The new penalty regime for late VAT payments starts on 1 January 2023

Indirect Tax



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The new penalty regime to be introduced by HMRC on 1 January 2023 will be much fairer than the current default surcharge system.

Key Points

What is the issue?

A new penalty system will be introduced for VAT periods beginning on or after 1 January 2023. According to HMRC, it will penalise ‘only the small minority who persistently miss their submission obligations rather than those who make occasional mistakes’.

What does it mean for me?

A VAT registered business will be charged a 2% penalty for VAT not paid by the end of day 15 after the due payment date. There will be a further 2% penalty for tax still unpaid by the end of day 30. An annual penalty rate of 4% will apply thereafter until the tax is finally paid.

What can I take away?

Late payment interest will be charged on all tax paid late. It will be charged at annual rate of 2.5% above the Bank of England base rate. There is a big incentive to pay all tax owed as quickly as possible, to avoid both penalty and interest charges. A formal time-to-pay agreement reached with HMRC will prevent penalties being charged but not interest.

1 January 2023 will be a massive date in the VAT calendar. The longstanding and very draconian default surcharge regime will be replaced by a new system to penalise late payments of VAT returns. I ask you to join me in a toast to the policy section in HMRC that decided to end both the existing system and for its work in creating the new regime, which will definitely be much fairer. Well done!

To cut to the chase, the aim of the new system will be to penalise persistent offenders – rather than taxpayers that are, say, one day late with their payment because of an oversight in their diary or confusion with their online banking arrangements. And, quite rightly, the new system will increase the penalty – and also introduce an interest charge – according to how long the payment is outstanding.

For example, a 2% penalty will be charged for tax owed at the end of day 15 after the due payment date; and a further 2% will be charged for tax still outstanding by the end of day 30. And an annualised penalty rate of 4% will apply thereafter. Every VAT registered business will have a clear incentive to pay its VAT bill as soon as possible – a good thing!

Limitations of the current system

The main problem with the current default surcharge system is that a business gets the same penalty for being one day late with its VAT payment as one year. Defenders of the system will highlight the fact that you get a lifeline with your first late payment – HMRC issues a surcharge liability notice. Smaller businesses with

annual sales of less than £150,000 get two lifelines. And if the business makes its payments on time for the next 12 months after receiving a surcharge liability notice, it regains its lifeline.

The other main condition is that the surcharge increases with each default from 2% to 5%, then 10%, and finally 15%. So, by the time that a business hits the dreaded 15% rate, it will have paid tax late at least five times. It should have got its act together by then!

To illustrate the draconian nature of the existing regime, many VAT enthusiasts will remember the First-tier Tribunal case of *Susanna Posnett* [2016] UKFTT 557. A sole trader journalist made a one-off land sale for £10.36 million plus VAT and which was subject to VAT because of her option to tax election. Unfortunately, she was already on a 15% default surcharge because of minor misdemeanours with her previous periods. So, when she paid her August 2015 return one week late, she was charged a default surcharge of – pause for dramatic effect – the incredible amount of £217,701. She lost her appeal because the law had been applied correctly by HMRC.

With the new system, her penalty would have been zero because she fully paid the tax owed within 15 days of the due payment date. She would only have been charged interest, probably less than £1,000.

Features of the new regime

- If a business pays its VAT late, it will be charged interest from day one. The interest rate will be 2.5% above the Bank of England's base rate. Interest is not a penalty; it is commercial restitution to compensate HMRC for late payments.
- There will be no penalty charged if VAT has been paid by the end of day 15 after the due payment date. So, for example, tax declared on the March 2023 return is payable by 7 May; therefore payment needs to be made by close of play on 22 May to avoid a 2% penalty.
- If any tax is still owed by close of play on day 30 – 6 June 2023 in my example – a further 2% penalty will be charged on this outstanding balance.
- From day 31, an annualised penalty rate of 4% will apply until the outstanding tax is paid; e.g. an extra 1% penalty for payments made three months and 30 days late.
- A penalty is only charged on tax owed on the penalty trigger dates, so there is an incentive to make part payments.

- The new system will apply for periods beginning on or after 1 January 2023, so make sure you pay your January and February 2023 returns on time because the old regime will still apply!

Note: As a first-year concession until 31 December 2023, a penalty will not be issued by HMRC if **all** tax owed on a return is fully paid within 30 days of the due payment date. Note the word 'all' to get this concession. See ***Penalty calculations***.

Penalty calculations

Raj, a computer consultant, submitted his VAT return for March 2023 before 7 May 2023 – the filing and payment deadline – but did not pay his tax liability of £100,000 until 7 August 2023 i.e., three months late.

Raj will be charged 2% penalties at the end of days 15 and 30 after the due payment date, and an annualised penalty of 4% for the next two months.

Total penalty:

(£100,000 x 4%) + (£100,000 x 4% x 2 months/12 months) = £4,666

Legislation and HMRC guidance

The relevant legislation about the new system is explained in Finance Act 2021 Sch 26 and s 117. HMRC's published guidance can be found at tinyurl.com/yckz4x2k.

I was initially confused by the statement in HMRC's guidance that a penalty would apply to tax 'you owe at day 15 plus 2% on the VAT you owe at day 30'. The use of the word 'at' seemed to contradict an earlier sentence that: 'You will not be charged a penalty if you pay the VAT you owe in full or agree a payment plan on or between days 1 and 15.' In other words, is a penalty first charged on day 15 or 16? And on day 30 or 31? However, Sch 26 Part 2 confirms that no penalty will be due on tax paid 'before the **end** of the 15 day period'.

A 2% penalty will apply to tax unpaid 'after the **end** of the 15 day period but before the **end** of the 30 day period' (author's emphasis). The word 'period' is confirmed as starting from the day after the due payment date. To quote the old song… what a

difference a day makes!

Here are some other practical tips:

- There will be a potential escape route if there is a ‘reasonable excuse’ for a late payment. However, I expect there will be fewer ‘reasonable excuse’ appeals because the penalties will be fairer, so there will not be a big financial incentive to put pen to paper and appeal to HMRC or a tribunal.
- If a time-to-pay arrangement is agreed with HMRC, the penalty clock stops ticking. But late payment interest will still be charged on the basis of commercial restitution.
- There is also a potential concession for ‘special circumstances’. HMRC has discretionary power to reduce or not charge a penalty for late payment if it considers it appropriate.

As with the current system, the ideal outcome for any VAT registered entity is to pay all tax owed by the due date. The late payment regime will then be as irrelevant as suntan lotion on a rainy day in Manchester. To help achieve this outcome, see ***Practical tips to reduce or avoid a late payment penalty***.

Practical tips to reduce or avoid a late payment penalty

- **Direct debit:** It makes sense to pay all VAT returns by direct debit, so that HMRC will automatically collect the payment three working days after the due date.
- **Time-to-pay agreements:** No penalty will be applied once a time-to-pay agreement has been accepted by HMRC. So, for example, if an agreement is reached on day 20 after the due payment date, this will avoid a penalty being charged in the first year due to HMRC’s temporary 30 day concession explained in the article. However, interest will still be charged from the due payment date.
- **Submit returns on time:** Make sure that your clients submit their returns on time, even if they cannot pay the tax owed by the due date.
- **Make part-payments:** Penalties are charged according to tax owed at the end of days 15 and 30. This gives a clear incentive to pay as much tax on time as possible, and part-payments thereafter to reduce the scope for HMRC to issue late penalty notices and charge interest.

Conclusion

I have focused on the new penalty system for late payments in this article. But, as so often, there's more. For periods starting on 1 January 2023 and later, a new points and penalty system will also be introduced for late VAT returns. This is a radical change from the current system where only late VAT payments are penalised, although a late return still generates a surcharge liability notice. What will this new system mean in practical terms? An interesting outcome is that late repayment returns will be subject to a potential penalty, which has never happened before in the 49 year history of the nation's favourite tax.

You will need to alert your farmer clients about this one – it will be as popular with them as a New York steakhouse is for vegetarians. I will cover the quirks and pitfalls of this system in my next article for *Tax Adviser*.