EXPLANATORY MEMORANDUM TO

THE PENALTIES, OFFSHORE INCOME ETC. (DESIGNATION OF TERRITORIES) (AMENDMENT) ORDER 2013

2013 No. 1618

1. This explanatory memorandum has been prepared by Her Majesty's Revenue and Customs and is laid before the House of Commons by Command of Her Majesty.

2. Purpose of the instrument

2.1 The purpose of this Order is to amend the Penalties, Offshore Income etc. (Designation of Territories) Order 2011 (SI 2011/976) by changing the categories into which the 14 territories identified in the Order are placed for the purposes of determining penalties under Schedule 24 to the Finance Act 2007. These changes are being made because the UK has entered into new agreements with those 14 territories, providing for improved sharing of tax information and other enhanced forms of tax cooperation. The changes mean that the maximum penalty that can be charged in respect of undeclared income tax or capital gains tax on income or gains from activities, sources or assets in those territories will be lower from the date the Order comes into force.

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

3.1 None.

4. Legislative Context

4.1 Schedule 24 to the Finance Act 2007 contains penalty provisions for non-compliance with tax obligations. It includes a framework of penalties for non-compliance relating to income tax or capital gains tax on income or gains from overseas activities, sources or assets. For the purposes of this framework, there are three different categories of non-compliance and each category attracts a different penalty loading.

4.2 Paragraph 4A of Schedule 24 to Finance Act 2007 explains the three categories. Non-compliance relating to offshore matters (that is, in respect of income and gains arising from activities, sources or assets in an overseas territory), and where the tax at issue is income tax or capital gains tax, can fall into one of categories 1, 2 or 3.

4.3 Non-compliance in category 1 attracts penalties of up to 100 per cent of the potential lost revenue for deliberate and concealed actions or failures, up to 70 per cent of the potential lost revenue for deliberate but not concealed actions or failures, and up to 30 per cent for careless actions or failures. For non-compliance in category 2 these loadings rise to a maximum of 150 per cent, 105 per cent and 45 per cent respectively. And for

non-compliance in category 3 they rise to 200 per cent, 140 per cent and 60 per cent respectively.

4.4 For these purposes, all overseas territories are designated as either a "category 1 territory", a "category 2 territory" or a "category 3 territory". Non-compliance relating to an offshore matter involving a "category 3 territory", for example, will fall into category 3 and attract the maximum penalties of up to 200 per cent, 140 per cent and 60 per cent outlined above.

4.5 All non-compliance relating to domestic matters (that is, in respect of profits, income and gains arising from activities, sources and assets in the UK) falls automatically into category 1, as does all non-compliance relating to offshore matters where the tax at issue is a tax other than income tax or capital gains tax.

4.6 Paragraph 21A of Schedule 24 to Finance Act 2007 provides that a "category 1 territory" and a "category 3 territory" is any territory designated as such in an Order made by the Treasury, and that a "category 2 territory" is any territory not so designated. This means that category 2 is a default category, into which all territories not designated as either category 1 or category 3 in an Order made by the Treasury will automatically fall.

4.7 The designation of a territory as a "category 1 territory" or a "category 3 territory" must take account of:

- the existence and quality of any arrangements between the UK and that territory for the sharing of tax information (and, in particular, whether these provide for the automatic exchange of information for tax enforcement purposes); and

- the existence and quality of any other arrangements between the UK and that territory for cooperation in tax matters (and, in particular, the extent to which these assist or are likely to assist in the protection of UK tax revenue).

4.8 A territory with which the UK has arrangements for the automatic exchange of information for tax enforcement purposes, or other enhanced tax cooperation arrangements which assist or are likely to assist in the protection of UK tax revenue, will be designated as a "category 1 territory". A territory with which the UK has no, or inadequate, arrangements for the exchange of information or other forms of cooperation in tax matters meeting these parameters will be designated as a "category 3 territory". All other territories will fall into category 2.

4.9 The first Order designating territories for these purposes was The Penalties, Offshore Income etc. (Designation of Territories) Order 2011 (SI 2011/976), which came into force on 6 April 2011. The Order now being made and to which this Explanatory Memorandum relates amends that original Order, updating the designation of the 14 territories identified in the new Order to reflect new agreements entered into between the UK and those territories providing for the exchange of information for tax purposes and

other enhanced forms of tax cooperation that assist or are likely to assist with the protection of UK tax revenue.

5. Territorial Extent and Application

5.1 This instrument applies to all of the United Kingdom.

6. European Convention on Human Rights

As the instrument is subject to negative resolution procedure and does not amend primary legislation, no statement is required.

7. Policy background

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

7.1 Schedule 24 to Finance Act 2007 includes a special framework of penalties, introduced by Schedule 10 to Finance Act 2010, for tax non-compliance relating to income or gains from activities, sources or assets outside the UK. This framework applies to income tax and capital gains tax only and introduces enhanced penalties for non-compliance relating to such offshore matters.

7.2 The special framework was introduced in recognition of the fact that tax information from overseas is often more difficult to obtain than similar information from within the UK. This means that non-compliance using offshore arrangements is harder to detect and remedy and the belief that non-compliance using these sorts of arrangements is more likely to go undetected may encourage such non-compliant behaviour. The special framework, with its provision for enhanced penalties where non-compliance involves the use of offshore arrangements, is intended to supply a remedy and re-balance the deterrents.

7.3 The level of penalty is determined in part by the territorial location of the activities, sources or assets giving rise to the income or gains to which the non-compliance relates, and territories are categorised by reference to the existence and quality of any arrangements between the UK and each territory for the exchange of information or other forms of tax cooperation. Territories with which the UK has arrangements for the automatic exchange of tax information, or other arrangements for enhanced tax cooperation that protect or are likely to protect UK tax revenue, will be placed in category 1. Territories with which the UK has no arrangements for the automatic exchange of tax information or other forms of tax cooperation, or where any arrangements in existence are of insufficient quality, will be placed in category 3. And all other territories will be placed in category 2.

7.4 The penalties applying to non-compliance relating to category 2 and 3 territories are enhanced, with the highest potential penalties applying in respect of category 3 territories set at double those applying to category 1 territories. These loadings reflect the

impact that the existence and quality of arrangements between the UK and other territories for the exchange of information and other forms of tax cooperation has on the relative difficulty encountered in detecting and deterring non-compliance.

7.5 Because the special framework must take account of the existence and quality of these arrangements, it is important to monitor the categories into which territories are placed and to update these to reflect developments such as the entering into new agreements between the UK and overseas territories for the exchange of information or other forms of enhanced tax cooperation. The purpose of the Order is to update the categories of the 14 territories identified in the Order to reflect the entry into force of new tax information exchange and tax cooperation arrangements between the UK and those territories.

7.6 As a result of those agreements and the improved tax transparency and cooperation produced by them, 12 territories (Antigua and Barbuda, Armenia, Bahrain, Barbados, Belize, Dominica, Grenada, Mauritius, San Marino, Saint Kitts and Nevis, Saint Lucia, and Saint Vincent and the Grenadines) are moving from category 3 to category 2 and two territories (Liechtenstein and Switzerland) are moving from category 2 to category 1.

- Consolidation

7.7 This instrument amends, for the first time, The Penalties, Offshore Income etc. Designation of Territories) Order 2011 (SI 2011/976). The two instruments will not be consolidated.

8. Consultation outcome

8.1 The changes made by this instrument have not been consulted on. The changes are made in accordance with the principles laid down in the empowering primary legislation, which were the subject of extensive consultation, and serve only to reduce the maximum penalty that can be faced in respect of undeclared income tax or capital gains tax liabilities arising from activities, sources or assets in the 14 territories named in the instrument. The changes result from extensive negotiations between the UK and the relevant Government authorities in the 14 territories named in the instrument.

9. Guidance

9.1 The existing guidance on the operation of the penalty provisions published by Her Majesty's Revenue and Customs will be updated to reflect the changes made by this instrument.

10. Impact

10.1 The impact on business, charities or voluntary bodies is negligible, with no impact on the tax compliant.

10.2 The impact on the public sector is negligible.

10.3 A Tax Information and Impact Note covering this instrument will be published on the HMRC website at http://www.hmrc.gov.uk/thelibrary/tiins.htm.

11. Regulating small business

11.1 The legislation applies to small business, but only insofar as the maximum penalty faced by a non-compliant small business with respect to undeclared income tax or capital gains tax liabilities arising from activities, sources or assets in the 14 territories named in the instrument may change.

11.2 No new requirements are placed on firms employing up to 20 people by the instrument.

12. Monitoring & review

12.1 The categories into which overseas territories are placed for the purposes of the penalty provisions will be reviewed regularly and updated in light of material developments (for example, the entry into force of new agreements for sharing tax information).

13. Contact

Lee Harley at Her Majesty's Revenue and Customs (Tel: 020 7147 2674 or email: (lee.harley@hmrc.gsi.gov.uk) can answer any queries regarding the instrument.