Report
by the Comptroller
and Auditor General

The exchequer departments

Tax reliefs

HC 1256 SESSION 2013-14 7 APRIL 2014

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The exchequer departments

Tax reliefs

Report by the Comptroller and Auditor General

Ordered by the House of Commons
to be printed on 7 April 2014

This report has been prepared under Section 6 of the National Audit Act 1983 for presentation to the House of Commons in accordance with Section 9 of the Act

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Comptroller and Auditor General
National Audit Office

26 March 2014

HC 1256 | £10.00

This report examines the administration of the overall system of tax reliefs and, following this landscape review, we intend to examine the administration of particular reliefs.

10390 04/14 NAO

Contents

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Key contextual information

Tax reliefs

All tax systems include **tax reliefs**, which in many cases are an essential part of defining the scope and structure of a tax by providing rules which establish where the tax burden is and is not intended to fall.

Some reliefs, known as **tax expenditures**, are designed to deliver specific policy objectives by providing behavioural incentives to achieve economic and social objectives. These are often an alternative to public expenditure, and have similar effects.

1,128

tax reliefs enacted for individuals and businesses as at March 2013

180

tax reliefs for which HMRC has estimated a cost

£101bn

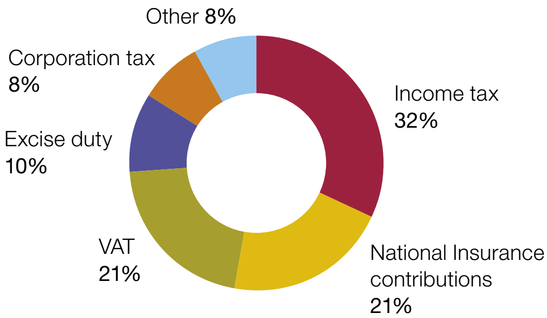
summed cost of tax expenditures (reliefs with similar objectives to spending programmes)

UK tax revenue

£476bn

UK tax revenue collected by HMRC in 2012-13

Analysis of taxes collected, 2012-13

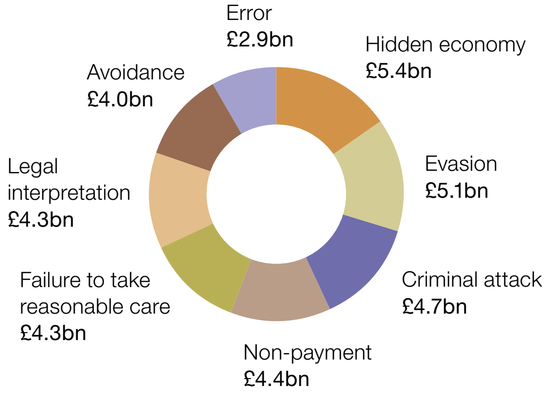


UK tax gap

7%

the tax gap in 2011-12 was £35 billion, or 7 per cent of tax liabilities in that year

Value of tax gap by behaviour, 2011-12



Summary

Introduction

1 The government collects taxes to fund public services, and can use the tax system to help people, households and businesses with targeted financial support. All tax systems include tax reliefs, which in many cases are an essential part of defining the scope and structure of a tax by providing rules which establish where the tax burden is and is not intended to fall.

2 There are more than 1,000 tax reliefs in the UK. Reliefs can help maintain the competitiveness of tax systems and governments can use tax reliefs as a mechanism to redistribute wealth, support economic growth and influence behaviour. Tax reliefs may also be used for practical purposes such as establishing the correct income and profit for tax purposes and making the tax system simpler to use. **Figure 1** summarises these different objectives as they are defined by HM Revenue & Customs (HMRC).

Figure 1
Different objectives of reliefs

HMRC classification	Purpose	Examples
Reliefs to correctly measure income or profits	To make sure that taxable amounts are correctly recognised, in the right year	Companies can deduct losses from previous years from current profits Companies must use a set rate of depreciation for each class of asset
Reliefs to ensure the scope of the tax is as intended	To make clear where a group or activity is not intended to be taxed. Usually this is to prevent unintended changes in behaviour	Cabin crew are exempt from air passenger duty Exemption of intermediaries from Stamp Duty (e.g. share traders)
Reliefs to improve the progressivity of tax	Allowances and thresholds to create different effective rates of tax	Income tax personal allowance Inheritance tax nil rate band threshold
Reliefs to create simplicity	Reliefs used to avoid disproportionate administrative costs	10 per cent wear and tear allowance for landlords Exemption of gifts below £250 from inheritance tax
Reliefs introduced by international agreements	To comply with international obligations or avoid double taxation	Double taxation relief Zero rate VAT for intra-community trade within the EU
Tax expenditures – reliefs to provide incentives for behaviour for economic and social objectives	To positively encourage a kind of behaviour, compensate for market failure or promote wider objectives	Enterprise Investment Scheme Income tax exemption for Individual Savings Account

Notes

1 Tax reliefs may have more than one purpose and so could fall under more than one category.

2 HM Revenue & Customs has categorised some but not all reliefs by objectives.

Source: HM Revenue & Customs

3 Some reliefs, known as 'tax expenditures', are designed to deliver specific policy objectives by providing behavioural incentives to achieve economic and social objectives. These are often an alternative to public expenditure, and have similar effects. Policy makers may prefer tax expenditures to spending programmes because they are thought to be the most effective and efficient way to achieve a policy objective.

4 Tax reliefs are delivered in various ways, and their design has implications for the complexity of the tax system, the costs of administration and the distribution of the taxpayer burden. This report uses a broad definition of the term 'tax reliefs' to include all of the tax mechanisms illustrated in **Figure 2**.

Figure 2
Tax relief mechanisms

Delivery mechanism	Example
Exemption – exclusion of an otherwise taxable amount from the tax base.	Principal private residence relief exempts the gain on disposal of a taxpayer's main place of residence from capital gains tax.
Deduction (also referred to as allowance) – an amount to be deducted when computing a taxable profit or gain.	Under income tax, corporation tax and capital gains tax, relief is allowed for losses (where expenditure exceeds revenue) on particular activities and transactions.
Credit (also known as 'offset') – an amount by which the tax liability is reduced. Some credits allow a payment to the taxpayer if the amount of relief exceeds the tax liability.	Under UK corporation tax, credit is available for up to £24.74 for every £100 of qualifying research and development (R&D) expenditure for loss-making companies.
Rate reliefs – a reduced rate of tax applicable to all or part of the tax base.	Certain goods are subject to reduced rates of VAT, and some are zero-rated.
Tax-free threshold – a specified portion of the tax base on which no tax is payable.	Personal allowance of £9,440 – in 2013-14 – before income tax is payable.
Deferral – a temporal delay in payment of a tax liability.	Companies use rollover relief to defer corporation tax from sales of certain assets where they reinvest in a replacement asset.
Modification for administrative simplicity – a special arrangement that modifies payment or compliance requirements for a specified group of taxpayers.	Income tax rules allow a deemed 5 per cent flat-rate deduction for the cost of personal service intermediaries.

Note

1 Variations of these mechanisms exist but are not listed here. Some reliefs use combinations of these mechanisms.

Source: Tax Administration Research Centre analysis for the National Audit Office

5 HMRC publishes cost estimates for some reliefs, but does not total these figures. Doing so would give only a broad indication of the scale of the tax reliefs landscape for two reasons. First, interactions between tax reliefs mean that simply combining the costs of individual reliefs will tend to overstate the true picture; and second, HMRC does not have cost data for a large number of reliefs, and the effect of excluding these will understate the overall position. It is important to recognise that, while the provision of reliefs reflects government's choices about where to place the tax burden, it would be unrealistic to assume that all of the revenue that appears to be foregone through tax reliefs could be collected. Some reliefs simply help define the tax base, such as the first three categories in Figure 1, and could not be otherwise collected. A higher overall tax burden could reduce economic productivity and the UK's global competitiveness, and may not be sustainable in the medium term.

6 In this report we have shown the total cost of tax reliefs compared to GDP in order to give a broad indication of the scale of the tax reliefs landscape. HMRC has asked us to include the following text: "*HMRC disagrees with the inclusion in Figure 3, paragraph 15 and paragraph 1.12 of the total of the costs of the separate tax reliefs. As the report itself explains at paragraph 5, HMRC does not publish this figure, because it does not represent an amount of money which might be obtained by Government – due, for example, to interactions between the reliefs. It is therefore misleading to refer to the figure*."

7 The cost of tax reliefs – so far as this is measureable – appears to be growing at a time when public spending is reducing. Each tax relief has an administration cost and carries the risk that revenue will be lost through error, tax avoidance and fraud. For tax expenditures, there is also the opportunity cost of the revenue foregone as a result of the policy decision to offer a relief. Reliefs may also have both intended and unintended consequences, such as the distortion of markets. The efficient and effective administration of the system of tax reliefs therefore presents a large and complex challenge for HMRC.

8 HM Treasury and HMRC (the exchequer departments) share oversight of tax reliefs and there is no single accounting officer responsible for their effectiveness. HMRC works with HM Treasury (the Treasury) to develop, design and deliver tax policy. The Treasury is responsible for strategic tax policy design and HMRC for delivering and maintaining policy and the administration of the tax system. The two departments share an analysis function, whose responsibilities include predicting the impact of changes to tax reliefs proposed in the budget and producing published statistics on tax reliefs and taxes in general.

Scope of this report

9 Under section 6 of the National Audit Act 1983, the Comptroller and Auditor General (C&AG) has powers to carry out examinations into the economy, efficiency and effectiveness of the way government departments use their resources in discharging their functions. The National Audit Act 1983 does *not* allow the C&AG to question the merits of policy objectives of the department which is being examined. This safeguards his independence and objectivity and makes him free from political influence. While our work therefore does not question policy intent, we do evaluate whether policy instruments are well-designed and adequate to deliver that intent.

10 HM Treasury has asked us to include the following text: *"The Treasury does not agree that the above paragraph reflects NAO's powers in relation to tax policy and therefore the scope of this report and future reports. The Treasury's position is that all tax reliefs reflect policy decisions about the incidence of taxation and distribution of the tax burden, taken by ministers and agreed by Parliament. As such the Treasury's view is that the design and impact of a relief are questions of policy and therefore outside of the NAO's remit. The Treasury does not believe this fetters the ability of the NAO to look at the effectiveness of the way in which tax reliefs are administered by HMRC."*

11 In future work evaluating how tax reliefs are developed and implemented, we expect to place greatest scrutiny on tax expenditures where there is a responsibility on the exchequer departments to assess whether they are meeting their stated policy objectives. But we are interested in the administration of all tax reliefs, as structural features of the tax system also require effective administration and control to ensure they are not abused.

12 We therefore describe in this report the complete landscape of tax reliefs and the main ways in which reliefs of different types are administered by the exchequer departments. We intend to evaluate the administration of particular reliefs in later work. We do not question whether a tax relief is the right choice of policy instrument.

13 This report covers:

- Part One: The landscape of tax reliefs in the UK; how they are used and the risks they carry;
- Part Two: How the exchequer departments assess the performance of reliefs and respond to emerging differences between their performance and their intended objectives; and
- Part Three: How the exchequer departments assess, monitor and respond to the risk that reliefs are abused.

Number and scale of tax reliefs

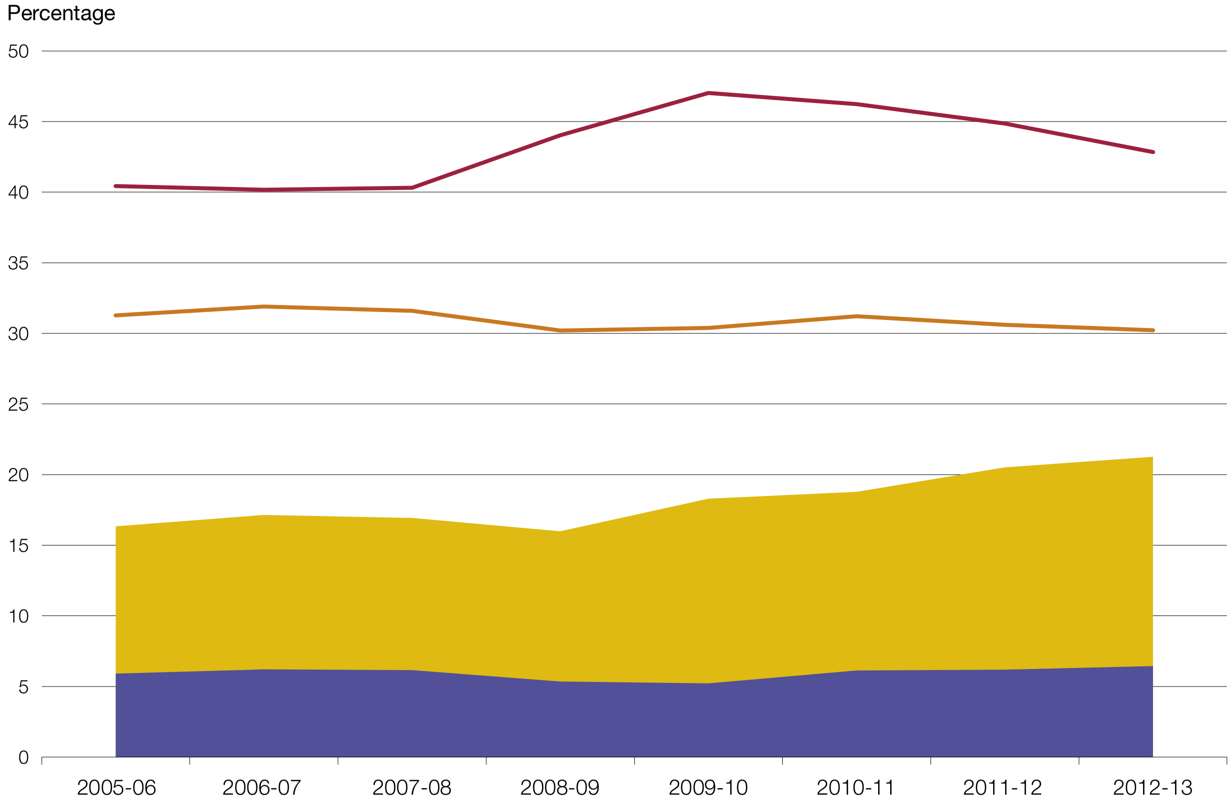
14 **The number of reliefs is growing**. In March 2011 the Office of Tax Simplification identified 1,042 tax reliefs in the UK. It reviewed a sample of 155 and recommended that 47 should be abolished – either because they had expired, there was no longer a policy rationale, the value was negligible, or the administrative burden outweighed the benefit. Since then Parliament has abolished 48 reliefs but has introduced 134 new reliefs. By December 2013 the total number of reliefs had increased to 1,128 (paragraph 1.11).

15 **The value of reliefs in relation to tax revenue and public spending has increased in recent years**. As a proportion of GDP, the sum of all tax reliefs has increased from 16 to 21 per cent since 2005-06, while tax revenues have decreased marginally. This increase is mainly explained by increases in the income tax personal allowance, the thresholds for national insurance contributions, and the standard rate of VAT (because as the standard rate of VAT rises, so does the value of VAT reliefs). The value of tax expenditures has increased in real terms from £91 billion to £101 billion over this period (from 5.9 to 6.5 per cent of GDP). Since 2010-11, while public spending has fallen sharply, the value of reliefs has continued to rise (**Figure 3**) (paragraph 1.12).

Figure 3

The value of tax relief has increased relative to tax revenues

Total managed expenditure, tax revenues and tax reliefs as a percentage of GDP



	2005-06	2006-07	2007-08	2008-09	2009-10	2010-11	2011-12	2012-13
Total managed expenditure (%)	40.4	40.2	40.3	44.0	47.0	46.2	44.9	42.9
Tax revenues (%)	31.3	31.9	31.6	30.2	30.4	31.2	30.6	30.2
Tax reliefs (including tax expenditures)[3] (%)	16.3	17.1	16.9	16.0	18.3	18.8	20.5	21.3
Tax expenditures (%)	5.9	6.2	6.2	5.3	5.2	6.1	6.2	6.5

Notes

1 Figures shown in real terms.

2 Excludes minor reliefs.

3 Includes the impact of changes to the personal allowance threshold, VAT rates and the rate of National Insurance contributions.

Source: National Audit Office analysis of HM Revenue & Customs cost data of principal reliefs

16 **HMRC has not systematically categorised tax reliefs according to the function they perform**. HMRC publishes a list of the main tax reliefs and their costs annually, identifying separately those it regards as tax expenditures. However, HMRC acknowledges that its categorisation is crude: some reliefs classed as tax expenditures, such as the relief on registered pension schemes, also contain structural elements; many of the smaller reliefs are not categorised; and, in common with most other tax administrations, a lack of relevant data means that HMRC does not know the cost of many reliefs (paragraphs 1.4 and 1.10).

How reliefs work and the tax at risk from abuse

17 **Tax reliefs are an essential part of the tax system**. All taxpayers and consumers benefit to some extent from tax reliefs, which also offer practical advantages to the exchequer. For example, tax expenditures can offer low administrative costs and provide differentiated financial support that would not be cost-effective through means-tested spending programmes. They may also target support or deliver objectives more effectively than a spending programme. However, the nature of the tax system means that it would not be feasible for most reliefs to work within a finite budget and the cost of reliefs can therefore rise beyond expectations (paragraphs 1.13 to 1.14).

18 **Tax reliefs play a significant role in defining the scope of tax and determining where the burden of tax falls**. For example, the threshold set for inheritance tax defines the scope of tax by providing that no tax is payable on most estates. Corporation tax rules provide flexibility to reduce the risk that the viability of a business is threatened by having to pay a high tax bill when it can least afford it. For example, loss relief helps to smooth the taxation of profit over a company's lifespan, allowing trading losses to be carried back a year or carried forward to set off against future profits; and the deduction of interest from taxable profits can substantially reduce tax liabilities where major acquisitions have been funded by debt, thus making it easer for companies to invest (paragraphs 1.18 to 1.25).

19 **All tax reliefs create opportunities to misuse and avoid tax**. The number of reliefs and interaction between them adds to the complexity of the tax system and increases the risk of error. The risk of abuse varies according to many factors including the relief's objectives and value, how it works, and the customer group. The efficient and effective administration of the system of tax reliefs therefore presents a large and complex challenge for HMRC (paragraphs 1.16 and 1.39 to 1.41).

20 **The boundary between the legitimate use of tax reliefs and tax avoidance is not always clear**. HMRC describes tax avoidance as an attempt to exploit legislation to gain a tax advantage that Parliament did not intend. It publishes a description of the types of avoidance scheme that it will always challenge because it regards them as contrived arrangements designed to avoid tax. Six of the nineteen types of avoidance it describes are designed primarily to exploit tax reliefs (paragraphs 1.33 to 1.38).

21 **Some tax reliefs are the target of illegal tax evasion and criminal attack**. The way some reliefs work means that HMRC makes payments to customers following claims, making them attractive to fraudsters. Criminals have exploited reliefs which involve a cash payment or refund to extract money from HMRC. Examples have included fraudulent claims for film tax relief, payments made to charities under gift aid, and VAT refunds made against zero-rated items. In each case a common approach has involved creating fake transactions to trigger payments from HMRC (paragraphs 1.39 to 1.41).

22 **The value of tax at risk from the abuse of reliefs is unknown but likely to be significant**. HMRC does not separately identify the tax at risk or lost through the abuse of reliefs. It publishes an annual estimate of the tax gap, which it estimated to be £35 billion in 2011-12. It estimated that £4.3 billion of tax was lost from cases where individuals and businesses had challenged HMRC's interpretation of how the tax law, including rules for relief, should apply. It estimated that £4 billion of the tax gap arose from avoidance, a high proportion of which involves exploiting tax reliefs. Evasion and criminal attack accounted for a further £9.8 billion, some of which is explained by 'VAT carousel fraud' and other transaction based frauds that depend on certain products or activities being exempt from tax or taxed at a lower rate (paragraphs 1.43 to 1.44).

Monitoring performance

23 **There is no documented framework specifically governing the introduction or modification of tax reliefs**. In 2010 the Treasury increased the policy cycle for creating new reliefs from 7 to 18 months. This was to allow more time to consult on the objectives of a proposed measure, to appraise the options and to draft legislation. The Treasury also committed to developing a framework for the introduction of new reliefs, recognising that it should consider new reliefs carefully, and that these should only be introduced when there is a strong and proven case. It has yet to develop such a framework. Since 2011, the scope of tax impact notes has narrowed and an options appraisal is no longer required (paragraphs 2.8 to 2.12).

24 **The monitoring arrangements for reliefs vary across HMRC, but it administers most reliefs as part of its wider administration of the tax streams**. HMRC has over 100 analysts who routinely monitor trends and patterns in tax receipts and the impacts of tax policies. In doing so, they monitor those reliefs with the most significant impact on overall tax receipts and may undertake closer examination of a relief if its impact is not in line with expectations. HMRC has identified the need for more tailored monitoring arrangements for some reliefs. Of 46 reliefs identified on HMRC's website as tax expenditures, it has established dedicated units to oversee 9. HMRC created these units to concentrate expertise and to promote particular outcomes, such as encouraging investment. By concentrating expertise in these areas HMRC is better able to give customers a consistent service, ensure compliance, and promote the take-up of reliefs (paragraphs 2.13 to 2.17).

25 **HMRC does not evaluate tax reliefs systematically, and has commissioned few evaluations of their impact**. The Treasury depends on HMRC's feedback on the use of specific reliefs. Evaluation is important to understand the extent to which a tax relief is misused, its behavioural consequences and, in the case of tax expenditure, whether it is meeting its social or economic objectives. HMRC's analysis unit has undertaken some evaluation of reliefs and has commissioned and published 19 external evaluations of tax expenditures since 2003, for which it paid £1.8 million in total. Most have focused on how the reliefs have changed behaviour, rather than seeking to quantify the benefits or estimate the costs of revenue foregone, avoidance, or administration. The evaluations cover reliefs worth around £6 billion a year, which is around 6 per cent of the known value of tax expenditures. More systematic or comprehensive coverage would require HMRC to allocate a greater proportion of its resources to evaluative work (paragraphs 2.18 to 2.20).

26 **We found limited monitoring of changes in the cost of particular reliefs**. HMRC reports the cost of around 200 reliefs to provide transparency, but it does not routinely produce data on trends to track movements in reliefs unless policy changes are proposed. Around a quarter of 92 principal reliefs we examined had experienced significant changes in value. We identified 26 tax reliefs which had increased by more than 50 per cent in real terms in the past ten years, and 30 which had increased by more than 25 per cent in the last five. There are many reasons why the value of a relief might increase, including a rise in the underlying rate of tax, but none of the increases prompted the exchequer departments to evaluate the reliefs concerned (paragraphs 2.21 to 2.27).

Managing the risk of reliefs being abused

27 **HMRC responds proactively to the serious challenge of administering the complex system of tax reliefs and addressing the opportunities for abuse it creates**. It is evolving its business model to increase the range and volume of compliance interventions, including by reinvesting £994 million of department-wide efficiency savings to tackle tax avoidance, evasion, criminal attack and debt between 2010-11 and 2014-15. It has developed cutting-edge technology that uses data in powerful ways to help it detect fraud and criminal attack (paragraphs 3.2 and 3.7).

28 **The design of tax law is critical to reducing the scope for reliefs to be exploited by fraudsters or for the avoidance of tax**. Since 2009, HMRC has formally assessed all new tax reliefs while still in draft form, focusing in particular on the design of measures that might give rise to fraud or avoidance. It is inherently difficult to predict how a new relief might be abused, however, due to the complexity of the way measures interact across the tax system and the contrived structures or transactions that may be created to abuse them. Where abuse is detected, HMRC may advise that legislation is introduced quickly or retrospectively to close a loophole, particularly where a large amount of tax is at risk. Some loopholes have been closed within days of HMRC becoming aware of them (paragraphs 3.3 to 3.5 and 3.12 to 3.13).

29 HMRC has high success rates in challenging avoidance schemes that exploit tax reliefs, but avoidance cases can take a long time to investigate and resolve. Some scheme promoters deliberately slow down the process because tax rules normally allow taxpayers to hold on to disputed tax, no matter how unlikely they are to succeed in litigation. HMRC estimates there are around 65,000 open cases involving marketed tax avoidance schemes. Over 85 per cent of these date back to 2009-10 or earlier. HMRC has consulted on measures to accelerate the payment of disputed tax where similar claims have already failed and these will be included within Finance Bill 2014 (paragraphs 3.16 to 3.18).

30 The time needed to collect data and take remedial action places an onus on robust design and more proactive monitoring of the performance of reliefs. HMRC has introduced measures to require early disclosure of avoidance schemes seeking to exploit design weaknesses. By collecting data from across its business in real time – such as to track how a new relief or a significant change to relief is being exploited – HMRC could assess the extent of emerging threats sooner, allowing it to act more quickly to safeguard revenue. In the case of research and development (R&D) tax credits, we found that good practices – including the relief's phased introduction, annual reporting of its performance, independent evaluations, and an estimate of its costs and benefits – had meant that the cost of the relief had stayed in line with forecasts. Wider application of these practices by the exchequer departments' approaches could provide an effective control on the introduction of other reliefs (paragraphs 3.6 to 3.10 and 3.26 to 3.28).

Concluding comments

31 Tax reliefs are an important and longstanding element of fiscal policy and are growing in number. They are also essential to the effective operation of a tax system. This report is intended to describe the landscape across all tax reliefs in the UK, and to put Parliament in a position to consider whether the major elements in the management and responsiveness of the system are working adequately, or are in need of more focused attention.

Part One

Tax reliefs and how they are used

1.1 All tax systems include tax reliefs, which in many cases are an essential part of defining the scope and structure of a tax by providing rules which establish where the tax burden is and is not intended to fall. Reliefs can help maintain the competitiveness of tax systems and governments can use tax reliefs as a mechanism to redistribute wealth and support economic growth, and influence behaviour. Tax reliefs are also introduced for practical purposes such as establishing the correct income and profit for tax purposes and making the tax system simpler to use.

1.2 HM Treasury oversees the tax system, including designing tax reliefs. HM Revenue & Customs (HMRC) administers the tax system, including tax reliefs, and maintains tax policy.

1.3 In this part we consider:

- the categorisation, number and scale of tax reliefs;
- how tax reliefs are used; and
- the potential tax at risk from abuse of reliefs.

The categorisation, number and scale of tax reliefs

Categorising reliefs: structural reliefs and tax expenditures

1.4 The UK has over 1,000 tax reliefs, allowances and exemptions (**Figure 4**). The reason reliefs are introduced, and the delivery mechanisms vary. Most reliefs are 'structural' in that they are integral to the way a tax is constructed and how it works, reflecting the government's choices about who and what to tax. For example, some reliefs simply define the scope of a tax (such as exempting cabin crew from air passenger duty), others are allowances that make a portion of income tax-free (such as personal income tax allowance), and some are mechanisms to help certain groups of taxpayers (for example, £30,000 of some redundancy payments is tax-free). Other reliefs reflect international obligations (such as common laws within the EU, to ensure the EU single market works effectively. For example, the zero rate of VAT for international trade).

Figure 4

Number of tax reliefs by tax stream, as defined by the Office of Tax Simplification, at March 2013

Sources of revenue	Revenue raised (£bn)	Number of reliefs	Number of reliefs with cost data	Summed value of reliefs[1] (£bn)	Most significant relief
Income tax and National Insurance contributions	252.6	407	62	173.8	Income tax personal allowance (£68.5 billion)
Corporation tax	39.2	119	7	3.8	Small companies tax rate (£2.1 bilion)
Income tax and corporation tax[2]	(see above)	89	6	21.0	Capital allowances reduce the value of business assets at a set rate of depreciation for each class of asset (£20 billion)
Value added tax	101	58	33	79.1	Zero rate VAT on food (£15.8 billion)
Other indirect taxes	62.7	110	23	2.9	Relief from hydrocarbon oils duty for oil used for industrial purposes (£1.4 billion)
Capital gains tax	3.9	45	5	15.8	Relief on sale of principal residence (£10.4 billion)
Inheritance tax	3.1	88	13	22.4	Nil rate band (£18.4 billion)
Stamp duties	9.5	115	24	1.5	Group relief from stamp duty (£0.9 billion)
Other[3]	3.6	97	7	15.2	Double taxation relief on foreign income (£15 billion)
Total	**475.6**	**1,128**	**180**		

Notes

1 Approximate cost is the sum of the cost of those reliefs published in HMRC tables. The data also excludes the amounts paid out in film tax credit, which was £205 million in 2012-13.

2 Some reliefs relate to both corporation tax and income tax.

3 'Other' includes reliefs relating to more than one tax stream or affect specific industries, such as reliefs for aggregates levy and landfill tax.

Source: National Audit Office analysis of data from HM Revenue & Customs and the Office of Tax Simplification

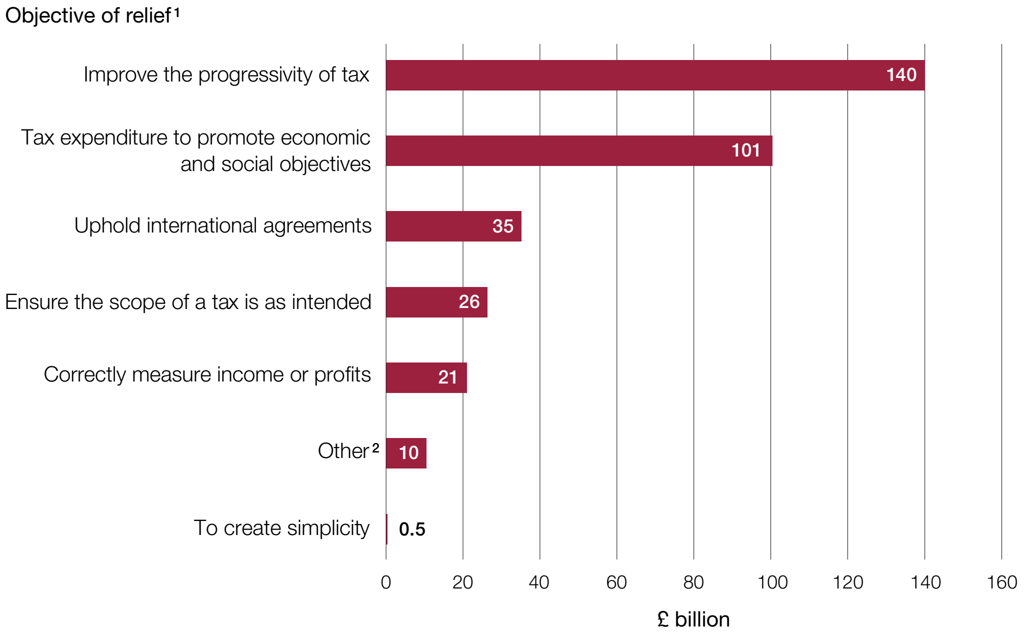
1.5 Reliefs may also be introduced to help or encourage particular taxpayers, activities or products in pursuit of social or economic objectives. Such reliefs are often an alternative to public expenditure, and have similar effects, and they are therefore called 'tax expenditures'. For example, tax reliefs and credits are available to companies to encourage research and development (R&D) activity, a policy objective that has also been pursued through grant funding.

1.6 The distinction is not always straightforward between reliefs that are a part of the structure of the tax system and those that are tax expenditures. HMRC has not comprehensively categorised tax reliefs by objective or delivery mechanism. **Figure 5** provides our analysis of the value of reliefs by objective.

Figure 5

Estimated value of the principal reliefs by objective

HMRC and the Treasury do not categorise reliefs by their objective. Our allocation is broad and indicative



Notes

1 Reliefs can fulfil more than one objective. HMRC publishes a list of reliefs that are tax expenditures but does not categorise other reliefs by their objective. We have categorised other reliefs by their key objective. Only one relief is included in some categories (correct measurement and creating simplicity) because only the principal reliefs are included.

2 'Other' includes reliefs where the primary category is not clear, for example relief on substantial shareholdings, tonnage tax, tied oil schemes.

Source: National Audit Office analysis of HM Revenue & Customs data

The number and scale of tax reliefs

1.7 HMRC reports annually on around 400 tax reliefs and has assessed the cost of these where it has sufficient data. HMRC has estimated the value of 92 principal tax reliefs and 88 minor tax reliefs. Twenty reliefs account for almost 85 per cent of the estimated value of tax reliefs (**Figure 6** overleaf).

1.8 HMRC publishes cost estimates for some reliefs, but does not total these figures. Doing so would give only a broad indication of the scale of the tax reliefs landscape for two reasons. First, it does not allow for any behavioural changes as a result of the reliefs and the interactions between tax reliefs mean that simply combining the costs of individual reliefs will tend to overstate the true picture; and second, HMRC does not have cost data for a large proportion of reliefs, and the effect of excluding these will understate the overall position. It is important to recognise that, while the provision of reliefs reflects government's choices about where to place the tax burden, it would be unrealistic to assume that all of the revenue that appears to be foregone through tax reliefs could be collected. A higher overall tax burden could reduce economic productivity and the UK's global competitiveness, and may not be sustainable in the medium term.

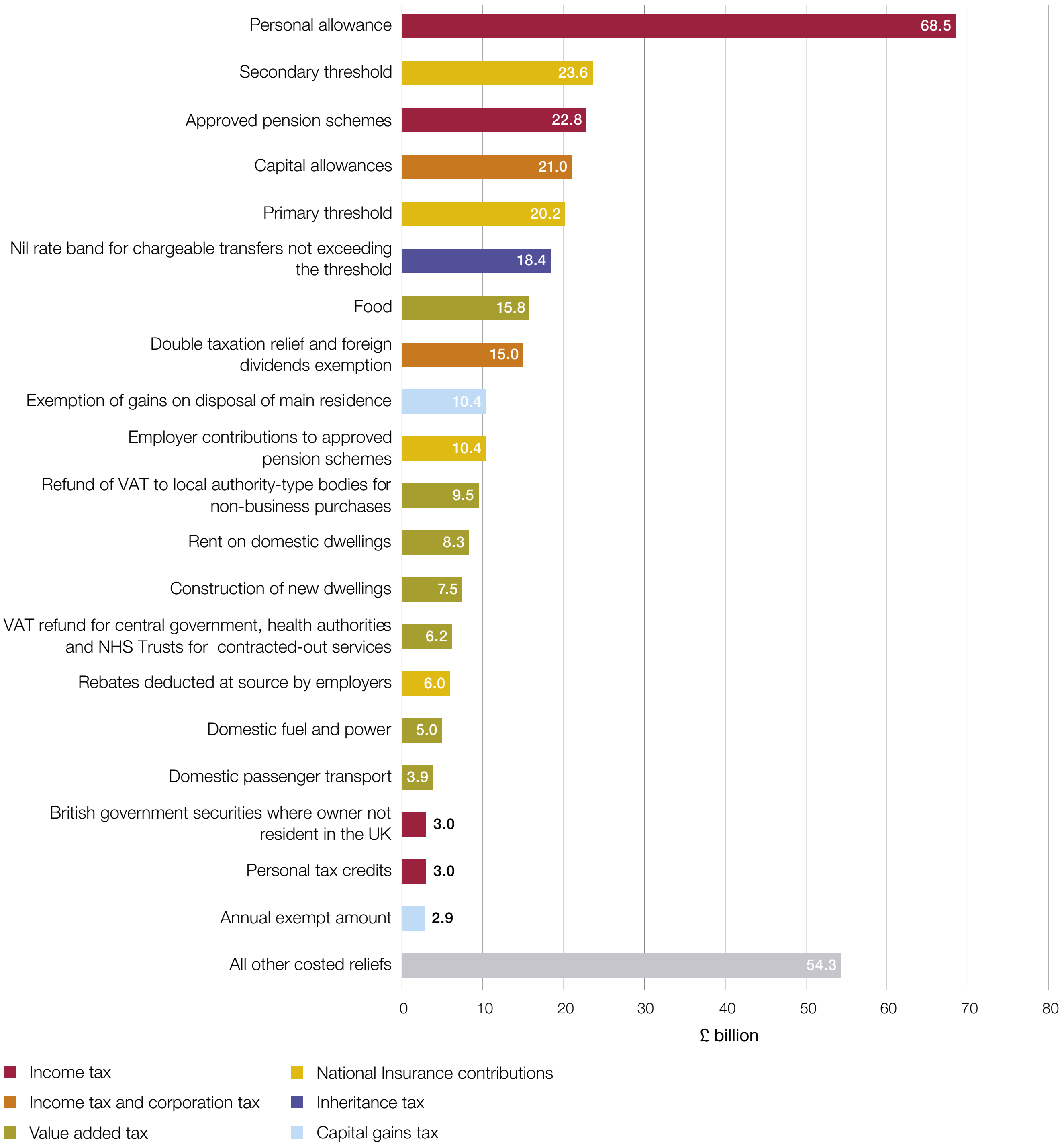
1.9 As the nature of tax reliefs varies so widely, it is more meaningful to consider the constituent parts of their summed value than to focus on the aggregate figure:

- Tax expenditures accounted for £101 billion in 2012-13. The largest relief classified by HMRC as a tax expenditure was relief on contributions to registered pension schemes (£22.8 billion).
- Reliefs that, by HMRC's definition, achieve the desired progressivity of the tax system accounted for £140 billion. By far the biggest single component was the personal allowance on income tax, valued at £68.5 billion in 2012-13. Any decision to change the level of the personal allowance would make a significant difference to the combined value of all reliefs.
- Other structural reliefs in 2012-13 summed to £93 billion.

1.10 HMRC has insufficient data on tax returns to make a reasonable estimate of the value of 219 other tax reliefs that it reports. The estimates are incomplete because data is not always available. Most of the Organisation for Economic Co-operation and Development (OECD) countries have similar gaps in data. Most countries that report costs focus primarily on tax expenditures (**Figure 7** on page 19). They do not report the aggregate value of all reliefs, including those that are structural features of the tax system. Comparisons are limited as definitions of tax expenditures vary. Only France and Italy have estimated the value of more tax reliefs than the UK.

Figure 6
Largest reliefs by value

Twenty tax reliefs account for most of the estimated value of tax relief 2012-13

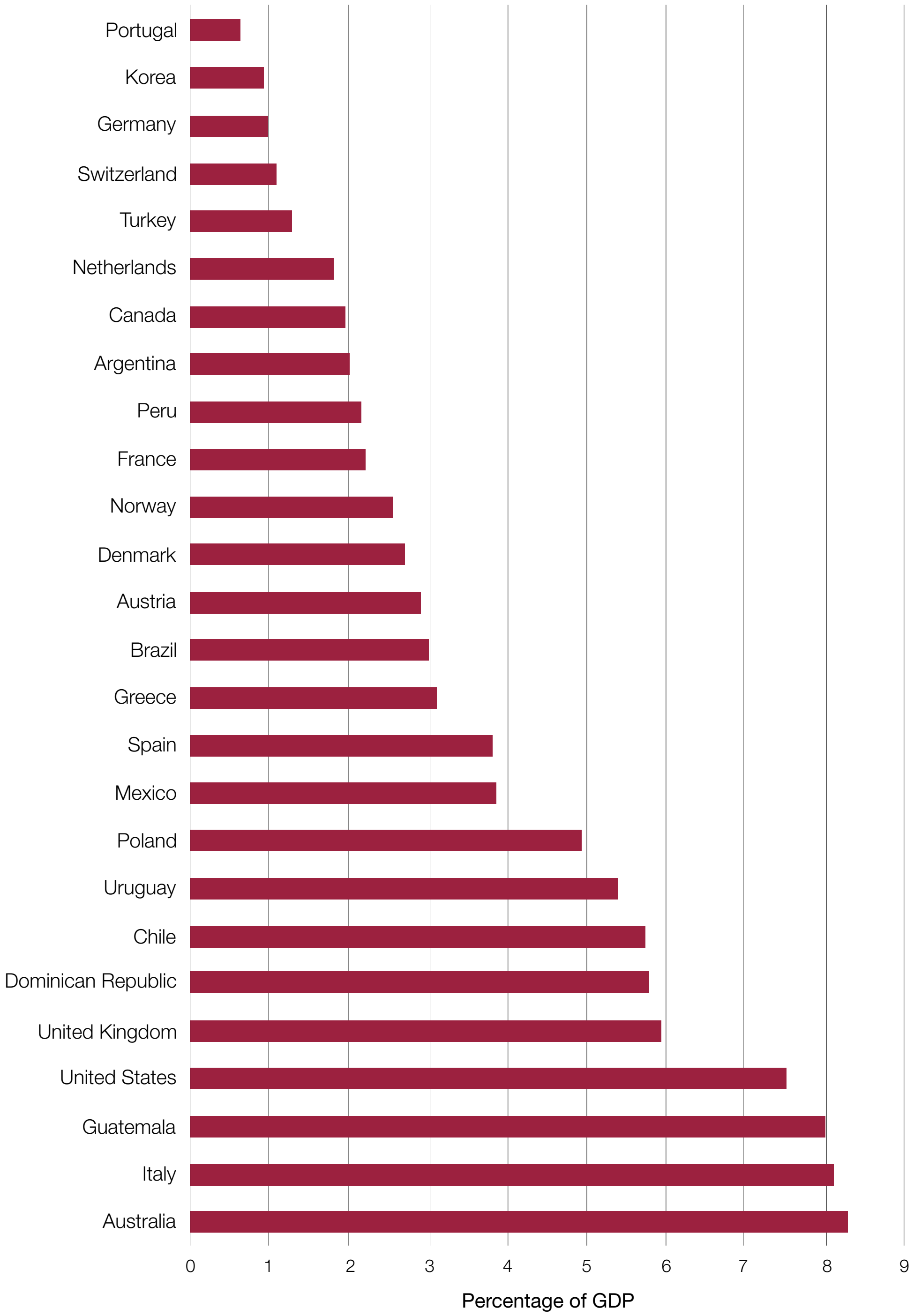


Note

1 This analysis is only based on costed reliefs.

Source: National Audit Office analysis of HM Revenue & Customs data

Figure 7
Tax expenditures as a percentage of GDP for 26 countries



Note

1 All figures are for 2010, except Guatemala which is for 2009.

Source: International Monetary Fund, *Fiscal monitor*, April 2011

1.11 Creating reliefs in the tax system can add to complexity.[1] In 2010, HM Treasury set up the Office of Tax Simplification to help simplify the tax system. In March 2011, the Office of Tax Simplification identified 1,042 tax reliefs in the UK. It reviewed a representative sample of 155 and recommended that 47 should be abolished either because they had expired, there was no longer a policy rationale, the value was negligible, or the administrative burden outweighed the benefit.[2] Since then Parliament has abolished 48 reliefs and introduced 134 new reliefs. By March 2013 the total number of reliefs enacted in UK law had increased to 1,128.

1.12 The measurable value of reliefs has increased relative to tax revenue. As a proportion of GDP, the summed value of tax reliefs has increased from 16.3 to 21.3 per cent since 2005-06, while tax revenues have decreased marginally. Most of this increase is explained by increases in the value of structural reliefs, with the personal allowance alone rising from £45.6 billion to £68.5 billion in real terms over this period. Other significant factors are increases in the thresholds for National Insurance contributions and the standard rate of VAT (because as the standard rate of VAT rises, so does the value of VAT reliefs). Tax expenditures increased in real terms from £91 billion to £101 billion over these eight years, rising from 5.9 to 6.5 per cent of GDP (Figure 3).

How tax reliefs are used

1.13 All UK taxpayers use tax reliefs to some extent. For example, nearly everyone who lives in the UK is entitled to an income tax personal allowance, the amount of income that each person is allowed each year before having to pay tax; and all consumers benefit to varying degrees from reduced and zero rates of value added tax on certain goods. Some reliefs can only be used in specific circumstances and require the taxpayer to claim them.

1.14 The use of tax reliefs offers some practical advantages to the exchequer but also carries risks. For example, tax expenditures can offer low administrative costs and provide differentiated financial support that would not be cost-effective through a means-tested spending programme. However, most tax expenditures cannot be controlled by setting a finite budget, as are spending programmes, so the costs can rise beyond expectations. Moreover, all tax reliefs carry the risk that they will be misused to avoid or evade tax. The number of reliefs and the interactions between them also add to the complexity of the tax system and increase the risk of error.

1 HM Treasury, *Tax policy making: a new approach*, June 2010.
2 Office of Tax Simplification, *Review of tax reliefs – final report*, March 2011.

1.15 Most people and businesses use reliefs in the way intended by Parliament. However, each tax relief creates potential routes to be exploited in ways not intended. The range of behaviours include:

- Using the relief as intended. This may involve a change in the taxpayers' behaviour to take advantage of the relief.
- Adopting a different **legal interpretation** of tax relief rules from that intended by Parliament, or one which tests the boundaries of that intent.
- **Tax avoidance** – creating contrived financial or operating arrangements purely or primarily to exploit a tax relief.
- **Tax evasion** – where individuals and businesses deliberately, and illegally, set out to not pay the tax due.
- **Criminal attack** – where organised criminals or other parties set out to systematically exploit tax reliefs to defraud the tax system and extract payments from HMRC.

1.16 Several industries and groups take a strong interest in tax rules and ways to advise their clients on how they can make the best use of the available reliefs. Accountancy firms, major banks and leading lawyers support and advise individuals and businesses on their tax affairs. Providing tax advice is worth almost £2 billion a year in the UK to the 'big four' accountancy firms alone, and almost $25 billion globally.[3] In addition, some specialist accountancy firms have business models that depend on creating and promoting avoidance schemes.

1.17 In this section we consider case examples to illustrate how a sample of reliefs are used. We focus on five areas, drawing on HMRC's data and website and other public sources:

- Reliefs which define the structure and scope of a tax
- Use of tax expenditures
- Challenging HMRC's interpretation of tax law
- Tax avoidance involving reliefs
- Illegal evasion and criminal attack.

3 HC Committee of Public Accounts, *Tax avoidance: the role of large accountancy firms*, Forty-fourth Report of Session 2012-13, HC 870, 26 April 2013.

Reliefs which define the structure and scope of a tax

1.18 All tax systems include tax reliefs which in many cases are an essential part of defining the scope and structure of a tax by providing rules which establish where the tax burden is and is not intended to fall. This section describes some examples of reliefs which define the structure and scope of a tax.

Reliefs from inheritance tax

1.19 Inheritance tax is an example of a tax which under HMRC's definition, provides progressivity in the tax system by ensuring the burden falls most on those who can most afford to pay. It is unlike most other taxes in that the amount of relief far exceeds the amount of tax collected. Several reliefs define the scope of the tax and the value of these reliefs in 2012-13 was £22.4 billion, seven times the value of tax collected (Figure 4).

1.20 In 2010-11, there were 560,000 deaths, of which 16,000 (3 per cent) resulted in an inheritance tax liability. Most estates were not notified for probate because there was a surviving spouse or because they were relatively small. Of the 260,000 deaths that were notified for probate, 36,000 estates were valued at above the tax threshold. Of these, 20,000 did not have to pay any inheritance tax because of the value of reliefs and exemptions they were able to claim.

Corporation tax reliefs

1.21 The distribution of corporation tax is not spread evenly. A small number of very large businesses pay significant amounts. In 2011-12, 35 of the UK's 975,000 companies paid 21 per cent of all corporation tax. The largest 800 businesses, dealt with by HMRC's Large Business Service, have typically contributed around half of all corporation tax paid in recent years. However, in 2012-13 more than half of the 800 largest businesses paid less than £10 million each in corporation tax. Around 20 per cent of these 800 businesses paid no corporation tax in 2012-13.

1.22 The amount of corporation tax paid by individual businesses may also vary significantly each year, according to their industry and individual trading conditions. For example, in 2010-11 a quarter of all businesses paying corporation tax had no corporation tax payable in the previous year.

Loss reliefs

1.23 Loss reliefs help smooth the taxation of profit over a company's lifespan. They allow trading losses to be carried back a year or carried forward to set off against future profits from the same trade. The aim is to ensure that tax is charged on the overall profits, recognising that losses may first need to be incurred before a company makes a profit.

Group loss relief

1.24 Group relief ensures that the same overall UK corporation tax is paid regardless of whether a business chooses to operate through a single company or many companies. Companies within a group can transfer losses to set against group profits in that year. Analysis of corporation tax statistics indicates that group loss reliefs play a significant role in stabilising the amount of corporation tax paid (**Figure 8** overleaf).

1.25 Deduction of interest from taxable profits can substantially reduce tax liabilities where major investment or acquisitions have been funded by debt. **Figure 9** on page 25 shows how a loan arrangement to pay for an acquisition might work when funded by loans within a group. In this example a company takes out a loan from its subsidiary overseas to finance a major acquisition. The overseas subsidiary in this example is responsible for borrowing money from the markets to fund the group's activities. The company spreads the cost of the acquisition in instalments across its lifetime, so that it recognises the costs when it generates profits. In addition, lifetime interest on the loan will reduce profits that incur tax in the UK until the loan is repaid. The loan can be structured so the company repays it in one payment. This generates larger interest deductions rather than where the loan is paid off in instalments. The interest that the subsidiary gets is taxed in a country with a lower tax rate. This kind of tax planning can be effective within existing tax rules, although there are rules that limit the scope of such tax planning.

Use of tax expenditures

1.26 Those reliefs known as tax expenditures are designed to deliver specific objectives by providing behavioural incentives to achieve economic and social objectives. This section describes examples of tax expenditures.

Pension saving

1.27 To encourage individuals to take responsibility for retirement planning, the government provides pensions tax relief on personal and employer contributions, and scheme investment income and gains. Each year around 500,000 individuals with combined private pensions wealth of £120 billion, built up by making use of this relief, start to access their pension savings. The cost of providing this relief is around £23 billion a year.

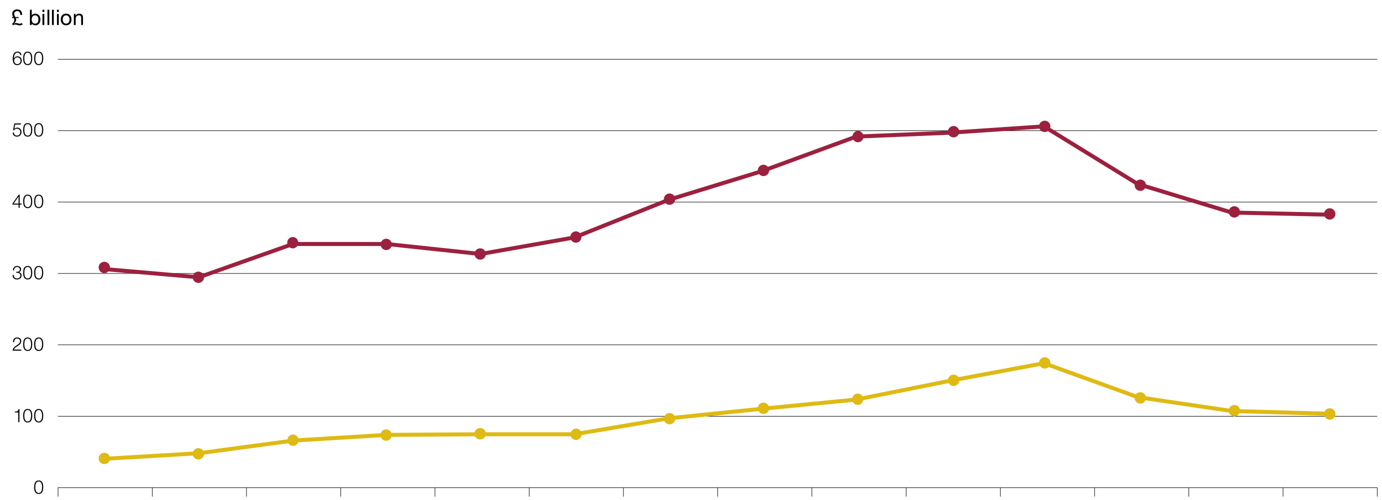
Investment by businesses

1.28 The Seed Enterprise Investment Scheme (SEIS) is designed to help small, early stage companies raise equity finance. SEIS offers tax reliefs to individual investors buying shares in small companies at a very early start-up stage. It has helped over 1,600 companies to raise over £135 million of funding through the scheme.

1.29 Research and development (R&D) tax reliefs provide companies with an incentive to carry on additional research and development. In 2011-12 over 12,000 companies invested £11.9 billion in research and development. These companies claimed R&D tax credits worth almost £1.2 billion.

Figure 8
Levels of group relief compared to total taxable profits

Group loss reliefs to offset increases in profit and other income[1]



	1998-99	1999-00	2000-01	2001-02	2002-03	2003-04	2004-05	2005-06	2006-07	2007-08	2008-09	2009-10	2010-11	2011-12
● Total taxable profits, other income and gains	306.2	295.0	341.5	341.4	327.4	350.4	402.8	443.1	491.3	496.8	505.6	425.0	385.2	382.4
● Group relief[2]	41.6	49.2	66.9	75.1	75.9	75.9	98.1	111.3	124.2	150.6	174.9	127.8	108.4	104.6

Notes

1 Figures are expressed in real terms. HMRC publishes figures prior to 2005-06 in calendar years.

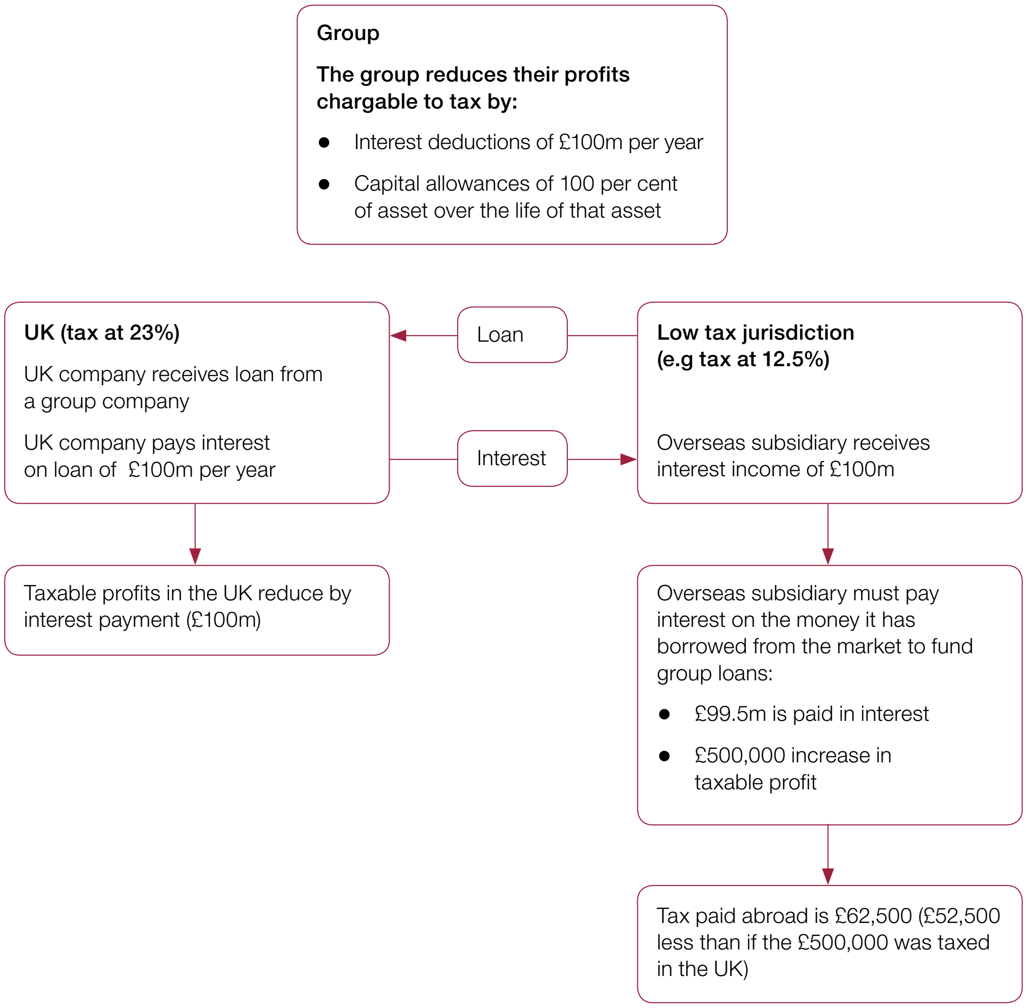
2 Group relief is based on profits before tax. The actual value of tax relieved under group relief is between 26 per cent and 31 per cent of the value shown in the graph depending on the rate of corporation tax at the time.

Source: National Audit Office analysis of HM Revenue & Customs corporation tax statistics

Figure 9

How a company might use a group loan arrangement

There may be no material tax advantage from borrowing within a group rather than directly from the market



Source: National Audit Office analysis

Support for oil and gas production

1.30 Oil and gas field allowances are available for new fields and existing ones where there is declining production. The allowances are intended to support the extraction of oil and gas in commercially marginal fields, helping to maximise the productive life of those fields.

Inheritance tax

1.31 Agricultural and business property relief are two of the tax expenditures that commonly reduce or remove liability to inheritance tax. These reliefs aim to ensure that family businesses do not have to be broken up and sold to pay inheritance tax. Under agricultural property relief, farmed land can qualify for relief. Other assets eligible for relief include an interest in a business, assets used in that business or unlisted shares. **Figure 10** shows that the value of these reliefs has grown faster than the amount of tax collected. The reliefs are regularly cited by firms that undertake tax planning as ways of reducing inheritance tax that are relatively easy to use.

Challenging HMRC's interpretation of tax law

1.32 Taxpayers can challenge HMRC's interpretation of tax relief rules. For example, a recent legal case disputed whether a painting displayed in a stately home that was open to the public should be exempt from capital gains tax. The First Tier Tax Tribunal found that it was not exempt from capital gains tax. This decision was appealed and the Upper Tax Tribunal ruled that it was correct to classify the painting as 'plant' (a working asset) because it was actively attracting visitors to the heritage site. As a result it was treated as a 'wasting' asset for tax purposes and was exempt from capital gains tax when it was sold for £9.4 million, even though it had appreciated in value.[4] HMRC took this case to the Court of Appeal in a bid to restore the decision of the First Tier Tax Tribunal, but it did not find in HMRC's favour. Lord Justice Briggs commented that the judgment may be "surprising to those unfamiliar with the workings of Capital Gains Tax ... but this is the occasional consequence of the working of definitions and exclusions which, while aimed successfully at one potential inroad into the charge to tax, unavoidably allow others by what the legislators appear to permit as an acceptable if unwelcome side-wind."[5] HMRC will need to decide whether it wishes to appeal the decision, seek a legislative change, or accept that the definition should stand.

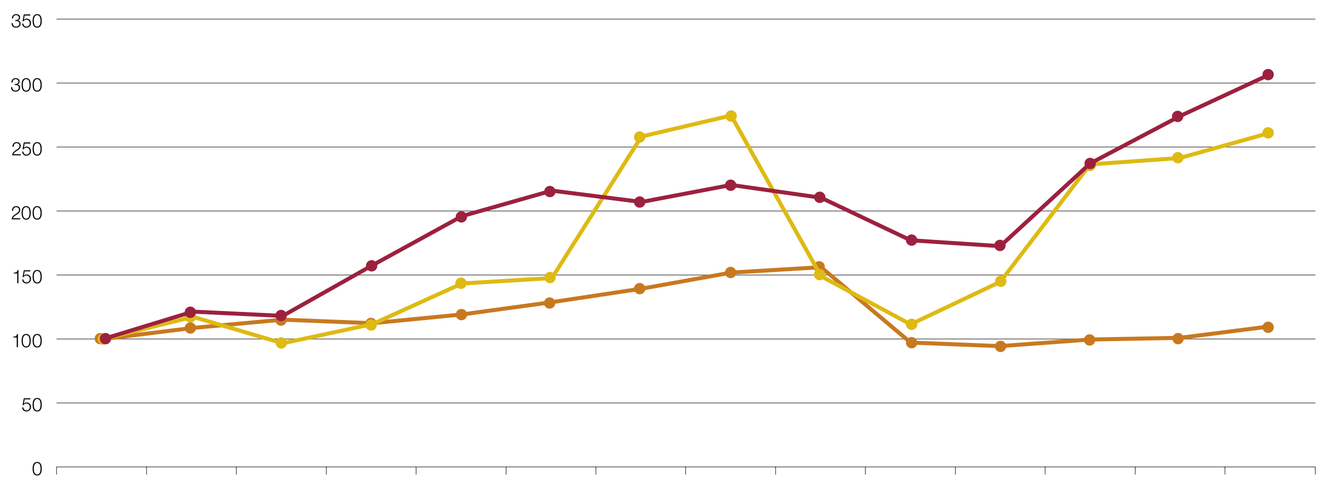
4 Upper Tier Tribunal Court Judgment, Lord Howard of Henderskelfe (Deceased) v Revenue and Customs [2013] UKUT 129 (TCC), 11 March 2013.

5 Court of Appeal Judgment, HM Revenue and Customs v Lord Howard of Henderskelfe (Deceased), [2014] EWCA Civ 278, 19 March 2014.

Figure 10

Indexed change in inheritance tax revenue compared with the cost of agricultural property relief and business property relief

The cost of both agricultural property relief and business property relief has risen faster than overall revenue collected through inheritance tax



	1999-00	2000-01	2001-02	2002-03	2003-04	2004-05	2005-06	2006-07	2007-08	2008-09	2009-10	2010-11	2011-12	2012-13
Agricultural property	100	121	118	157	196	215	207	220	210	177	172	237	273	306
Business property	100	117	97	112	143	148	258	274	149	111	145	236	241	260
Inheritance tax revenue	100	109	115	112	119	129	139	152	156	97	95	100	101	110

Note

1 Figures are indexed from 1999-00 and adjusted for inflation.

Source: National Audit Office analysis of HM Revenue & Customs data on reliefs

Tax avoidance involving reliefs

1.33 HMRC describes tax avoidance as an attempt to exploit legislation to gain a tax advantage that Parliament did not intend. HMRC has highlighted areas where it is concerned about the aggressive use of tax reliefs to avoid tax. Since 2011 HMRC has published 'spotlight' articles online highlighting 19 types of avoidance schemes that it will challenge. Of these, six involve tax reliefs (**Figure 11**). All of the schemes use artificial transactions.

1.34 Avoidance schemes use artificial and complex transactions. HMRC won a recent tax tribunal that involved individuals who had claimed to be engaged in the second-hand car trade. The scheme aimed to generate large tax deductible losses for the incidental cost of obtaining finance. **Figure 12** on page 30 shows how complex the operation of this scheme was and shows the flows of money.

1.35 The boundary between the appropriate use of tax rules and tax avoidance is not always immediately obvious. Some tax planning and use of reliefs goes beyond what is reasonable under UK tax rules, including variations of the examples we have described earlier in this part.

1.36 HMRC has challenged inheritance tax avoidance that uses the purchase of agricultural property as described in paragraph 1.31. An amendment to legislation in 2013 stopped an exploitation of the rules that had allowed debts to reduce the value of an estate regardless of whether the debt was paid after death. Some arrangements involved loans to buy agricultural land that qualified for a relief, so that the taxable value of the estate was reduced twice. Other arrangements involved contrived debts that were not repaid so there was no real reduction in the value of the estate.

1.37 Group companies have been known to take advantage of group relief using artificial means in the past. An unintended consequence of group relief is that it can lead to trading of deferred tax assets. A method used to reduce tax has been the targeted purchase of companies with large trading losses. In 2013 HMRC introduced rules which complement long-standing anti-avoidance rules, to restrict this practice.

1.38 Some companies have used loan arrangements to gain additional tax relief, using artificial structures that provide no operational benefit other than to reduce tax through interest deductions. In Figure 9, the loans come from the overseas subsidiary through money it has borrowed from the market. If the subsidiary was funded by money provided from the operating company, rather than from borrowing, then the arrangement would be unlikely to comply with UK tax rules and would be considered avoidance.

Figure 11

HM Revenue & Customs spotlight articles highlighting attempted abuse of tax reliefs

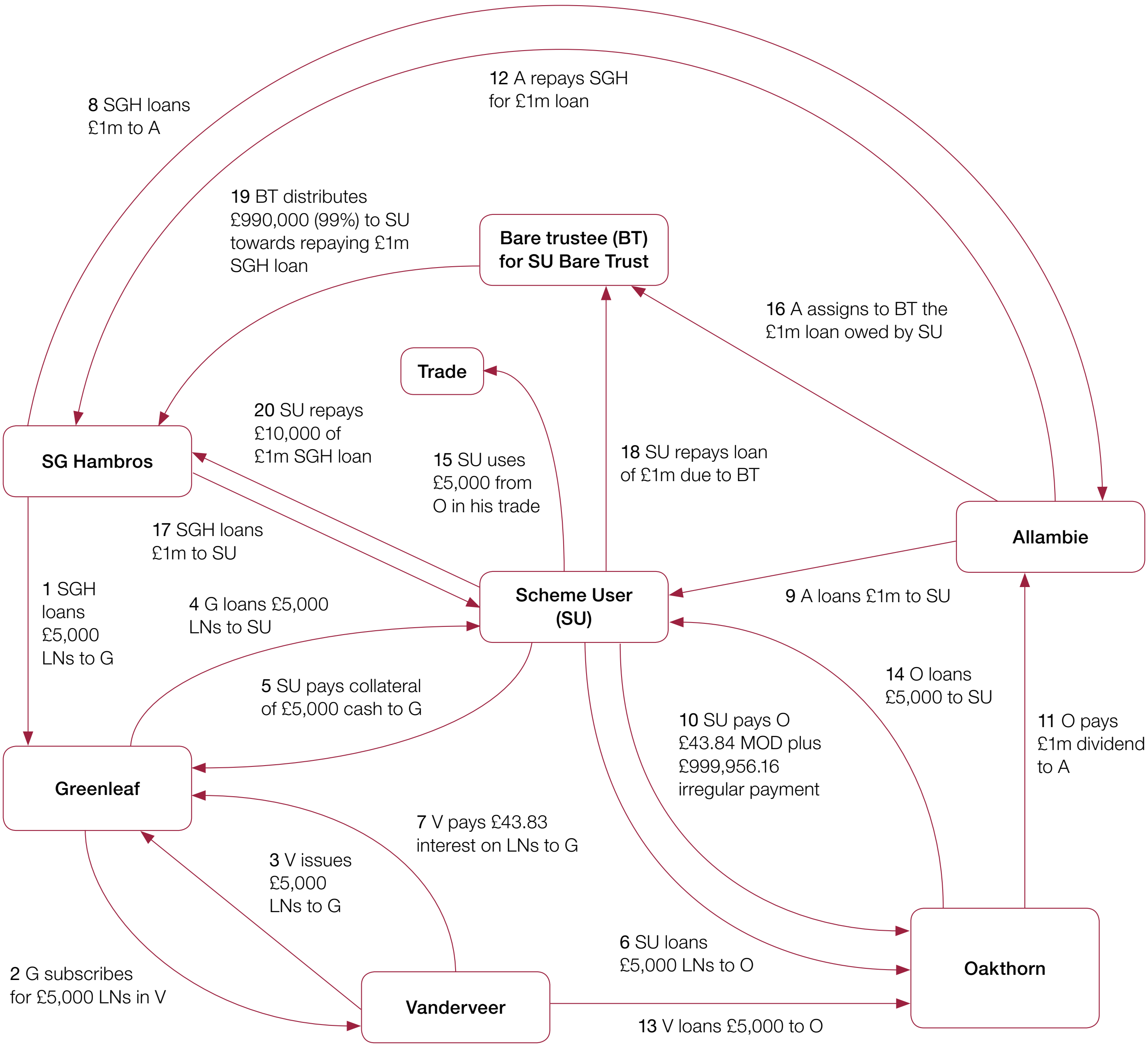
Relief	Abuse of relief
Business premises renovation allowance is intended to support the regeneration of deprived regions of the UK. Business investors can claim a tax allowance for 100 per cent of costs converting or renovating empty business premises.	The schemes use circular loans to increase the expenditure qualifying for relief. The investors' risk is limited as they do not have to repay the loan.
Gift aid enables charities to claim a tax repayment on donations from individuals at the basic rate. Higher rate taxpayers can claim relief for higher rate element.	Uses a circular series of payments, which involve no real gift by the individual. The individual claims tax relief on the 'gift' and the charity claims for a repayment.
Property business loss relief allows people to claim losses arising from agricultural expenses or capital allowances as a deduction from their taxable income.	Schemes use a series of highly artificial transactions to create artificial losses to reduce taxable income. Although the land and the business are genuine, the transactions are not.
Stamp Duty Land Tax (SDLT) relief for intermediaries. SDLT is usually payable when buying or transferring property or land above a certain value.	An intermediary purchases a property and sells it to the real purchaser in circumstances where it is claimed SDLT is not due. For example, a company buys property through an intermediary company, which then immediately issues the property to its shareholders as a dividend. The scheme claims that the shareholder was not liable for SDLT as it had not paid anything for the property.
Share loss relief allows claimants to offset losses on disposing shares in a company against taxable income.	Individuals pay for shares in a company through a non-refundable loan. Losses are said to arise when the shares become of negligible value or they are sold for very little.
Sideways loss relief allows individuals to offset losses incurred in trading against their other tax liabilities.	The schemes aim to create a trading loss for individuals. The schemes are often funded in part by borrowing and may include a mechanism that means repayment is guaranteed.

Source: National Audit Office analysis

Figure 12

Example of complicated transactions in an avoidance scheme

Flow charts of cash in a recent case heard by the Tax Tribunal



Note

1 LN – loan notes; BT – Bare trustee; SGH – SG Hambros; G – Greenleaf; V – Vanderveer; SU – Scheme User; O – Oakthorn; A – Allambie; MOD – Manufactured Overseas Dividend.

Source: Tax Tribunal, decision number TC 03314, available at: www.financeandtaxtribunals.gov.uk/Aspx/view.aspx?id=7618, accessed 4 March 2014

Illegal evasion and criminal attack

1.39 Some reliefs involve customers making claims that entitle them to a payment or refund of tax from HMRC. These include tax credits paid out under film tax relief, payments made to charities under gift aid, and VAT refunds made against zero-rated items. Being able to claim cash payments means that these reliefs are subject to criminal attack. HMRC has processes to identify and tackle criminal attack. We reviewed instances where criminal gangs exploited reliefs such as zero-rated VAT on exports and gift aid to get money from HMRC. In each case, the common approach was to create fake transactions that triggered payments from HMRC (**Figure 13** on pages 32 and 33).

1.40 Film tax relief has also been subject to instances of attempted fraud using fake transactions. In 2013, the individuals behind Evolved Pictures were prosecuted and convicted for misusing reliefs. Under the guise of producing a film, Evolved Pictures told HMRC that it had spent millions of pounds on the film, including paying actors and film set managers. The company claimed that this meant a VAT repayment was due and that the production was entitled to film tax relief. However, during checks HMRC found that this work had not been done. It therefore challenged the company's claims of £1.5 million in VAT repayments and £1.3 million in film tax credit.

1.41 Pension relief is also subject to fraud. Two people were recently found guilty of setting up false pension schemes to claim relief by hiding fake contributions among genuine payments. They triggered almost £5 million of payments to the scheme administrator. The perpetrators included a leading tax professional, the former president of the Association of Taxation Technicians.

1.42 Certain features of the tax system may make them at more risk of abuse. This is an area where more detailed research and evidence gathering would be useful.

The value of tax at risk

1.43 HMRC does not estimate the tax at risk or loss from taxpayers abusing reliefs. Instead, it monitors all the tax it considers to be at risk across the tax streams, without separately identifying which elements relate to the potential abuse of reliefs. It publishes an annual estimate of the tax gap which it defines as "the difference between the amount of tax that should, in theory, be collected by HMRC, against what is actually collected".[6] The IMF considers the UK's estimates of the tax gap to be "one of the most comprehensive studies of the tax gap internationally".[7]

1.44 HMRC estimated the tax gap to be £35 billion in 2011-12. Of this, £4 billion arises from avoidance, a high proportion of which involves exploiting reliefs. It estimates £4.3 billion of potential tax loss from cases where HMRC and individuals or businesses have different views of how the tax law, including rules for relief, applies to specific and often complex transactions. Evasion and criminal attack account for £9.8 billion of the gap. Between £0.5 billion and £1 billion of this is missing trader intra-community fraud.

6 HM Revenue & Customs, *Measuring tax gaps 2013 edition*, 11 October 2013, p. 6.
7 International Monetary Fund, *Assessment of HMRC's Tax Gap Analysis*, August 2013, p. 8.

Figure 13
Abuse of reliefs through fraudulent schemes

Criminals have used complex 'carousel' arrangements to exploit zero-rating of exports

EU Supplier

Trader 'A' buys goods worth £1 million from an EU supplier. The purchases are zero rated for VAT purposes

UK Trader 'A'

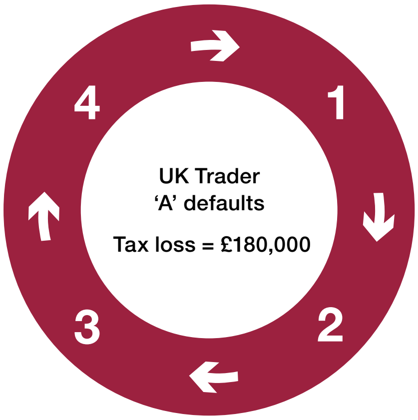
Trader A sells the goods to another UK trader (the 'Buffer') for £900,000 plus £180,000 VAT. The trader disappears, owing HMRC £180,000

UK 'Buffer'

The Buffer sells the goods for £950,000 plus £190,000 VAT to a UK exporter at the end of the chain, and accounts for VAT correctly

UK Exporter 'Broker'

Sells the goods back to the original EU supplier, goods classed as zero rated for VAT purposes. The broker reclaims the input VAT of £190,000 from HMRC



Example

A European Union supplier from another member state sells goods for £1 million to a trader based in the UK free of VAT.

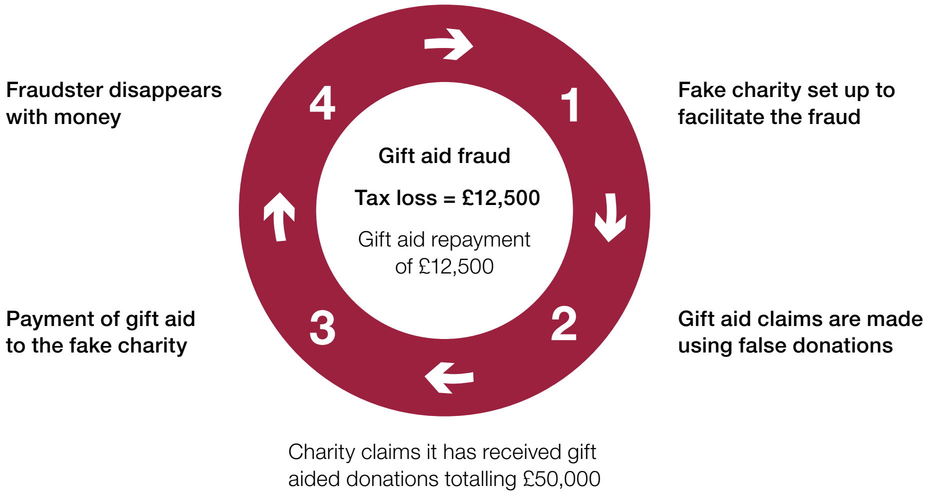
The trader sells the goods to another trader ('the buffer') at a reduced price of £900,000 plus £180,000 VAT. To avoid the price of goods spiralling up each time the carousel turns, one business in the chain must sell at a loss. The initial UK trader subsequently goes missing without paying the VAT due.

The buffer accounts for VAT correctly and sells the goods to a trader at the end of the UK chain ('the broker') for £950,000 plus £190,000 VAT.

The broker makes a zero-rated VAT sale back to the original European Union supplier for £970,000 and is entitled to reclaim the input VAT of £190,000 on the goods purchased from the buffer. HMRC pays the claim and incurs a cash loss because the missing trader did not pay the VAT due on the sale to the buffer.

Figure 13 *continued*
Abuse of reliefs through fraudulent schemes

Criminals have generated fraudulent gift aid payments using similar principles



Example

Fake charity set up. The fraudsters establish a charity within the UK and register with the appropriate regulator. They may use stolen personal information to avoid detection. Alternatively they may hijack a dormant charity.

Gift aid claims are fabricated. The fraudulent charity submits a gift aid claim. In reality the charity has received no donations. Charities have to provide a list of donors. The fraudsters may use stolen personal information so that the donations appear to be from legitimate taxpayers.

Payment of gift aid. If HMRC does not identify the fraudulent activity, the charity will receive a cash repayment. This will be worth 25 per cent of the total value of donations they claim to have received.

Fraudster disappears with money. Having received the cash payment the fraudster disappears with the money.

Source: National Audit Office analysis

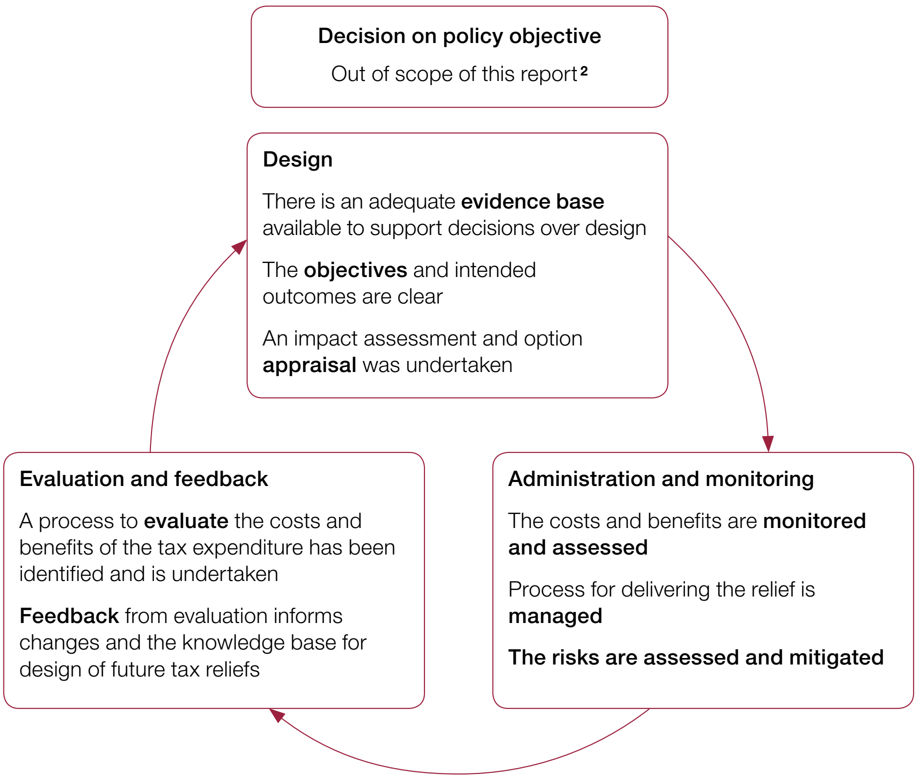
Part Two

How the exchequer departments assess the performance of reliefs

2.1 As government auditors, we expect to see evidence of an effective system of controls to administer tax reliefs. We have considered the approach of the exchequer departments against good practice from Treasury guidance and overseas and academic research (**Figure 14** and Appendix Three).

Figure 14

Characteristics of an effective system to design, manage and evaluate tax reliefs[1]



Notes

1 Some elements of this system are only relevant to tax expenditures.

2 The C&AG does not comment on the merits of policy objectives.

Source: National Audit Office summary of HM Treasury guidance on appraisal and evaluation (*The Green Book* and *The Magenta Book*)

2.2 In this part we consider how reactive the exchequer departments are to emerging differences between the reliefs' performance against their expressed intention and intended benefits. We consider:

- the role of the exchequer departments, the Treasury and HMRC, in developing, monitoring and evaluating tax reliefs;
- how the departments use data to monitor and evaluate the cost and benefit of tax reliefs; and
- whether movements in the value of reliefs merit further investigation.

The role of the exchequer departments in developing, monitoring and evaluating tax reliefs

2.3 The Treasury and HMRC oversee tax reliefs. The Treasury proposes new tax rules and HMRC provides technical advice and feedback on administering the tax system, including tax reliefs. HMRC is responsible for ensuring that tax administration complies with UK and EU legislation, while also making the system as efficient, effective and as easy to understand as possible.

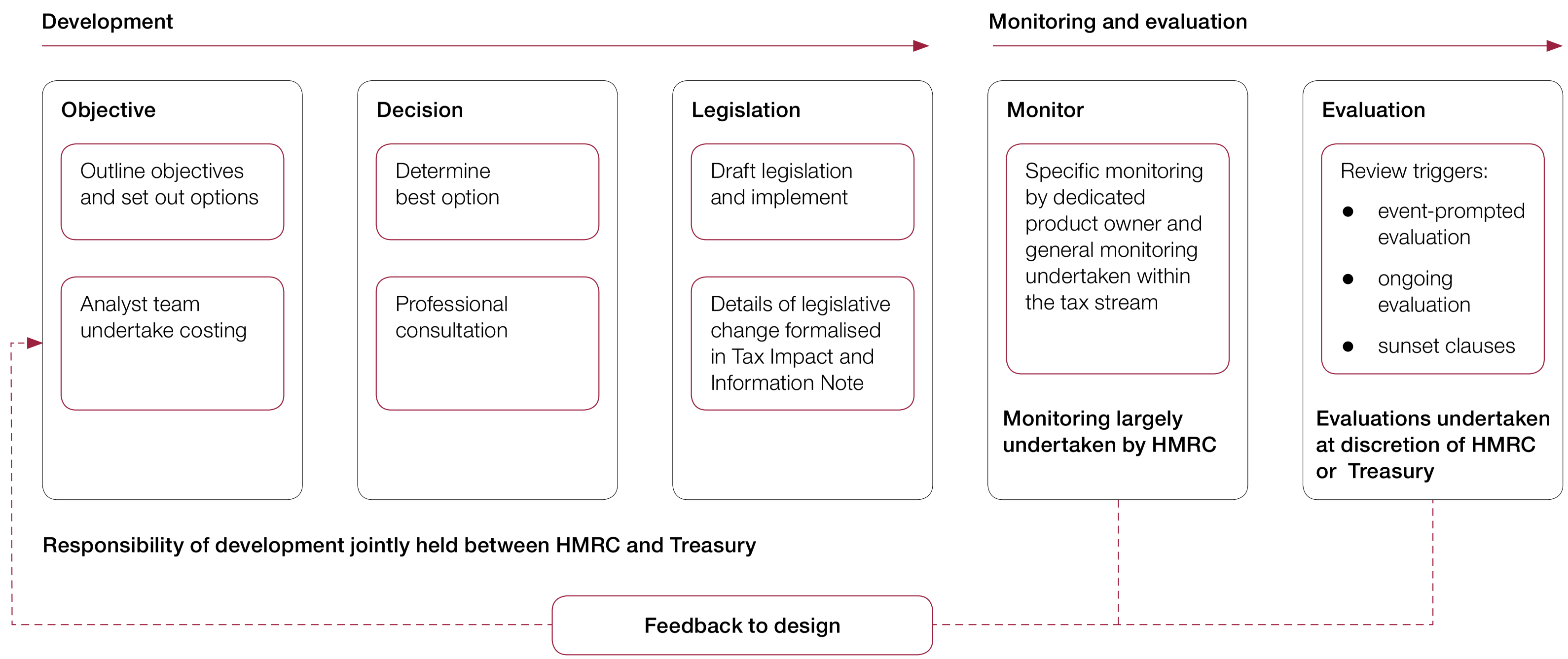
2.4 There is no single accounting officer responsible for tax reliefs. HMRC works in partnership with the Treasury to develop, design and deliver tax policy. The Treasury is responsible for designing tax policy and HMRC implements and maintains it. This work includes predicting the impact of proposed changes to tax reliefs and publishing statistics on tax reliefs and taxes in general. The Office for Budget Responsibility scrutinises HMRC's forecasts for new measures.

2.5 **Figure 15** overleaf shows the management cycle of reliefs and the responsibilities of each department.

2.6 All public sector organisations are expected to follow the principles in Managing Public Money, which sets out the standards expected of all public services. The Treasury also publishes guidance for public sector bodies on completing appraisals before committing funds to a policy (The Green Book) and guidance on evaluation (The Magenta Book). The Green Book sets out the principles in relation to appraisal which may be relevant to the way that policy options for tax expenditures are considered, and should form the basis of any investment decision relating to the implementation or administration of a relief (for example, purchase of new IT systems, creation of new units). Similarly any evaluation of the tax relief which Government commits itself to might sensibly draw on the principles set out in the Magenta Book. Whether and how to act on the outcome of any evaluation which considers the extent to which the relief addresses any policy objectives is a policy matter for ministers.

2.7 The NAO considers that a clearer statement about the responsibility on the exchequer departments for administering tax reliefs and tax expenditures would aid transparency and accountability.

Figure 15
Management cycle for developing, monitoring and evaluating tax measures



Note

1 Dotted lines indicate discretionary parts of the process.

Source: National Audit Office analysis of HM Revenue & Customs and HM Treasury governance process

Developing reliefs

2.8 Tax reliefs are developed the same way as other tax measures. For each budget proposal, a detailed costing is undertaken to forecast the effect of the change on tax receipts for the next five years. These figures are published alongside the Budget. In developing these forecasts HMRC estimates the levels of take-up and possible non-compliance. These assumptions are scrutinised by the Office for Budget Responsibility. HMRC and the Treasury told us that the creation of the Office for Budget Responsibility had brought greater transparency to tax forecasts and receipts.

2.9 In 2010, the government increased the policy cycle for creating new reliefs from 7 to 18 months to allow more opportunities for consultation, options appraisal, and drafting legislation. HMRC told us that where a longer consultation period had been implemented, it had led to fewer amendments to bills because technical issues were resolved in consultation, rather than during the passage of legislation.

2.10 The Treasury has recognised that it should consider new reliefs carefully, and only introduce them when there is a strong and proven case. In June 2010, the Treasury committed to developing a framework for introducing new reliefs.[8] It also proposed to use 'sunset clauses' more, and to do more post-implementation evaluation to ensure that the case for continuation of the relief remains strong. Treasury has not yet introduced the framework for introducing new reliefs.

2.11 Under the Treasury's proposals it argued that when the government makes changes to the tax code there must be enough time for the policy and legislation to be properly scrutinised. In 2011, tax information and impact notes (TIINs) were introduced to replace tax impact assessments. **Figure 16** overleaf summarises the requirements for different types of policy changes. Impact assessments no longer include an options appraisal or quantify the financial impact of risks (such as avoidance) as they did until 2010.

2.12 Staff we spoke to said that the Budget Policy Oversight Panel considers the risks during the design process. The panel consists of Treasury and HMRC directors responsible for developing tax policy. The panel governs across the policy partnership and focuses on risks to policy development within the budget cycle, rather than administrative risks. Our discussions with staff indicated a strong culture in both departments to consider and tackle the risk of avoidance and new measures are routinely proofed against avoidance by specialist staff. However we could not find evidence of a broader, structured risk assessment for new reliefs to identify risks for future monitoring. Instead reliance is placed on continuity of HMRC staff involved in design discussions with Treasury colleagues.

8 HM Treasury: *Tax policy making: a new approach*, June 2010.

Figure 16

Tax information and impact notes are less onerous than impact assessments

Elements included	Spending programme impact assessments	Pre-2011 tax impact assessments	Post-2011 tax information and impact notes
Identification of the problem	✔	✔	✔
Outline policy objective	✔	✔	✔
Options appraisal	✔	✔	✗
Net Present Value calculated for the preferred option	✔	✔	~ [3]
Key assumptions, sensitivities and risks	✔	✔	✗
Comparison with EU requirements	✔	✔	✗
Consideration of environmental impacts	✔	✔	✗
Statement of policy review	✔	✔	~

Notes

1 Tax information and impact notes were introduced in March 2011 to consider a wider range of impacts of tax policy changes than the previous impact assessment regime.

2 ~ denotes partial application.

3 Calculation of exchequer and economic impact is undertaken, but no net present value calculation.

Source: National Audit Office analysis of documents

Monitoring reliefs

2.13 In general, HMRC and the Treasury monitor overall tax receipts for each tax stream. Monitoring arrangements for reliefs vary across HMRC. The department administers most reliefs as part of the wider administration of the relevant tax stream which allows HMRC to take a wider view of how reliefs are used alongside other relevant tax rules. HMRC has over 100 analysts who routinely monitor trends and patterns in tax receipts and the impacts of tax policies. HMRC sometimes uses specialist units to administer a relief and monitor its performance. HMRC must balance competing objectives to collect tax and encourage take-up of reliefs to meet policy objectives. HMRC has greater incentive to focus on collecting tax to achieve targets for tax yield. It has rarely set targets or performance measures for take-up of reliefs, or for achieving social or economic objectives. We observed that some tax teams do focus largely on reliefs. For example specialist teams monitoring share schemes and capital gains tax.

2.14 Within HMRC, each tax is assigned a product owner who has responsibility for the legislative frameworks that define it, including the relevant reliefs. HMRC may assign a dedicated product owner to manage a relief depending on its purpose and significance, and its role in the wider structure of the tax.

2.15 HMRC does not distinguish the cost of monitoring tax reliefs from the wider administration of the tax system. The costs may be significant. The business tax group, whose customers frequently use reliefs, employed 4,000 people and cost £199 million in 2012-13. Around 15 per cent of 27,000 staff working on individuals' tax deal with specialist areas of personal tax where the use of reliefs is common, such as inheritance tax, capital gains, charities and high-net-worth individuals. These areas cost around £110 million to administer in 2012-13.

2.16 HMRC has tailored monitoring arrangements for some tax expenditures. Of the 46 tax expenditures identified on HMRC's website, it has established five dedicated units to oversee nine reliefs. Specialist units oversee tax reliefs relating to research and development, film tax relief and creative sectors, small company investment schemes, foreign business investors, and tonnage tax. HMRC created the units to concentrate expertise because the reliefs require specialist technical knowledge. The reliefs are also intended to promote particular outcomes, such as encouraging investment. The specialist teams help to give customers a consistent service, and to promote compliance and take-up.

2.17 We examined three specialist units (R&D, film tax and the small companies enterprise centre) which HMRC identified as its best practice examples (**Figure 17** on pages 40 and 41). The units did not have targets for take-up but all of these units carried out work to promote the relief. The R&D unit was the only unit to routinely report on performance. It had overseen an increase in claims from 6,000 to 18,000 a year while also reducing resources by 40 per cent. It was also the only unit to test a sample of claims; the other units carried out 100 per cent testing. HMRC told us that the film tax relief unit reviews all claims due to the low volume of applications and undertakes differing levels of scrutiny depending on the detail of the claim. There is a statutory requirement on HMRC to provide a definitive response to any application for Enterprise Investment Scheme or Seed Enterprise Investment Scheme approval. The total staff cost of the units is £4.1 million a year.

Figure 17

Example monitoring approaches adopted by specialist units

Unit	**Research and development (R&D)**	**Film tax relief**	**Small companies enterprise centre**
Reliefs administered	Research and development tax credits Patent box	Creative industry reliefs: film tax relief, relief for animation, relief for high-end TV production	Enterprise Investment Scheme (EIS) Seed Enterprise Investment Scheme (SEIS) Venture capital trusts
Application process	Claims are submitted online as part of yearly tax return submissions Maximum of two years to file a claim – amounts can be amended thereafter (to lesser amounts only)	Claims are submitted online as part of yearly tax return submissions Claims are supported by a cultural certificate, received from the British Film Institute Claims are provisional until film is finished. Any variance is then addressed in the final claim	Investments in EIS and SEIS companies have a statutory requirement to be certified as qualifying by HMRC before investors are eligible to claim tax relief If the company application is successful, individual investors can then apply for relief
Guidance and technical support provided	HMRC internal guidance is publicly available HMRC encourages new claimants to discuss their R&D in advance, to encourage correct claims and ensure that proper records are kept to support claims	HMRC internal guidance is publicly available	HMRC internal guidance is publicly available Companies can contact the unit to obtain advance assurance on whether they are likely to comply with the legislation
Number of applications for relief per year	18,000 (although volumes are rising following the removal of the £10,000 minimum expenditure threshold)	350–450 (volumes will increase with the introduction of more reliefs for the creative industries)	7,000–9,000 (67 per cent of claims get advance approval)
Size of the unit	46	8	30
Number of claims per staff	391	44	217
Annual staff costs for unit	£2.4 million	£390,000	£1.3 million
Percentage of claims reviewed	A sample of claims is audited	All claims are reviewed	All applications are reviewed
Performance monitoring and management	The unit aims to process each tax credit claim within 28 calendar days Annual reporting of cost data and number of claimants There is a general aim to promote take-up of the relief but no target	The unit aims to process each tax credit claim within 28 calendar days Annual reporting of cost data and number of claimants No targets in relation to take-up	The unit aims to process 95 per cent of applications within 30 working days Annual reporting of cost data No targets in relation to take-up

Figure 17 *continued*

Example monitoring approaches adopted by specialist units

Unit	Research and development (R&D)	Film tax relief	Small companies enterprise centre
Work to promote take-up of reliefs	Estimated 50 per cent of the unit's time is spent encouraging take-up. HMRC staff attend trade events to promote the relief, sometimes in partnership with other government agencies Take-up has increased from 6,000 to 18,000 between 2006 and 2013 while senior staff resources have fallen by 40 per cent	HMRC presents at industry events. The unit works with the film industry and their accountants to promote the relief and ensure it works properly	Some promotion work to make investors aware of schemes including promotion through investor-led angel networks For example, after introducing SEIS, HMRC sent flyers to individuals who were more likely to be interested in this type of investment. HMRC also works with the Department for Business, Innovation & Skills to publicise reliefs alongside other initiatives to encourage investment in small companies
Evaluation	One recent evaluation was carried out in 2010 to assess how R&D spend is used and the impact it has had	One informal evaluation carried out since 2007 to support state aid renotification	Evaluations carried out to support state aid renotifications A sunset clause triggered evaluation and closure of the Corporate Venture Scheme in 2010

Source: National Audit Office analysis

Evaluating and reporting on reliefs

2.18 HMRC identifies the major policy changes where there is a case for an evaluation. HMRC has limited resources to undertake this work internally and has to focus on the areas that offer the most valuable return. The exchequer departments sometimes commission independent evaluations of reliefs, provided by external research organisations. HMRC has commissioned 19 such evaluations since 2003, for which it paid £1.8 million in total. Most have tended to focus on the impact of the reliefs rather than assessing the costs of revenue foregone, avoidance or administration. The evaluations cover reliefs costing at least £6 billion a year, around 6 per cent of the known value of tax expenditures. **Figure 18** on pages 42 and 43 summarises the findings.

2.19 The exchequer departments do not have a framework to evaluate tax reliefs systematically. HMRC told us that it tended not to commission evaluations because it did not consider them to be cost-effective. For example, HMRC told us that in some cases it would not be possible to obtain meaningful results from evaluation, or that gathering the necessary data would impose a disproportionate burden on the public or business.

Figure 18

Coverage and findings of formal HM Revenue & Customs and Treasury evaluations, 2012-13

Relief evaluated	Aim of relief	Cost of relief[2] 2012-13 (£m)	Cost of evaluation(s)[1]	Conclusion
Enterprise management incentives (EMI) (2003, 2008)	Share incentive scheme	65	£250,000	2008: A survey of businesses and employees using the relief with EMI suggested there was good awareness of EMI but not of all the features. EMI was used to retain staff and was viewed favourably against other schemes.
ISA review (2007)	Encourage savings	1,900	£55,000	The relief could not help people without money to save. Those who did save use a variety of saving products and were motivated by financial goals rather than tax savings from ISAs.
Enhanced capital allowances for energy saving technologies (2008)	Green agenda	Not known	£200,000	Survey and research findings suggested the scheme had influenced changes in behaviour, with a possible saving of 3,200kT of CO2 emissions.
Enterprise investment scheme (EIS) and venture capital trusts (VCTs) impact on company performance (2003, 2008)	Individual investment in smaller companies	565	£90,000	2008: Companies that used the schemes benefited from increased capital investment, employment and sales compared with other companies. The schemes had little effect on profitability and productivity.
Share Incentive Plan (SIP) and Save As You Earn (SAYE) (2007, 2008)	Share incentive scheme	495	£355,000	2008: A survey of organisations and employees using and not using these schemes suggested they had a positive effect on employee relations. Impact on productivity was neutral.
Gift aid (2007, 2008, 2009, 2012)	Support charitable giving and charities	1,510	£278,000	2009: A survey of 4,000 donors and interviews with 12 major donors suggested that 35 per cent of higher rate donors claimed the relief they were entitled to, those claiming accounted for nearly 80 per cent of higher-rate donations. Changing the system would result in winners and losers.
R&D tax credits (2005, 2010 x2)	Support R&D	1,200	£415,000	2010: Analysis of UK companies' tax returns showed that a £1 relief stimulated £3 investment but had little effect on decisions to engage in R&D. Large companies were the main beneficiaries (90 per cent of the relief by value and two-thirds of applications).
Film tax relief (HM Treasury) (2011)	Support UK film industry	205	Not applicable	Analysis of the cost and uptake of the relief showed it had met its objectives of supporting smaller, limited budget films and encouraging UK film production. The current relief has been less open to abuse than previous versions.
Stamp duty land tax first time buyers relief (2011)	Support first time buyers	150	£45,000	A study of factors affecting the housing market suggested the relief has had no significant impact on affordability and there was no increase in purchase volumes.

Figure 18 *continued*

Coverage and findings of formal HM Revenue & Customs and HM Treasury evaluations, 2012-13

Relief evaluated	Aim of relief	Cost of relief[2] 2012-13 (£m)	Cost of evaluation(s)[1]	Conclusion
Regional employer NICs holiday for new businesses (2011)	Support SMEs[3]	Not known	£35,000	A third of potentially eligible businesses were aware of the scheme. The research highlighted that agents could be used more to promote the scheme.
Seed enterprise investment scheme (SEIS) (2013)	Corporate investment – SMEs[3]	Not known	£48,000	Interviews undertaken to assess the early operation and implementation of SEIS. Initial participation appeared to be relatively low, although this is to be expected given that the scheme had only been open a few months.
Total		**£ 6,090m**	**£1.8m**	

Notes

1 Cost of evaluations are in 2012-13 prices.

2 All cost data comes from published HMRC cost data for 2012-13, where available. With the exception of first time buyers where data used is the nominal cost in 2010-11 and film tax relief, where the cost data comes from HMRC's 2012-13 accounts.

3 SMEs – small and medium enterprises.

Source: National Audit Office analysis of HM Revenue & Customs and HM Treasury research papers

2.20 HMRC's internal analysts may undertake closer examination of a tax relief if they have a material impact on tax receipts. This may result in internal unpublished evaluations of the relief. For example, in 2010 it undertook an evaluation on the reformed regime for pension contributions relief, the largest of the reliefs it categorises as a tax expenditure.

Monitoring changes in the values of reliefs

2.21 HMRC does not actively monitor the actual costs of all new reliefs against forecast amounts. Tax reliefs are not subject to the same controls as spending programmes because there are no budgets and income is not collected, but they are monitored as part of the wider monitoring of tax receipts. Nonetheless variance analysis can be valuable in understanding why levels of tax revenue vary, how far tax reliefs are used, and to detect rising abuse.

2.22 We found limited monitoring of changes in the cost of particular reliefs. HMRC reports estimates of the cost for around 200 reliefs to provide transparency. It also produces corporation tax statistics, R&D statistics and information on film tax reliefs. HMRC's analysis unit does not routinely produce data on trends, unless it is specifically requested. For example, requests for further analysis may be made if a policy change is being considered or if levels of tax receipts are not as expected. The data HMRC publishes annually includes previous year comparators, so significant movements in estimates between years may be identified but movements over longer periods may not.

2.23 Around a quarter of 92 principal reliefs we examined had significant changes in value. We identified 26 tax reliefs that had increased by more than 50 per cent in real terms in the past ten years (to 2012-13). Some 30 reliefs had increased by more than 25 per cent in the past five years. The analysis excludes movements that can be wholly explained by an increase in the rate of VAT.

2.24 In many cases policy changes have contributed to overall changes in the level of tax relief, but this is not always the case. We identified six principal tax reliefs where no policy change had occurred and the value of the relief had increased by more than 50 per cent in ten years. In some cases increases may be due to the growth of particular services or asset values. For example, the value of the exemption from income tax for government securities held by non-residents grew because the amount of government securities held by non-residents increased from £159 billion in 2007 to £417 billion in 2012. Despite cost significantly exceeding original forecasts, HMRC has not reviewed the reliefs.

2.25 Some reliefs have experienced substantial increases within five-year periods. We identified four reliefs that had increased by more than 50 per cent in real terms since 2008-09 and where there had not been a policy change (**Figure 19**). The total value of these reliefs increased from £575 million to £1.2 billion in 2012-13 in real terms. The movements in estimates have not triggered evaluations for any of the reliefs.

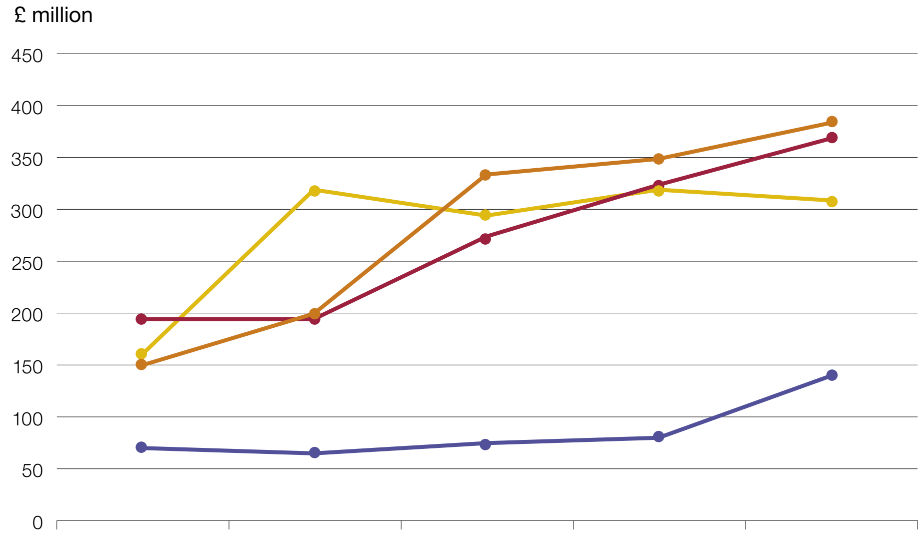
2.26 Even where policy changes cause cost variations, monitoring against forecasts helps assess the impact on tax revenue. We identified nine reliefs where a change in policy did not fully account for the increase in the cost of the relief over the past ten years. For example, **Figure 20** on page 46 shows the correlation between announced changes to venture capital trusts (VCTs) and the enterprise investment scheme (EIS) and the movement in overall costs. The Treasury, in its 2004 budget forecast, estimated that changes to VCTs and EIS – including a two-year temporary change to the level of income tax relief for VCTs – would have no cost impact in 2004-05. The changes would then cost an additional £55 million in 2005-06, and an additional £60 million in 2006-07. In 2004-05 the cost before the change was £200 million. The actual cost increased to £480 million in 2004-05 and to £580 million in 2006-07. In 2007-08, the cost fell to £230 million.

2.27 More recent changes to caps on VCTs and the EIS announced in 2011 are not subject to time limits. Early data indicate that the changes are costing more than expected. The Treasury has forecast these policy changes will add to the cost of the reliefs by £105 million in 2012-13, and then between £110 million and £120 million each year for the following three years. In 2012-13 there was an actual increase of £205 million, almost double the forecast. HMRC told us this is due to the introduction of the feed-in tariffs initiative, from April 2010, that resulted in large amounts of investment into the renewable energy sector.

Figure 19

Tax reliefs increasing by more than 50 per cent since 2008-09

Significant changes in the value of four tax reliefs

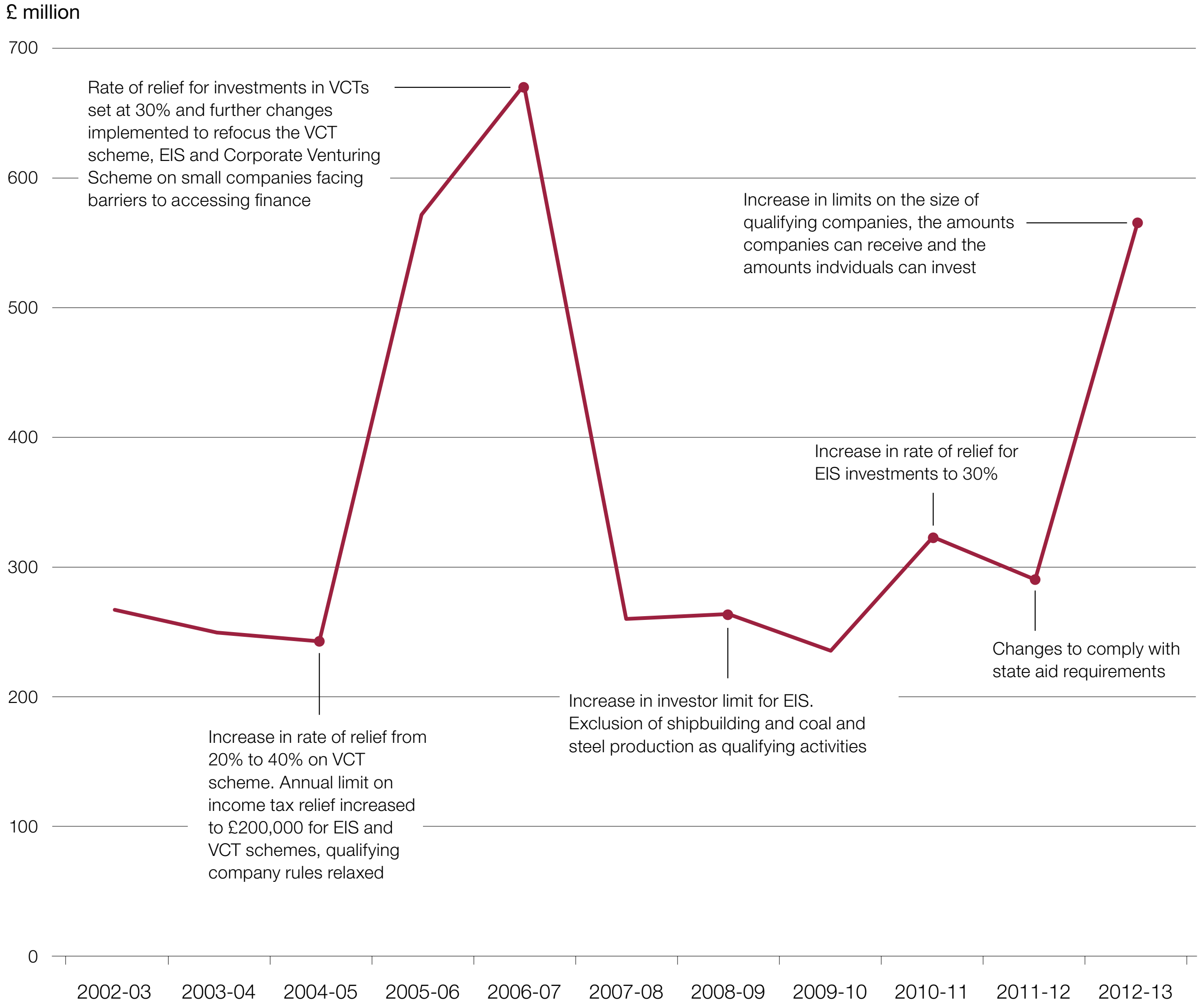


	2008-09	2009-10	2010-11	2011-12	2012-13
Agricultural property	195	195	275	325	370
Share Incentive Plan (Income tax and National Insurance)	160	320	295	320	310
Business property	150	200	335	350	385
Exemption of electricity generated from certain renewable resources	70	65	75	80	140

Source: National Audit Office analysis of HM Revenue & Customs data

Figure 20
Enterprise investment scheme and venture capital trusts

Major policy announcements in relation to EIS and VCTs and changes in cost data



Notes

1 The figures in the graph above are in real terms (2012-13 prices) to aid comparison over a longer time period. The figures in paragraph 2.26 are in cash terms, and not adjusted.

2 Data for EIS (enterprise investment scheme) and VCTs (venture capital trusts) are presented in aggregate to allow comparison with Treasury forecasts.

3 Cost data is from unpublished receipts data provided by HMRC. The budget costing is £55 million in one year and £60 million in the next, £115 million in total.

4 There may be a time lag of one year for the impact of the policy and changes in cost data.

Source: National Audit Office analysis of HM Revenue & Customs data

Part Three

How the exchequer departments assess, monitor and respond to the risk that reliefs are abused

3.1 In Part One we identified how tax reliefs are used and where this may differ from what was intended either from legal interpretation, tax avoidance, tax evasion or criminal attack. In this part we consider how aware or reactive the exchequer departments (HM Treasury and HM Revenue & Customs (HMRC)) are to the risks of abuse. We consider:

- how HMRC tries to design out avoidance;
- how the exchequer departments use information to detect types of abuse;
- HMRC's response to evidence of abuse; and
- the time needed to repeat the management cycle of design, monitoring and evaluation to ensure that reliefs are used effectively.

3.2 HMRC's future business model involves an increased focus on compliance and enforcement. HMRC is reinvesting £994 million between 2010-11 and 2014-15 to tackle tax avoidance, evasion, criminal attack and debt. HMRC expects the investment to help to secure £22 billion a year in compliance revenues by 2014-15 – almost 70 per cent more than 2010-11.

How HMRC designs out avoidance

3.3 Since 2009 HMRC has formally assessed new legislative measures to identify potential avoidance risks. Before that, HMRC considered avoidance risks in new measures on a more ad hoc basis. HMRC assigns new tax measures a level of risk based on, for example, how much of the tax system it covers and an assessment of the cost. Measures assessed as high risk are subject to examination by experienced avoidance specialists at HMRC while still in draft. HMRC also considers the potential for fraud where the reliefs provide payments or credits.

3.4 As part of the design phase of tax reliefs, HMRC also considers how reliefs may interact with other parts of the tax code and the potential this creates for avoidance. This is inherently difficult to do as it involves identifying abnormal ways of using the reliefs, which may rely on the fine detail of legislation. The tax tribunal case, discussed in Part One, demonstrates the complex ways in which avoidance schemes try to take advantage of different parts of the tax code (Figure 12). The scheme relied on combining two rules in the tax code in a novel way, using rules on stock lending which treats manufactured dividends as a fee, and rules on income tax trading which allowed fees to be tax deductible. The manufactured dividend rules would normally only apply to banks and financial traders, and the rules on income tax to individuals. HMRC estimated the total tax at risk from this scheme was £290 million.

3.5 HMRC has had success in using 'principle-based legislation', which sets out at a high level the principle behind the legislation. Although this type of legislation still contains detailed rules, articulating the principle behind the legislation allows the courts to apply the principles to new variants of avoidance that may not have existed when the legislation was drafted. HMRC told us that this is far less likely to result in loopholes than in legislation which is heavily prescriptive. The government introduced 'group mismatch' rules in 2010 using principle-based legislation. These rules tackled incidents where an interest deduction in one group company was not matched by an equivalent receipt in the creditor company. HMRC identified that its previous attempts to tackle this through piecemeal changes to legislation had only resulted in new types of avoidance which attempted to get around the new rules. Since the new legislation was introduced no further schemes of this type have been disclosed.

How the exchequer departments use information to detect threats and abuse of reliefs

3.6 HMRC's primary source of information on the use of tax reliefs comes from taxpayer returns. For each tax stream, case officers check a sample of returns while a series of automated checks assesses the risk for all taxpayers. Certain reliefs are flagged as high risk on HMRC systems. Taxpayers using these reliefs are more likely to be selected for review.

3.7 HMRC checks taxpayer returns against other data sources, including whether a taxpayer uses a registered avoidance scheme. Its CONNECT system checks claims against data collected from a wide range of sources to identify patterns, hidden relationships and inconsistencies or suspicious activity in tax returns. HMRC estimates that CONNECT has yielded around £2.6 billion in extra tax, on an investment of £45 million since it was launched in 2010.

3.8 HMRC is adding 100 extra investigators and extra risk and intelligence staff to identify and deal with avoidance and evasion by the wealthiest individuals. It is increasing the number of specialist personal tax inspectors to prevent inheritance tax evasion and avoidance, using offshore trusts, bank accounts and other entities.

3.9 HMRC seeks to keep the administrative cost of the tax system, including the burden it imposes on taxpayers, to a reasonable minimum. Tax returns therefore have a limited capacity which restricts the amount of information HMRC collects on tax reliefs. HMRC lists 219 tax reliefs on its website where the cost of reliefs is not known because data is not collected. Gaps in data also restrict the potential for computer checks. HMRC has people and systems to assess the risk of abuse based on information from third parties, but their effectiveness depends on the quality of the information provided.

3.10 HMRC has developed ways to provide earlier warning of avoidance. Since 2004 'disclosure of tax avoidance schemes' (DOTAS) rules require promoters to tell HMRC about their schemes. Scheme users should put the scheme reference number on their tax returns. HMRC checks for anomalies. However some promoters seek ways to not disclose schemes, meaning HMRC must still undertake other checks to identify all avoidance schemes. HMRC has consulted on enhancing DOTAS and improving the information it collects and draft legislation for the 2014 Finance Bill was published in January 2014.

HMRC's response to evidence of abuse

3.11 Where HMRC identifies abuse of reliefs it has a choice of responses. Its course of action will depend on whether the misuse of a relief is technically legal or illegal and the strength of its evidence. It can:

- propose changes to legislation in response to avoidance activity to keep the use of tax reliefs within the intended scope;
- litigate and test the avoidance activity at tax tribunal; and
- investigate and prosecute where fraud is suspected.

Responses to avoidance activity

Use of legislation

3.12 When HMRC detects an avoidance loophole it may recommend that the government changes the law. Parliament has enacted 40 anti-avoidance measures since 2010. HMRC may advise that legislation is introduced quickly to counter further activity of a similar nature, particularly where the avoidance activity puts large amounts of tax at risk. This may be done as a precautionary measure, where HMRC believes that the avoidance will not succeed when tested in court but wants to stop further claims. This has allowed loopholes to be closed within days of HMRC becoming aware of them (**Figure 21**). HMRC may also recommend that the government introduces a targeted anti-avoidance rule to improve compliance with existing legislation.

3.13 Sometimes reliefs may be abolished entirely in response to abuse. In December 2012 the government announced that it would abolish income tax relief for the payment of patent royalties, with immediate effect. HMRC had no evidence of any use of the relief that was not for the purpose of tax avoidance.

3.14 Government introduced a 'general anti-abuse rule' (GAAR) from July 2013, which is designed to tackle abusive tax avoidance schemes where the current law is unable to defeat arrangements that achieve a tax outcome the legislation had not intended. HMRC will need to prove to the court whether a particular arrangement is abusive, rather than for the taxpayer to prove that it is not. The rule is subject to a 'double reasonableness' test as a taxpayer safeguard and an independent panel will provide non-binding advice on whether it is appropriate for HMRC to proceed with a GAAR challenge.

Figure 21

Example of the early detection of avoidance activity and counteraction through legislation

In late 2009 HMRC received information of an avoidance scheme that was about to launch. The scheme used reliefs available on the donation of shares. The promoter was known to HMRC as being active in the creation and marketing of avoidance schemes. Based on the promoter's prior activity, HMRC were able to judge the likely scale of take-up for the scheme, which they assessed was likely to put tens of millions of pounds of tax revenue at risk.

HMRC did not have a complete picture of how the scheme planned to operate at this time. It believed it would have been able to challenge the scheme under existing legislation, but advised ministers to introduce immediate measures that would stop the scheme from running.

In December 2009 the Financial Secretary to HM Treasury announced that the government would introduce measures in the Finance Bill 2010 to tackle this particular form of abuse. He also announced that the measures would take effect from the date of his speech.

The detection and counteractions stopped this particular scheme from being successfully marketed.

Source: National Audit Office analysis

3.15 The rule has yet to be tested in practice. HMRC estimates that introducing this legislation will protect £235 million in tax revenue between 2014-15 and 2017-18. HMRC has published examples of cases that it believes would have been prevented under the GAAR. Four of these directly relate to misuse of tax reliefs, including a case involving capital allowances worth over £70 million in lost tax.

Litigation of avoidance activity

3.16 Dealing with attempts to avoid tax using reliefs does not necessarily require a change to the law. HMRC may assess that the scheme does not work under current legislation. Where HMRC disputes the use of a tax relief it will issue a revised assessment of the tax liability, or it may take other appropriate action and encourage taxpayers to settle and make appropriate payment as early as possible. Where the taxpayer is unwilling to settle, HMRC will continue to challenge the claim and, if necessary, contest it in the courts. **Figure 22** overleaf shows an example timeline for this process based on five marketed avoidance schemes involving tax reliefs.

3.17 Avoidance schemes can take a long time to investigate and resolve. Some scheme promoters deliberately slow down the process because some tax rules allow taxpayers to hold on to disputed tax, no matter how unlikely they are to succeed. HMRC estimates there are around 65,000 open cases involving marketed tax avoidance schemes. Over 85 per cent of these date back to 2009-10 or earlier. Two significant areas of open avoidance cases are stamp duty land tax reliefs and sideways loss relief. HMRC has consulted on measures to accelerate the payment of disputed tax where similar claims have already failed and these will be included within Finance Bill 2014.

3.18 HMRC has a good rate of success when it does litigate. In November 2012, we reported that between April 2010 and October 2012 110 cases entered litigation. Of these cases 60 had judgments at the time of our report, and HMRC had been successful in 51 (85 per cent) of them.

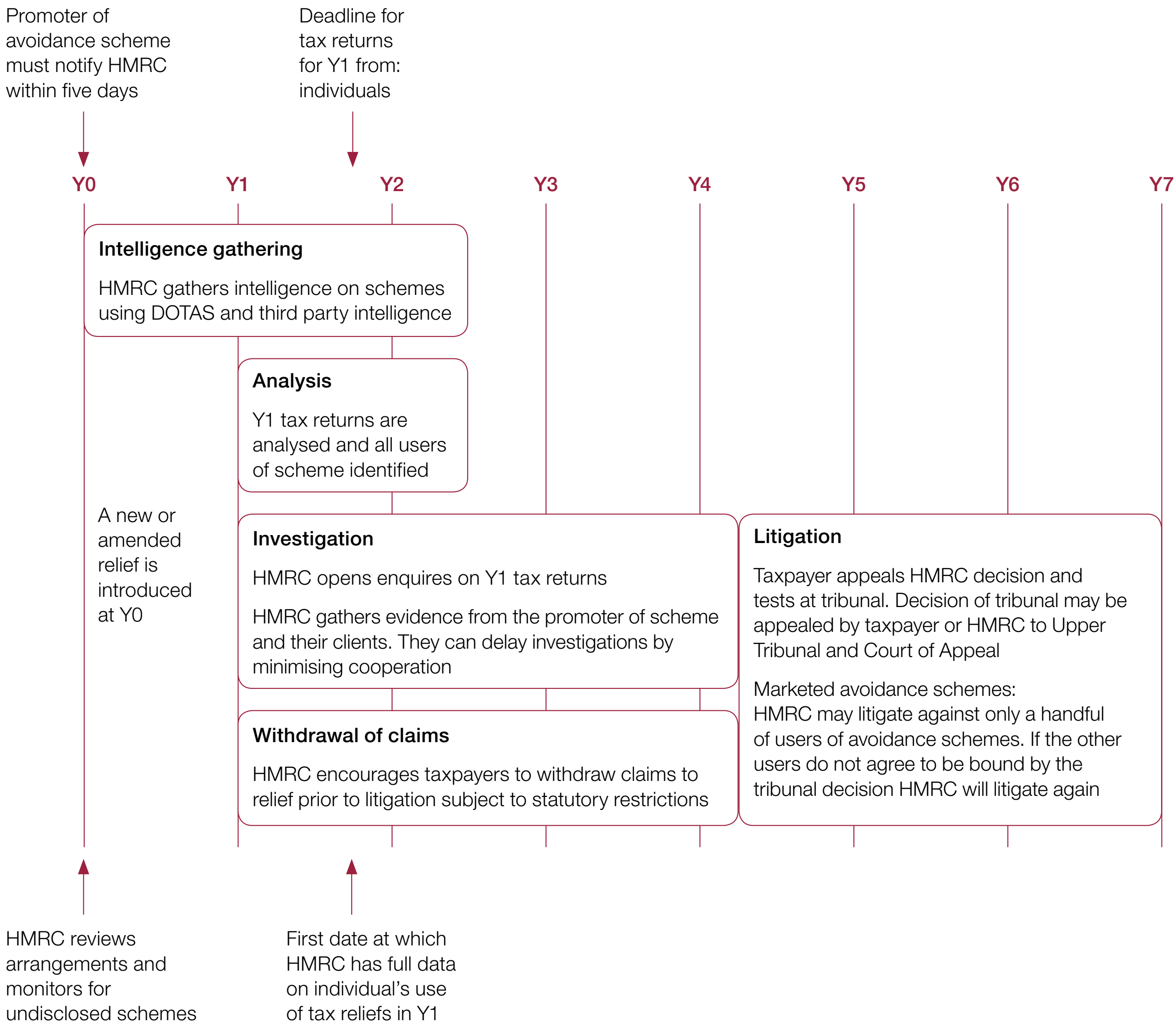
Responses to fraud

3.19 HMRC statistics indicate that the tax gap has reduced over the past six years as a proportion of tax due. It has fallen from 8.3 per cent of tax due in 2005-06 to 7 per cent in 2011-12.

Figure 22

Example timeline to detect and counter avoidance activity abusing tax reliefs

Phases in HMRC's response



Notes

1. This figure is an indicative example based on the average times taken to investigate and act against five marketed avoidance schemes targeted at a relief. Actual times vary. The shortest period we reviewed from a scheme starting to the resolution of all claims was 4.5 years and the longest was 10 years.
2. The length of time from a scheme launching to HM Revenue & Customs receiving tax returns will vary depending on when the scheme launches and the rules on claiming the relief.

Source: National Audit Office analysis of HM Revenue & Customs data on marketed avoidance schemes that use reliefs on donations; HM Revenue & Customs, Tackling Marketed tax avoidance consultation document, January 2014

3.20 One significant reason for the reduction is HMRC's progress in tackling missing trader and carousel fraud of VAT (we illustrate this abuse in Figure 13). HMRC is reinvesting £25 million of efficiency savings to projects directly related to tackling VAT missing trader intra-community fraud, with the aim of generating benefits of £1.6 billion over the spending review period. We reported in 2012-13 that HMRC had used industry intelligence well to respond to the risks of VAT fraud and had liaised with other European tax administrations to tackle it. By enhancing its monitoring of business sectors and introducing a number of sector-specific interventions, it has reduced the tax loss from a peak of £3 billion to £4 billion in 2005-06.[9] The amount of tax lost has stayed broadly stable between £0.5 billion and £1.5 billion from 2007-08 onwards with the estimate for 2011-12 being between £0.5 billion and £1.0 billion.

3.21 HMRC is also setting up local taskforces to identify and deal with tax cheats, using criminal and civil powers. These taskforces have focused on activity relating to specific reliefs. For example, in July 2011, an HMRC taskforce focused on fast food establishments in London, where the amount of zero-rated VAT sales did not conform to HMRC's expectations based on its analysis of national data. This taskforce raised £25 million by encouraging businesses to make accurate disclosures about their VAT obligations rather than risk prosecution.

3.22 HMRC is allocating more resources to increase the pace and number of tax evasion cases being brought before the criminal and civil courts. It has recruited an additional 200 criminal investigators to increase the number of people prosecuted for tax evasion from only 165 in 2010-11 to 1,165 by 2014-15.

Timeliness of HMRC's response

3.23 The timeliness of data on tax reliefs is limited by the timing of tax returns (although some claims for relief may be made outside the tax return process). Although data are collected monthly for PAYE returns, filing deadlines for the self-employed and companies, where the risk of abuse is greater, lag behind the financial year to which they relate.

3.24 A risk with introducing new reliefs is that they will cost more than expected, both through legitimate and improper use. HMRC's monitoring needs to be informed by an accurate understanding of taxpayer behaviour. Depending on the timing of events and accounting periods, individuals and companies can file returns up to 21 months and two years (for companies) after a relief is first used.

9 Comptroller and Auditor General, *HM Revenue and Customs 2012-13*, 2 July 2013, Part 3.

3.25 In Part Two we reported on monitoring arrangements for three units, which HMRC identified as good practice examples. Here we review how the costs of film tax reliefs and R&D reliefs changed following policy changes, to consider the challenge in maintaining the effective design of reliefs. Two of the reliefs monitored by the third unit – the small companies enterprise centre – are discussed in paragraphs 2.26 to 2.27.

3.26 We found that the costs of film tax relief have varied significantly following policy changes. **Figure 23** shows how the annual cost of film tax relief rose to over £650 million at its peak in 2006-07. When film tax relief was introduced in 1997 it was forecast to exist for three years and to cost £30 million.[10] Both HMRC and the Treasury acknowledged that the design of the relief meant it was susceptible to abuse by avoidance schemes. Further changes were made to extend the scope of the relief before evidence of abuse was uncovered. The Treasury forecast that restrictions it had introduced in 2002 would save over £200 million in each of the subsequent two years.[11] Further measures were introduced in 2005 to curb avoidance, however costs continued to increase until 2007 when the relief was redesigned and reintroduced. Since 2007 the relief has focused on the producers of films, rather than the investors under the old scheme, and since this change HMRC does not believe that this relief can be subject to the same large scale abuse.

3.27 In contrast, the cost of R&D tax credits has risen broadly in line with forecasts from £590 million in 2004-05 to £1.2 billion in 2011-12. A number of factors may have contributed to this success, spanning the development, monitoring and evaluation cycle. The Treasury has steadily broadened qualifying criteria in four stages over nine years. HMRC's R&D specialist unit publishes an annual report of performance, and in the past ten years it has undertaken three evaluations. This was the only relief we identified where cost–benefit analysis had been used to consider its success in achieving its objectives.

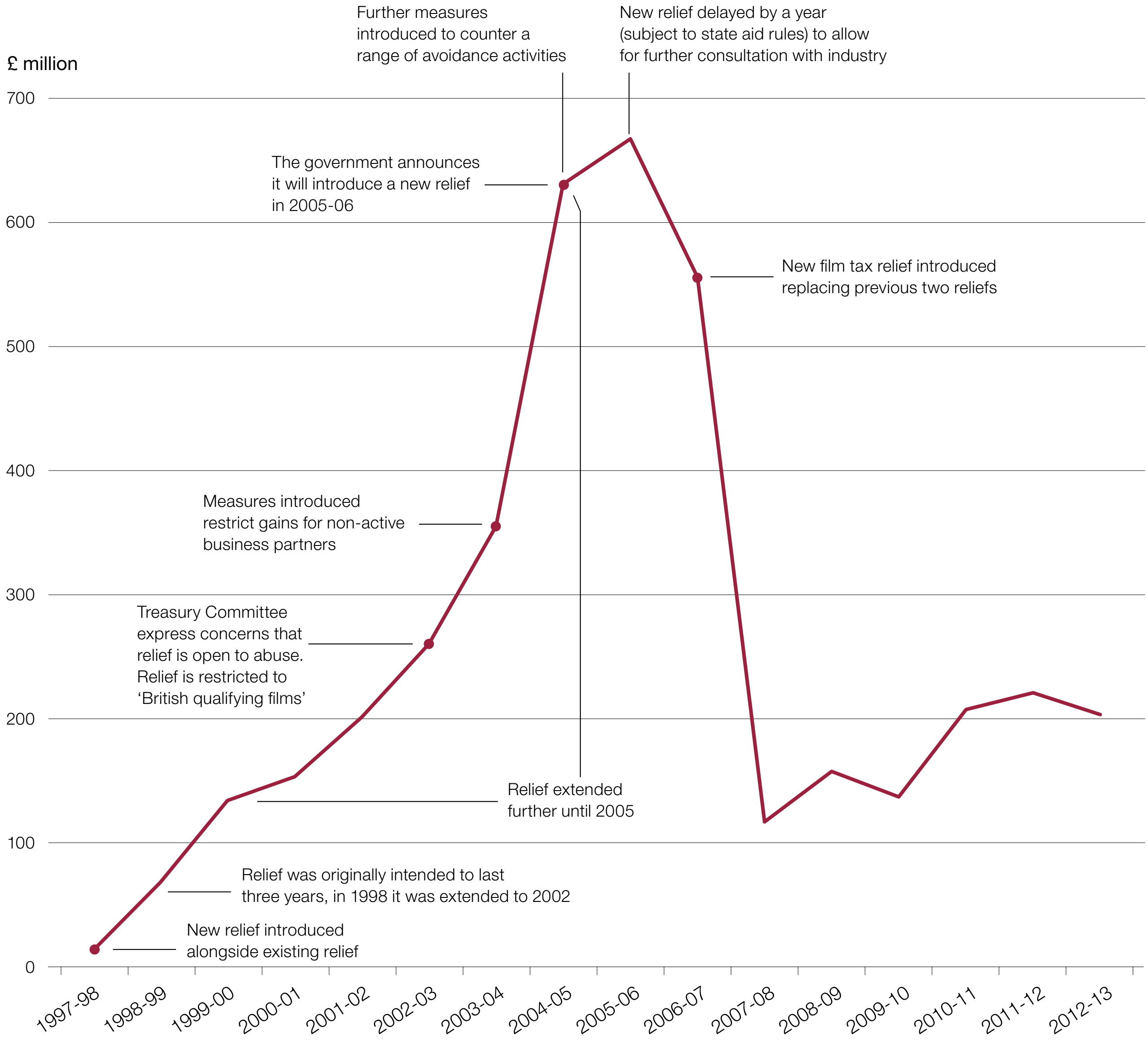
3.28 By collecting data from across its business in real time – such as to track how a new relief or a significant change to relief is being exploited – HMRC could detect emerging threats sooner, allowing it to act more quickly to safeguard revenue. Appendix Three identifies good practices that it can follow to improve assurance on performance through the lifecycle of reliefs.

10 House of Commons Debate, 2 July 1997, cc 307-308, available at: www.publications.parliament.uk/pa/cm199798/cmhansrd/vo970702/debtext/70702-21.htm#70702-21_spmin1, accessed 10 March 2014.

11 HM Treasury, Budget 2002, available at: http://webarchive.nationalarchives.gov.uk/20100407010852/http:/www.hm-treasury.gov.uk/bud_bud02_chapter_a.htm, accessed 10 March 2014.

Figure 23
Cost of film tax reliefs

The cost of film tax reliefs before and after the new relief was introduced



Notes

1 Costs are in 2012-13 prices.

2 The cost data for 1997–2006 relate to the existing 'Section 42' relief from 1992 and the new 'Section 48' relief introduced in 1997.

Source: National Audit Office analysis of HM Revenue & Customs data

Appendix One

Our audit approach

1 We intend to carry out a series of studies to assess whether in developing, introducing and modifying tax reliefs, the exchequer departments (HM Treasury and HM Revenue & Customs (HMRC)) exercise appropriate control and rigour. This report examines the administration of the overall system of tax reliefs and, following this landscape review, we intend to examine the administration of particular reliefs.

2 This report considers:

- the landscape of tax reliefs in the UK and the risks they carry, with examples of how they are abused;
- how the exchequer departments assess the performance of reliefs and respond to emerging differences between their performance and their intended objectives; and
- how the exchequer departments assess, monitor and respond to the risk that reliefs may be abused.

3 Our audit approach is summarised in **Figure 24**. Our evidence base is described in Appendix Two.

Figure 24
Our audit approach

The government's objective

The coalition government wants to reform the tax system to make it more competitive, simpler, greener and fairer.[1] The Treasury has identified the need for more scrutiny and evaluation of tax policy reforms including reliefs.[2]

How this will be achieved

The Treasury and HMRC share oversight of tax reliefs. The Treasury is responsible for strategic tax policy design and HMRC for delivering and maintaining policy and the administration of the tax system. In 2010 the Treasury committed to developing a framework for the introduction of new reliefs.

Our study

The study considered:

- the range and scale of tax reliefs and the risks they carry;
- the nature of risks reliefs carry, such as abuse; and
- how the Treasury and HMRC monitor, assess and manage the performance of reliefs.

Our key questions

What is the range and scale of tax relief and what risks do reliefs carry?

How do the exchequer departments assess the performance of reliefs and respond to emerging differences between their performance and their intended objectives?

How do the exchequer departments assess, monitor and respond to the risk that reliefs are abused?

Our evidence

(see Appendix Two for details)

We considered the scale and risk of tax reliefs by:

- commissioning the Tax Administration Research Centre to consider the definition and categorisation of tax reliefs;
- reviewing Budget and HMRC publications;
- reviewing work by the Office of Tax Simplification identifying the number of reliefs;
- reviewing methods of categorisation considered by HMRC; and
- reviewing published examples and other literature to consider risks of reliefs.

We assessed the departments' performance by:

- developing a good practice framework from academic and tax administration research;
- reviewing design guidance and the scope of impact assessments;
- conducting case studies of good practice units identified by HMRC;
- interviewing staff in the Treasury and HMRC;
- reviewing published evaluations; and
- comparing relief cost data over time.

We reviewed the response of departments to the risk of abuse by:

- reviewing HMRC reports of the tax gap;
- considering HMRC plans to reduce abuse for examples relating to reliefs;
- checking how many spotlights on abuse relate to reliefs; and
- for good practice case example reliefs mapping out cost and policy changes to consider the speed of response of the exchequer departments in tackling abuse.

Notes

1 The Coalition: our programme for government (May 2010), available at: www.gov.uk/government/uploads/system/uploads/attachment_data/file/78977/coalition_programme_for_government.pdf, accessed 10 March 2014.

2 HM Treasury, *Tax policy making: a new approach*, June 2010.

Appendix Two

Our evidence base

1 We reached our findings on the administration of the overall system of tax reliefs in the UK following our analysis of evidence collected between October 2013 and January 2014.

2 This landscape review does not seek to conclude on the value for money of the overall system of tax reliefs in the UK. Instead it sets out: the number and value of tax reliefs in the UK and how they are used; the systems in place to administer tax reliefs in the UK; and what we would expect from an effective system of controls throughout the lifecycle of tax reliefs.

3 To define the tax reliefs landscape and assess how tax reliefs are administered in the UK:

- We undertook interviews with HM Treasury and HMRC on the design, monitoring and evaluation processes that exist for tax reliefs. We also undertook specific discussions on risk and abuse with HMRC's anti-avoidance team.
- We visited three specialist units (the R&D Unit in Cambridge, the film tax and creative team in London and the Small Companies Enterprise Centre in Cardiff). We also conducted interviews with the specialist teams that monitor share and saving schemes, pensions, capital gains tax and inheritance tax. We observed how reliefs are discussed at tax stream level (for corporation tax).
- We met the Office of Tax Simplification to discuss the work they undertook in 2011. We undertook further analysis with them to provide an updated total of the number of reliefs in the UK. We compared this data to the data produced by HMRC.
- We analysed published HMRC data on the cost of reliefs, on the tax gap and from its regular 'spotlight' publications on avoidance. We adjusted costs to reflect real rates where appropriate.
- We examined relevant Treasury publications, including budget publications for the past ten years. We mapped out cost and policy changes to consider the speed of the exchequer departments' response in tackling abuse. We adjusted costs to reflect real rates where appropriate.

- We undertook a review of Tax Information and Impact Notes (TIINs) and evaluations published by HMRC and the Treasury relating to reliefs. We compared these to the coverage of previous tax impact assessments and public expenditure impact assessments.
- We held discussions with various experts, including tax practitioners, academics and government officials.

4 To establish a framework for the effective control throughout the lifecycle of a relief:

- We reviewed HMRC's developing framework for categorising reliefs.
- We commissioned the Tax Administration Research Centre to consider: how to define and categorise tax reliefs; how tax reliefs should be costed; and appropriate methods for evaluating the effectiveness of tax reliefs.
- We undertook a literature review to provide overseas comparisons. We reviewed relevant reports on tax reliefs produced by individual countries, comparative information produced by the International Monetary Fund and the Organisation for Economic Co-operation and Development (OECD) and guidance produced by the US Government Accountability Office.

Appendix Three

Good practice approaches to improve assurance over tax reliefs

1 **Figure 25** identifies good practice examples that can be followed to improve assurance on performance through the lifecycle of reliefs.

Figure 25

Good practice approaches to improve assurance over tax reliefs' performance

Good practice examples

Overall governance and reporting of reliefs

Clear institutional framework
Tax reliefs should only be developed through structured processes and with parliamentary authority. Costs should be estimated annually and reported to Parliament alongside the regular budget proposal to the legislature.

Categorising reliefs
Categorise by purpose and delivery mechanism. New Zealand developed a matrix to identify tax expenditures and have started to categorise tax expenditures by type (whether the objective is social, business or other) or on how they impact current tax take. Other countries have also categorised reliefs in different ways, for example by function or tax area.

Managing the number of reliefs
The German government's overall aim is to reduce and revise the number of tax reliefs. In the UK, the Office of Tax Simplification reviewed 155 out of 1,042 reliefs and recommended 47 be abolished.

Use sunset clauses and time limits
Germany normally set a time limit for its tax expenditure before a relief is introduced. The US use sunset clauses on some tax expenditures, at the date of expiry the tax expenditure must be reconsidered.

Figure 25 *continued*
Good practice approaches to improve assurance over tax reliefs' performance

Pre-implementation

Undertake analysis
Analyse the proposed legislation to identify specific risks in relation to administration of the relief and opportunities for abuse.

Get pre-implementation measurements
Both empirical and behavioural for a sample of taxpayers to research options.

Use sample data
Collect sample data from taxpayers to undertake cost–benefit analysis to forecast the effects of the tax relief.

Testing of options
Extend cost–benefit analysis to appraise different options, possibly using micro-simulations or computable general equilibrium models.

Undertake sensitivity analysis
Given difficulties quantifying behavioural effects, obtain a range of possible values.

Consider how the tax relief will be administered and whether additional collection of data is required.

Monitoring and evaluation of individual relief

Routinely collect available data and compare to forecasts. Variances from forecasts should lead to more in-depth review.

Consider the accuracy of cost estimates
In its budget reports France provides an indication of how good cost estimates are.

Variances in relief trigger further analysis and evaluation

Supplement with additional data
If necessary – to improve understanding of the effect of the relief's introduction and to determine its overall success.

Regularly compare tax expenditures with public spending alternatives
The Australian Tax Expenditure Statement 2012 includes a table comparing the cost of tax expenditures to the cost of direct expenditures in the same area.

Regularly evaluate reliefs
In the Netherlands and Canada, tax reliefs are reviewed on an ongoing basis by the Department of Finance, aiming to review each relief every five years.

Source: Analysis of academic research and practices reported by other tax administrations

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National Audit Office

Design and Production by NAO Communications
DP Ref: 10390-001

£10.00

ISBN 978-1-904219-16-3

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