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*Research report 574*

# Making Tax Digital: Late Submission Penalty Models

## A qualitative research project exploring customer responses to potential penalty models for use under Making Tax Digital.

Behaviour, Insight and Research Team

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# Behaviour, Insight and Research Team

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## *Research requirement (background to the project)*

One of the central tenets of Making Tax Digital (MTD) is the expectation that customers will update HMRC on their tax affairs more regularly. For most businesses, landlords and self-employed this will mean providing updates on a quarterly basis. As such, the introduction of Making Tax Digital for Business will necessitate some changes to the penalty system for late submissions.

HMRC is therefore taking the opportunity to start the transformation of the penalty system it committed itself to in the Summary of Responses to the Penalties Discussion Document, published in September 2015. As part of this, HMRC sought insight into how customers would perceive and respond to some potential late submission penalty models to inform a formal consultation exercise that ran from March to June 2017. The research focused on direct tax obligations, specifically Income Tax Self-Assessment, and how the models would work for the new quarterly obligations under Making Tax Digital for Business. We did not explore how the models would work for VAT or other indirect tax obligations.

In the research four different potential penalty models were explored with customers:

- **Warning model[1]:** Customers would be given warnings for the first three deadlines that they missed but no penalty would be issued. After missing a fourth deadline customers would enter a “Penalty Phase”. Whilst in the penalty phase, customers would be charged a penalty straight away for every deadline that they missed. Customers would need to meet four deadlines in a row to come out of the penalty phase or to wipe clean any warnings they received. Once they had done this, they would revert to receiving warnings for the first three missed deadlines.
- **Suspension model:** Customers would be liable to a penalty for missing one deadline. However, the penalty would be suspended and would not be charged if they submitted their update within 30 days. If customers did not meet this condition, they would have to pay the penalty. If customers missed a second deadline within 12 months, they would again be liable to a penalty. However, this would be suspended and would not be charged if they submitted their update within 30 days. After submitting two updates late in a 12 month period, customers would no longer be eligible for suspensions for the next three submission obligations (which could run between tax years). If they missed any of these three deadlines, they would be charged a penalty straight away. After this, customers would return to stage one, where they would be offered a 30 day suspension for their first and second late updates within a 12 month period. Customers would also return to stage one after 12 months if they had only missed one deadline.
- **End of period review model:** Customers would be given a warning for the first deadline that they missed but would not be penalised. If they missed any more deadlines in the same period, customers would be notified that they would be charged a penalty after they submitted their End of Period statement. One penalty would be charged at the end of period review, when customers submitted their End of Period statement (i.e. 10 months after the end of the period). The value of the penalty

[1] On public consultation this model was presented as the ‘points’ model rather than ‘warning’ model.

charged would take into account the second and any subsequent missed deadlines, and each would contribute equally to the total.

- **Annual review model:** This model would work in the same way as the End of Period model except that the penalty would be charged at the end of financial year (i.e. after the Q4 update). End of Period statements would be treated as an obligation within the financial year in which they occurred.

The research sought to understand customer **understanding** of the draft models and views on their **fairness** and **effectiveness**.

## *When the research took place*

The research was designed and carried out between January – March 2017. Fieldwork took place between 16th February and 1st March 2017.

## *Who did the work (research agency)*

The research was undertaken by the Employment Welfare and Skills (EWS) team within Ipsos MORI's Social Research Institute.

## *Method, Data and Tools used, Sample*

A qualitative approach was undertaken for this study, which consisted of four extended discussion groups. Each was held with a purposively selected sample of 11 Self Assessment customers who had an annual business turnover of more than £10,000.

All participants were recruited by specialist recruiters. A purposive sampling approach was adopted, whereby key quotas were set and participants were recruited according to these using a screening document. The sample was designed to include four different customer types:

- Self-employed customers (without employees)
- Landlords
- Small businesses/ partnerships with employees
- Customers who were registered for Self Assessment and VAT

Within the recruited sample there was a mix of VAT registered and non-VAT registered customers. The sample also included a mix of customers who employed tax agents and those who did not.

The focus groups took place in London.

Before each discussion group respondents were reassured that their responses would remain confidential and anonymous and that no identifying information about them would be passed back to HMRC by Ipsos MORI.

The interview data was fully analysed using a robust inductive approach, as part of which the data was synthesised thematically and interrogated for patterns and relationships.

## *Main Findings*

The main findings from this research are outlined below.

**Customer responses to Making Tax Digital (MTD) and therefore future penalty models were determined by their business type.**

Self-employed customers and landlords had low awareness of MTD and were the most resistant of all customer groups to its introduction. Small businesses and SA customers registered for VAT were more pragmatic about the introduction of MTD. Customers who were registered for VAT were also more open to the introduction of MTD as they were already reporting to HMRC quarterly, making it easier for them to see how this would work under MTD.

**The customer journey to understanding the models was determined by their pre-existing knowledge of MTD.**

Customers' initial responses to the penalty models were coloured by their reactions to MTD. Customers who were more resistant to the introduction of MTD took longer to understand the penalty models.

The ability to understand the models varied: There were those who were more able to quickly understand the penalty models and those for whom it was more challenging. Regardless of the ease or difficulty with which customers understood the models, all customers acknowledged that they would be unlikely to commit a lot of time to understanding a future MTD penalty model. They expected HMRC to push information about the penalty model and how it worked to them through their Business Tax Account, email, letter and text message.

**How the models were presented also influenced how they were received by customers.**

Seeing both a written description and an accompanying illustration helped customers understand how the model worked by supporting them to visualise the different components. Customers also benefitted from seeing a description of more than one model. This aided understanding, as customers could assess the relative merits of each.

**Some key principles emerged, showing how customers expected a penalty model associated with MTD would work:**

1. **Ability to understand the model.**

   Understanding was seen as the most important principle of any future penalty model. Understanding was essential to the development of a penalty model as it underpinned perceptions of both fairness and effectiveness. Customers needed to be able to understand the rules of a model for it to be considered as fair. This fundamental need to understand any future penalty model led to a preference for simplicity.

   However, customers realised that there was a trade-off to be made between simplicity (supporting understanding) and fairness, in that a simpler model would be less finely tuned to achieve an appropriate balance of leniency. Tolerance for a more complex model was reliant on HMRC informing customers of where they were in the process, for example, how many chances they had to miss a filing deadline before being penalised.

2. **Chances to make a mistake before being penalised.**

   The number of chances offered to make a mistake before being penalised was also seen as an important feature of any penalty model. Offering customers the chance to make a mistake or file late before being penalised reflected positively on HMRC, as it was seen to demonstrate an appreciation that customers may miss a deadline due to reasons beyond their control from time to time. Giving customers a chance to file late also reinforced the idea that penalties were in place to encourage compliance, not as a mechanism for raising revenue. However, there was a balance to be struck between leniency, fairness and simplicity in the number of chances offered.

   Offering too many chances was seen as being too lenient and was viewed negatively by customers who felt that it did not encourage compliance. Customers felt this could mean that fewer people would comply which would be unfair to both HMRC and compliant customers.

   Customers felt that offering three chances to miss a filing deadline was very lenient and might mean that some customers would try and take advantage of this. Offering three chances to miss a filing deadline before being penalised was also seen as missing an opportunity to help embed the habit of filing quarterly, as there was no immediate deterrent to filing late.

   Customers felt that one or two chances to file late was appropriate. Here again there was an inherent tension between fairness and simplicity. Offering customers the chance to miss two deadlines was seen as generous (but not at risk of being seen as too lenient). However, this desire for two chances perhaps reflected that there was very low awareness of current safeguards in which customers can appeal against penalties if they have a reasonable excuse for filing late. As such, customers worried that they needed additional chances to file late in case they were prevented from filing on time due to something unexpected or outside of their control, such as an unexpected stay in hospital. Landlords and the self-employed were more likely than small businesses to be worried about this as they had sole responsibility for ensuring filing deadlines were met,

as opposed to small businesses who shared this responsibility or had someone else who could look after this.

*“Two [chances to miss a deadline] would be fairer. Three is a huge amount of the year.” Small business owner*

*“People could play the system though, be strategic. Three warnings are too much, more than half the year’” Small business owner*

Customers felt that a model which allowed one chance to file late would be clear and easy to understand, and they would know exactly where they stood.

**3. A penalty or no-suspension phase**

Customers expected that after missing the permitted number of filing deadlines they would receive a penalty on any filings submitted late during a certain period of time. Debate centred around whether this should be rolling or for a fixed period and the length of time which it would be expected to last.

A rolling penalty period, which required customers to file on time a certain number of times before allowing them further chances to miss a filing deadline was seen as supporting customers to learn the new system and rewarding them for good behaviour. However, it was also recognised that this would add complexity as it could run between tax years. Customers felt that, in this scenario, they would be reliant on HMRC to push information to them about where they were in the process, that is, how many times they were required to file on time before their chances re-set.

Allowing customers to regain their chances to miss a deadline after a fixed period of time regardless of whether they had demonstrated good compliance was seen as lacking this behavioural reinforcement. However, it was simpler and easier to understand. This was particularly the case if the penalty model were to reset at the end of the tax year. Customers felt that this would encourage compliance by being easy to understand. It also benefitted from a degree of familiarity as many customers currently perceived their tax affairs in terms of tax years.

*“It [the penalty model] should be educational. It should be not just about fining people but about encouraging good behaviour.” Small business owner*

**4. A suspended or immediate penalty**

Customers also debated whether or not a penalty should be suspended if the update was made within a specified period of time of the original deadline. A benefit of this approach was felt to be that it created an incentive to submit an update even after the deadline had

been missed. However, some customers felt that it could be seen to weaken the deadline.

As such, customers felt that in order to succeed, a suspension period could only be offered a limited number of times, as outlined above. The length of the suspension period would need to find a balance between giving a real opportunity to make the update but not being too lenient. For instance, a suspension period which lasted 30 days was seen as being very lenient as by the end of this period customers would be a significant way towards needing to make their next update. Customers felt that fourteen days might strike a balance between offering customers time to make the update without offering too long to do so.

*"It's good to have a suspension period…gives you a chance." Landlord*

5. **Timeliness of penalty payments**

The final consideration was whether penalties should be paid at the time of the missed deadline, or consolidated and paid at a particular point in time, for instance at the end of period statement or end of quarter four. There was a broad consensus that penalties should be paid at the time of the missed deadline. This directly linked the penalty to the missed update, and so was seen as the most effective way of encouraging compliant behaviour. In contrast, customers felt that if a penalty was paid in the future there was a risk that it may not act as an effective deterrent as they could treat the penalty as if it was part of their taxes for that period, rather than as a penalty for a missed update. There was also a concern that cumulative penalties could mount up and become challenging to pay.

*"The penalty should happen sooner to motivate people to pay [file] on time. It should be imminent" Small business owner*

*"I think the fact you don't pay till 10 months late is not an incentive to pay [file] on time, I think it feeds dissent." Landlord*[2]

### Incentives

The prospect of incentives as a reward for filing on time or early was raised spontaneously by all groups. Incentives were seen as something which could work alongside penalties to encourage consistent compliance and which would reflect positively on HMRC. However,

[2] Where customers talked about paying they were referring to filing, this was evident from the rest of the discussion and clarifications within the conversation. The language used is reflective of the current behaviour.

customers recognised that whilst an incentive would be appreciated, penalties were more likely to drive compliance.

There was a broad range of ideas on what a potential incentive could be. Suggestions included a revised payment structure under which Self Assessment customers who file their return by a certain date can pay their SA tax liabilities via PAYE; tax discounts; a prize draw; supermarket or retail vouchers and cinema tickets.