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Dear Sir or Madam

RE: CITY OF LONDON LAW SOCIETY'S RESPONSE TO "REFORM TO BEHAVIOURAL PENALTIES"

Please find below The City of London Law Society's ("**CLLS**") response to the HM Revenue & Customs ("**HMRC**") consultation document published on 26 March 2025 entitled "Reform to Behavioural Penalties" (the "**Consultation**").

INTRODUCTION

The CLLS represents approximately 21,000 City lawyers through individual and corporate membership including some of the largest international law firms in the world. These law firms advise a variety of clients from multinational companies and financial institutions to Government departments, often in relation to complex, multi-jurisdictional legal issues.

The CLLS responds to a variety of consultations on issues of importance to its members through its 22 specialist committees. This response to the Consultation has been prepared by the CLLS Tax Committee. The current members of the Committee can be found at www.clls.org.

COMMENTS ON CONSULTATION DOCUMENT QUESTIONS

1. **Question 1: What are your views on removing the minimum 10% penalties for (1) inaccuracies disclosed after 3 years, and (2) failures to notify disclosed after 12 months for non-deliberate behaviour?**

1.1 We welcome the proposal to remove the minimum 10% penalty currently applicable to inaccuracies disclosed after 3 years, and instances of a failure of notify which are disclosed after 12 months (for non-deliberate behaviour). In our view, the measure would be beneficial for both for HMRC and taxpayers.

1.2 Firstly, were the minimum penalties to be removed, we consider that HMRC is likely to benefit from an increase in taxpayers making 'late' disclosures, and therefore potentially recoup more underpaid tax than under the current penalty system.

1.3 At present, a taxpayer coming forward after the 3 year or 12 month periods (as appropriate) does so in the knowledge that they will definitely receive a penalty. Such guaranteed penalty arguably acts as a deterrent for taxpayers from making 'late' disclosures at all, as they know that not only will they need to repay any underpaid tax, but they will also be liable to pay at least 10% of that figure on top as a penalty.

1.4 However, were a taxpayer able to make a 'late' disclosure to HMRC without a guaranteed penalty (as per HMRC's proposal), they are more likely to come forward to report the inaccuracy and/or failure to notify. Such taxpayers are also, in our view, likely to be more cooperative with HMRC, and provide good quality disclosure in relation to the error (i.e.

telling, helping and giving fully), so that they minimise, or potentially remove all together, any penalty which may arise from the delayed disclosure. This is because they are still in the position to potentially prevent any penalty from being incurred at all, should they provide a detailed initial disclosure and cooperate with HMRC's further documentary and information requests in relation to the issue.

1.5 Further, eliminating this restriction on the deduction for cooperation will increase the incentive for taxpayers to cooperate. The most striking example relates to careless penalties where the disclosure is prompted. With the 10% restriction giving an effective minimum penalty of 25% (and a maximum of 30%) the current regime gives only trivial incentive for cooperation.

1.6 In addition to removing the financial deterrent from making a late report, another advantage of the proposal to remove the 10% minimum penalty is a reduction of HMRC discretion. At present, as noted by HMRC in the consultation document, determining *when* a disclosure was made requires HMRC officers to apply a subjective judgment. For example, under the current system, when considering whether to apply a penalty in relation to a failure to notify, an HMRC officer is required to determine when the initial requirement to notify arose in order to then be able to determine how delayed the eventual notification is.

1.7 Many of the obligations which give rise to a failure to notify are subjective in themselves – for example the requirement for a taxpayer to notify HMRC where there is a "*material change in nature of supplies made by a person previously exempted from [VAT] registration*" requires consideration of what is 'material'. Were HMRC to consider that there was a failure to notify that material change, in addition to determining what is 'material', HMRC is also required to determine when that 'material change' in the nature of the taxpayer's supplies takes place – thus adding an extra layer of subjectivity.

1.8 Removing the minimum 10% penalty where a disclosure is made either 3 years or 12 months (after the inaccuracy or failure to notify respectively) removes the need for HMRC to make this second subjective determination of when the original issue occurred. As a consequence, there may be fewer appeals against penalties issued, on the basis that there are fewer subjective HMRC decisions which could be challenged. A reduction in appeals could free up HMRC time and resource to be used elsewhere.

2. **Question 2: What are your views on the ways in which HMRC could (1) simplify penalty reductions for unprompted disclosure and (2) simplify penalty reductions for the quality of disclosure?**

Unprompted disclosures

2.1 In our view, HMRC's proposal to apply a set reduction based on whether a disclosure is prompted or unprompted – regardless of the type of behaviour, or 'type' of disclosure - appears sensible.

2.2 Under the current penalty regime, the difference in the minimum penalty thresholds for prompted and unprompted disclosures are inconsistent between (i) the accuracy and failure to notify penalty ranges for instances of careless behaviour (15% for inaccuracy vs 10% for a failure to notify), and (ii) the different behaviours within each type of penalty.

2.3 The purpose of reducing the penalty imposed where a taxpayer has made an unprompted disclosure is to encourage taxpayers to come forward voluntarily and disclose instances of non-compliance to HMRC. This purpose remains the same regardless of whether there is an inaccuracy in a return, or there has been a failure to notify HMRC. There is therefore no reason why the percentage reduction for an unprompted disclosure should be different between the two penalty regimes.

2.4 HMRC's proposal for a set reduction standardises the financial credit given to taxpayers coming forward and is therefore simpler for taxpayers to understand. Taxpayers can easily

see the financial benefit to them in making a disclosure to HMRC before a discrepancy is otherwise discovered.

2.5 The proposed set reduction, or indeed any other distinction that HMRC may choose to implement between the penalties for prompted or unprompted disclosures, should be put on a statutory footing. If HMRC's guidance does not quite agree with the statute, there would be ample scope for disputes.

Further proposed changes to the 'unprompted disclosure' rule

2.6 We would also welcome further clarity on when a disclosure is considered to be 'unprompted'. HMRC Manual CH403202 states[1] that a disclosure is unprompted where "*it is made at a time when the person making it has no reason to believe that HMRC have discovered or are about to discover the inaccuracy, under-assessment, failure to notify, deliberate withholding of information or wrongdoing*".

2.7 This manual also states that *"Disclosures made during a compliance check will usually, but not always, be prompted. A disclosure could be considered unprompted if the inaccuracy, under-assessment, failure or wrongdoing disclosed was outside the scope of the compliance check and would not have been found in the normal course of the check.*"

2.8 In our experience, this legislation and guidance is not particularly easy to apply.

2.9 In particular, it is not apparent what 'about to discover' means. A taxpayer may have an investigation open in to one of its tax returns for a prolonged period whilst HMRC looks in to the tax treatment of a particular transaction – this investigation can in some instances be open of a number of years, with infrequent communication from HMRC during this time. It is clear that HMRC may be 'about to discover' an error in relation to the transaction which has caused them to open an enquiry in to the return. However, where the enquiry is open and the taxpayer discovers and discloses an inaccuracy relating to an entirely different transaction within that period, was HMRC 'about to discover' the inaccuracy, thus making the disclosure prompted?

2.10 Our concern in particular arises from the fact that HMRC can often go long periods (sometimes 6 months or more) without communicating with a taxpayer whilst an enquiry remains open. A taxpayer may be aware of the reason an enquiry was originally opened, and thus consider that they are making an unprompted disclosure when telling HMRC about a separate issue – yet HMRC may, since opening the enquiry, have become aware of , or interested in, that separate issue, but not have communicated that to the taxpayer. HMRC would thus consider the error to be prompted, in contrast to the taxpayer considering it to be unprompted.

2.11 Although HMRC guidance (Compliance Handbook 82422) sets out a list of 'examples' of where a penalty would be considered prompted or unprompted, this is by no means comprehensive. Instead, we would welcome clear, principled guidance on (i) how much information HMRC needs to have had about an inaccuracy, under-assessment or failure to notify, in order for a disclosure to be prompted, and (ii) how, and to what extent, HMRC is required to demonstrate that knowledge?

2.12 For example, is it sufficient that HMRC have an open enquiry for the appropriate period and tax in question for them to be 'about to discover' an error in that period? Or must they have identified the particular transaction or income stream or claim for relief for which they consider there may be a discrepancy (even if they do not have precise details of the discrepancy itself)? Similarly, is it sufficient for there to be a record in HMRC systems which shows that HMRC were actively investigating a matter or were aware of some details of the

[1] In accordance with paragraph 9(2) of Schedule 24 of the Finance Act 2007

matter disclosed? Or must HMRC have communicated such knowledge, or interest in a matter, to the taxpayer in order for a disclosure to be considered prompted?

2.13 In our view, the latter is preferable – i.e. HMRC must have identified a particular transaction/income stream etc of interest, and communicated that interest to the taxpayer, in order for any error to be 'about to [be] discover[ed]' (and a disclosure thus prompted, with no reduction in penalty accordingly).

2.14 Regardless of the threshold however, our priority is for HMRC to provide the clear principled guidance on what 'about to discover' means in order that a taxpayer can clearly understand when a disclosure is prompted or unprompted, and understand the level of penalty applied accordingly.

Quality of disclosure

2.15 In our experience, the three 'elements' of a taxpayer's cooperation with HMRC ('telling', 'helping' and 'giving') often overlap – for example, explaining the matter disclosed to and/or raised by HMRC (part of the 'telling') often overlaps with the 'giving' as a taxpayer will provide relevant documents as part of their explanation. Similarly, 'helping' HMRC to quantify any amount of unpaid tax will often necessarily involve 'giving access' to relevant internal records.

2.16 Due to this practical overlap between the different elements of taxpayer cooperation with HMRC, in principle, we agree with HMRC's proposal to merge the quality of disclosure factors. However, HMRC has proposed merging only 'telling' and 'helping', and has left 'giving access' as a separate factor.

2.17 Attributing separate weight to 'giving access' risks inadvertently penalising taxpayers for entirely proper assertions of privilege. A taxpayer should not be required to produce documents to HMRC in order to benefit from a reduction in the amount of a penalty if in so doing the taxpayer would be waiving privilege in those documents.

2.18 Our proposal would therefore be for all three elements which go to determining the quality of taxpayer disclosure to be merged in to a single consideration of 'helpfulness', rather than distinguishing between the various methods of that helpfulness.

2.19 This is above all the case where different taxes, different types of taxpayer and different levels of complexity require different levels of disclosure and/or explanation from taxpayers to HMRC. One matter may be conceptually simple, and require limited explanation, but require the disclosure of a lot of financial data in order for HMRC to quantify the discrepancy. Conversely, a disclosure may require limited financial data and involve only a simple calculation, but involve a complex intra-group structure which requires a more detailed explanation to HMRC. A taxpayer could be equally helpful and cooperative in both circumstances, but due to the arbitrary division between 'telling', 'helping' and 'giving' experience different penalty outcomes.

2.20 The single consideration of 'helpfulness' may also avoid the disadvantage experienced by taxpayers who do not 'admit' an error to HMRC (and thus may not be considered to have 'told' HMRC) on the basis that they disagree there has been an error at all. This may arise in circumstances where HMRC have queried the tax treatment applied to a particular transaction, following which the taxpayer has responded to detailed document requests and provided detailed explanations for the tax treatment applied, yet maintains that the tax treatment applied is correct (i.e. disagrees with HMRC on the application or interpretation of the statute in question). The taxpayer is entitled to disagree with HMRC, and appeal the issue to the First-tier Tribunal (Tax Chamber) – yet in these circumstances has not 'admitted' the issue and thus would not be considered to have provided the maximum 'telling' support expected by HMRC, even though they have been helpful in terms of the information and explanations provided.

2.21 A single consideration of ‘helpfulness’ would, in the event HMRC’s position was ultimately upheld and a penalty issued, allow that taxpayer’s overall ‘helpfulness’ to factor into penalty reduction, without any reduction being prejudiced by a reluctance to ‘admit’ the issue where there was a disagreement over interpretation which required a tribunal to resolve.

2.22 Should this single consideration of ‘helpfulness’ be advanced, we consider it would be appropriate for HMRC to provide a list of factors which they consider to be ‘helpful’ and may lead to penalty reduction, but without attributing any weight to each factor. This would provide clarity to taxpayers and those who advise them.

3. **Question 3: With reference to the existing inaccuracy and failure to notify penalty ranges, what would you consider to be proportionate and appropriate penalty rates for both deliberate behaviour and repeated instances of deliberate behaviour? Which factors should be considered when applying these?**

3.1 We do not support the idea of increasing financial penalties for repeated instances of deliberate behaviour. We consider that HMRC would be likely to use such a tool in preference to its existing criminal and civil powers for tackling tax avoidance. We consider that HMRC has not made the case for taking such an approach.

4. **Question 4: How could penalties for offshore non-compliance be simplified whilst still acting as an effective deterrent?**

4.1 We agree with respondents to the 2024 Call for Evidence that the increase in information-sharing agreements has led to a significant reduction in the types of behaviour that the enhanced penalty regime was designed to address, and that information-sharing presents a better deterrent than enhanced penalties.

4.2 We are also mindful that the entire penalty system is premised on providing "*an effective deterrent*" to non-compliance. The view that increased rates for offshore non-compliance are required seems to assume that the rates charged for onshore non-compliance would be any less effective a deterrent. We do not understand that assumption.

4.3 We therefore believe that the need for enhanced penalties for offshore non-compliance has passed. We do not believe that, were HMRC to simplify the system by charging the same penalties as for onshore non-compliance, there would be any increase in offshore non-compliance.

4.4 Nor do we consider that the enhanced rates for offshore non-compliance are justified by the particular characteristics of that behaviour. There is nothing inherently ‘worse’ in a taxpayer, as the consultation document puts it, "*hid*[ing] *their income and assets to evade tax*" offshore than onshore. While it was certainly once true that concealing assets offshore was much less likely to be detected by HMRC, and therefore justified an increased penalty on much the same grounds that the low likelihood of detection made this behaviour particularly pernicious, the fact that HMRC is now likely to identify taxpayers who hide assets offshore means that there is no reason to treat these behaviours differently.

5. **Question 5: How could HMRC simplify penalty suspension while retaining an effective prompt to taxpayers to address the source of the inaccuracy?**

5.1 The ability to suspend a penalty is a critically important part of the system, and HMRC’s proposals to increase its use are welcome.

5.2 The suggestion that automatically suspending penalties "*could place greater responsibility on the taxpayer to identify the source of the inaccuracy and put in place their own mitigations to address it*" is probably correct, and could be a helpful change. Taxpayers often have difficulty in agreeing appropriate penalty suspension conditions with HMRC. Moving to a model that trusts taxpayers to identify ways in which they can avoid making errors in future is likely to have a number of positive effects:

(A) It is likely to be more effective, because taxpayers are likely to know their businesses, and the difficulties they have with tax compliance, better than HMRC does. They are therefore better placed to work out how to ensure future compliance.

(B) It removes a source of friction in the relationship between HMRC and taxpayers. Often taxpayers will agree that a penalty should be suspended, and that steps should be taken to avoid future errors, but will disagree with HMRC's proposals for how this is to be done. This proposal removes this problem.

(C) It will achieve significant efficiencies in taxpayers' time, and presumably that of HMRC, to move to a more 'outcome-based' system where there is no need to spend time agreeing precisely how taxpayers will ensure their future compliance.

5.3 The assumption underlying this is that HMRC will properly set the outcome that the penalty suspension needs to achieve. For smaller businesses, this might be easy: e.g. "*Your next VAT return will not contain errors.*" That is a much more challenging exercise for a large business, whose returns might contain many more inputs and variables. It will be important to ensure that the outcome that HMRC sets is realistic and achievable.

5.4 We do not support the use of cautions. We agree with the consultation document that they are likely to be treated less seriously by some taxpayers. We also do not believe that a caution is likely to be as effective as a suspended penalty in ensuring that taxpayers take steps to prevent future errors.

6. **Question 6: What do you see as the opportunities and challenges of this approach? How does it compare with potential simplification to existing penalties, as outlined in Chapter 3?**

6.1 The proposals for re-writing the penalty system are relatively brief, and if this option is to be pursued, we consider that further detail should be brought forward for consultation.

6.2 The current penalty system is reasonably clear and is well-understood. The costs involved in changing to a new system should not be overlooked. We therefore do not see a case for an effective re-invention of the system.

6.3 That is particularly the case when the proposal is to create a new system based on essentially the same parameters. That suggests that the current system aims to achieve the right goals, and that the better approach is to look for improvements that can be made to it.

6.4 However, assuming that this proposal is taken forward, we would make the following observations:

(A) We agree with HMRC that the proposal appears to increase the discretion available to HMRC officers in this space (in particular, because the process for computing the penalty has fewer, broader inputs). This would not be welcome. Taxpayers feel that the results of the penalty system as it stands are not predictable and changes increasing the level of discretion would exacerbate this problem.

(B) We are troubled by the suggestion that "*reasonable care*" would now be a matter for the taxpayer to prove, rather than for HMRC to disprove. Shifting the burden of proof in this way represents a significant change to the way that the penalty regime operates. As matters stand, HMRC needs to consider whether, considering the conduct, a penalty ought to be imposed. This change would mean HMRC issuing a penalty effectively as a matter of course where there is an error. As well as representing a change in the relationship between HMRC and the taxpayer, and a fundamental unfairness (because tax appeals entail practical and financial concerns for taxpayers, and this may deter them from challenging penalty decisions) we consider this proposal would likely lead to some difficult practical issues:

(1) This change removes HMRC's responsibility to consider the taxpayer's conduct and passes it to the taxpayer and the First-tier Tribunal. The FTT's resourcing problems are well known. The additional penalty appeals would not help this problem.

(2) It seems likely that some taxpayers would, in the knowledge that they will likely face a penalty in the first instance, decline to notify HMRC of errors. This would lead to a reduction in the tax HMRC recovers and increase the tax gap.

7. **Question 7: What is your view on HMRC's use of tougher non-financial sanctions to deter and respond to deliberate and repeated non-compliance and to promote future compliance?**

7.1 We would expect non-financial sanctions to have some effect, but in relatively few cases. This is because we do not expect that the majority of taxpayers involved in deliberate and repeated non-compliance – those involved, effectively, in quite brazen evasion – would be particularly influenced by the knowledge that other licences (regulatory, or driving) could be affected. We accept that there may be some cases where it does make a difference.

CONTACT DETAILS

Should you have any queries or require any clarifications in respect of our response or any aspect of this letter, please feel free to contact me by telephone on 020 7296 5783 or by email at Philip.harle@hoganlovells.com.

Yours faithfully

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