxpayer safeguards, and an interest regime which provides recompense, fairness and simplicity.

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 Implementation Stage 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) that the benefits justify the costs.

Signed by the responsible Minister:



Date: 14 April 2009

Summary: Analysis & Evidence

Policy Option: 2	Description: **Align rates for charging and paying interest only for those taxes and duties where HMRC are currently charging and paying interest**

COSTS

ANNUAL COSTS

One-off (Transition) **Yrs**

£ Negligible

Average Annual Cost (excluding one-off)

£ Negligible

Description and scale of **key monetised costs** by 'main affected groups' Option 2 includes alignment of interest regimes only and does not include reform of penalties. There are no known additional compliance costs which taxpayers would incur in complying with their tax and legal obligations, and we do not expect changes in interest rates to be any more frequent than they are now. The financial impact on taxpayers and HMRC depends on the interest charged and paid, and the divergence of rates.

Total Cost (PV) **£ Negligible**

Other **key non-monetised costs** by 'main affected groups' There may be some cost to the taxpayer in becoming familiar with a new regime, but this is expected to be negligible and will be offset by a more simplified and streamlined process for the calculation and application of interest. This should improve cost effectiveness and provide saving in resource time.

BENEFITS

ANNUAL BENEFITS

One-off **Yrs**

£ Nil

Average Annual Benefit (excluding one-off)

£ Negligible

Description and scale of **key monetised benefits** by 'main affected groups' As above, the financial impact on individual taxpayers and HMRC would depend on the levels of interest charged and paid. Greater harmonisation of the interest charging and paying rules could bring administrative benefits for taxpayers, their advisers and HMRC. These benefits cannot be quantified precisely, but are likely to be small but worthwhile.

Total Benefit (PV) **£ Negligible**

Other **key non-monetised benefits** by 'main affected groups' The simplification of the interest regime will provide taxpayers/others with a fairer system which is more comprehensible and manageable, and will enable them to spend less time understanding how it works.

Key Assumptions/Sensitivities/Risks Although the compliance costs are likely to be minimal, taxpayers will see changes in the actual interest rate they pay.

Price Base Year 2009	Time Period Years p.a.	**Net Benefit Range** (NPV) **£ Negligible change**	**NET BENEFIT** (NPV Best estimate) **£ Negligible change**

What is the geographic coverage of the policy/option?			United Kingdom	
On what date will the policy be implemented?			N/K	
Which organisation(s) will enforce the policy?			HMRC	
What is the total annual cost of enforcement for these organisations?			£ Negligible change	
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	
Annual cost (£-£) per organisation (excluding one-off)	Micro	Small	Medium	Large
Are any of these organisations exempt?	No	No	N/A	N/A

Impact on Admin Burdens Baseline (2005 Prices)

Increase of	£Nil	Decrease of	£ Negligible	**Net Impact**	(Increase - Decrease) Negligible decrease

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

Summary: Analysis & Evidence

Policy Option: 3	Description: Legislative change for late filing and late payment penalties and charging and paying interest, both applied consistently and automated across the four main taxes.

COSTS

ANNUAL COSTS

One-off (Transition) **Yrs**

£ c. 93 million 10

Average Annual Cost (excluding one-off)

£ c. 36 Million p.a.

Description and scale of **key monetised costs** by 'main affected groups' **HMRC**: one-off costs (£84m) for investment in IT systems and up to £150k training costs associated with the interim PAYE reforms. **Operating costs**: of about £22m per year once all reforms are bedded in. **Taxpayers**: one off familiarisation costs of £4m for the new P35 form, and £4.7m for the new rules. Ongoing costs of £14m (£3.5m for appeals and £10.5m for the P35).

Total Cost (PV) **£ 169 Million**

Other **key non-monetised costs** by 'main affected groups' These forecasts are subject to refinement as detailed work on IT implementation planning progresses and timing will depend on the competing demands for HMRC resources. A risk based approach for PAYE is proposed initially.

BENEFITS

ANNUAL BENEFITS

One-off **Yrs**

£ Nil

Average Annual Benefit (excluding one-off)

£ c. 5 Million p.a.

Description and scale of **key monetised benefits** by 'main affected groups' Aligned rules, facilitating clearer messages about obligations and the consequence of not meeting them; a more targeted approach to late payment; harmonising interest across all taxes discourages taxpayer arbitrage/prioritisation in paying, and offers fairer recompense between those who do and don't pay. Most of these benefits cannot be quantified, but HMRC will see operating savings of nearly £5m from better compliance.

Total Benefit (PV) **£ Not quantifiable**

Other **key non-monetised benefits** by 'main affected groups' A fairer regime will benefit all taxpayers, in terms of recompense to the Exchequer from those who default on their obligations. The intended affect of the penalties and interest on taxpayer compliance will encourage taxpayers to pay on time for all taxes, to provide a level playing field and no benefit for late payment.

Key Assumptions/Sensitivities/Risks All costs and benefits have been evaluated over 10 years but implementation will be staged so they will arise in different years. A series of very cautious assumptions have been made about the likely behavioural changes for each tax to arrive at broad estimates of both operational costs and likely financial implications for the Exchequer.

Price Base Year 2009	Time Period Years 10	**Net Benefit Range** (NPV) **£ Not quantifiable**	**NET BENEFIT** (NPV Best estimate) **£ Not quantifiable**

What is the geographic coverage of the policy/option?				United Kingdom
On what date will the policy be implemented?				By 2018/19
Which organisation(s) will enforce the policy?				HMRC
What is the total annual cost of enforcement for these organisations?				£ NA
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 Low	Small Low	Medium Low	Large Low
Are any of these organisations exempt?	No	No	No	No

Impact on Admin Burdens Baseline (2005 Prices)

Increase of £6 million Decrease of £ Nil **Net Impact** (Increase - Decrease) c. £6 million increase

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

Evidence Base (for summary sheets)

1. Introduction

1.1 Following the creation of HM Revenue and Customs (HMRC) from the merger of the Inland Revenue and HM Customs and Excise, HMRC has been taking forward consultation on a programme of legislative changes to provide a modern and effective framework of law and practice for the new Department. The changes resulting from this work will help HMRC deliver the O'Donnell Review aims of better customer service, greater effectiveness and improved efficiency.

1.2 During this strand of the modernisation programme, HMRC engaged in a consultation process with external stakeholders and taxpayers, seeking their views on:

- greater alignment of the interest charging and paying rules to bring benefits to taxpayers, their advisers and HMRC; and
- on deterrents and the associated safeguards considering the circumstances in which taxpayers should become liable to civil penalties when they do not meet their obligations to submit returns and pay tax on time.

1.3 The aims of the policies behind this package were to a) establish a more effective interest regime based on the principles of recompense, fairness and simplicity, and, b) modernise and align the penalty and safeguard structures to make them both fairer and easier to understand and more effective. All taxes[1] and duties administered by HMRC are in scope for these reviews, with the exception of tax credits, child benefit and customs duties.

1.4 The consultations ran between June 2008 and February 2009. HMRC published the first two of its consultation documents on the 19 June 2008:

- 'Interest – Working Towards a Harmonised Regime' and
- 'Meeting the obligations to file returns and pay tax on time'

1.5 Further consultation documents were published by HMRC on 24th November 2008 to provide the details of the preferred approaches as a result of the ongoing/previous consultations. These documents were supported by impact assessments and draft legislation detailing the new proposals. Their titles were:

- 'Interest – Working Towards a Harmonised Regime' : Summary of Responses and Proposals, and
- 'Meeting the obligations to file returns and pay tax on time: Consultation Responses and Refined Models'

1.6 These proposals have evolved through the consultation period with the scrutiny by external stakeholders of evidence and analysis published by HMRC. The final interest and penalty regimes reflect input from a wide range of evidence and sources including through external consultation, interrogation of internal HMRC systems and independent qualitative research. The final policies will be legislated after the Budget, then implemented over a period of at least 4 to 5 years as IT systems and business processes for each tax are modernised.

1.7 Separate impact assessments (IA's) were prepared to document the progress of the consultations. The impacts of the two streams of work are very closely linked, especially in the work relating to in year PAYE and development and costing for changes required to the IT

[1] With the exception of Customs duties "taxes" should be taken in this document to include all the taxes, duties and national insurance contributions for which HMRC is responsible. Taxpayer should be taken to include anyone paying such taxes as well as those paying tax on behalf of another person.

systems. Therefore, for the final/implementation stage, a joint IA for interest and penalties has been prepared to better reflect the policy and operational environment.

1.8 The IA contains a number of sections which cover current structures and the processes followed to gather the evidence to develop the preferred option and the final structures of the new regimes for penalties and interest. These sections are as follows:

- Section 1 introduction
- Section 2 existing penalty and interest structures
- Section 3 policy options considered and the reasoning behind why the preferred option was taken forward
- Section 4 provides a detailed account of the policy development process
- Section 5 explains about the independent qualative research that was undertaken
- Section 6 considers implementation
- Section 7 covers the costs and benefits associated with the new regimes

2. Existing Penalty and Interest structures

2.1 There are currently differences in the way that penalties and interest are applied across the various taxes and duties that HM Revenue and Customs administers and this can be complicated for taxpayers, their advisers and HMRC. 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 taxes and the penalty and interest regimes may vary considerably.

2.2 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 the two separate former Departments.

2.3 The current rules on interest have evolved over time with additions and adaptations applied as each major tax has been reviewed or each new tax or duty has been introduced. As such there are a number of different rules applying for interest across the taxes which when taken together are complex, inconsistent, and difficult for taxpayers to understand.

Current structure for charging and paying interest

2.4 For some taxes, interest is charged as soon as payment is late; for others it is only charged where underdeclarations are assessed, and for some liabilities there is no late payment interest charged at all. In addition, where repayment interest currently applies it may be called a supplement, credit interest or statutory interest, and it applies at a number of different rates depending on the tax to which it relates.

2.5 This variation in applying and calculating interest, coupled with the differences in language, adds unnecessary complexity which is at odds with an effective modernised tax system. Many business taxpayers have VAT, Income Tax or Corporation Tax and PAYE bills to pay and each with different rules. The different rules, when considered together across taxes, fail the desired principles for a harmonised regime in a number of ways. This is because interest:

- is not always charged
- is not paid consistently
- where charged, is not always imposed automatically
- from the date which interest runs is not set consistently
- is calculated by reference to different formulae
- is charged at different rates for different taxes
- rates change irregularly and unpredictably
- may be charged and paid at the same rate or at different rates
- is not always tax deductible
- uses inconsistent language between taxes

Current penalty structures for late filing and late payment

2.6 Some of the penalty structures 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.

2.7 Most tax regimes have separate sanctions for late filing and late payment although some wrap the penalty for late payment and late filing into one sanction (e.g. the VAT default surcharge). Typical sanctions for late returns or late payments can include:

- fixed penalties (for example a fixed sum of £100);
- penalties related to the amount of tax unpaid (for example a penalty of 5% of the amount of tax paid late);
- penalty interest (for example 10% points above the normal interest rate).

3. Policy Options for Interest & Penalties

3.1 The underlying policy aims presented during the consultation process were to harmonise, align (where sensible) and modernise the interest regime, penalty structures and safeguards based on the following design principles. The policy development process is explained in detail in Section 4 and it was this process that helped form the preferred option from those options that were considered by HMRC.

3.2 Respondents were supportive of a structure that met all of the policy aims and option 3 was therefore developed as the preferred option.

3.3 The policy options which have been considered are as follows:

Option one - Preserve the status quo

3.4 Taking this option would mean that HMRC continues using different structures for interest and penalties for different taxes for late filing and late payment. Retaining these structures could be complicated for taxpayers, their advisers and HMRC.

3.5 Under the existing interest regime there are currently thirteen statutory formulae in use generating a number of different interest rates charged on late payments and applied to overpayments of tax – the current rates can be found on HMRC's Internet. These different rates combined with the fact that interest is not consistently charged and paid across taxes adds complexity. This complexity has extra cost and resource implications for taxpayers, their advisers, and for HMRC as it does not enable taxpayers to identify easily the consequences of paying late.

3.6 The penalty structures inherited from the former Departments would remain unaligned continuing the confusion for taxpayers and their agents and resulting in a missed opportunity to reduce administrative costs for both the taxpayer and HMRC and to increase the proportion of taxpayers filing and paying on time. Some existing penalty structures are ineffective and some can result in disproportionate impacts on the taxpayer.

Option two - An interim measure for interest only to align rates for charging and paying interest for those taxes and duties where HMRC are currently charging and paying interest

3.7 Option 2 was an interim option for interest but there was no corresponding option for penalties – this was because it was intended to move from the existing penalty regimes to one that would legislate to modernise and align penalty structures and safeguards.

3.8 This option would simplify the existing regime for charging and paying interest for those taxes where it already exists by aligning the rates charged and paid but not change the timings. For those taxes the revised interest regime would be based on the principles of recompense, fairness

and simplicity, with one common rate of interest for late payment and another for all overpayments, although not necessarily the same rate.

3.9 There should be benefits for taxpayers through easier understanding of the basis on which interest is charged and paid out on those taxes and duties where it currently applies. However significant IT changes would not be expected which would mean lower IT costs for HMRC compared to option three.

Option three - To charge and pay interest consistently and automatically on all taxes duties and to legislate to modernise and align (where sensible) penalty structures and safeguards - preferred option

3.10 This option has emerged as the preferred option following feedback from respondents to proposals contained in the June and November consultation documents for interest and penalties.

3.11 This option follows the same principles for interest outlined at option 2 and builds on the changes suggested there. Under this option the interest regime would be extended to include all other taxes and duties where no interest is currently charged or paid [i.e. in-year PAYE and VAT where HMRC is in receipt of a return], as well as aligning the underlying rules for interest. This would ensure that interest would be applied consistently to all late payments and repayments of tax. The interest charged and paid would be:

- based on the Bank of England Base Rate;
- changed shortly after base rate changes;
- with a differential between the amount charged and paid.

3.12 The final interest regime would be one that creates fairness between taxpayers who had paid on time and those who had not paid on time. Those taxpayers who had paid on time would therefore do so in the knowledge that the system was fair, as those who did not pay on time would be charged interest.

3.13 For penalties a number of different penalty structures were considered in consultation with stakeholders and a number of preferred models emerged. The key elements of the new penalty structure are:

- separate penalty regimes for late filing and late payment;
- penalties separated from interest;
- tax geared penalties to tackle prolonged failure;
- the lowest rates possible that will influence behaviour (and taking into account interest on late payment).

3.14 In taking this option forward as the preferred option HMRC considers that it is the option that is most likely to achieve the policy aims and objectives.

3.15 This option requires significant investment in IT and business process change which will take time to deliver. In light of this, this option would be implemented in a phased way over several years.

3.16 The method of implementing proposals for employer's in-year PAYE has been modified, at least initially. It is now proposed to apply the interest and penalties to employers initially on a risk based basis, targeted at the worst offenders and building on current debt management activities.

4. Policy Development Process

Background

4.1 The consultation documents which considered new regimes for interest and penalties were published along side one another and the consultation processes ran concurrently. And although the different roles of interest and penalties are apparent, the clear links between the consultations were recognised by stakeholders.

4.2 The evidence came from a detailed analysis of current penalty and interest regimes, consideration of design principles, literature review and qualitative research and ideas were then tested in consultation. The consultation process was extensive and views were sought from a broad cross section of external stakeholders that covered all taxes. This information was complemented with information gathered by HMRC from its analysts and interrogation of its IT systems.

4.3 The June consultation provided a broad understanding on a number of key principles that would underpin how any future interest and penalty regimes were to be structured. HMRC received 26 written responses to the consultation documents and conducted 16 one to one discussions and two workshops involving taxpayers, representative bodies and tax professionals.

4.4 These responses and findings from a focus group and the Ipsos MORI research were summarised in consultation documents published in November 2008, and these documents took forward final proposals for respondents to consider.

4.5 HMRC received some 45 responses to the November consultations and 18 meetings were held with representative bodies. The proposals put forward in the November consultations were broadly supported by stakeholders and subject to technical refinements represent the final penalty and interest proposals taken forward.

4.6 During the consultation process a number of diagrams were produced to illustrate how the new penalty regime for various taxes were developed for late payment and late filing and how they would impact and interact as appropriate with interest. Interim diagrams were produced in previous IA's and the final diagrams have been reproduced as Annexes in this document.

4.7 In the remainder of this section there is a more detailed explanation about the consultation process and how the feedback influenced and helped develop the new interest and penalty regimes. There is also more direct reference to specific areas of work such as in year PAYE, Quarterly Instalment Payments (QIPs), which are specifically mentioned in the consultation documents and where feedback was requested from respondents about how interest and penalties should be taken forward in a new regime.

The consultation process

Interest: June consultation

4.8 The June consultation document contained a number of proposals and views were sought from respondents about the structure of a new interest regime. It included discussion points about the way interest is presently charged, how the rates are calculated (including debate about the 'rounding' process), and the differentials between late payment rates and overpayment rates and highlighted particular issues for PAYE and VAT. HMRC engaged with taxpayers and representatives to find solutions that would achieve the best balance of the design principles.

4.9 The document looked at how the principles of recompense, fairness and simplicity could be reflected in the rates themselves. It acknowledged that, in setting the rate or rates for a revised harmonised interest regime careful consideration of the existing Quarterly Instalment Payments (QIPs) position and the dynamics behind that position needed to be carefully considered with the possibility of separate rates for QIPs alongside the revised harmonised rates of interest for other taxes and duties.

Interest: outcomes of the June Consultation

4.10 Respondents broadly indicated that:

- harmonisation across all taxes was welcomed – with the exception of QIPs;
- the majority recommend basing the interest rate on the Bank of England base rate;
- changes to the rates should track the changes to the Bank of England base rate;
- there should be a differential in the rate of interest charged for late payment and repayment but the range of the differential should be kept to a minimum;
- interest should be charged and paid on in-year PAYE by extending the End of Year return (P35) to include details of in-year monthly payments due for comparison with HMRC's record of amounts paid to determine late payment and overpayment;
- interest should be charged and paid on VAT and duties when a return is received.

Interest: November consultation

4.11 Feedback from the June consultation was fed into the November consultation document and respondents were then asked to feed back on a number of proposals designed to help HMRC develop a new regime. The key proposals where responses were requested were about whether:

- a single rate should paid by HMRC on 'overpayments' across all taxes, duties, and penalties, other than QIPs;
- a single rate should charged by HMRC across all taxes, duties, and penalties etc that a taxpayer pays late to HMRC, other than QIPs;
- companies paying under the QIPs regime to have different rates;
- interest should to be paid and charged as simple interest;
- a set of aligned rules, including for QIPS, with rates that are calculated by reference to the Bank of England base rate, and track any changes in that rate.

Interest: outcomes of the November consultation

4.12 Responses are summarised in a response document published at Budget 2009.

4.13 Respondents were pleased to be able to contribute their views and the following is a summary of their responses:

- there was general satisfaction with the proposal to use simple interest for both paying and charging interest, though a small number felt that compound interest would better reflect the commercial world;
- almost all respondents who expressed a view stated that using the Bank of England base rate as the starting point for calculating interest rates is the best solution. There was less agreement concerning the frequency of changes to HMRC rates, with suggestions varying from immediately following changes to base rate to a set date each quarter;
- there was also some divergence over the proposal for differential rates for paying and charging interest, with some saying it is standard commercial practice and others that HMRC is not a commercial lending organisation and seeing unfairness in differentials;
- there was very strong support for in-year PAYE to be brought into the interest regime. However, many felt that doing this via a modified P35 would be over-burdensome on employers. There was some opposition to the idea that interest incurred on monthly payments should be charged at the end of the year;

- all but one respondent supported the retention of the special rules for Corporation Tax (CT) QIPs;
- there was general agreement that the current rules on carry back losses in CT should be maintained, though a handful of respondents wanted this to be extended to Income Tax Self Assessment (ITSA) on grounds of fairness;
- there was overwhelming agreement that the proposals meet the objectives of recompense, fairness and simplicity.

Other interest related matters

Quarterly Instalment Payments (QIPs)

4.14 The Quarterly Instalment Payments (QIPs) regime is for large payers of Corporation Tax, and the current rates of interest for QIPs differ from those which apply to other taxes, and to Corporation Tax paid by other companies. Historically this difference reflects, in part, the ability of large companies to obtain more attractive rates of interest on the open market, and the fact that companies have to estimate tax liabilities (before the relevant return is made) which may increase the likelihood of over or underpayments.

4.15 The June consultation document acknowledged the dynamics behind the current QIPs regime, and in setting the rates for the new interest regime acknowledged that careful consideration would have to be given to take account of these special circumstances when proposals for setting the rates for the new interest regime suggested one set of rates for charging interest and another for paying interest.

4.16 QIPs were subject to discussion and feedback during both consultations and there was a strong steer from respondents to maintain the status quo for QIPs and it was decided therefore that there would not be a move away from the present way that QIPs are administered. Respondents were asked to endorse this view as part of the November consultation and the rationale for this is covered in chapter 3 of that document under the heading 'Special circumstances'. Following an analysis of responses received from respondents it was concluded that the current QIPs regime would remain broadly unchanged.

VAT & duties

4.17 The June consultation document explained how the interest regime operates for VAT and duties. The current regime is not automatic neither is there a consistent approach in the way interest is charged and paid. It was proposed during that consultation to change to a system which would enable HMRC to charge and pay automatic interest on VAT and duties in all instances where a return was received and tax was paid late and where there is an overpayment shown on the return. This proposal was not opposed by the respondents, and it was concluded by HMRC that interest should be charged and paid on VAT and duties when a return is received.

Penalties: June consultation

4.18 The June consultation document considered the effectiveness of the existing responses to late filing and payment and went on to consider a possible structured approach to late filing and payment. It also considered how this approach could be adapted for frequent obligations such as VAT and PAYE.

Penalties: outcomes of the June consultation

4.19 Most respondents broadly supported the aim to align penalty structures across the taxes and appreciated the approach adopted by HMRC. Some key themes from the responses are as follows:

- most respondents commented on the need for HMRC to simplify filing and payment obligations where possible, to take more steps to make it easier for people to comply with those obligations and to provide good support for those who had difficulties;

- following on from this, respondents were clear that whilst penalties were necessary to reinforce the obligations, they were not the full picture and use of HMRC resources should reflect this;
- some respondents thought HMRC should explore the use of incentives as a means of encouraging taxpayers to file and pay on time;
- many respondents said that whilst penalties were appropriate for late filing, they were less sure this was the case for late payment;
- however most accepted that very late payers and repeatedly late payers should be treated differently either by receiving penalties or closer scrutiny from HMRC.

Penalties: November consultation

4.20 The proposals from the June consultation were fed into the November consultation document which considered further how a structured approach for a new penalty regime, based on the design principles, might operate. The consultation document:

- looked at further research that has been carried out over the summer both internally and via external researchers into taxpayer behaviour and reaction to debt. This helps to build the evidence base for the reform of penalties;
- outlined what the June 2008 consultation covered and summarised how people responded to that consultation. It also discussed some of the outcomes from stakeholder workshops held over the summer;
- looked at a proposed way forward based on the research and responses HMRC has received to the June consultation. It made the case for charging penalties for late filing and late payment and highlights the importance of robust safeguards;
- sought views on a number of penalty models for both annual and one-off taxes and those where the obligation to file or pay is more frequent; and
- looked at the extra challenges of encouraging taxpayer to pay their in-year PAYE on time and presented a model that should overcome these difficulties.

Penalties: Outcomes of the November consultation

4.21 The responses were summarised in a response document published at Budget 2009. Key messages included:

- praise for HMRC's honest and open approach to consultation and that HMRC is listening to stakeholders' views;
- general agreement with HMRC's approach to tackle late filing of returns and late payment;
- strong support for the proposed safeguards and unanimous support for suspension of penalties whilst in time to pay arrangements;
- broad support for the penalty models developed;
- request for HMRC to reconsider whether it needs to require all employers to submit an extended P35; and
- helpful suggestions of refinements to the models.

In year PAYE: Interest & Penalties

4.22 All consultations explored in depth the challenge of improving in-year PAYE payments by employers.

4.23 Presently, interest is only charged on PAYE after the end of the year on any amounts outstanding for that year. Employers are required to make payments of PAYE 'in-year' but where these are late interest are not currently charged. Views were requested during the consultation about how interest might be charged on in-year late payments under the PAYE system. Likewise since there are currently no penalties for late payment of in-year PAYE views were also sought about the introduction of a penalty regime.

4.24 HMRC put forward three options for amendments to the PAYE process in the June consultation documents to address late payment of in-year PAYE: monthly statements, monthly estimates or extending the large employers' surcharge. Many respondents expressed disquiet about all three. However a fourth and more suitable option, suggested early in the consultation, was considered and developed during the November consultation. This fourth option was suggested in a significant number of written responses.

4.25 This option required the employer to provide a schedule of monthly in-year PAYE payment details in additional boxes to be included on the End of Year P35 return. After the year end, HMRC would reconcile the payments actually received in year with the amounts declared as due to be remitted. The monthly figures would be an aggregate for each month, not split into PAYE, NIC, Student loans, Statutory Payments or CIS payments nor by employee.

4.26 Reconciliation of an expanded end of year return with the in-year payment record would identify any discrepancies e.g. month 4 payments received 3 weeks late. Interest would then be charged (or paid) together with late payment penalties, if appropriate. The focus of this reconciliation would be on whether payments had been made on time. If HMRC considered an employer was manipulating these entries on the return they could be subject to audit.

4.27 As a consequence of requiring employers to report amounts due to be paid, albeit after the year end, together with the knowledge that interest and possibly penalties will be applied, will deter people from paying their PAYE late and achieve better compliance. Where there are genuine difficulties meeting liabilities, it will encourage people to come forward to HMRC to seek a time to pay arrangement, knowing that late payment penalties will be suspended if they do.

4.28 The November consultation documents took these proposals forward. Views were sought on the interest proposals for charging interest on late payments of in-year PAYE based on an extended P35 and the potential for a deminimis limit. For penalties HMRC asked for responses to questions about the design principles and evidence of administrative burdens about penalties linked to late payment of in year PAYE. The responses received on this issue indicated:

- agreement for the need to take steps to address late payment by employers of in-year PAYE;
- overall support for the proposals but a significant number of respondents including small business and payroll professional representatives, expressed concerns about additional administration burdens;
- concern that the proposals would unfairly impact on smaller employers, especially those that administer their own payroll, who did not have sophisticated systems to automatically populate the expanded P35 with the additional information. The impact would also be felt by those struggling with cash flow particularly in the current climate;
- an additional burden on employers who, due to increased risks for errors on the return, may need to spend time identifying and rectifying the error as well the time needed appealing against a penalty; and
- a suggestion that in year PAYE could be checked through Employer Compliance visits and by analysing monthly variations in PAYE payments (Debt Management activity).

5. Independent qualitative research

5.1 Ipsos MORI was commissioned by HMRC in 2008 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 interest, penalty and support regimes.

5.2 Fifty-two in-depth interviews were conducted between July and August 2008 with individuals or businesses (of varying sizes) 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 taxpayers who pay on time. Five agents were also interviewed to understand their viewpoint on the issues and proposed changes.

Main Findings

- Paying tax was perceived to be less important than making other payments.
- Participants recognised that interest and penalties for non payment is necessary in order to ensure that all taxpayers are treated fairly.
- The research also found that charges for non payment should be proportional to the debt accrued.
- Participants felt that sanctions should be clear, transparent and based on correct information.
- Participants appreciated being forewarned about any action to be taken against them with respect to unpaid taxes.

5.3 As a result of this research HMRC modified its proposals to remove any fixed penalties for late payment, which were seen as being counterproductive and disproportionate. Proposals to suspend penalties when the tax is subject to a time to pay arrangements have also been included. HMRC also recognised the importance of alerting taxpayers to impending interest or penalties.

Focus groups

5.4 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.

6. Implementation

6.1 HMRC engaged with its IT partners to complete a short but intense study to identify order of magnitude IT and business change costs of delivering the proposed models and interest. This concentrated on the four main taxes (PAYE, ITSA, VAT, and CT) and included identifying potential solutions, feasibility and sequencing decisions. The study covered estimated operating costs and considered both tactical and strategic IT solutions. The costs at this stage are indicative and will be subject to commercial challenge and identifying refined requirements.

6.2 The study identified that for three taxes changes could be made to current systems and for one (PAYE) would require replacing the current system for processing employer payments and creating a new platform. This would be a stepping stone to a more strategic IT system for HMRC, which could in future be used for other taxes. Creating common outputs from customers is an integral part of the proposed solution. This has the benefit of generic reminder and penalty letters being pursued from a centralised point in the Department. The study is based on a number of cautious assumptions drawn out at in depth workshops with relevant specialists for each tax about likely changes in taxpayer behaviour, operational impacts, and levels of appeals arising from increased activity to address prolonged and repeated delay.

6.3 The preferred option, to align and harmonise the penalty and interest regimes will require significant IT investment and business process change. There will be some significant costs

associated with those changes. For this reason, it is likely that the new penalties and interest regimes will be implemented in phases over a number of years.

A risk based approach for employers' in year PAYE

6.4 This is particularly the case for in-year PAYE where a fully automated introduction of the penalty and interest structures would require a new IT system which may take several years and be expensive to implement. In recognition of this and of concerns raised about the administrative burden of an expanded P35 required for this option, the intention is now to apply interest and penalties to late paid employers' PAYE on a risk basis, targeting the worst offenders, building on existing debt management activities. Furthermore, risk assessment will be carried out to identify those who appear to be seeking an unfair advantage by underpaying in the early part of the year and take steps to apply interest and penalties to these employers as well. It is envisaged that this targeted approach would result in an increase in on time payment as employers are made aware of the new potential consequences of late payment. Whilst implemented in this way, employers would not be required to submit the extended information on their P35 returns (monthly breakdowns of payment due to be made to HMRC) until the necessary IT support is introduced which is not envisaged before 2018/19.

7. Costs and benefits

7.1 These reforms are designed to simplify and harmonise the treatment of late filing and late payment across all tax regimes[2]. As such, the impact on the vast majority of taxpayers who file and pay on time will be negligible. Only those who do not file or pay on time will be significantly affected.

7.2 Maintaining the status quo (option 1) involves no change in costs or benefits, and provides the baseline for comparison with the other two options. Option 2 provides quick, but reduced benefits at a reduced cost, and option 3 (which includes option 2) maximises the benefits but over a longer time frame and at increased cost. Option 3 is the preferred long-term option.

7.3 The reformed system will be fairer to all taxpayers, and more effective in encouraging people to pay the right amount of tax at the right time. There will be additional benefits in the level of support offered to those having difficulty meeting their obligations, most notably removing late payment penalties where someone agrees a time to pay arrangement with HMRC.

7.4 In the short term, taxpayers will need to familiarise themselves with the new rules that are being introduced, while HMRC will incur costs in modifying its IT systems, revising its forms etc and staff training. Financially, those who file or pay late may see changes in the interest rates or penalties applied.

7.5 The administrative impacts are detailed below for each option. The financial impacts are covered subsequently.

Administrative Costs

Option 2: Aligning interest rates where HMRC already charge and pay interest

7.6 This option affects only those tax regimes where interest is currently applied (the main ones being Income Tax, Corporation Tax and National Insurance Contributions). In each case, rates may rise or fall from their current level, but the end result will be a simpler and fairer system with uniform rates across all the affected regimes.

7.7 Rate changes already occur naturally (broadly in line with changes in Bank of England base rates) and do not impose any significant administrative costs on taxpayers. The new rates may cause more or less interest to be charged (or paid out) to taxpayers, but harmonisation will be

[2] The two exceptions are the Quarterly Instalment Payment (QIPs) Scheme and Tax Credits. Both will remain unaffected by these proposals (except in cases of fraud).

implemented in the same way as existing rate changes and will have minimal impact on administration.

7.8 There will be a small benefit in terms of simplicity: any taxpayer currently subject to multiple rates will avoid that complication in future. HMRC will see a similar benefit in processing costs. These benefits are worthwhile and may reduce the potential for error, but they cannot be quantified precisely.

Option 3: Modernising interest rates and penalties across all tax regimes

7.9 This preferred option involves a phased implementation, allowing the timing of each element to be varied in line with the circumstances in each tax area. This approach avoids the prospect of large-scale change in any one year, allows the capital investment costs to be spread out, and minimises risk.

7.10 For the purposes of this Impact Assessment, we have assumed the following implementation schedule (which may be subject to change as a result of funding and other operational considerations):

Regime	Reforms take effect
PAYE (interim reforms)	2010-11
Income Tax Self-Assessment	2011-12
VAT	2013-14
Corporation Tax	2015-16
PAYE (longer term reforms)	2018-19

Typically, HMRC will incur systems development costs up to 2 years in advance of implementation.

7.11 We have also assumed that implementation of interest and penalty reforms for the other taxes and duties administered by HMRC would take place in parallel with the above schedule for the main taxes as and when operationally and financially feasible. For some of these taxes, notably Excise duties, further IT investment would be required although this has not yet been costed.

One-off set-up and familiarisation cost

7.12 Taxpayers will need to familiarise themselves with the new rules. With one exception, those who file and pay on time will not be materially affected and the familiarisation cost to them will be negligible. The exception is in the PAYE regime, where for an automated process, employers will need to adapt to a modified P35 return from 2018-19 onwards. In the main, however, it is only those that do not file or pay on time that will be directly affected by these reforms. We estimate the following number of taxpayers to come under this heading for the main taxes to be:

Income tax self assessment	1.65 million
VAT	0.45 million
Corporation tax self-assessment	0.60 million
PAYE	0.90 million

7.13 Some taxpayers may fall under more than one regime, so the actual number affected will be lower than the 3.6 million total implied.

7.14 Taxpayers, accountants and advisers will also need to familiarise themselves with the new rules, although the fact that all regimes will now be treated in the same way will reduce familiarisation costs considerably.

7.15 Those who receive penalties or interest charges/payments will need to understand the new rules. The new structure for income tax is similar to the old and familiarisation costs are likely to be negligible. For Corporation Tax and VAT, the cost will be small (the changes are relatively small). For in-year PAYE, the changes are more significant and will require more familiarisation time. It is difficult to put precise numbers on the costs, because many taxpayers will rely on their accountants to be aware of the new rules. Equally it is difficult to predict the number of taxpayers who will file or pay late. Nevertheless, HMRC expects around 5 minutes would be sufficient for most CT and VAT taxpayers, with 15 minutes for PAYE. This cost will be incurred once only and totals around £4.7 million across all those affected. Those who file and pay on time would not incur this cost.

7.16 Later from 2018/19 all employers (or their accountants or payroll agents) will need to familiarise themselves with the new rules for completion of the P35. The rules themselves are straightforward and it is unlikely that such time would be significant. A tentative estimate of £4m across all employers is included in the cost/benefit analysis (about 5-10 minutes each on average).

7.17 HMRC will need to upgrade and develop the necessary computer systems and internal processes in advance of implementation. The cost of this investment is significant in aggregate, but spread out over the staggered implementation period. HMRC has engaged with its IT Partners to identify the IT costs of delivering the proposed reforms, focusing on the four main taxes (PAYE, ITSA, VAT, and CT). Three of the current systems would be upgraded, and the system for processing employers' PAYE payments would need to be replaced. This last step would be a useful step towards an improved IT strategic solution for HMRC. The total one-off costs for HMRC are forecast at £84m (before any Net Present Value adjustment). This forecast is subject to further refinement as detailed work on IT implementation planning progresses. The precise detail of implementation and its timing will depend on the competing demands for HMRC resources. The figures include the eventual automation for PAYE although a risk based approach for PAYE is proposed initially.

7.18 The interim PAYE proposals will involve HMRC staff being deployed on compliance activity, essentially contacting and advising taxpayers and helping them comply with any debt obligations. This activity will cease when full PAYE automation takes effect in 2018/19. Staff costs will be funded from within existing allocations, although HMRC will incur a one-off staff training cost of up to £150,000. Some additional costs may be incurred (IT improvements, media awareness campaigns etc.) although these remain unquantified at the present time.

7.19 The impact on taxpayers of the interim PAYE reforms will depend on individual circumstances and cannot be quantified precisely in advance. The impact on those who pay on time will be negligible. Those who do not will be given appropriate support and guidance to help minimise any non-compliance.

Ongoing administrative costs once the reforms have bedded in

7.20 The administrative costs for taxpayers associated with filing and payment will be affected by these reforms although the impact will be limited. There will be cost increases in some areas (primarily for employers), decreases in others and a further decrease resulting from more people being encouraged to pay on time. The benefits section explains the decreases in detail.

Costs of P35 completion

7.21 The main increase in administrative costs will be incurred by employers, as they complete the new monthly liability boxes on the P35 return for the automated solution from 2018/19. This will affect all employers and the cost will depend on the ease with which businesses can obtain and validate the necessary information. Consultation responses confirm that there may be considerable variability according to individual firms' circumstances and decisions: for example some firms may choose to modify their existing record-keeping systems in order to facilitate P35 completion. Others may prefer to leave existing systems intact, and spend a little extra time on the P35 later. Finally, many firms may already have access to the necessary information and not experience any significant extra cost.

7.22 Based on consultation responses, we believe the extra time could range from around 5-10 minutes (for those firms with simple schemes, and existing electronic access to monthly liability information) up to around 4 hours (for those with the most complex schemes). The latter would be exceptional, however, and our central estimate is an extra 10-20 minutes per employer per return, equivalent to a total burden of around £7-14m per annum. The central figure of £10.5m is quoted in the summary on page 3. Taxpayers might be able to reduce this time if they chose to make one-off modifications to existing record-keeping systems.

Cost of appeals

7.23 The new regime includes a number of safeguards to ensure fair and equitable treatment. Taxpayers will have a right of appeal if they disagree with any interest payment or penalty. Forecasting the number of appeals cannot be done precisely, and nor can the outcomes of those appeals, but HMRC fully accepts that where an appeal succeeds, there will have been an additional burden on compliant taxpayers in making and pursuing that appeal. It is not always possible to eliminate these costs because many correctly-issued penalties are issued because HMRC were unaware that a valid reasonable excuse existed.

7.24 For costing purposes we have assumed that these reforms will lead to an increase in the number of appeals made (because appealable penalties are being extended to regimes which do not currently have them). It is possible that the simpler and fairer rules will reduce the need for appeals in some cases, but the overall net effect is likely to be an increase. We have assumed an extra 110,000 appeals being handled per year (around a 30% increase) with the majority of these (70,000) will occur in Corporation Tax, where we are introducing penalties for late payment for the first time. The total administrative costs associated with these extra appeals is estimated to be around £3.5m for HMRC, and the same for taxpayers or their advisers.

Other costs to taxpayers

7.25 We do not envisage any other costs of significance. Changes to interest rates are unlikely to pose any additional costs over and above the current level (c.f. option 2 above).

Costs to HMRC

7.26 HMRC's annual processing costs will also change. Some costs will fall (see the benefits section below) but costs associated with handling queries, appeals, and any associated communication, will rise. The annual cost, once all reforms have bedded in, is forecast at £22m (including the £3.5m for appeals mentioned above). This forecast is subject to further refinement as detailed work on IT implementation planning progresses. The precise detail of implementation and its timing will depend on the competing demands for HMRC resources. The figures include the eventual automation for PAYE although a risk based approach for PAYE is proposed initially.

Summary of Costs

7.27 The vast majority relate to HMRC (IT development etc.). The costs to taxpayers are limited to initial familiarisation with the new rules, and an additional cost to employers associated with the redesigned P35 return and costs related to appeals.

7.28 The total cost, expressed in net present value terms over 10 years, is £169m of which £136m will be borne by HMRC.

Administrative Benefits

Benefits to taxpayers

7.29 The new rules are designed to be simpler, fairer and more effective. These benefits are by nature qualitative, and difficult to quantify in numerical terms. The benefits have been monetised as far as possible, but this covers only a minority of the effects, and HMRC will monitor and gauge the full impact through post-implementation review.

7.30 The main benefits for taxpayers and their agents are:

- improved **simplicity** – clearer and simpler rules, less confusion over which rules apply, greater certainty and fewer errors;
- improved **fairness** – similar taxpayers will be treated in the same way;
- improved **recompense** – proper recompense will be paid for early or late payments;
- compliant taxpayers will be reassured that non-compliance is addressed effectively;
- the new rules will be more responsive to changes in money market rates;
- improved **support** – the new rules encourage early dialogue, enabling those in difficulty to receive advice and support early; and
- improved **safeguards** – all taxpayers will have a right of appeals and single reasonable excuse provision.

7.31 The main driver for reform, and the main benefit resulting from it, is the impact on compliance, encouraging and helping taxpayers file and pay on time. Aligned regimes across taxes will facilitate clear messages about filing and payment obligations and the consequences of not meeting them. For example, the fairer rules on proper recompense will encourage those who do not currently pay on time to do so. Those having difficulty will receive earlier and more focused support, again encouraging better compliance. Every taxpayer that responds in this way will see an immediate reduction in paperwork, penalties and costs.

7.32 The proportion of taxpayers filing on time is expected to rise, most significantly in those areas which do not have a full penalty regime at present. PAYE payment-on-time rates are expected to improve from 50% to over 75%, while PAYE filing and Corporation Tax Filing will both see improvements of around 3-4 percentage points. Other taxpayers may modify their behaviour too. As the changes bed in is expected there will be further behavioural changes, particularly a reduction in very late payment and filing (subject to tax geared penalties).

7.33 Estimating the precise time saved by those taxpayers that modify their behaviour is very difficult, because it depends on the individual circumstances in each case. These benefits are therefore classed as unmonetised within this impact assessment. But they remain a significant impact, and one which will be felt by a large number of taxpayers.

Benefits to HMRC

7.34 The benefits for HMRC are similar to the above, namely a reduction in processing costs resulting from fewer taxpayers entering the late filing and/or late payment regimes. Some of this cannot be quantified, but we estimate a reduction in the number of determinations (i.e. cases of late filing where HMRC issues an estimated tax bill) for both ITSA and PAYE. The associated reductions in HMRC costs are around £4m and £0.7m respectively. The total of nearly £5m is equivalent to £28m in NPV terms over the 10-year evaluation period.

Financial effects

Option 2: Interest rate harmonisation across regimes where interest is currently applied

7.35 The consultation on interest harmonisation has concentrated on developing the framework for an interest regime that met the three principles of recompense, fairness and simplicity. As noted above, the conclusion reached following that consultation was to keep the current set of rates for the QIPs regime and for the rest of the taxes to have one rate for interest charged on late payments and a further rate for interest paid on overpayments.

7.36 Given the current regime has 13 different rate formula inevitably moving to one set of rates will mean that many taxpayers will be subject to a different rate as a result of harmonising the rates. This means that those currently paying or receiving interest may see an increase or decrease in the rate applied to each tax and consequently there will be winners and losers. In determining

what those rates should be, and the gap between them, consideration has been given to both where those rates currently sit and also how rates compare to those available commercially.

7.37 This analysis has shown that the difference between the average bank loan rate and the average (notice) deposit rate has over the past 10 years never fallen below 3.4 percentage points and the average differential over the period was 6.3 percentage points. Last year the differential between the interest rates charged and paid by HMRC on the main taxes ranged between 3.5 and 4.5 percentage points. As noted above, those responding to the consultations suggested that the differential should be kept to a minimum. With reference to the above analysis a differential of 3.5 percentage points would see HMRC differentials on the main taxes reduced to their lowest point and at a rate that is less than the commercially available differentials. As such 3.5 percentage points would achieve a balance between the three principles behind interest harmonisation.

7.38 As detailed above, under option two and three, interest rates would track changes to the Bank of England base rate. This then leads to the question of where the base rate sits within the differential. The two tables below compare the rates charged and paid by HMRC in 2008 with what rates would have been charged by HMRC had the rates been set at base rate less one percentage point paid on overpaid taxes and base rate plus 2.5 percentage points.

	Rate paid by HMRC following MPC decision in					
	Jan-08	**Oct-08**	**Nov-08**	**Dec-08**	**Jan-09**	**Feb-09**
Main direct taxes	3	2.25	1.5	0.75	0	0
Indirect taxes	4	3	2	1	0	0
Base rate -1	4	3.5	2	1	0.5	0

	Rate charged by HMRC following MPC decision in					
	Jan-08	**Oct-08**	**Nov-08**	**Dec-08**	**Jan-09**	**Feb-09**
Main direct taxes	7.5	6.5	5.5	4.5	3.5	3.5
Indirect taxes	7.5	6.5	5.5	4.5	3.5	3.5
Base rate +2.5	7.5	7	5.5	4.5	4	3.5

7.39 If the rates were set in line with these tables the rates paid by HMRC on overpayments of the main taxes would have been either the same or higher over the whole period; where higher as much as 1.25 percentage points would have been paid. Conversely the rates charged would have been either be the same or higher than under the current regime; where higher the rate charged would not be more than half a percentage point higher. Looking over a ten year period the rates that would have been paid and charged by HMRC would have compared favourably with average rates available. In almost all cases the rate charged by HMRC would have been less than the average bank loan rate and in all cases the rate paid by HMRC would have been the same or higher than the average (notice) deposit rate. As such having rates set at base rate less one percentage point for interest paid by HMRC and set at base rate plus 2.5 percentage points for interest charged by HMRC would achieve a balance between the three principles behind interest harmonisation

7.40 In 2008 legislation was taken to ensure that the rates currently paid by HMRC could not fall below zero. During the consultation exercise some of those responding suggested that a ‘floor’ for interest paid on overpaid taxes should be introduced to ensure that interest would always be paid by HMRC on overpaid taxes. A rate of 0.5 percent would provide such a floor but without the rate paid by HMRC getting greatly out of kilter with the base rate. The legislation that will be introduced in the Finance Bill will allow for such a floor to be introduced. There are no plans to introduce a corresponding floor for the interest charged by HMRC – this would mean that the interest charged by HMRC would always reduce following a reduction in the base.

7.41 Harmonised interest rates could be introduced for those areas where interest is already charged and paid this summer and extended to other taxes in line with the staged implementation described later in this document.

7.42 The specific effects of reform will vary according to the tax regime concerned, and the numbers of taxpayers affected. The actual rates charged will be determined at regular intervals and publicised on the HMRC website. As the rates will track the Bank of England base rate the rates charged and paid by HMRC will reflect the economic circumstances, interest rates and commercial rates at the time, and so we cannot provide specific figures within this impact assessment.

7.43 HMRC have considered the possible effects to the Exchequer for aligning interest rates for charging and paying interest only for those taxes and duties where HMRC are currently charging and paying interest. Using 2005/06 data HMRC estimates the effect on the exchequer will be slight or negligible for IT/CT and PAYE.

Option 3: Full automation across all tax regimes

7.44 Option 3 is effectively an extension to option 2 and includes all the effects listed under the latter.

7.45 HMRC analysts have considered the possible impact of the proposed changes in terms of flow of funds to and from the Exchequer. Their analysis is based on full implementation and automation for the main taxes (Income Tax, Corporation Tax, VAT and employers' PAYE). At this stage it does not take into account the effects for the other taxes administered by HMRC. A separate consideration of the possible impact of the risk based approach for employers' PAYE is at para 7.52. The figures should be treated with considerable care being based on a series of cautious assumptions.

7.46 One of the key objectives of the reforms is to improve the amount of tax that is paid on time The analysis suggests that around £1bn to £3bn more tax will be paid on time (primarily employers' PAYE), which should reduce HMRC's costs in chasing debt and the risk of non-payment.

7.47 The analysis indicates that whilst the effects vary across taxes, generally those whose lateness is prolonged and repeated will pay more in interest and penalties than they do under the current regimes. The estimated average additional impact for each non-compliant taxpayer for each of the main taxes is set out in the table below together with the current estimates of when the new regimes will come into effect for each tax (subject to capacity and funding constraints). For those in financial difficulties who agree a time to pay arrangement with HMRC, late payment penalties will be removed.

Tax	Estimated [annual] numbers of late filers and payers currently	Estimated [annual] average additional interest and penalties payable per non-compliant taxpayer if no behavioural change	Estimated year in which change first takes effect
Income Tax Self Assessment	1.65m	£100	2011-12
VAT	0.45m	£600	2013-14
Corporation Tax	0.6m	£200	2015-16
PAYE	0.9m	£100-£300 depending on the number of defaults in a year	2018-19

7.48 The figures have been compiled using 2005/06 data and the modelling is based on the cautions assumptions set out below. If a taxpayer defaults for more than one tax they may have a greater

impact.

7.49 For VAT interest payments HMRC's annual VAT data snapshot for 2007-08 shows that there was in the region of 500,000 repayment traders that year. Broadly speaking this gives an average interest repayment per trader of around £400.

7.50 For taxpayer filing:

- assumes that filing compliance improvements come from those who are currently between 1 and 12 months late;
- assumes that daily penalties would be paid for 15 days;
- some adjustment has been made for the possibility of inaccurate or out of date data in HMRC systems (more so for CT) and for penalties not being paid due to appeals or non-collection;
- assumed the number of VAT defaults per defaulter in a period remains unchanged;
- used estimated average tax liabilities from existing data for tax geared penalties.

7.51 For taxpayer payment:

- assumes that payment compliance improvements come from those who are currently between 1 and 12 months late;
- assumed unpaid tax is half of tax due to calculate tax geared penalties;
- some adjustment has been made for the possibility of inaccurate or out of date data in HMRC systems (more so for CT) and for penalties not being paid due to appeals or non-collection;
- used mid point for interest rate 2006/07 i.e. 6/9/06;
- assumed the number of VAT defaults per defaulter in a period remains unchanged;
- for PAYE used estimated average liabilities and that a third of schemes paid the full amount late and 15% paid half late. Assumed 80% of defaulters paid within 6 months and 90% within 12 months;
- two scenarios were considered: 4 late payments in a year and 12 late payments in a year.

Risk based approach to late paid employers' PAYE

7.52 HMRC's experience and responses received to the consultation, suggest that the risk based approach to late paid employers' PAYE should go some way to improving payment profiles, although will not deliver the same degree of benefit as full automation. The extent of the benefit will be determined by the amount of resource that HMRC is able to deploy to this work and the effectiveness of communication of the new regimes.

Administrative burden

7.53 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.

7.54 In this case, most of the costs and benefits relate to those who have filed or paid late, and hence fall outside the strict definition of "compliant". There are two exceptions:

- the requirement for all employers to complete the new boxes on the P35 return; and
- the administrative cost to business taxpayers of making appeals.

7.55 Administration burden is always quoted in 2005 terms (both 2005 prices and 2005 populations) to ensure consistency with HMRC targets (which were set in 2005). In these terms, the relevant admin burden figures are £5.4 million for the P35 and £0.8m for appeals. The rounded total is £6 million.

7.56 These numbers are essentially a subset of the figures from the earlier cost section, but adjusted from a 2009 to a 2005 basis.

Risks and Caveats

7.57 All the numbers presented in this evidence base are best estimates. They are subject to a significant degree of uncertainty resulting from the long implementation period, the uncertain economic environment and data quality issues.

7.58 The administrative cost estimates, particularly for HMRC, are reasonably robust. The economic impacts (e.g. resulting from changes in compliance behaviour) are more difficult to predict accurately. Nevertheless, HMRC believes that the figures shown err on the side of caution and are thus a reasonable basis on which to compare the costs and benefits of reform.

7.59 Inevitably, such comparison is difficult to do in quantitative terms, because many of the benefits are qualitative. HMRC will monitor developments and progress throughout the 10-year period, and beyond, to ensure that any issues are addressed and uncertainties resolved.

Specific Impact Tests: Checklist

7.60 We have carried out an Equality Impact Assessment screening and concluded that a full EQIA is not required, having discussed with HMRC's Individual Stakeholder Forum and representatives of diversity groups.

Competition Assessment

7.61 These proposals have been subject to the Competition Filter. The proposals will not impact on any business's capacity to enter markets or compete vigorously within them.

Small Firms Impact Test

7.62 Small firms are not exempt from this measure. These proposals are aimed primarily at non-compliant taxpayers. To exempt small businesses would be to exempt the vast majority of UK enterprises from changes which aim to level the playing field by tackling more effectively and consistently those who seek an advantage through not complying with their obligations. If a more lenient approach was offered to businesses of less than 20 employees there would be a risk that larger businesses would disaggregate.

7.63 We have carefully considered whether these proposals will have any impact on the following other specific impacts:

- Legal Aid
- Sustainable Development
- Carbon Assessment
- Other Environment
- Health
- Human Rights, and
- Rural issues

and conclude that they do not impact.

Specific Impact Tests: Checklist

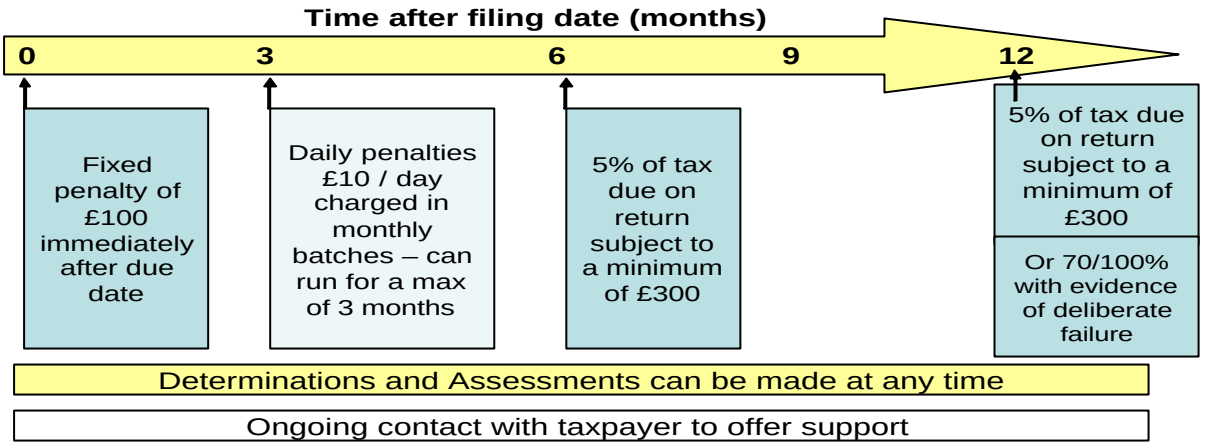
Use the table below to demonstrate how broadly you have considered the potential impacts of your policy options.

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	*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

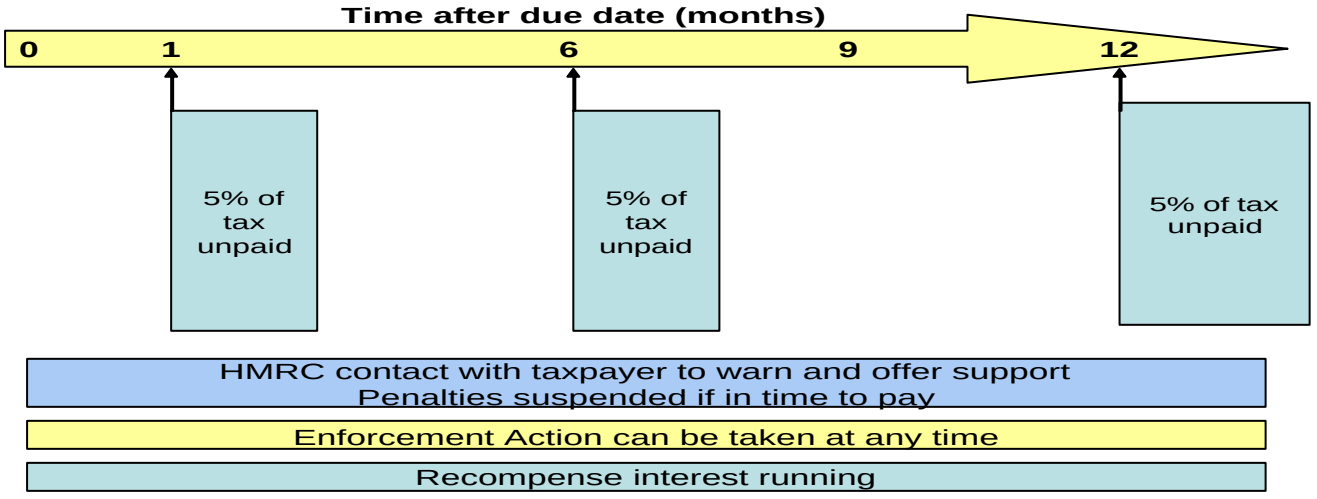
ANNEXES

Late filing (annual taxes)

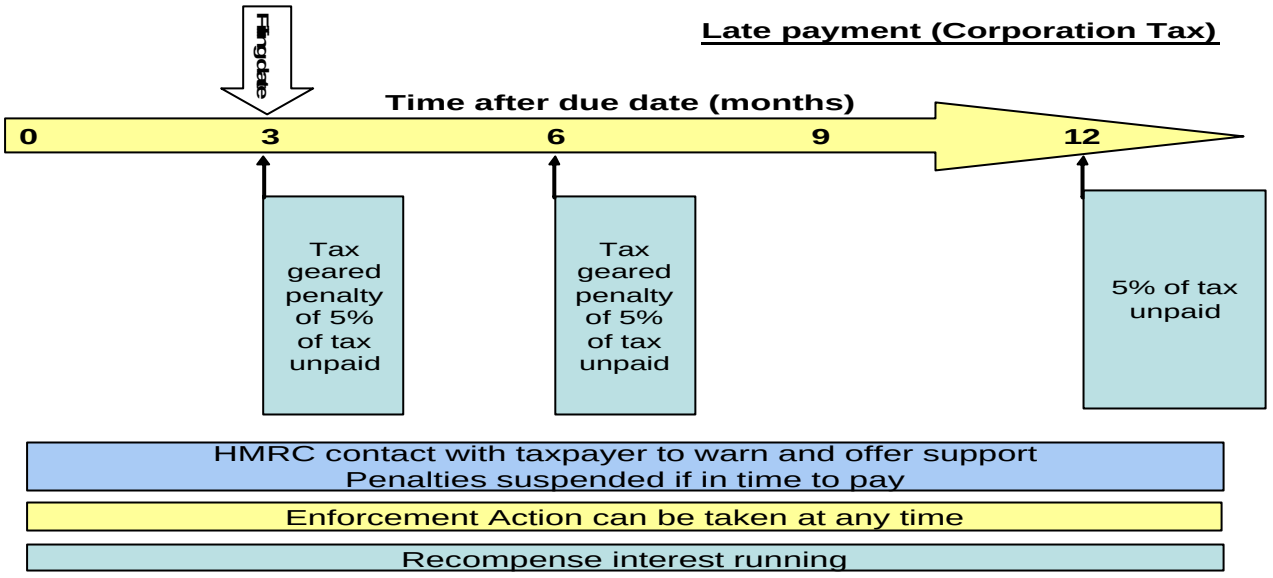


The first response to a return not being received by the filing, or due, date would be a fixed sum penalty of £100. Daily penalties of £10 per day would be charged in monthly batches at the end of each month. For prolonged failure to file a return, a tax geared penalty of 5% would be charged at month 6 and again at month 12. For deliberate failures to file returns there would be higher penalties of up to 70% of the tax due on the return and for deliberate failure with concealment the penalty will be up to 100%.

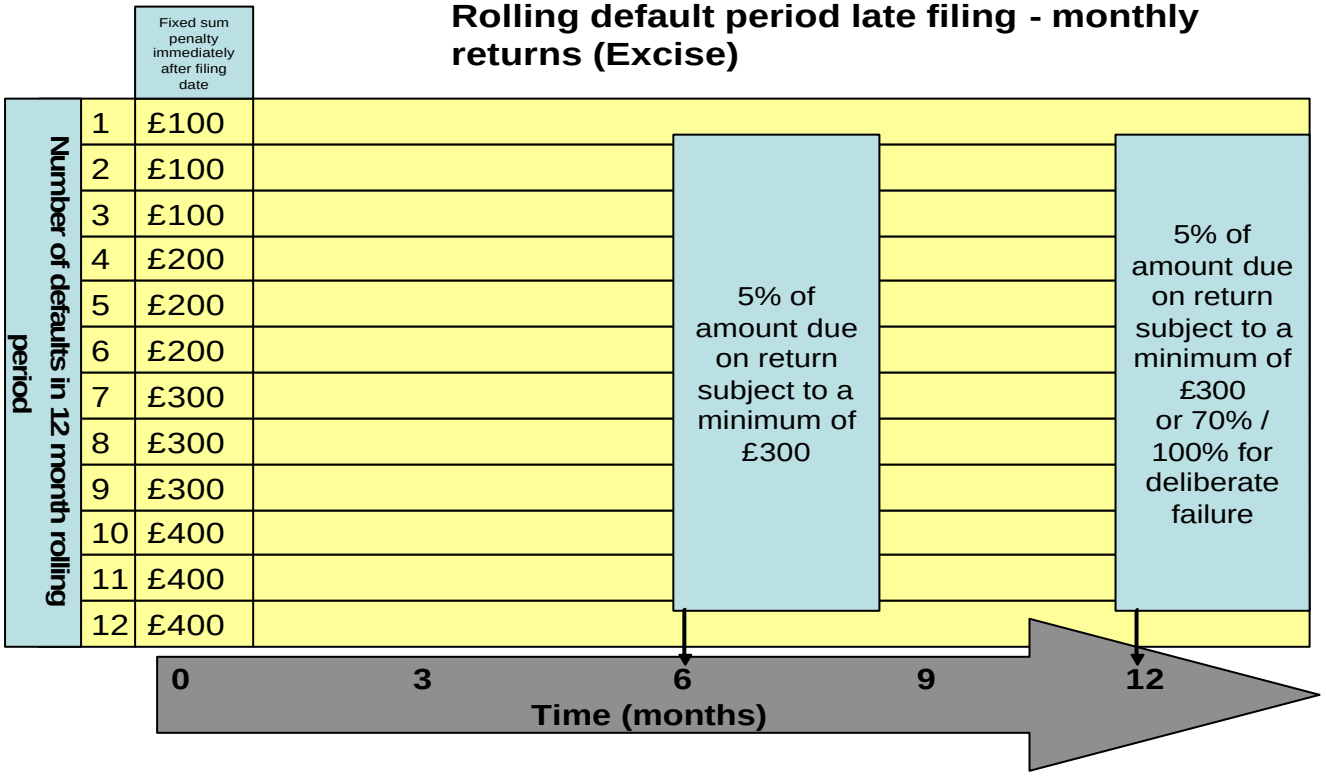
Late payment (annual taxes)



There would be no penalty immediately after the due date for late payment. If tax due is not paid in full one month after the due date the taxpayer would become liable to a tax geared penalty of 5% of the tax unpaid. Further tax geared penalties would become due on tax that remains unpaid at 6 months and 12 months.



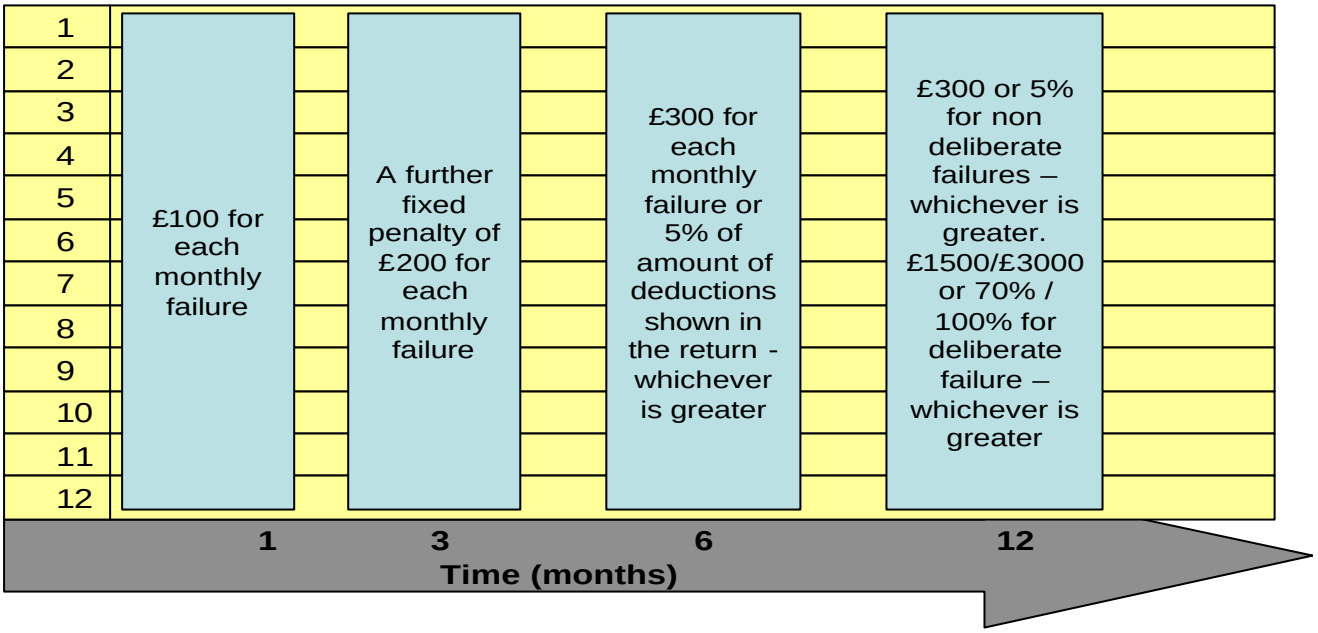
The penalty model would operate in the same way as the annual late payment model except that for CT the first tax geared penalty would apply at 3 months after the due date for payment.



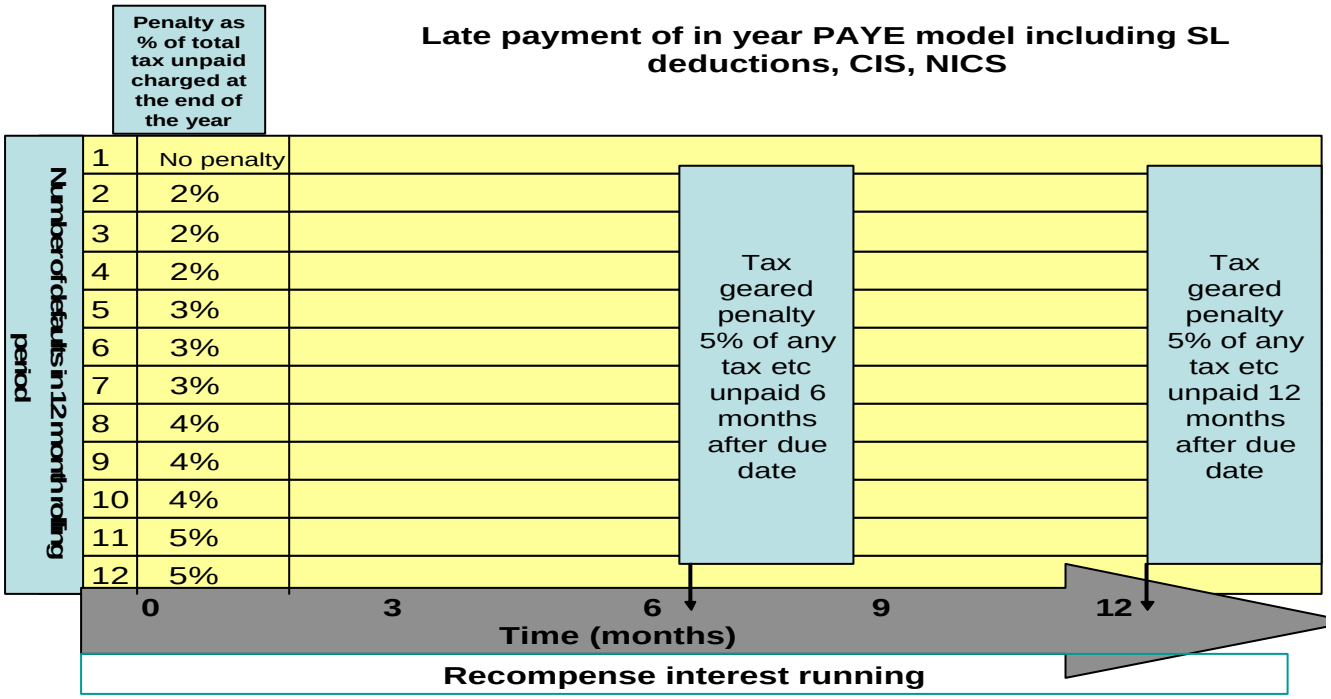
The first time a taxpayer default (fails to submit a return by the filing date), they enter a default window which expires on the anniversary (12 months) of the default. Any further defaults extend the default window until the anniversary of the latest default. The penalty is calculated by reference to the number of returns filed late in the default window. The first default would make the taxpayer liable to a fixed sum penalty of £100. Further defaults in the window would attract higher fixed sum penalties if the failure is repeated more than 3, 6 or 9 times in the default window.

Where the delay in filing is prolonged there would be tax geared penalties at the rate of 5% of the amount due on the return at 6 months and 12 months. There would be higher tax geared penalties of up to 70% of the tax due on the return for deliberate failure and up to 100% for deliberate failure with concealment.

late filing– monthly return (CIS)

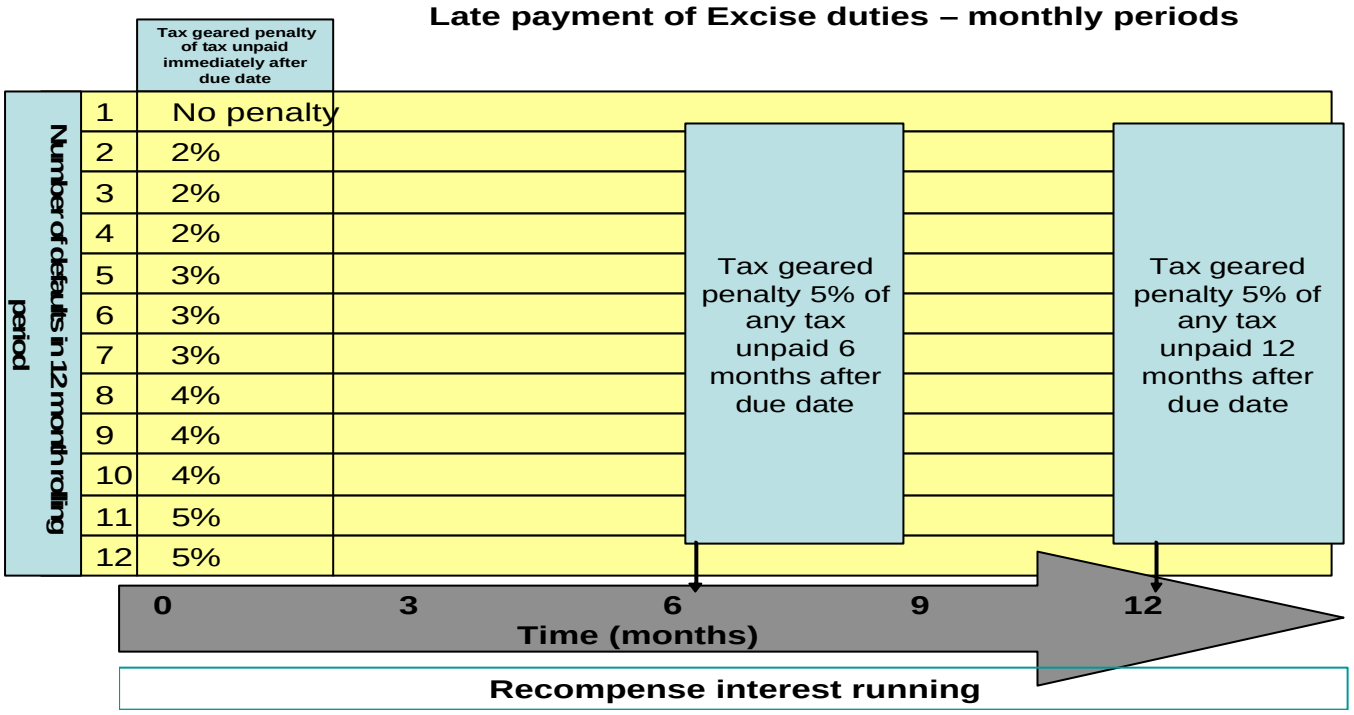


For any return that is not submitted by the filing date the contractor would become liable to a fixed penalty of £100. Any return that is still outstanding 3 months after the filing date would attract an additional fixed penalty of £200. For very late returns at 6 months and 12 months there would be either a deduction geared penalty or a fixed penalty of £300. For deliberate failure there would be higher tax geared penalties of up to 70% of the deductions due on the return and up to 100% for deliberate failure with concealment. For returns that show no deductions the penalties would be fixed at £1500 for deliberate failure and £3000 for deliberate failure with concealment.



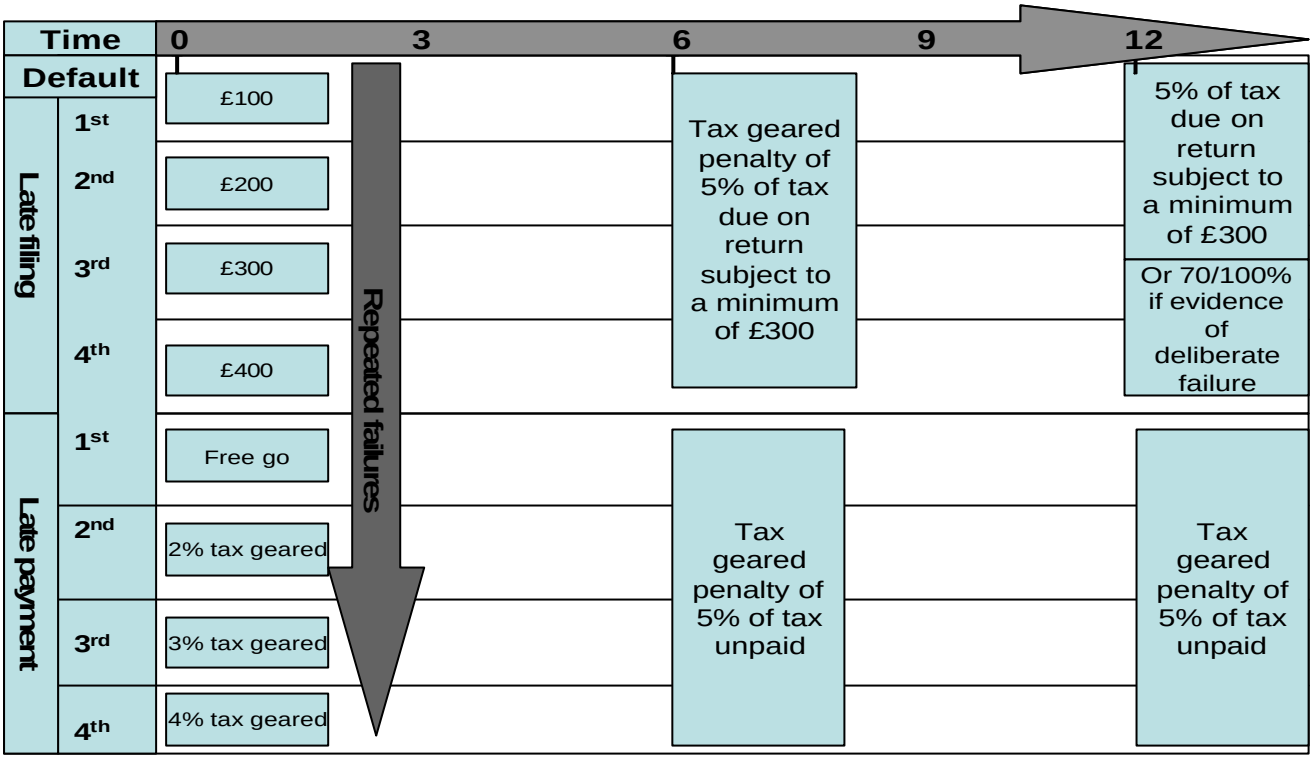
The first time a taxpayer defaults they enter a default window which expires on the anniversary of the default any further defaults extend the default window until the anniversary of the latest default. Taxpayers can only leave the default window by paying on time for 12 months. Penalties are calculated by reference to the number of defaults in the default window. The first default – the default that starts the

default window would not trigger a penalty at all. Any further defaults in the default window would be penalised according to the number of late payments with higher percentages where the failure is repeated more than 3, 6 or 9 times. Any payment outstanding for more than 6 months after the due date would become liable to a penalty of 5% of the amount of tax unpaid at the point the penalty is charged. If any payment is outstanding more than 12 months after the due date the taxpayer would become liable to a further penalty of 5% of the amount of tax unpaid at the point the penalty was charged.



The first time a taxpayer defaults they enter a default window which expires on the anniversary of the default. Any further defaults extend the default window until the anniversary of the latest default. Taxpayers can only leave the default window by paying on time for 12 months. Penalties are calculated by reference to the number of defaults in the default window. The first default – the default that starts the default window would not trigger a penalty at all. Any further defaults in the default window would be penalised according to the number of late payments with higher percentages where the failure is repeated more than 3, 6 or 9 times. Any payment outstanding for more than 6 months after the due date will become liable to a penalty of 5% of the amount of tax unpaid at the point the penalty is charged. If any payment is outstanding more than 12 months after the due date the taxpayer would become liable to a further penalty of 5% of the amount of tax unpaid at the point the penalty was charged.

Frequent filing and payment obligation (rolling default period model) – VAT, IPT



Filing

The first time a taxpayer defaults (fails to submit a return by the due date) they enter a default window which ends on the anniversary of the default and receives a fixed penalty of £100. Any further defaults in the default window result in a penalty of £200 rising to £400. In addition any return outstanding more than 6 months after the due date would receive a tax geared penalty of 5% of the amount due on the return and a further 5% of the amount due on the return if it is outstanding for more than 12 months.

Payment

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 make the taxpayer liable to a penalty of 2% of the tax unpaid rising to 4% of tax unpaid. In addition if any tax is outstanding for more than 6 months the taxpayer becomes liable to a penalty of 5% of the tax unpaid and a further 5% penalty if any payment is outstanding for 12 months.