

The Monitoring and Control of Tax Exemptions for Charities



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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Summary and conclusions

Introduction

1 The National Audit Office estimate that there are around 300,000 charitable bodies in the United Kingdom entitled to a range of direct tax benefits. Charities are exempted from income tax and corporation tax on most sources of income and from capital gains tax provided that their income and capital gains are applied for charitable purposes only. These reliefs are worth up to about £1 billion annually. There are also inheritance tax reliefs for property given to, or held by, charities. Three bodies, with a variety of differing powers, are responsible for the general support and supervision of charities across the United Kingdom: the Charity Commission in England and Wales; the Scottish Charities Office; and the Charity Branch of the Department of Health and Social Services for Northern Ireland. However, as tax rules apply uniformly throughout the United Kingdom, there is one system of tax relief. For the direct taxes other than inheritance tax this is handled by the Financial Intermediaries and Claims Office (FICO), an Executive Office of the Inland Revenue. Inheritance tax is administered by the Capital Taxes Office and is outside the scope of this study.

2 FICO administer the exemptions from income tax, corporation tax and capital gains tax enjoyed by charities, repay the tax deducted at source from their income (£744 million in 1996-97) and supervise the operation of covenanted giving, gift aid and payroll giving. Their primary objectives are to ensure that bodies which qualify for tax exemptions obtain the benefit of those exemptions and comply with their tax obligations. They seek to achieve these objectives principally through:

- administering repayments of tax to bodies eligible for tax exemptions;
- detecting and correcting non-compliance with tax law;
- deterring avoidance and encouraging the prompt settlement of tax liabilities; and
- maximising voluntary compliance.

Main findings and conclusions

The administration of tax exemptions for charities

3 Eligibility for tax exemptions is decided on the basis of charitable status. Charities can, at present, claim payment of tax credits on United Kingdom company distributions and repayment of tax deducted from their income - in particular, donations received under deed of covenant and gift aid. Deeds of covenant may include deeds made by trading subsidiaries of charities by which the subsidiary's profits are donated to the parent charity. Before paying a tax claim made by a body purporting to be charitable, FICO check that the body is in fact a charity. The National Audit Office examined 60 applications to FICO by bodies claiming charitable status and found all but one of the cases had been properly evaluated against the qualifying criteria, and FICO had already put the one exception right before the National Audit Office's study. There are some forms of income, such as bank and building society interest, which many organisations - including charities - are entitled to receive without deduction of tax, by self-certifying their status to the payer. Recent developments in FICO's compliance strategy, together with their more general work in monitoring schemes such as the tax deduction scheme for interest, should provide some assurance that charities receive income without deduction of tax only in appropriate cases. However, FICO do not have records of the number of charities receiving income without deduction of tax or the value of that income.

Recommendation 1

FICO should consider undertaking a special project to establish the level of risk to the Exchequer from the tax exemptions enjoyed by charities which do not make repayment claims and review whether their compliance strategy properly addresses the risks in such cases (paragraph 2.9).

4 In 1996, the Charity Commission removed more than 8,000 charities from their register, the majority of which no longer existed or had merged with other charities. In such cases, there was a risk that organisations could continue to be in a position to receive tax repayments if FICO are not aware of the decision. Until recently, the Charity Commission sent FICO details of some, but not all, of the organisations they had removed from their register. Following discussions in January 1997, the Charity Commission have agreed to send FICO details of all charities removed from their register due to activities incompatible with their status, or for other reasons. FICO have now received the first details under this agreement. The National Audit Office welcome this development.

Recommendation 2

FICO Bootle should consider how best to use the additional information provided by the Charity Commission about charities removed from their register to help minimise the risk of organisations being in a position to receive tax repayments in inappropriate cases (paragraph 2.18).

Targeting compliance work

5 FICO's compliance effort consists of repayment checks, charity audits and accounts examinations. They check that all repayment claimants are entitled to tax exemptions, perform arithmetic checks on all larger claims, and carry out additional more detailed checks on a sample of claims. Charity audits involve the inspection of records maintained by organisations in support of repayments of tax paid on donations made under deeds of covenant and gift aid. Accounts examinations are carried out in three stages: a basic scrutiny of charity accounts; a technical review of specific entries in the accounts; or a more in depth investigation.

6 FICO Bootle target three categories of repayment claims for detailed checking: all first claims; all claims over a certain amount; and a small sample of other claims. FICO do not monitor the number of checks undertaken for each of these categories or the resultant error rates. There was no documentation to explain the sample size used in the checking process, as this had been in place for many years.

7 In 1995-96, FICO Scotland made detailed checks on all repayment claims received. However, this did not lead to a significant increase in recoveries. FICO Scotland recovered 0.35 per cent of repayments issued compared to 0.27 per cent by FICO Bootle. The National Audit Office note that from April 1997 FICO Scotland has adopted the more efficient sampling basis for repayment checks used by FICO Bootle.

Recommendation 3

FICO should identify the incidence of error and tax recovery arising from each of the repayment categories checked in detail, and reassess the justification for each, to ensure that the level of work undertaken on repayment claims is sufficient, cost effective, and targeted at the areas of greatest risk (paragraph 3.10).

8 Around 46,500 (England, Wales and Northern Ireland) and 5,300 (Scottish) charities claimed income tax repayments on donations made under deed of covenant or gift aid in 1996-97. FICO conduct approximately 1,000 charity audits each year. In 1996-97, 828 were carried out on charities in England and Wales and

200 on charities in Scotland. To date, FICO Bootle have selected charities for audit visits on the basis of auditors' judgement and a minimum value of annual repayment claims; and, in 1995-96, they also used criteria giving greater priority to cases with the largest repayments. From April 1997, they have introduced a risk-related targeting system which aims to concentrate resources on audits of the 6,400 largest repayment claiming charities. This takes into account risk factors such as: the main source of income; previous compliance history; and, charity type. FICO will also select a small sample of the remaining 40,100 charities receiving tax repayments each year to ensure a minimum coverage of the rest of the audit field. FICO Scotland select charities for audit partly on a cyclical basis, but they also make use of the judgement of staff processing repayments, who draw to the auditors' attention cases where tax may be at risk.

Recommendation 4

FICO Bootle should collate the results of their charity audits and analyse them to confirm that their new targeting arrangements are effective. FICO Scotland should adopt the targeting approach used by FICO Bootle (paragraph 3.15).

9

FICO select accounts for examination from four sources: the scrutiny of accounts submitted by charities with repayment claims; referrals from other charity sections within FICO; referrals from other Revenue offices; and special projects. The National Audit Office found that very few cases selected through the scrutiny of accounts resulted in recovery of tax. Special projects directed at specific charity types or particular areas of tax have resulted in more cases where recoveries of tax are made. In the view of the National Audit Office, the effectiveness of accounts scrutiny is constrained by: the exclusion in FICO Bootle of accounts from charities who do not make repayment claims; and, in both offices, the exclusion of charities who fail to send in their accounts as required. Looking at the scrutiny process as a whole, the National Audit Office consider that there is scope to refine the process to focus on areas of higher risk.

Recommendation 5

FICO should target accounts examinations from the full population of charities, including those which make repayment claims and those which do not (paragraph 3.21). Instead of scrutinising only those accounts received, FICO should develop a system for requesting accounts from charities based on the level of their annual income (paragraph 3.24) and those with high risk features, such as a known history of non-compliance (paragraph 3.22). Whilst concentrating resources on high risk cases, FICO should also request accounts for a small sample of low risk cases to ensure coverage across the whole of the known charity population (paragraph 3.24).

Recommendation 6

FICO's scrutiny of accounts should be more structured and rigorous. They should examine fewer accounts in greater depth, assisted by approved testing programmes and guidance notes on items which present a significant risk to tax (paragraph 3.27).

10 The use of known avoidance schemes is difficult to detect from accounts scrutiny and therefore FICO target certain schemes through special projects, which have been successful in recovering tax.

Recommendation 7

FICO should consider the scope for more special projects and improve their management information to include an assessment of risk and the tax recovered from each scheme. This, together with information on the incidence of avoidance, should enable the Inland Revenue to build a profile of the types of charity attracted to individual schemes and thus improve the targeting of resources (paragraphs 3.29 and 3.30).

Conduct of compliance work

11 Consistency of approach in compliance work is important to ensure the equitable treatment of charities and the effective working of cases. The National Audit Office found differences in working practices between FICO Bootle and FICO Scotland, including: 100 per cent checks of repayment claims in Scotland as against sample checks in Bootle (until April 1997); the absence of a full audit report for audits in Scotland; penalties charged when errors are found in Bootle but not in Scotland; and, a more rigorous approach to accounts examinations in Bootle than in Scotland.

Recommendation 8

FICO should continue to strengthen liaison arrangements between their Bootle and Scotland offices to ensure a consistent approach to the monitoring and control of charities (paragraph 4.12).

12 The National Audit Office's review of accounts case-work and management information showed that, as FICO management had already recognised, there was scope for improving the speed of settlement of investigation cases. In July 1996, FICO began a review of cases which were over three years old to determine why these cases had not been settled and what needed to be done to settle them. This resulted in eight cases over five years old being settled in 1996-97.

Recommendation 9

To improve speed of clearance, FICO should adopt a case progression strategy that emphasises early contact with the charity/agent in order to resolve any misunderstandings, ensure regular pursuit of outstanding replies and, in complex cases, obtain early technical and legal advice (paragraph 4.20).

13 FICO repay charities the tax paid on donations made under deed of covenant and gift aid. To gain assurance that those making donations have paid sufficient tax to cover the repayments, FICO notify donors' tax districts in all gift aid cases where more substantial donations are made. The tax office then carries out checks to ensure that the donor has paid sufficient tax to cover the amount deducted from the donation. Tax districts are asked to notify FICO in cases where, after their checks, they need to make a recovery of tax from the donor. In 1996-97, FICO repaid £136.6 million of tax on gift aid donations. Recoveries notified by tax offices amounted to £1.4 million.

14 In 1994, as part of their annual statutory audit, the National Audit Office expressed concern that FICO were taking insufficient follow-up action to ensure that tax districts had carried out the 'tax to cover' checks (only four per cent of cases resulted in recoveries and were then notified to FICO). In response, FICO followed up 209 forms relating to company donations and 241 forms relating to donations by individuals. FICO were unable to identify the tax districts for 97 per cent of corporate donors. This was largely due to the recent introduction of new reference numbers for companies throughout the United Kingdom, which meant that FICO were unable to readily identify corporate donors' tax offices from the information on the donors' certificates. Checks of individual donations, for which 95 per cent could be traced, identified 16 cases (6.6 per cent) where there was insufficient tax to cover; of which six cases (2.5 per cent) required recovery action.

Recommendation 10

FICO should conduct periodic reviews, at least once every five years, of a sample of larger gift aid donations referred to tax districts to monitor the effectiveness of 'tax to cover' checks and to ensure that the procedures and forms used are adequate (paragraph 4.27).

15 In 1995-96, tax repayments on donations made under deeds of covenant amounted to £235 million, more than twice the amount repaid on gift aid. However, unlike gift aid, FICO do not routinely notify tax districts of donations made under deeds of covenant; as these tend to be for much smaller individual amounts than gift aid.

16 In 1994, the National Audit Office raised concerns that details of deed of covenant donations were not being routinely notified to tax districts. In response, FICO conducted a small exercise in which they checked whether there was sufficient 'tax to cover' for 187 donations of £500 or less made under deed of covenant from a single charitable trust. They found that there was no 'tax to cover' in seven cases (3.7 per cent), although only one (0.5 per cent) was for a significant amount and would have led to recovery procedures. FICO consider that routine notification of donations made under deed of covenant would probably not be an effective use of resources and it is unlikely that significant amounts of tax are at risk from these donations because of a lack of tax to cover. This reflects their view that there has been a swing away from larger deeds of covenant (with the exception of Profit Shedding Deeds) since the introduction of gift aid. The National Audit Office consider, however, that this exercise was too limited to give an appropriate degree of assurance.

Recommendation 11

FICO should carry out an annual exercise to provide assurance that the risk to public funds from repayments made under deeds of covenant for which there is no 'tax to cover' is, and remains, immaterial (paragraph 4.30).

Voluntary compliance

17 FICO consider that voluntary compliance - ensuring that charities are aware of their obligations and able to fulfil them correctly without intervention - is the most effective form of compliance. The National Audit Office found that FICO's guidance to charities was clear and comprehensive. FICO provide: a range of leaflets on charity matters and organise educational seminars; technical advice on request; and, ad hoc educational advice summarising the main findings arising from charity audits, accounts investigations and repayment reviews. The focus of these activities might be improved, however, if FICO took steps to measure the effectiveness of the different types of support provided.

Recommendation 12

FICO should underpin their voluntary compliance effort with a formal analysis of the results of compliance reviews to identify and address areas of concern before they lead to a significant level of error (paragraph 5.5). They should continue to explore ways of informing charities of common problems and providing guidance in these areas to clarify requirements and reduce the scope for future error (paragraph 5.8). They should also consider including, in their future survey programme, material to identify whether FICO's voluntary compliance efforts are reaching their target audience (paragraph 5.18).

18 Throughout this examination FICO have been responsive to the National Audit Office's suggestions and have already taken action in some areas and begun considering new initiatives in others. FICO told us that, in considering whether, and when, to implement these recommendations, they would need to take account of resources and other priorities.

Part 1: Introduction

1.1 The National Audit Office estimate, from information held by the Charity Commission and the Inland Revenue, that there are around 300,000 charities in the United Kingdom. Of these, some 184,000 are registered in England and Wales, 24,000 in Scotland and 7,500 in Northern Ireland. The remaining 85,000 are either exempt or excepted from registration under the Charities Act 1993 and include 40,000 churches, 43,000 unregistered charities and 2,000 miscellaneous bodies, which include museums and galleries, universities, grant maintained schools and friendly societies.

1.2 There is no definition for the term 'charitable purpose' in statute law. Charities have been classified by the courts into four categories: for the relief of poverty; for the advancement of education; for the advancement of religion; and, for other purposes beneficial to the community. Charities concerned with social welfare and the provision of recreational or leisure facilities are a separate category of charities under the Recreational Charities Act 1958.

1.3 Charities are entitled to tax exemptions on most of their income and capital gains (the value of these exemptions is up to about £1 billion), provided that their income and gains are applied solely for charitable purposes. The statutory authority for these exemptions is contained in three main pieces of legislation: Sections 9(4) and 505-506 of the Income and Corporation Taxes Acts (ICTA)1988; and Section 256 Taxation of Capital Gains Act (TCGA) 1992. A glossary of terms is given at Appendix 1.

The role of the Financial Intermediaries and Claims Office (FICO)

1.4 The Inland Revenue monitor and control the taxation of charities and companies controlled by charities through their Financial Intermediaries and Claims Office. FICO operate a range of repayment businesses for financial intermediary, charity and non-resident customers. They also act as the tax office responsible for most non-resident individuals, trusts and companies with liability to United Kingdom income tax or capital gains tax, supervise the arrangements for taxing non-resident landlords' property income and provide specialist advice to other parts of the Inland Revenue.

1.5 FICO administers the exemption from taxation enjoyed by charities, repays the tax deducted at source from their income, pays tax credits and transitional relief they are entitled to receive on their United Kingdom dividends, and supervises the operation of covenanted giving, gift aid and payroll giving. Their primary objectives for this aspect of their work are to ensure that bodies which qualify for tax exemptions obtain the benefits of those exemptions and comply with their tax obligations. They seek to achieve these objectives principally through:

- administering repayments of tax to bodies eligible for tax exemptions;
- detecting and correcting non-compliance with tax law;
- deterring avoidance and encouraging the prompt settlement of tax liabilities; and
- maximising voluntary compliance.

Regulatory bodies

1.6 In discharging their responsibilities, FICO must work with three separate regulatory regimes for charities in England and Wales, Scotland, and Northern Ireland. However, charities in each country are governed by a single system of taxation. Brief details of the regulatory arrangements throughout the United Kingdom, together with the relevant regulatory authorities, are summarised in Figure 1. A more detailed summary is at Appendix 2.

The organisation of FICO's charity function

1.7 FICO has two offices handling charity affairs: the main office, which handles charities in England, Wales and Northern Ireland, is located in Bootle; a smaller office, based in Edinburgh, handles Scottish charities. FICO employ around 94 staff on charity related work in Bootle, five staff in Nottingham and Worthing (who report to local managers and ultimately to the Deputy Controller of FICO Audit and Compliance) and 12.5 staff in Scotland.

**Bodies dealing with
charities in the United
Kingdom**

Figure 1

For charities located in:	Arbiter of charitable status	Determination of eligibility for tax exemptions	Regulation and support of charities
<i>England and Wales⁽¹⁾</i>	Charity Commission	FICO Bootle	Charity Commission
<i>Northern Ireland</i>	FICO Bootle	FICO Bootle	Charity Branch of Voluntary Activity Unit -DHSS (Northern Ireland)
<i>Scotland</i>	FICO Scotland	FICO Scotland	Scottish Charities Office

Note 1. Certain charities (for example, universities, churches and other places of worship, and friendly societies etc.) are exempted or excepted from registration with the Charity Commission. FICO Bootle decide whether these bodies are entitled to tax exemptions; but, for registered charities, a consequence of registration is that the registered body must be treated as a charity for tax purposes.

Figure 1 shows that there are a number of bodies responsible for the supervision and regulation of charities across the United Kingdom. These bodies have different statutory powers (see Appendix 2). However, only FICO is responsible for determining whether unregistered bodies are eligible for charitable tax exemptions.

Source: National Audit Office

Tax reliefs available to charities and FICO's control over them

1.8 Charities are exempted from income tax and corporation tax on most sources of income, such as interest earned from bank and building society deposits, rent from property and income from investments, and from capital gains tax, provided their income and gains are used charitably. (There are also inheritance tax exemptions). Figure 2 outlines the various reliefs available and their value; the checks undertaken by FICO; and, the volume of activity and recoveries in 1996-97.

The scope of the National Audit Office examination

1.9 This report examines the way in which the Inland Revenue discharge their responsibilities for the taxation of charities. This report does not examine: taxation policy towards the voluntary sector, which is dealt with by the Inland Revenue's Savings and Investment Division; and, inheritance tax, which is dealt with by the Capital Taxes Office, on which the National Audit Office plans to report in 1998. Appendix 3 shows the position of these two offices, and FICO, within the Inland Revenue and an outline of FICO's organisational structure is at Appendix 4. Finally,

Figure 2

(a) Tax repayments on deeds of covenant, gift aid donations and payments of tax credit on company dividends

Nature of relief and value	Work undertaken by FICO	Volume of activity and recoveries ⁽¹⁾	
		<i>Bootle</i>	<i>Scotland</i>
Charities are entitled to reclaim the income tax deducted from donations made to them under deeds of covenant or the gift aid scheme (single donations in excess of £250). Charities may also claim from FICO the payment of tax credits on dividends and other distributions from UK companies (and transitional relief). In 1996-97, FICO made tax repayments of £744 million (including payments of tax credit and transitional relief).	Considering applications for tax exemptions.	Approximately 8,000 applications	3,435 Applications
	Checks on repayments to verify entitlement to tax exemptions, the arithmetic accuracy of the claim and the existence of adequate supporting vouchers.	177,832 claims Recoveries £1,891,712	12,660 claims Recoveries £162,737
	Charity audits - these usually entail a visit to a sample of charities to check that charities have received the full amount of the donation on which a tax repayment has been made and that the documentation supporting the repayment claim is in order.	828 Audits Recoveries £874,815	200 Audits Recoveries £6,901
	'Tax to cover' checks - assistance to local tax offices to ensure that donors have paid sufficient tax to cover the tax repayment claimed by individual charities on their donations. Gift aid only.	Volume not known Recoveries £1,400,000	Volume not known Recoveries not separately identified

(b) Trading income and capital gains

Nature of relief and value	Work undertaken by FICO	Volume of activity and recoveries ⁽¹⁾	
		<i>Bootle</i>	<i>Scotland</i>
Charities are entitled to tax exemptions on trading income provided that the trade: is exercised in carrying out the charity's primary purpose; or is mainly carried out by its beneficiaries. Charities must pay tax on all their trading income if these conditions are not satisfied; but they may establish a trading subsidiary which covenants all or part of its annual profits to its parent charity. Exemption from capital gains tax. Value: Not known by the Department	Examination of accounts for evidence of irregularities and avoidance in areas such as non-charitable expenditure and non-exempt trading income.	3,830 Accounts scrutinised	2,280 Accounts scrutinised
		266 Technical Reviews	254 Technical Reviews
	Checks that trading subsidiaries have actually paid over tax repaid to charities.	56 Accounts Investigations	5 Accounts Investigations
		Recoveries £3,503,367	Recoveries £2,509
		1,719 Deeds Checked	Not known

continued ...

Figure 2
continued

(c) Other sources of income such as gross interest from banks and building societies

Nature of relief and value

Charities can benefit from arrangements (frequently also available to other classes of taxpayer) to receive investment income without deduction of tax at source. Such arrangements cover bank and building society interest, income from gilts, authorised and unauthorised unit trusts, foreign dividends and (outside Scotland) common investment funds. Charities self-certify their eligibility for gross payments. Financial institutions are therefore not required to check this prior to the payment of investment income gross.
Value: Not known by the Department.

Checks undertaken by FICO Bootle

Compliance activity on income from these sources is carried out by a separate section within FICO and does not form part of their specific work on the tax affairs of charities.
Recoveries relating to charities are not separately identified.

Note 1: All figures quoted relate to 1996-97.

Figure 2 highlights the different tasks and the volume of work undertaken by FICO offices in Scotland and Bootle.

Source: Inland Revenue

this report does not examine the way in which HM Customs and Excise ensure that charities fulfil their obligations to Value Added Tax and the other taxes and duties for which they are responsible.

1.10 The National Audit Office investigated the following aspects of FICO's performance:

- the administration of tax exemptions for charities (Part 2);
- the targeting of repayment checks, charity audits, and accounts examinations (Part 3);
- the conduct of compliance activity and its success in minimising the risk of error and avoidance (Part 4); and
- the promotion of voluntary compliance (Part 5).

1.11 The National Audit Office's findings and recommendations are based on interviews with officials and the examination of papers, management information and statistics held at FICO; attendance on five charity audits; the examination of a sample of casework for each of the issues identified (Appendix 5); and the views of national organisations with an interest in the service given to charities (Appendix 6). The work was carried out between October 1996 and March 1997.

The National Audit Office examined 265 cases in total and also examined the annual accounts of 238 charities. The cases examined were selected randomly from lists of recently completed cases, but the sample sizes were not large enough for the results to be extrapolated over the whole charity population to draw general conclusions.

Part 2: The administration of tax exemptions for charities

Introduction

2.1 This part of the report examines FICO's arrangements for managing charities' eligibility for tax exemptions.

2.2 FICO determine charities' eligibility for tax exemptions and repay tax on: donations made under gift aid and deeds of covenant (including profit shedding deeds whereby trading subsidiaries donate their profits to the parent charities); and, income from legacies. Charities also claim payment of tax credits on United Kingdom company distributions. A body representing itself as a charity will apply to FICO if it wishes to make tax claims and, at that stage, FICO check that the body is indeed charitable. This involves establishing whether the body is a registered charity or, for bodies outside the scope of registration, determining the body's status. In 1996-97, FICO considered around 8,000 applications from charities in England, Wales and Northern Ireland and 3,435 applications from Scottish charities. 4,767 applications from charities in England, Wales and Northern Ireland were admitted and a further 1,339 were under consideration. In Scotland, 1,532 applications were accepted. From 1 April 1997, FICO have begun to compile management information about all applications from organisations claiming to be entitled, in principle, to charity tax exemptions.

2.3 Eligibility for tax exemptions is decided on the basis of charitable status. For charities required to register with the Charity Commission in accordance with Section 3(2) of the Charities Act 1993, a consequence of registration is that the body is treated as a charity for all purposes in law. If there is likely to be a difficulty over whether a body is eligible for charitable status, then the Charity Commission will contact the Inland Revenue prior to registration. For those not required to register with the Charity Commission, FICO undertake their own checks to determine charitable status. Where these checks indicate that certain actions, such as putting a governing instrument into charitable form, need to be taken before charitable status can be granted, FICO will provide appropriate assistance. Under the Law Reform (Miscellaneous Provisions) (Scotland) Act 1990, FICO Scotland is additionally required to provide information to the general public about Scottish bodies recognised as charities. This is done through an index recording basic information as supplied by the charity.

2.4 The National Audit Office evaluated the approval and management of tax exemptions by FICO against the following questions:

- should FICO compile and maintain a database of all organisations who benefit from tax exemptions on the basis of their charitable status? (paragraphs 2.5 to 2.9);
- do FICO have qualifying criteria for determining which bodies are eligible for tax exemptions, on the basis of charitable status, and do they ensure that all charities meet these criteria prior to agreeing entitlement to tax exemptions? (paragraphs 2.10 to 2.12); and
- do FICO conduct periodic reviews of charities on their database, to ensure they are still eligible for tax exemptions? (paragraphs 2.13 to 2.18).

Should FICO compile and maintain a database of all organisations who benefit from tax exemptions, on the basis of their charitable status?

It would be impractical for FICO to compile a database of all organisations who are eligible for tax exemptions on the basis of their charitable status. However, they should consider further work to improve their understanding of the risks related to charitable bodies who receive income and benefit from tax exemptions, although they have not made claims for tax repayments.

2.5 FICO Bootle maintain a live database of the 84,000 charities that have made a claim for a tax repayment or who have applied for charitable tax exemption during the last three years. They also maintain a dormant database of a further 213,000 charities whose last tax repayments or enquiries occurred more than three years ago. In Scotland, FICO maintain a Scottish Charities Index and a separate database for those charities which claim repayments of tax. Therefore, as the only organisation with the authority to approve tax repayments, FICO have the information needed to monitor and regulate tax repayments closely.

2.6 They do not, however, necessarily hold information on organisations self-certifying their entitlement to receive gross income arising from: common investment funds; gilts; and, interest from banks and building societies. This is because there is no requirement for such organisations to notify the Inland Revenue that they have self-certified their entitlement to receive gross income and because financial institutions are not required to check an organisation's eligibility

for tax exemptions with FICO prior to making payments of investment income gross (i.e. without the usual deduction at source of income tax at the lower rate of 20 per cent). FICO monitor financial intermediaries' compliance with the tax deduction scheme for interest, but they do not have records of the numbers of charities receiving income without deduction of tax or the value of the income.

2.7 In 1994, as part of their annual statutory audit, the National Audit Office expressed concern about the ability of charities to receive gross investment income through a common investment fund, without having to obtain FICO's agreement to their entitlement to tax exemptions. FICO told the National Audit Office that they took assurance from the fact that the fund in question was regulated by the Charity Commission and that their subsequent review of two such funds found no evidence of investments by ineligible bodies. All the charities investing in the two funds they reviewed were registered with the Charity Commission and many were submitting repayment claims to FICO in respect of other income.

2.8 In February 1996, FICO began a five year programme to examine each of the 25 common investment funds. Each year, they plan to call for details of investors in five funds, select a sample of charity investors for review and call for the accounts of those charities which do not feature on FICO's repayment database. These will then be scrutinised to identify any tax at risk. They expect this exercise to enable them to build a picture of: the number of charities investing in common investment funds who do not claim repayments; and, the amount of income received gross by those charities. FICO have also recently introduced procedures to obtain a sample of accounts from charities not claiming repayments for detailed scrutiny. They plan to look for evidence of any tax at risk within charities which are not on FICO's repayment database but may be receiving income without deduction of tax.

2.9 These recent developments in FICO's compliance strategy, together with the work FICO do more generally in monitoring schemes such as the tax deduction scheme for interest, should provide some assurance that charities receive income without deduction of tax only when they are entitled to do so. The Charity Finance Directors' Group, however, drew the attention of the National Audit Office to the heavy use of tax exempt vehicles such as common investment funds by charities, many of whom would have no reason to make a repayment claim. **The National Audit Office recommend** that FICO should consider undertaking a special project to: establish the level of risk to the Exchequer from the tax exemptions enjoyed by charities which do not make repayment claims; and, review whether their compliance strategy properly addresses the risks in such cases.

Do FICO have qualifying criteria for determining which bodies are eligible for tax exemptions, on the basis of charitable status, and do they ensure that all charities meet these criteria prior to agreeing entitlement to tax exemptions?

FICO have appropriate qualifying criteria for determining which bodies are eligible for tax exemptions and perform sufficient checks to ensure that charities meet these criteria before approving their entitlement to tax exemptions.

2.10 To assess whether a body, not registered with the Charity Commission, is established for charitable purposes only, FICO use their knowledge of charity law (acquired from training material, precedents and textbooks) to examine the objects of the body. They also check whether the body exists solely for the public benefit (that is for the benefit of the community), conduct a brief review of the powers of the body, and check that the body has acceptable arrangements for winding up.

2.11 In its recent examination of the regulation and support of charities by the Charity Commission (HC 2 1997-98), the National Audit Office examined a sample of 35 registration cases completed in 1996 and found that the Commission's examination of objectives was thorough. Commission staff had identified and pursued the main issues relating to charity objectives and other matters arising from governing instruments.

2.12 The National Audit Office examined 30 applications to FICO Bootle from bodies claiming eligibility for tax exemptions and 30 similar applications handled by FICO Scotland, to establish if the qualifying criteria had been properly applied prior to agreeing their eligibility to tax exemptions. Seventeen were registered with the Charity Commission and, of the remaining 43, all but one had been properly evaluated against the qualifying criteria. In this one case, a body was accepted as established for charitable purposes on the basis of a constitution which failed to state the purposes of the organisation. The error was found when the organisation subsequently informed FICO Bootle of a change in name. Having realised that approval had been given on the basis of insufficient evidence, FICO took steps to ensure that further evidence was provided. This evidence confirmed that the organisation could continue to benefit from charitable tax exemptions.

Do FICO conduct periodic reviews of charities on their database, to ensure they are still eligible for tax exemptions?

FICO do not carry out separate, routine reviews of charities receiving tax exemptions on their database.

2.13 Once eligibility for tax exemptions is approved, a charity will normally remain on the database unless, for example, it is removed following information from the Charity Commission that it has ceased to be charitable. In FICO Bootle this will either be in the 'live' range, if it has claimed repayments in the last three years, or the 'dormant' range (from where it can be reactivated). FICO Scotland have just one repayments database. FICO will update charity details if new information arises from their repayment checks or is provided by the charity. There are no distinct routine checks to establish whether charities continue to be eligible for tax exemptions. However, a charity's abuse of its entitlement to tax exemptions for example, through application of income for non-charitable purposes, may be picked up through FICO's compliance activities, and may be indicated in the Charity Commission's monitoring of charities with income or expenditure over £10,000 a year.

2.14 FICO are considering whether to add this type of check to its charity audits. This would involve the auditor identifying whether there have been any material changes to the charity's constitution or activities since its status was last reviewed and referring appropriate cases to the specialist 'Title' section in FICO for review.

2.15 The Charity Commission have responsibility for regulation and support of registered charities in England and Wales and, as a result, they take an active approach to checking continuing eligibility to charitable status. In 1990, the Commission introduced a mailing programme to all registered charities to ensure that they were active and that the details on their register were accurate. Since the Commission commenced its mailing programme, removals from the register have increased significantly. In 1996, more than 8,000 charities were removed, the bulk of which were small or defunct organisations, or branches of main charities that had been merged into the parent body. Until recently, the Charity Commission have only informed FICO of charities removed from the register as a result of 'class actions' whereby whole categories of charity, such as gun clubs, are removed on the grounds that they are no longer considered eligible for charitable status.

2.16 The National Audit Office obtained a list of the 22 charities that had been removed by the Charity Commission from their Register in 1996 due to activities inconsistent with their charitable status. This was to establish whether these were still included on FICO's live repayment database and, therefore, in a position to receive tax repayments. Eleven could not be found on either database, seven were listed in the dormant database (signifying that no claims had been made for three years) and four in the live database. Of the four listed in the live database, two were successor organisations to those removed from the Charity Commission Register. FICO informed the National Audit Office that the Charity Commission had confirmed that a third had, in fact, remained on the Register.

2.17 However, one charity, which had been removed from the Charity Commission's Register in 1996, was still on the live database and so potentially in a position to receive tax repayments after its charitable status had been withdrawn. In that case, FICO had requested information from the Charity Commission on the body's status in February 1995, but no answer was received and no follow up action taken by FICO. FICO informed the National Audit Office that no tax had been lost in the case and acted immediately to stop this former charity receiving any repayments of tax to which it was not entitled.

2.18 In January 1997, FICO discussed the feasibility of the Charity Commission regularly passing to them details of all organisations removed from their register. The Charity Commission have since agreed to send details to FICO Bootle of all charities removed from the Charity Commission Register due to activities incompatible with their status, or for other reasons. FICO have already received the first details under that agreement. **The National Audit Office** welcome this development and **recommend** that FICO Bootle should consider how best to use the additional information to help minimise the risk of organisations being in a position to receive tax repayments in inappropriate cases.

Part 3: The targeting of compliance work

Introduction

3.1 This part of the report examines the way in which FICO target their compliance activity to encourage charities' prompt compliance with their tax obligations and deter tax avoidance. The main areas of risk arising from tax privileges enjoyed by charities, and the compliance activity which addresses these risks, are set out in Figure 3.

Areas of tax at risk
addressed by FICO's
charity compliance effort

Figure 3

Area of tax risk	FICO charity compliance activity		
	Repayment Checks	Charity Audits	Accounts Examinations
Foreign Income Dividends (for which there is no payable tax credit)	✓		
Distributions by UK Companies	✓		
Covenants/Gift Aid			
Incorrect or invalid	✓	✓	
No tax to cover	✓		
Benefits received by donor	✓	✓	✓
Profit shedding overclaims	✓		✓
Non-exempt trading income			✓
Non-charitable expenditure			✓
Gross investment income received by ineligible bodies			✓
Miscellaneous avoidance areas			✓
Charities with subsidiary companies			✓

Figure 3 shows that the repayments checks and charity audits focus on the correctness and validity of covenanted and gift aid donations and taxed income on which charities claim tax repayments, whilst accounts examinations focus on all other areas of tax at risk that can only be detected through the scrutiny of accounts and in-depth reviews.

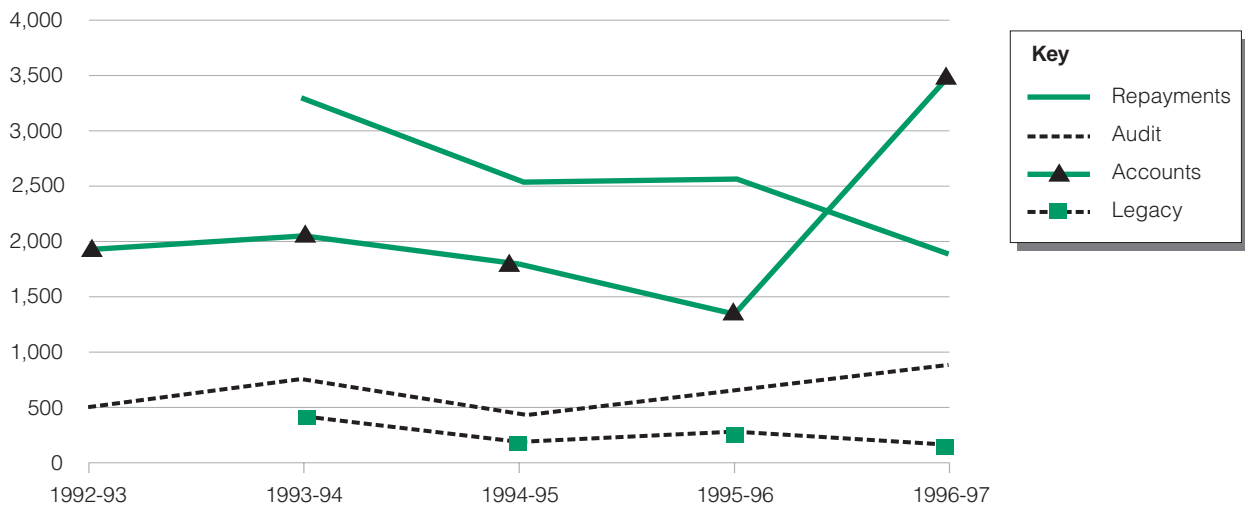
Source: National Audit Office

3.2 Between 1993-94 and 1995-96, FICO's overall yield from its principal charity compliance areas fell from £6.8 million to £4.1million (Figure 4). A number of factors contributed to the decline in yield. For example, in FICO Bootle, recoveries from repayment checks were particularly high in 1993-94, and declined thereafter, because there were initially large errors in claims to the transitional relief for charities introduced in 1993 following the reduction in tax credit attached to company distributions. In Scotland, FICO attribute the decline in

Figure 4

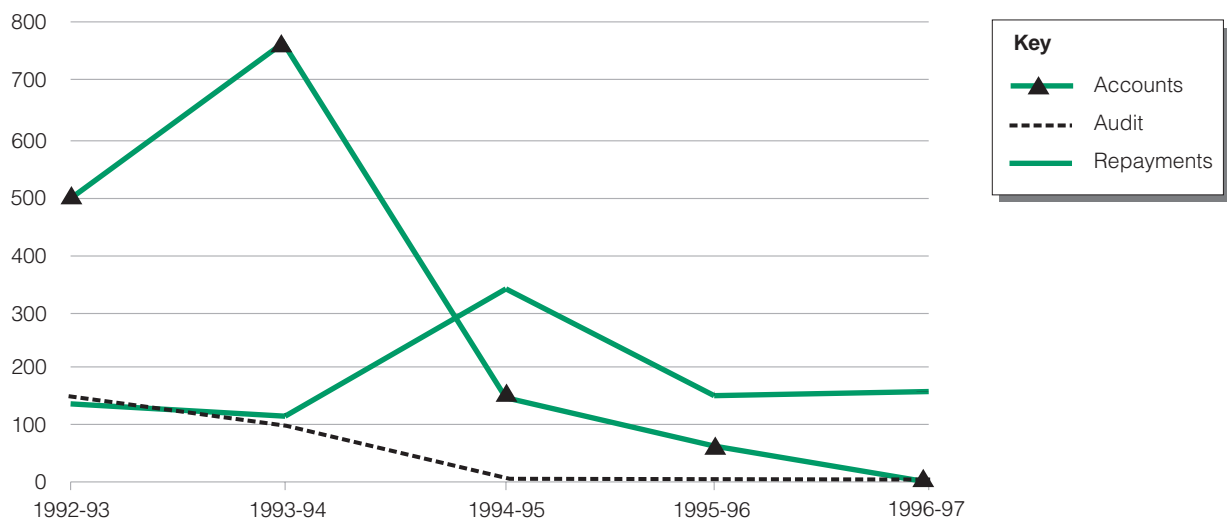
FICO's recovery yield from charity compliance activities, 1992-93 to 1996-97 (£000's)

A: Bootle



- Notes: 1. Repayments figures in 1995-96 include exceptional recoveries of £1.5 million 'tax to cover' and 1992-93 figures are not available for repayments or legacy figures.
2. The 1996-97 accounts investigation recoveries include an exceptional recovery of £2.2 million from a case covering 8 years.

B: Scotland



- Notes: 1. Accounts figures include recoveries from special projects, which resulted in recoveries of £215,751 in 1992-93, £42,255 in 1993-94 and £22,277 in 1995-96.
2. Separate figures for legacy recoveries are not available.

Figure 4 shows that FICO Scotland compliance recoveries have fallen significantly over the past four years. The Inland Revenue attribute this decline in yield to improved voluntary compliance.

Source: National Audit Office analysis of FICO management information.

yield to improved voluntary compliance following a concerted effort on their part to educate church groups in the management of their tax affairs. However, the trend in yield has not been entirely downwards. Yield from FICO Bootle’s audit work has risen over the years and settlement of a particularly large accounts examination case led to a significant increase in yield in 1996-97.

3.3 The proportion of charity audits and accounts investigations settled with a monetary recovery increased between 1992-93 and 1996-97 (Figure 5). In addition, the proportion of FICO Bootle technical reviews which proceeded to the investigation stage increased from five per cent in 1992-93 to 16 per cent in 1996-97.

The percentage of FICO charity audits and accounts investigations settled with a monetary recovery, 1992-93 to 1996-97

Figure 5

Year	Charity audits ⁽¹⁾		Accounts investigations ⁽²⁾	
	Bootle	Scotland	Bootle	Scotland
1992-93	47	56	58	63
1993-94	51	31	65	66
1994-95	40	16	63	76
1995-96	44	6	67	88
1996-97	38	4.5	64	100

Notes: 1. The number of charity audits settled increased in Bootle from 748 to 828 and in Scotland from 172 to 200 between 1992-93 and 1996-97.

2. The number of accounts investigations settled decreased in Bootle from 140 to 56 and in Scotland from 64 to 5 between 1992-93 and 1996-97.

Source: National Audit Office analysis of FICO management information.

Figure 5 shows that during recent years there has been an improvement in the targeting of accounts work, with the proportion of reviews concluding in a monetary settlement increasing between 1992-93 and 1996-97.

3.4 The National Audit Office examined the scope for improving the selection of charities and trading subsidiaries for review against the following questions:

- are there clear and consistent objectives for compliance activity? (paragraphs 3.5 to 3.7);
- is there comprehensive coverage of all types of charity and areas of potential tax avoidance, based on an assessment of the tax at risk? (paragraphs 3.8 to 3.29); and
- is full use made of different information sources in targeting? (paragraphs 3.30 to 3.34).

Are there clear and consistent objectives for compliance activity?

FICO set clear objectives for their compliance activity.

- 3.5** In selecting cases for investigation or review FICO seek to:
- use risk-assessment for selection and prioritisation of work;
 - use information technology to analyse third party information so that cases selected for review are those where the tax is most at risk;
 - identify any areas within FICO where the risk potential for avoidance has not been fully assessed or addressed;
 - ensure that triggers and systems are in place so that technical and operational areas refer suitable cases to the compliance section at the earliest opportunity; and
 - co-operate and work with other specialist offices and the Inland Revenue network.

3.6 To support these objectives, FICO set annual targets for the number of charity audits and accounts compliance reviews. FICO Scotland set omnibus targets for the total number of settled charity audits, accounts investigations and accounts reviews for all aspects of their compliance work. They do not set separate targets for their compliance work in the charity sector. FICO Bootle exceeded their target for the number of audit visits but did not meet their accounts and post-audit investigation targets. FICO Scotland exceeded all their overall targets in 1996-97 (Figure 6).

3.7 The Inland Revenue do not target compliance yield as a matter of policy. However, the National Audit Office consider that there are other factors, such as the proportion of cases leading to recoveries and coverage levels for particular types of charities, that FICO should take into account to improve the effectiveness of their compliance arrangements. **The National Audit Office recommend** that FICO underpin their compliance activity by taking account of factors of this sort when developing their risk model and monitoring the quality of the conduct of cases. FICO Scotland should also set specific targets for their compliance activity in the charity sector.

FICO compliance activity
targets 1996-97

Figure 6

Bootle

Compliance activity	Target	Results
Charity audits	740	828
Post-audit investigations	350	311
Accounts investigations	80	56

Scotland

Compliance activity	Target	Results
Charity audits	170	200
Accounts reviews ⁽¹⁾	250	254
Accounts investigations ⁽²⁾	65	69

Notes: 1. The figures shown for accounts reviews is an aggregate figure, of which charity reviews account for around one half.

2. The investigations carried out by accounts inspectors in FICO Scotland chiefly cover non-charitable areas; only five were charity investigations.

Source: FICO management
information

Figure 6 shows that FICO Bootle exceeded their audit visit target but did not meet their accounts and post-audit investigation targets. FICO Scotland exceeded all their overall targets in 1996-97.

Is there comprehensive coverage of all types of charity and areas of potential tax avoidance, based on an assessment of the tax at risk?

Charity audits cover charities receiving repayments for gift aid or deeds of covenant. They do not cover charities' gross investment income. Furthermore, a large proportion of accounts investigations are selected on the basis of accounts scrutiny, which only covers the population of charities which submit accounts to FICO (approximately ten per cent of all charities). Areas of avoidance can be difficult to identify through routine accounts examination, requiring special projects to be undertaken instead. Risk assessment is used to a limited extent in the selection of cases for review.

3.8 FICO acknowledge the need to improve their use of risk assessment techniques and have introduced, or are actively considering, new initiatives in many areas. These, together with our detailed findings on repayments checks, charity audits and accounts examinations, are considered further below.

Repayment checks

3.9 In 1996-97, FICO Bootle received and processed 177,832 tax repayment claims under the deed of covenant or gift aid scheme from 46,500 charities. They check all claims to the relevant entries on either their live or dormant databases, to ensure that claimants have been agreed as eligible for tax exemptions, and perform arithmetic checks on all larger claims. They target three categories of repayment claims for detailed checking (to ensure consistency with tax law and supporting vouchers): all first claims (5,039 in 1996-97); all claims over a certain amount; and, a small sample of other claims. The sample used in the checking process is selected by computer, using a points system for grading particular risks, such as a change in charity details since the previous claim and the size of the repayment claimed.

3.10 In contrast, FICO Scotland checked all the 12,660 claims it received during 1996-97 from around 5,300 charities. This did not lead to a significant increase in recoveries. FICO Scotland recovered 0.35 per cent of repayments issued compared to 0.27 per cent by FICO Bootle. The National Audit Office note that, from April 1997, FICO Scotland has adopted the more efficient sampling basis for repayment checks used by FICO Bootle. Although FICO Bootle's sampling approach to repayment checks is clearly more cost-effective than a 100 per cent check, the National Audit Office has four concerns over current arrangements:

- FICO Bootle do not monitor the number of checks undertaken on the different categories of repayment (paragraph 3.9) or the resultant error rates. Consequently, the National Audit Office were unable to establish whether current targeting arrangements are effective. **The National Audit Office recommend** that FICO identify the incidence of error and tax recovery arising from each of the repayment categories checked in detail, and reassess the justification for each, to ensure that the level of work undertaken on repayment claims is sufficient, cost effective, and targeted at the areas of greatest risk;
- FICO Bootle were unable to provide the National Audit Office with any documentation to explain the basis on which the sample size had been determined, as this had been in place for many years;
- the points system used in selecting the sample does not include a risk factor representing the past compliance history of a charity. Furthermore, FICO do not record which charities make errors and are, therefore, unable to identify 'persistent offenders' for targeting. **The National Audit Office**

recommend that FICO collate this information to identify whether it is a useful criteria for assessing risk. If so, then this functionality should be built into the model during its next review; and

- while FICO Bootle record types of errors detected (for example, in 1995-96, 70 per cent were arithmetic), FICO Scotland do not keep this information. **The National Audit Office recommend** that FICO Scotland introduce the same system of recovery codes as Bootle and undertake the analysis recommended above.

Charity audits

3.11 FICO also check tax repayments on donations made under deed of covenant and the gift aid scheme through charity audits. These usually entail a visit to the charity to examine supporting records, including the covenant register, original deeds, the cash book and bank statements. However, in smaller cases, chiefly where the annual claim is below £5,000, FICO undertake desk-based audits, dealing with the charities by correspondence.

3.12 In 1996-97, FICO Bootle carried out 828 charity audits, including 111 desk-based audits, and FICO Scotland completed 200 charity audits, which included no desk-based audits. This equates to a coverage level of 1.8 per cent of the 46,500 charities claiming repayments in England, Wales and Northern Ireland and 3.8 per cent of the 5,300 charities claiming repayments in Scotland. Around three-quarters of the charities visited are churches, which are the principal recipients of deed of covenant and gift aid donations. The number of charity audits conducted annually has increased by 11 per cent in the five years to 1996-97 (Appendix 7).

3.13 Until the introduction of a new targeting system in April 1997, FICO made little use of risk assessment in selecting charities for audit; although, as an interim measure in 1995-96, charities were selected for audit from four bands based on the size of their deed of covenant claims. With the exception of a small number of referrals from the accounts and repayments sections, FICO Bootle have conventionally selected charities for audit on the basis of a minimum annual level of repayment claim (£5,000) and auditors' judgement. Using this method, they could not be sure they were targeting those charities which presented the highest risk. For example, the National Audit Office's sample of accounts received, but not examined, by FICO identified a church in receipt of annual tax repayments exceeding £100,000 on its covenanted income which had never been audited. As at April 1997, 1,288 (20 per cent) of the 6,400 charities making the largest annual

repayment claims (those in excess of £4,000) had never received an audit visit. FICO Scotland select charities for audit partly on a cyclical basis, but they also make use of the judgement of staff processing repayments, who draw to the auditors' attention cases where tax may be at risk.

3.14 From April 1997, FICO Bootle introduced a new risk-related targeting system for charity audits. It aims to concentrate resources on audits of charities submitting the largest claims for tax repayments through a two tier approach to selection. The 6,400 charities claiming the largest tax repayments will be audited on three to ten year cycles. Their frequency of coverage is dependent upon an assessment of risk which will be based on a number of factors which include: no previous audit; the size of the annual deed of covenant and gift aid tax repayment claims (deeds of covenant are viewed as riskier than gift aid); the size of the charity's investment income claims; previous audit history; and, charity type. FICO Bootle aim to audit a small sample of the 40,100 remaining repayment claiming charities each year.

3.15 The **National Audit Office consider** that FICO Bootle should collate the results of their charity audits and analyse them to confirm that the new targeting arrangements are effective. **The National Audit Office also recommend** that FICO Scotland adopts the risk-based approach to targeting used by Bootle, and examines ways in which it can make its recovery performance more effective.

Accounts examination

3.16 FICO's accounts examination process encompasses work at three levels:

- **Accounts Scrutiny:** A two-stage scrutiny of those charity and trading subsidiary accounts thought most likely to present material risk to tax yield in order to generate cases in which queries on particular accounts figures are raised. A large proportion of accounts are excluded from scrutiny at the outset because the risk to tax yield is considered to be immaterial. The first stage then involves rapid review of accounts that have been passed on for examination to eliminate cases where, in the reviewer's judgement, it is clear no risks are present. The second stage involves a fuller scrutiny of the remaining cases, including the examination of previous accounts and information on the relevant charity file. During 1996-97, of 3,830 accounts scrutinised in FICO Bootle, 3,171 were eliminated in the initial rapid review, with 659 passing through to the second stage of fuller scrutiny;

- **Technical Review:** A review, involving correspondence with the charity/agent, and sometimes a meeting, which focuses on a specific query (either generated by an accounts scrutiny or from a case referral from other Inland Revenue offices or external sources); and
- **Accounts Investigation:** An in-depth investigation of a charity's tax affairs, usually involving a meeting with the charity/agent, which is launched after a technical review shows there to be genuine grounds for concern and strong prospects of a monetary recovery.

3.17 Referrals from other charity areas within FICO and Revenue offices are an important source of technical reviews and investigations. There has also been an improvement in the targeting of accounts work with the proportion of reviews concluding in a monetary settlement increasing in the time period, between 1992-93 and 1996-97, from 58 per cent to 64 per cent in FICO Bootle and from 63 per cent to 100 per cent in FICO Scotland (Figure 5). However, it is through accounts scrutiny that FICO seeks to achieve broad coverage of the charity population and identify potentially non-compliant charities for further review. The limitations in the current approach are described below.

Accounts scrutiny covers only a small, and potentially the most compliant, part of the charity population since it is driven by the supply of accounts

3.18 Although the number of charities has increased since the early 1990s, the number of charities who send their accounts to FICO Bootle annually has fallen from 60,000 to around 25,000, and by over one-third in Scotland, to around 2,200. There are two reasons for this. Firstly, FICO Bootle no longer periodically request accounts from charities that do not claim tax repayments on covenanted income, but may receive tax privileges in other areas such as bank and building society interest. They have adopted this approach because their view is that the greatest risks of non-compliance arise in cases involving repayment claims. Secondly, FICO do not generally pursue the large number of charities, almost half the total, who fail to submit accounts with their repayment claims. In total, FICO receive accounts from less than a tenth of all charities.

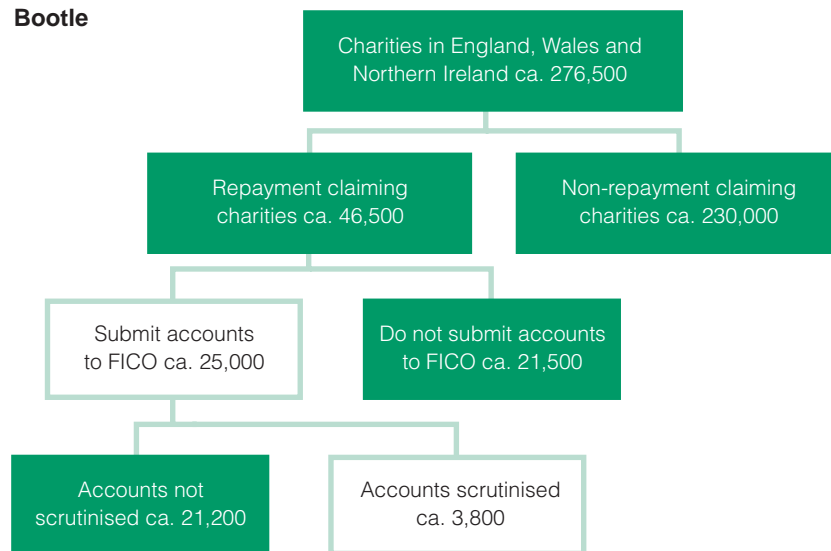
3.19 As Figure 7 shows, not all accounts received by FICO are scrutinised by the accounts examiners. In FICO Scotland, around two-thirds of accounts received are scrutinised, but in FICO Bootle the figure is around a sixth. This is because, as noted at paragraph 3.16 above, both FICO Bootle and, to a lesser extent, FICO Scotland do not scrutinise certain categories of account where, in their view, the

risk to tax yield is not material. In total, therefore, FICO review annually the accounts of around 6,080, or two per cent of all United Kingdom charities, which are drawn from the small proportion of charities that regularly send FICO copies of their annual accounts in support of their applications for tax repayments.

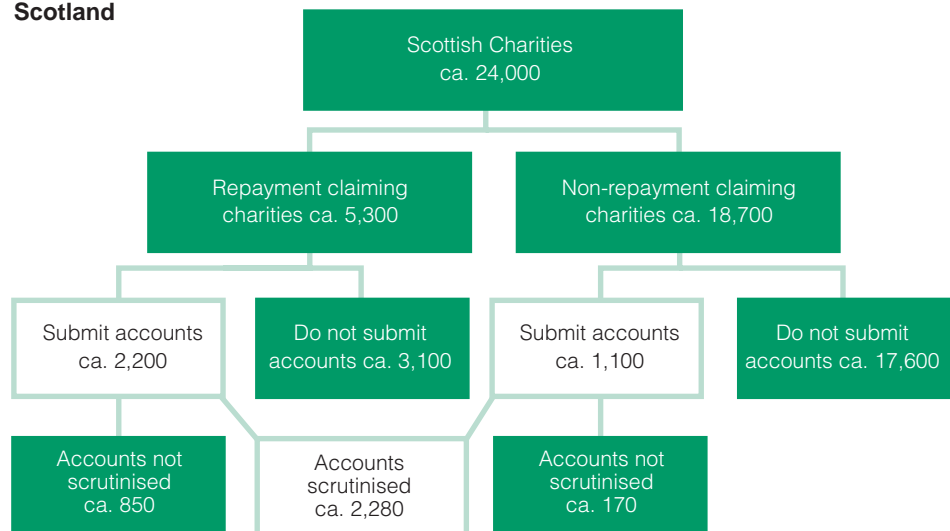
**The process of
obtaining accounts
for scrutiny at FICO
Bootle and Scotland**

Figure 7

Bootle



Scotland



Source: FICO management information and estimates

3.20 The National Audit Office consider that the effectiveness of FICO's current scrutiny of accounts is constrained by the fact it is largely reactive and centred on those charities most likely to be compliant; it focuses mainly on accounts received with repayment claims, rather than on a considered assessment of the tax at risk by charity size, type or past compliance history. An exception is where FICO carry out 'special projects' and request accounts from certain charities. Some past projects have focused on bar trading by certain charitable institutes and theatres, the conference income of universities, cathedral bookshops, and the leisure activities of some charitable associations. These projects have generally been successful in generating investigation cases that lead to recoveries. For example, a project which covered bar and games income in 154 (one-quarter of the total of) certain charitable institutes generated recoveries of over £600,000.

3.21 To improve the targeting of its accounts examinations, **FICO should select** charities for scrutiny from their charity databases rather than the population of accounts received. A sample of accounts should be drawn from two distinct populations: charities that claim repayments; and, those that do not. The first sample should be drawn from the repayment database. The second sample, for charities not receiving tax repayments, should be taken from the publicly available data held on the Charity Commission register which includes for each registered charity details of: the name; registration number and date of registration; objects; type of governing instrument; whether annual accounts have been received; and income and expenditure. This information was sent to FICO every six months but work is now in hand to allow FICO on-line access via a computer link to facilitate the selection of charities for scrutiny. In FICO Scotland, the sample should be drawn from the Scottish Charities Index.

3.22 **To ensure that FICO select** the most appropriate charities, they should widen their risk factors to include the activities and past compliance histories of charities, and information received from the Charity Commission and HM Customs and Excise. The selection of charities for accounts scrutiny that do not appear on either FICO or Charity Commission databases (for example, charities exempt or excepted from registration) can be informed by other information available to FICO directly or via third parties.

Accounts reviews should be focused on larger charities

3.23 Of the 323 largest United Kingdom charities and charitable trusts with gross annual income in excess of £5 million, 43 had been the subject of FICO technical reviews and investigations between 1992-93 and 1995-96. However, all but one of the National Audit Office's sample of FICO Bootle investigation cases

which had led to a recovery, related to charities with a turnover exceeding £100,000. The National Audit Office also concluded, from their own reviews of a sample of accounts received by FICO, that a substantially higher proportion of the accounts of charities with an annual turnover exceeding £100,000 contained items which merited further scrutiny than the accounts of charities with an annual turnover below £100,000.

3.24 **The National Audit Office** are concerned that insufficient attention is being directed at the largest charities and **recommend** that accounts review should be focused more closely on them. Charities, with an annual turnover of £100,000 or more, generate 90 per cent of voluntary sector annual income, and are required by the Statement of Recommended Practice on charity accounting to provide an in-depth analysis of their annual expenditure. Further enhanced targeting of the categories of accounts scrutinised, to eliminate low risk cases (see paragraph 3.19), should improve the proportion of accounts scrutinised which merit further enquiry and result in a more informed and effective review process. Smaller charities can be covered through charity audits and FICO requesting the accounts of a small sample of low risk cases to ensure coverage across the whole charity population. Charities with a turnover exceeding £1 million, which account for 70 per cent of the Voluntary Sector's annual income, should be screened regularly, with trends in key accounts items closely monitored.

Accounts examinations selected through the scrutiny process do not result in many likely recovery cases

3.25 FICO does not keep statistics showing the selection sources of technical review and investigation cases. Very few of the cases sampled by the National Audit Office, which were generated by accounts scrutiny, led to a recovery. Of the 20 FICO Bootle cases examined which had led to a recovery, 3 were selected through accounts scrutiny; the remainder were derived from referrals from other FICO and Revenue sections. Of the 20 FICO Bootle cases examined which had not led to a recovery, 13 were selected through accounts scrutiny.

3.26 Drawing on data provided by FICO, the National Audit Office calculated that the average time spent on the initial, stage one, rapid scrutiny of accounts (see paragraph 3.16), to determine whether further action is required, is around two minutes per account. Inspectors do not keep records of relevant accounts details to inform the review of the same charity in later years and do not work to a test programme.

3.27 **The National Audit Office recommend** that accounts scrutiny should be more structured and rigorous to ensure that work is directed at high risk items. FICO should review fewer accounts in more detail, assisted by approved testing programmes and guidance notes on items which pose significant risks to tax. They should consider whether a cost-effective management information system could be developed which would enable information from accounts examination to be recorded at a level of detail which could inform future strategy and the working of individual cases.

Complex avoidance activities are difficult to pick up from accounts scrutiny

3.28 The use of known avoidance schemes is difficult to detect from accounts. FICO are aware of different types of potential avoidance and have included guidance in their *Charity Manual* to advise accounts staff on how to handle such cases. To be in a better position to target charities who are likely to be involved in potential avoidance, FICO needs to collate information held on the incidence of avoidance and analyse this to identify areas of risk and build a profile of the types of charities with tendencies towards specific schemes.

3.29 The scrutiny of accounts restricts the examiner to looking at a charity's finances at fixed points in time. The accounts will not necessarily show individual events that have taken place within the year, if income is not broken down sufficiently in the statement of financial activities or in the notes to the accounts. For example, a charity may be paying money out of the United Kingdom to a foreign body in a way that aims to benefit a person in the United Kingdom who is not a charitable beneficiary. This would be non-charitable expenditure, with the result that the tax exemption may have to be withdrawn on part or all of the charity's income. This expenditure may not be immediately visible from scrutiny of the accounts as it may be hidden in other categories of expenditure. In the past, FICO have targeted avoidance via special projects on specific schemes. **The National Audit Office recommend** that FICO consider the scope for undertaking more special projects, focusing on risk areas such as payments to foreign charities (Figure 8), to gauge the level of risk in each avoidance area and identify the means of recovering lost tax.

**An example of a complex
form of tax avoidance:
payments to foreign
charities**

Figure 8

If a dominant trustee of a United Kingdom charitable family trust extracted money for personal use directly from the trust, the extraction would obviously be non-charitable and would come to the notice of the Charity Commission and the Inland Revenue. The following example demonstrates how the trustee could use a foreign charity to conceal the extraction and their tax liability:

- the trustee makes a gift aid payment of £20,000 to the charity. The charity claims back £5,974 tax on the gift aid payment. The trustee, as a higher rate taxpayer, also gets marginal relief of £4,416;
- the trustee arranges for a grant or loan of £25,974 to be made to a charity based abroad (which he controls) having similar aims to the United Kingdom charity;
- the foreign charity makes an interest free loan of £25,974 back to the trustee in the United Kingdom (with undefined repayment terms);
- since the money reaches the trustee as a loan, it is not taxable; and
- if the avoidance scheme is not detected and countered, the trustee is effectively £10,390 better off at the Exchequer's expense.

Source: Inland Revenue

Note: There is special legislation which enables FICO to counter activities such as this scheme.

Is full use made of different information sources in targeting?

Limitations in the management information available means that FICO cannot be sure that it is targeting compliance effort most effectively.

3.30 The National Audit Office attempted to use the recovery statistics kept on accounts examination cases to identify the usage and tax at risk from each of ten main avoidance schemes known to FICO, but were unable to do this from the two recovery codes used by FICO. **The National Audit Office recommend** that FICO introduces more specific recovery codes to allow avoidance schemes to be separately identified and collate information on the incidence of such schemes. This would enable FICO to build up a profile of the types of charities attracted to individual schemes, and thus improve the targeting of accounts Inspector resources.

3.31 The National Audit Office consider that FICO's classification of charities by type is not sufficiently sophisticated to be of value for targeting. FICO Bootle's accounts and audit staff classify charities into four activity types: education; religion; poverty; and, community; with a number of sub-codes. In 1996, FICO carried out an analysis of audit and accounts settlements by activity code, but were unable to establish any clear relationships with the risk of non-compliance. The National Audit Office found this to be partly because as many as 40 per cent of charities involved in accounts settlements in 1994-95 and 1995-96 were assigned to incorrect or non-specific charity codes.

3.32 FICO's main computer system for charity compliance work is the Charity Repayments System, which, in its present form, was introduced in FICO Bootle in late 1993. The system was designed chiefly for repayments processing, but is also used to select samples, via risk criteria, for checks of repayments. The database cannot easily be used to aggregate different claims made by individual charities and does not assign codes to particular types of charity to facilitate targeting. The system was partially introduced in FICO Scotland in July 1994 with FICO Bootle's sampling methodology adopted from April 1997.

3.33 A stand-alone database is being developed for charity audits, containing details of the largest 6,400 repayment-claiming charities, ranked by the size of their total annual repayment claims. The database will include a charity's location and type, the schemes used (gift aid or deed of covenant), as well as previous audit history. The data will be used to select charities for audit, using risk criteria.

3.34 Accounts examiners do not have access to a separate database for compliance targeting. Inspectors use ad hoc queries of the repayments database to identify cases for 'special projects'. Twice a year, FICO receive restricted details from the Charity Commission's Register but these are of limited use on tax compliance work. FICO have asked for wider access to the information held by the Charity Commission beyond the details held on the Public Register (paragraph 3.21), to support regulatory activity. They hope this will increase the scope for risk profiling, whilst minimising duplication of effort. The Commission's Register contains details on around 184,000 registered charities in England and Wales, including charities which do not claim repayments and may not be on FICO's database. The Charity Commission are considering this request and have informed the National Audit Office that, before a decision can be taken, issues surrounding the application of data protection rules, and the sharing of information given to them on an 'in confidence' basis, would need to be fully addressed.

Part 4: The conduct of compliance work

Introduction

4.1 This part of the report considers the way FICO conduct their charity compliance work and their success in minimising the risk of error and avoidance. The National Audit Office evaluated the conduct of reviews against the following questions:

- do FICO charity staff undertake adequate pre-review research? (paragraphs 4.2 and 4.3);
- do FICO undertake prescribed tests, have adequate written guidance, and clearly document reviews? (paragraphs 4.4 to 4.7);
- do FICO act consistently across cases and across offices? (paragraphs 4.8 to 4.12);
- do FICO progress reviews efficiently and cost-effectively, with regard to the tax at risk, and minimise the necessary compliance burden on the charity or trading subsidiary? (paragraphs 4.13 to 4.21); and
- do FICO liaise effectively with other relevant parts of the Inland Revenue and outside organisations? (paragraphs 4.22 to 4.32).

Do FICO charity staff undertake adequate pre-review research?

Effective pre-review research is undertaken on charity audits although FICO do not routinely examine church accounts prior to an audit visit. There was less documented evidence of initial research for accounts examinations.

4.2 Pre-review research is important to ensure that compliance work is informed by relevant information, either held by FICO or obtained from third parties, and focuses on key risk areas. On average, FICO Bootle auditors devote two hours to pre-visit work. For non-church audits, accounts section inspectors review the charity's most recent accounts before the visit, with productive results. However, church accounts are not reviewed. The National Audit Office reviewed a sample of church accounts that had not been examined by FICO and identified

some areas which they felt merited further attention. However, in the cases in question, FICO explained that, in their professional judgement, supported by legal advice received in an earlier similar case, it was unlikely that the areas in question, such as trading income from coffee shops, merited enquiry. The National Audit Office consider that FICO should keep their approach to preparing for church audits under review in the light of identified risks.

4.3 In the sample of accounts examinations reviewed by the National Audit Office, there was limited evidence of pre-review research in the form of accounts review, consideration of any previous audits or accounts examinations, or liaison with external bodies, such as HM Customs and Excise or the Charity Commission, to gain a wider understanding of the charity and its compliance record. At FICO Bootle, in over one-third of all cases sampled, the latest accounts were absent and, in two of the technical reviews examined, the Inspector appeared unaware of relevant FICO rulings five years earlier, until informed by the charities concerned. Most examination cases which result in a recovery originate from referrals, as opposed to accounts scrutiny (paragraph 3.25). In such cases, the National Audit Office found that the examiners tended to concentrate on the issue raised by the referee.

Do FICO undertake prescribed tests, have adequate written guidance, and clearly document reviews?

The use of testing programmes, guidance and the standard of documentation varies between different types of compliance activity and between offices.

4.4 The National Audit Office's review of case-work showed tests and documentation to be adequate for repayment checks in FICO Bootle and FICO Scotland and for charity audits in FICO Bootle. These areas were supported by clear written guidance. However, the National Audit Office found that charity audit work in FICO Scotland and accounts investigations in both offices were less formally structured.

4.5 Accounts examination documentation is particularly difficult to follow. The checks performed and the significance of any findings are not clearly identified. This makes quality monitoring, and the transfer of open cases to new inspectors, difficult. FICO Scotland produces a brief case summary for each settled investigation case, describing the reason for selection, the work undertaken and

the testing results. **The National Audit Office consider** this to be good practice, as it assists both targeting and research in subsequent reviews, and **recommend** its adoption for all compliance activity in both FICO Bootle and FICO Scotland.

4.6 **The National Audit Office further recommend** that brief guidance notes and tests be drawn up, and used for scrutinising accounts, and that a standard form of documentation be introduced. These changes should ensure that key risk areas have been considered and facilitate quality control.

4.7 FICO are considering increasing the scope of charity audits. The National Audit Office consider that the scope of tests performed during charity audits should be widened to ensure closer control over all types of tax exempt income received by charities, and accounts-related tax areas. Other sections within FICO administer tax relief at source from bank and building society interest, gilt interest and foreign dividends and interest. When auditing the operation of these areas of taxation, FICO check that the scheme operator has given gross payment only when entitled to do so under the rules of the scheme, which usually involve obtaining some form of evidence of eligibility. Whilst this provides some assurance regarding tax deduction schemes, the National Audit Office consider that, in conducting charity audits, FICO should adopt a more co-ordinated approach and improve the liaison arrangements between auditors and staff involved in other aspects of work on charities' tax affairs.

Do FICO act consistently across cases and across offices?

FICO compliance staff operate differently from each other on some issues both within and across offices.

Across cases

4.8 Consistency of approach to case-working is important to ensure that all charities are treated equitably and in accordance with the *Taxpayers' Charter*, and that individual cases are worked effectively, timeously and in line with best practice. Both repayments and charity audit compliance staff work to a standard test programme and there is management review of samples of completed cases to ensure a consistency of approach. However, the charity audits attended by the National Audit Office and their review of case-files revealed inconsistency in the extent to which checks were made and documented on benefits obtained by donors on their donations.

4.9 To promote consistency in accounts work, important technical rulings are publicised internally in the *FICO Charity Bulletin*. In addition, there is brief line-management review of all investigation cases settled by part qualified inspectors. However, accounts technical reviews are not formally reviewed on settlement by management. The National Audit Office analysed the outcome of technical reviews in 1995-96 and identified variations between individual inspectors in the proportion of cases investigated and achieving a monetary recovery. **The National Audit Office recommend** that FICO should monitor the outcome of accounts work to ensure that cases are being treated consistently.

4.10 The National Audit Office's review of accounts casework found that the type and level of checks performed was not always consistent. For example, FICO Bootle queried the car park income of one religious charity reviewed, claiming it involved a measure of active trading, but not in another, apparently similar, case. **The National Audit Office recognise** that detailed circumstances vary considerably from case to case **but consider** that the provision of more in-depth interim reviews of open cases would enhance consistency of treatment.

Across offices

4.11 The National Audit Office's analysis of case-work and management information revealed that working practices in FICO Bootle and FICO Scotland varied in some areas.

Repayment checks

- Until 1996-97, FICO Scotland checked 100 per cent of repayment claims whilst FICO Bootle checked a sample of claims. FICO Scotland adopted the Bootle selection strategy in April 1997 (paragraph 3.10); and
- FICO Scotland has always paid interest supplements on repayments which were not claimed in the year the income was received by the charity. FICO Bootle were aware of the need to pay repayment supplement, but experienced difficulties in determining the repayments affected. An internal review quantified and analysed the problem; and developed a plan to put matters right.

Charity audits

- Verification of donor benefits is an objective for charity audits carried out by FICO Bootle, but not for most church charity audits carried out by FICO Scotland; and
- FICO Scotland's charity audits are less structured than those conducted by FICO Bootle and the end of case 'report' issued to the charity is not comparable to the detailed Bootle *Inspection Report*.

Accounts examinations

- In Bootle, there is a clear distinction between charity audit and accounts examination work. In contrast, in Scotland, all but two of the 1995-96 settled investigations involved work, focusing on deed of covenant validity, that was audit, rather than accounts-based; and
- in 1995-96, FICO Bootle imposed penalties in 46 per cent of recovery investigation cases, whereas FICO Scotland do not seek to charge penalties in charity cases.

4.12 Whilst recognising that some differences in procedures reflect the different charity populations covered by the two FICO offices, others arise as a result of poor liaison and have resulted in charities being treated differently depending on the compliance activity of the office which handles their affairs. **The National Audit Office recommend** that FICO should continue to strengthen liaison arrangements between their Bootle and Scotland offices and continue to ensure a consistent approach to the monitoring and control of charities.

Do FICO progress reviews efficiently and cost-effectively?

Repayment checks and charity audits are generally progressed efficiently. However, an improvement could be made in the speed of settlement of some FICO Bootle accounts investigation cases.

Repayment checks and charity audits

4.13 FICO operate a customer-orientated 'repay now, check later' system for the payment of repayment claims, aiming, in 1995-96, to pay over 95 per cent of claims within ten days of receipt. FICO Scotland met this requirement in 95 per cent of cases checked under their Quality Monitoring System and FICO Bootle in 93 per cent of cases. FICO Bootle seek to review at least 97 per cent of claims which are subject to post-repayment checks within three months of repayment of the claim. In 1995-96, they met this requirement in 88 per cent of cases checked by their Quality Monitoring System. FICO Scotland did not have an equivalent target in 1995-96, as all repayments were subject to equivalent checks prior to payment.

4.14 During recent years, FICO have changed practices in three areas in an effort to improve cost-efficiency. Firstly, in 1993, FICO introduced desk-based charity audits for smaller charities, in which records are requested from charities for office-based examination. These take an average of five hours to complete against 13 hours for a field audit. The second innovation is the adoption of a sampling approach for the audit of large dioceses, which may comprise as many as 300 churches and whose records, from a sample of parishes, are checked at a central location. Sampling is also used for the detailed testing of deeds of covenant and gift aid certificates to ensure that most charity audits can be completed in a single day; and the results are then extrapolated to estimate the gross error in a charity's repayment claims. Finally, in 1996, FICO Bootle established new audit groups at Nottingham and Worthing to save on travel costs incurred on field audits in eastern and southern England, where charities are particularly concentrated.

4.15 For charity audits, FICO's published aim is to send the charity a report of the visit usually within six weeks of the visit. All case files reviewed by the National Audit Office met this target. No target is set for the speed of settlement of cases which involve post-audit correspondence with the charity to reach agreement on the size of any irregularities uncovered. During 1995-96, in FICO Bootle, the average elapsed time to settlement for such cases was 8.7 months. All cases outstanding for more than six months are monitored by the audit group leaders. The average elapsed time to settlement for similar cases in Scotland was four months.

Accounts examinations

4.16 FICO have targeted the average time taken to settle accounts investigations (see Figures 9 and 10). Nevertheless, some cases can remain open for long periods. Six of the 22 cases reviewed by the National Audit Office took over four years to settle and three of these passed through the hands of four or more different Inspectors. In a quarter of the cases, file evidence suggested that recorded elapsed times were understated. Reasons for taking longer than average included: slow charity/agent responses to requests for information; time taken by FICO in chasing-up outstanding correspondence; further issues emerging during the course of the investigation; and, in complex cases, the need to seek technical and legal opinions. In October 1995, 10 per cent of FICO Bootle's open investigation cases were with the Board of the Inland Revenue's Solicitor, for advice or awaiting hearing before the Special Commissioners. However this percentage has been steadily reducing and, in June 1996, this figure was under two per cent.

FICO Bootle: Settlement
of accounts
investigations -
performance against
target

Figure 9

Targets and results (for cases closed in the year)	1992-93	1993-94	1994-95	1995-96	1996-97
<i>Weighted Average⁽¹⁾</i>					
Target (in months)	19	19	21	20	19
Actual (average)	17	23	19	19	25

Note: 1. Calculated by the National Audit Office on the basis of ratios of cases settled by fully trained and non-fully trained inspectors during each year.

Source: National Audit Office
analysis of FICO Bootle
management information

Figure 9 shows that investigation cases settled in 1996-97 took, on average, 25 months to settle. In 1994-95 and 1995-96, comparatively few old cases were settled. FICO's action, in 1996-97, to settle very old cases has had an adverse impact on the average elapsed time performance.

4.17 While there are procedures in place to encourage progressive case-working, they are not always followed. FICO Bootle require all open investigation cases to be formally reviewed every six months by the Inspector and line manager, but there was no evidence of review in one-sixth of such cases in the National Audit Office sample. Furthermore, whilst Inspectors' guidance recommends an early meeting with the charity/agent to discuss points at issue, in a third of cases reviewed, first interviews did not take place until two years after case opening. The Inland Revenue have no powers to compel charities or their agents to attend meetings.

4.18 FICO recognise that there is scope for improving their performance in clearing investigation cases and, in July 1996, commissioned an officer formerly in the Special Compliance Office to undertake a review of cases over three years old. The purpose of the review is to determine why the cases have not been settled and what FICO needs to do to settle them. The reviewer will also advise FICO on the future conduct of charity compliance cases to avoid unnecessary delays in settlement. Figure 10 shows the number of years taken to clear cases settled in the last three years. Of the cases which took more than five years to clear, two took more than thirteen years.

**FICO Bootle: Speed of
clearance of settled
Investigation cases**

Figure 10

Time taken to settle cases	Number of cases				
	1992-93	1993-94	1994-95	1995-96	1996-97
Less than 3 years	126	89	64	67	43
3-4 years	4	8	8	4	3
4-5 years	4	4	7	2	2
Over 5 years	6	6	2	2	8
a) Total cases settled during the year	140	107	81	75	56
b) Number (and percentage) of cases which took over 3 years to settle	14 (10%)	18 (17%)	17 (21%)	8 (11%)	13 (23%)
c) Number (and percentage) of cases from (b) which generated no monetary recovery	6 (43%)	6 (33%)	5 (29%)	4 (50%)	8 (61%)

Figure 10 shows that over the last five years more than a third of cases which took over three years to settle generated no monetary recoveries. Cases which take a long time to settle can involve complex issues, including matters of principle which have to be tested at hearings before the Special Commissioners or in the courts.

Source: National Audit Office analysis of FICO Bootle management information.

4.19 In FICO Scotland, the average elapsed time for clearing account investigation cases was two months. During 1995-96, all cases were cleared within one year, with the longest taking 10 months. However, all but two of the 24 settled investigations involved work which resembled a charity audit, entailing visits to charities to check deed of covenant and gift aid records, rather than a full accounts review.

4.20 **The National Audit Office recommend** that, to improve speed of clearance, FICO adopt a case progression strategy that emphasises early contact with the charity/agent in order to resolve any misunderstandings, ensure regular

pursuit of outstanding replies and, in complex cases, obtain early technical and legal advice. To underpin this, **FICO should ensure** that, for all investigation cases, there is a plan for progressing and settling the case within a reasonable timescale and that the way the case has been progressed is taken into account when monitoring the quality of the conduct of cases.

4.21 The National Audit Office consider that this approach should also be extended to technical review cases. These currently take six months to clear on average, and, yet, over four-fifths are closed without leading to any recovery action.

Do FICO liaise effectively with other relevant parts of the Inland Revenue and outside organisations?

Liaison within FICO and between FICO and head office divisions is effective. More could be done to improve liaison between FICO and tax districts and between FICO and other agencies.

Internal liaison

4.22 The National Audit Office found, from case-work examined, evidence of active liaison amongst FICO's compliance sections and between FICO and the Department's policy and specialist divisions, such as Savings and Investment Division, the Board of the Inland Revenue's Solicitor, and the Special Compliance Office.

4.23 The Inland Revenue had also taken steps to address a liaison problem which had, in past years, adversely affected the handling of charities with trading subsidiaries. In December 1995, FICO took full responsibility for dealing with the tax affairs of the trading subsidiaries of charities. This has made it easier for prompt and effective action to be taken to recover tax over-repaid when a charity's trading subsidiary makes a covenanted payment, via a profit shedding deed, which exceeds the amount of its final trading profits. It has also enabled FICO to take a more active role in checking that the trading subsidiaries have paid over to the Inland Revenue tax on covenanted donations. FICO have decided to focus their checks in the latter area on the larger payments. The limit set concentrates attention on about half of the 2,000 annual profit-shedding donations. **The National Audit Office recommend** that FICO monitor the results of these checks to establish whether the limit could be cost-effectively raised or reduced.

4.24 The National Audit Office, in their review of charity audit and accounts case-files, found no evidence of structured liaison with the Department's Employer Compliance units. These units visit new, or potentially non-compliant, employers to check the operation of the PAYE system and the application of benefits in kind legislation. Consequently, the results of their examinations could provide a useful indicator of those charities who are most likely to be non-compliant. **The National Audit Office recommend** that FICO review their arrangements for sharing information with Employer Compliance units and monitor the extent and success of such referrals.

Liaison with tax districts on 'tax to cover' checks

4.25 Effective liaison between FICO and local tax districts is important to ensure that individuals and companies making donations have paid sufficient tax to cover the tax repayment made by FICO to the charity: these are known as 'tax to cover' checks. FICO Bootle arrange for donors' tax offices to be notified in all cases where charities have made gift aid claims and the donor's gifts exceed a specified amount for the tax year. In FICO Scotland, information is sent to tax offices on all individual gift aid donations over this amount. Six months after the end of the financial year, a form is sent to the donor's tax district requesting notification if insufficient tax has been paid to cover the claimed repayment. During 1994-95, FICO Bootle repaid £114 million on gift aid donations, and sent 33,000 forms to the local tax districts of which around 1,000 were returned because reference numbers did not correspond with donor details. In a further 135 cases, 0.4 per cent of the total, it was found that there was no 'tax to cover' and tax districts made recoveries, which amounted to £172,000.

4.26 In 1995-96, recoveries from the normal type of case discovered from these checks rose to £0.2 million and there was a further increase to £0.6 million in 1996-97. These checks also uncovered apparently systematic abuse by a group of charities involving a potential tax loss of £1.3 million for 1995-96 and a further £0.8 million for 1996-97. This abuse is being investigated by the Special Compliance Office. It is not yet clear how much of the tax thought to be recoverable will be collected.

4.27 In 1994, as part of their annual statutory audit, the National Audit Office raised concerns with FICO Bootle that they were taking insufficient follow-up action to ensure that 'tax to cover' checks had been carried out, given that only four per cent of cases resulted in recoveries which were notified to FICO. In response, FICO conducted a pilot exercise in which they followed up a sample of 450 forms issued for 1994-95. The results of this pilot were:

- FICO were unable to trace the tax districts for 97 per cent of the 209 company donations sampled as a result of partial or incorrect reference numbers. The exercise took place at a time when the Inland Revenue had just introduced new reference numbers for companies throughout the United Kingdom. As a result, FICO were unable readily to identify corporate donors' tax offices from the information on the donors' certificates. The exercise thus proved inconclusive. FICO have since significantly changed their procedures for company donations;
- FICO were able to trace 95 per cent (229) of the 241 donations by individuals and found that:
 - in 213 cases there was sufficient 'tax to cover';
 - in 10 cases there was insufficient 'tax to cover', but no assessment was raised because of the circumstances of the case or the small amount of tax involved; and
 - in six cases recovery action was required.

The report on this pilot exercise found that the form issued by FICO was unclear and some districts did not know what action they should take on its receipt. FICO subsequently took action to change the form in November 1996. **The National Audit Office recommend** that FICO conduct periodic reviews, at least once every five years, of a sample of larger gift aid donations, referred to tax districts, to monitor the effectiveness of 'tax to cover' checks and to ensure that the procedures and forms used are adequate.

4.28 The National Audit Office also raised, in 1994, concerns that, unlike gift aid, FICO do not routinely notify tax districts of donations made under deed of covenant. In 1995-96, tax repayments on deeds of covenant amounted to £235 million, compared to £110 million on gift aid. Although gift aid payments tend to be for larger individual amounts, as they must be for £250 or more, deeds of covenant are intrinsically more risky as they are paid over a period of time, and a donor who was a taxpayer in the first year may not be by the fourth year of a covenant.

4.29 FICO conducted a small pilot exercise in 1994 in which 187 deeds, from a single charitable trust, relating to 1992-93, were checked. The findings were:

- the taxpayer's record could not be traced in seven (3.7 per cent) of the cases; and
- there was no 'tax to cover' in a further seven cases (3.7 per cent), but in only one case (one half of one per cent) was the amount material.

FICO consider that these results indicate that it is unlikely there is material tax at risk, as only one of the cases discovered involved material amounts of tax and would, therefore, have resulted in a recovery. They concluded that routine notification of donations made under deed of covenant would probably not be an effective use of resources. Consequently, this exercise has not been repeated.

4.30 **The National Audit Office consider** that the exercise focused on a small and unrepresentative sample of modest donations from one charitable trust, all of which were for amounts of less than £500, and **recommend that FICO** should carry out an annual exercise to provide assurance that the risk to public funds from repayments made under deeds of covenant for which there is no 'tax to cover' is, and remains, immaterial.

Liaison with the other Agencies

4.31 The National Audit Office found that liaison arrangements with other agencies were not structured to best effect (Figure 11) although initiatives are now underway to improve information-sharing with both the Charity Commission, who carry out a large number of reviews of charities, and HM Customs and Excise, who undertake visits to look at the tax affairs of many individual charities. Prior to September 1996, general restrictions limited the extent to which the Inland Revenue and HM Customs and Excise could share information. And the law imposes restrictions precluding general exchanges of information between the Inland Revenue and the Charity Commission. Section 10 of the Charities Act 1993, however, permits the disclosure of information which relates to whether or not a body is properly registered and acting as a charity and, in practice, this has so far covered the bulk of information that might need to be exchanged between the two departments.

Figure 11

FICO's liaison with other Agencies on compliance work

Outside body

Form of liaison

Scottish Charities Office Regular, generating a small number of accounts queries each year.

Charity Commission Long-standing, but, until recently, not developed to best effect.

In the past, FICO Bootle kept a register of cases referred from the Charity Commission. However, the National Audit Office were told that it has 'fallen into disuse'. The National Audit Office, in their review of FICO case-work, found that one investigation case settled during 1995-96 arose from a Charity Commission referral. However, in a separate review of Charity Commission case-working (HC 2 1997-98), the National Audit Office found that taxation matters arising from Investigation and support work, for example ex-gratia gifts to former trustees and non-charitable trading, were not routinely passed to FICO.

In 1991 the Charity Commission noted that a tenth of its Investigation cases were referred by the Inland Revenue. However, National Audit Office reviews of both Charity Commission (HC 2 1997-98) and FICO case-work did not uncover any referrals during 1995-96. However, the Charity Commission told the National Audit Office that investigators from all three of their offices were currently working on cases in which there was some FICO involvement.

Since 1996, closer relations have been established between FICO and the Charity Commission and cases are being sought for joint working. The National Audit Office, whilst welcoming these developments, recommend that FICO record the number of referrals to and from the Charity Commission. This will enable them to monitor the extent and effectiveness of these arrangements.

HM Customs and Excise Until September 1996, there were general restrictions agreed by Ministers which limited the extent to which the Inland Revenue and HM Customs and Excise could exchange information. When Ministers relaxed these restrictions, the Department then advised that liaison officers should be appointed to facilitate the exchange of information. FICO aim, in future, to copy across the results of completed investigations. The National Audit Office consider that FICO might usefully build in information from VAT control visits to charities to inform their own risk assessments.

Source: National Audit Office interviews with FICO staff and review of case-work.

4.32 FICO are discussing with the Charity Commission ways to improve liaison in cases being worked so as to avoid duplication of effort. Recent initiatives have included work shadowing and short secondments of compliance staff. There are also plans for joint-working of selected future cases. Whilst supporting these developments, **the National Audit Office recommend** that FICO make full use of their power under Section 10 of the Charities Act 1993 to disclose to the Charity Commission information about institutions which appear to have been carrying on non-charitable activity or applying funds for purposes which are not charitable.

Part 5: Voluntary compliance

Introduction

5.1 This part of the report looks at FICO's success in maximising voluntary compliance, one of their three main compliance aims. FICO consider that ensuring charities are aware of their obligations and are able to fulfil them correctly without intervention is the 'most effective form of compliance'. FICO's technical and research staff are responsible for providing guidance on technical matters to charities and user groups, through leaflets, meetings and seminars. A telephone help line is also available for charities to receive advice on ad-hoc queries as they arise. Educational and technical advice is also provided during charity audit visits and during the course of accounts examinations.

5.2 The National Audit Office evaluated the effectiveness of FICO's promotion of voluntary compliance against the following questions:

- do FICO analyse their compliance results to guide their voluntary compliance effort? (paragraphs 5.3 to 5.5);
- do FICO provide clear written guidance which is directed at areas prone to error? (paragraphs 5.6 to 5.8);
- do FICO direct educational seminars at charities most in need of advice and pitch them at an appropriate level? (paragraphs 5.9 and 5.10);
- do FICO provide clear advice during reviews and in response to queries from charities? (paragraphs 5.11 to 5.14); and
- do FICO measure the effectiveness of their voluntary compliance effort? (paragraphs 5.15 to 5.21).

Do FICO analyse their compliance results to guide their voluntary compliance effort?

FICO utilise their compliance results to inform their voluntary compliance strategy, though there is scope to enhance the way in which information is analysed.

5.3 FICO record details of the types of recoveries made by each section in broad terms only, for example ‘no tax to cover on gift aid’ or ‘non-charitable trading activities’. There are only two types of recovery classification used for avoidance schemes (paragraph 3.30). There are liaison meetings involving all sections within FICO to discuss common problems arising from reviews, and information is provided for the internal *Charity Bulletin*, which publishes compliance results. However, this information is not formally analysed to identify which charities or groups of charities make repeated errors, or to establish common errors, in order to guide future compliance work.

5.4 FICO take action on specific issues if major problems are highlighted via their compliance efforts. For example, when transitional relief on dividend repayments was introduced, many charities were confused by the procedures and made errors on their repayment claims. FICO, therefore, sent a mail shot to all charities who had received dividend income in the previous three years to clarify guidance on this issue. FICO Scotland also found that charities were erroneously reclaiming tax on donations made prior to the start of the relevant deed of covenant. This was addressed by issuing improved guidance and explanations regarding payments made under deed of covenant.

5.5 **The National Audit Office recommend** that, to improve the targeting and effectiveness of educational programmes, voluntary compliance initiatives should be underpinned by a formal analysis of results of compliance reviews to identify and address areas of concern before they lead to a significant level of error. FICO should investigate the scope for enhancing the management information available by using more detailed descriptions of the results of their compliance work.

Do FICO provide clear written guidance which is directed at areas prone to error?

The guidance currently available to charities is clear and explains the main tax issues charities may find difficult to understand.

5.6 The Inland Revenue produce a range of leaflets (Appendix 8) covering the services charities can expect from the Inland Revenue, the tax exemptions available and the way in which charities can reclaim the tax paid by donors on charitable donations made as gift aid or under deed of covenant. FICO are regularly consulted about the scope of the Department's leaflets programme, and the content of those leaflets particularly relevant to their business, which they continuously seek to improve. The Charity Commission always consult FICO on the possible tax implications of the guidance contained in their leaflets, for example on charities and trading, and have produced a joint information pack on fund-raising. The Charity Commission are also looking into the possibility of access to Inland Revenue information for charities through their Internet site.

5.7 FICO Scotland issue a newsletter called *Scottish Charity Tax News* to all Scottish charities every year. This explains common problems and changes in procedures. It also provides further services, such as offers to provide seminars to specific groups of charities who require further guidance on particular topics. The Charity Law Research Unit told the National Audit Office that they, and the majority of charities they had contacted, thought very highly of the help received from FICO Scotland.

5.8 **The National Audit Office recommend** that FICO continue to explore ways of informing charities of common problems and providing guidance in these areas to clarify requirements and reduce the scope for future error.

Do FICO direct educational seminars at charities most in need of advice and pitch them at an appropriate level?

FICO responds well to charities which ask for advice, but should explore the scope for targeting specific charities or charity types where known problems exist.

5.9 FICO Bootle's technical and research staff give around eight seminars each year, covering topics such as charity trading, whilst audit staff deliver around 20, focusing on gift aid and deed of covenant matters. FICO's attendance is on an invitation basis: the topics for discussion are decided by the host organisation. During 1995-96, all but two of the audit seminars were presented to church groups, chiefly dioceses.

5.10 FICO Scotland, which has achieved a *Charter Mark* for its customer service initiatives, attend around ten charity seminars each year and host an Open Day once a year when charities can visit FICO to find out more about their work and ask

advice. They have also introduced a Charity Tax Doctor Service to give advice to charities claiming tax repayments. **The National Audit Office consider** that FICO could enhance their customer service further by targeting groups of charities shown, from an analysis of compliance results, to present significant risk to tax receipts or to be error prone.

Do FICO provide clear advice during reviews and in response to queries from charities?

Customer service surveys conducted by FICO show a high level of satisfaction with advice given by FICO to charities. However, FICO do not consistently give written feedback on the outcome of charity audits and accounts examinations.

5.11 Educational advice on charity tax matters is provided to charities and their agents by FICO officers during charity audits, accounts and repayments reviews. FICO also respond to specific postal and telephone queries. FICO Bootle's technical and research staff handle around 2,000 postal enquiries and receive an average of 4,800 telephone queries each year. FICO Scotland deal with a significantly smaller population and do not separately record the number of technical queries received. Instead, they keep global figures for the whole charity function.

5.12 A Quality of Service Survey carried out by FICO Bootle in October 1994 received 271 responses from a total of 400 charities and agents contacted. More than 80 per cent of respondents gave an 'above average' quality rating for FICO's written and telephone communications in terms of courtesy, clarity, helpfulness and accuracy. However, 21 per cent did believe the quality of service could be further improved. A FICO Scotland survey showed an equally high measure of customer satisfaction. However, a significant minority of respondents considered that more attention should be given to speeding up the response to written queries. Consequently, FICO Scotland introduced a new target in 1995 to encourage post to be dealt with inside 14 days rather than 28 days. FICO Bootle, in seeking to improve response times, have developed a range of standard letters which can be issued via the computerised repayments system. At present, 60 such letters are available.

5.13 The National Audit Office found, in its review of case-work, that educational advice was given regularly. For example, the areas covered included: the ineligibility of foreign income dividends for repayment of tax; the wording, witnessing and expiry of deeds of covenant; and, the processes involved in setting up trading subsidiaries. In FICO Bootle, the results of charity audits are set out in a

formal report to the charity concerned. However, in FICO Scotland, the National Audit Office found that the post-visit contact was less detailed and standardised. The post audit reports prepared by FICO Bootle are an important source of education and advice and **the National Audit Office recommend** that these be produced by FICO Scotland.

5.14 There was written evidence of educational advice in two-thirds of the 20 FICO Bootle accounts investigations cases sampled by the National Audit Office. However, in five of the 40 FICO Bootle technical review and accounts investigation cases sampled, there was no evidence of a final letter being sent to the charity or agent at the end of the case. **The National Audit Office recommend** that all cases should be closed with a letter informing the charity of the outcome of the review and containing relevant educational advice.

Do FICO measure the effectiveness of their voluntary compliance effort?

There is no formal system for measuring the effectiveness of different aspects of voluntary compliance.

5.15 FICO make considerable efforts to promote voluntary compliance within the charitable sector. Recoveries made by FICO in the last two years have fallen, which FICO attribute to the effectiveness of the voluntary compliance programme. FICO do not publish cost:yield targets in their Operating Plan, although an aim of their Compliance Strategy is to establish systems to supply cost:yield ratios and unit costs. The scope for recovery on charity audit is much less than for accounts reviews, which look at wider aspects of charities' commercial and financial activities. In 1995-96, 42 per cent of recoveries in FICO Bootle accounts investigated were for gross amounts exceeding £10,000. In contrast, only three per cent of FICO Bootle charity audit recoveries were for this amount, while two-thirds were for sums below £1,000. The average recovery from all charity audits conducted was £775 in Bootle and £29 in Scotland.

5.16 **The National Audit Office consider** that FICO could use customer surveys and re-evaluations of charities identified as non-compliant to measure their voluntary compliance effort. However, whilst recognising the scope for further survey work, the Inland Revenue consider that surveys of this type can be costly to organise and the results difficult to interpret.

Customer surveys

5.17 FICO have undertaken a number of surveys, which have focused on customer service issues; such as the quality of written and telephone communications and the clarity of advice given. There have been no surveys to identify the extent of knowledge on compliance issues within charities and the effectiveness of the guidance produced. FICO are therefore unable to measure the effectiveness of their voluntary compliance efforts or ensure that their efforts are reaching the target audience.

5.18 **The National Audit Office recommend** that FICO include, in their future survey programme, material to identify whether FICO's voluntary compliance efforts are reaching their target audience and to identify any problem areas which can be addressed via seminars or educational publications. The survey should attempt to measure the effectiveness of the different types of education to enable FICO to concentrate resources on the most useful methods of disseminating information. In 1997-98, FICO intend to survey delegates at charity seminars to find out charities' views on the effectiveness of FICO seminars as a voluntary compliance tool. They also intend to survey charity audit customers post-audit to find out the charity's views on the overall effectiveness of FICO's audit service. **The National Audit Office suggested** that these surveys could be expanded to incorporate compliance issues as well as customer service issues.

Re-evaluations of charities identified as non-compliant

5.19 Charities are not routinely re-inspected to ensure that FICO recommendations have been implemented. However, reviews of charities found previously to be non-compliant are carried out by the repayments, charity audit and accounts sections on an ad-hoc basis. The new charity audit selection system will introduce re-inspection of charities in regular cycles depending on charity size (paragraph 3.14).

5.20 FICO do not formally analyse the results of these subsequent reviews. Six of the 30 FICO Bootle 1995-96 charity audit cases examined by the National Audit Office made reference to previous audits of that charity. There was no evidence, in these cases, that specific attention was paid to the outcome of the earlier audits and whether the advice given had been acted upon by the charities concerned. However, two of these six later charity audits generated recoveries of tax, but it was not clear whether these arose from the same mistakes found by previous audits. In 1995-96, FICO Scotland visited 40 charities which had been subject to previous reviews and found minor problems leading to recoveries in only five of these cases.

5.21 Eighteen of the 40 technical review and accounts investigation cases examined by the National Audit Office in FICO Bootle made reference to previous compliance activity. The National Audit Office could find no evidence, however, of any action taken by FICO Bootle to ensure that previous matters of concern had been dealt with by the charities concerned. They recognise that this is partly due to the nature of accounts investigations, which focus on specific aspects of a charity's activities, rather than the implementation of a set of prescribed procedures as for charity audits. Nevertheless, **the National Audit Office recommend** that accounts investigations be widened to include checks that previous matters of concern have been dealt with.

Appendix 1: Glossary of terms

Accounts Investigation	An in-depth investigation by FICO following detected irregularities in the accounts submitted to the Inland Revenue.
Accounts Scrutiny	The analytical review of Annual Reports and Accounts submitted to the Inland Revenue by individual organisations.
Avoidance	The reduction of tax liability, in a way that is unintended by Parliament, by planning the structure of business or investment transactions.
Charity Audit	The inspection of records maintained by individual organisations in support of claims for repayment of income tax on covenanted annual or gift aid payments.
Common Investment Fund	Schemes established under the Charities Act 1993 to allow charities to pool their investments into a common fund.
Deed of Covenant	A legally binding agreement on an individual or company to donate a specific sum of money each year. To qualify for tax relief on donations, a deed of covenant must run for more than three years and satisfy a number of other conditions.
Evasion	The improper and culpable non-payment of a tax liability, e.g. understating income or failing to notify chargeability.
Gift Aid	The gift of a single sum to charity. To qualify for tax relief, the net donation after tax must be in excess of £250, and satisfy a number of other conditions.
Gilt Edged Securities (gilts)	Securities issued by HM Treasury on behalf of the Government.
Governing Instrument	A document setting out how a charity is to be governed. It will normally include: the formal name of the charity; its objectives; its management structure; the type and frequency of meetings to be held; details of the way in which financial affairs are to be conducted and the production of annual accounts; and, the procedures to be used in the event of winding up.
Non-charitable Expenditure	Expenditure which is not applied for charitable purposes. This can include: non-qualifying loans and investments; non-charitable overseas donations; excessive administrative costs; and, non-commercial payments to trustees.

Non-exempt Trading Income	To protect other traders from unfair competition, a charity is liable to tax on the profits of a trade unless: i) it is exercised in the carrying out of its primary purpose; or, ii) the work in connection with the trade is mainly carried out by beneficiaries of the charity; or, iii) it falls within Extra-Statutory Concession 4, which covers small, infrequently-held fund-raising events.
Profit Shedding Deed of Covenant	A deed which commits a trading subsidiary to remit its profits to its parent charity. (See Trading Subsidiary).
Repayment	The repayment of tax deducted at source from donations made to charities under deed of covenant or gift aid.
Tax to Cover	Checks by local Tax Districts to ensure that those making donations have paid sufficient tax in the relevant financial year to cover the repayment of tax made by FICO on donations made under deed of covenant and gift aid (see above).
Technical Review	An in-depth review of accounts where irregularity is suspected. This review precedes an accounts investigation (see above).
Transitional Relief	The tax credit payable by companies on their dividends was reduced from 25 per cent to 20 per cent in 1993. To reduce the impact of this change, an additional payment was made to charities on a sliding scale over four years.
Trading Subsidiary	A company owned by a charity and formed usually to carry out trading activities that would not attract tax exemptions if carried out by the charity itself. The trading subsidiary is liable to corporation tax on its trading profits, but through 'shedding' its profits under a deed it can reduce or extinguish its own corporation tax liability.
Voluntary Compliance	Encouraging taxpayers to fully understand and comply with their tax obligations so that they are fulfilled correctly without Inland Revenue intervention.

Appendix 2: The registration, monitoring and regulation of charities in the United Kingdom

Introduction

1 The main bodies responsible for charity administration in the United Kingdom are:

- the Charity Commission;
- the Voluntary Activity Unit (Charity Branch) of the Department of Health and Social Services for Northern Ireland;
- the Scottish Charities Office; and
- FICO, Inland Revenue.

The Charity Commission

2 The Charity Commission supports and supervises charities in England and Wales. The functions, duties and powers of the Charity Commissioners are defined in the Charities Act 1993 (consolidating the Charities Act 1960, which set out the basic framework for the present Charity Commission, and the Charities Act 1992, which strengthened the Charity Commission's powers). The Act requires the Charity Commission to encourage efficient and effective use of charitable resources and safeguard them for beneficiaries. The Charity Commission's activities include:

- a) maintaining an up-to-date and accurate register of charities for public access;
- b) providing advice to charities; and
- c) investigating charity abuse, maladministration and fraud.

3 A charity is required to register with the Charity Commission, in accordance with Section 3(2) of the Charities Act 1993, if it meets both the following criteria:

a) A charity is subject to the jurisdiction of the High Court. This means that it is established in England and Wales and any one or more of the following applies:

- all or a majority of the charity trustees are resident in England and Wales;
- all or most of its assets are held in England and Wales; or
- if a company, the organisation is incorporated in England and Wales.

b) Any one or more of the following applies:

- the organisation has permanent endowment (that is, some or all of its assets are required to be held as capital which cannot be spent as though it were income);
- the organisation has a total income from all sources exceeding £1,000 per year; or
- the organisation has the rateable use of, or owns or occupies, land, including buildings, and is responsible for paying rates to the local authority for that property.

Some charities (such as charities promoting the efficiency of the armed forces) are excepted from the requirement to register by specific regulations. Others, such as friendly societies and grant-maintained schools, are exempt under Section 2 of the Charities Act 1993.

4 FICO are responsible for determining eligibility to tax exemptions on the basis of charitable status. They are therefore responsible for assessing the charitable status of those English and Welsh organisations excepted or exempted from registration with the Charity Commission.

The Voluntary Activity Unit (Charity Branch) of the Department of Health and Social Services for Northern Ireland

5 The Department of Health and Social Services (DHSS) is the charity authority for Northern Ireland. Charities Branch of its Voluntary Activity Unit handles the normal day-to-day work. Most of its functions are carried out under the Charities Act (Northern Ireland) 1964 and the Charities (Northern Ireland) Order 1987. It has no statutory role in connection with the establishment of new charities and consequently there is little contact between the DHSS and Title Section, FICO. Its main functions concern giving consent to the disposal of land or buildings by charity trustees, and making schemes to change the objects of charities whose original functions can no longer be carried out effectively. Apart from its specific functions under the legislation, a major part of the Branch's work consists of giving informal advice to trustees and their solicitors.

6 There is no registration process for charities based in Northern Ireland. Their charitable status is examined when they apply to the Inland Revenue. The same considerations apply as for unregistered bodies in England and Wales. The letter from the Inland Revenue granting charitable status is an important document, since it is the only documentary proof of charitable status that a Northern Ireland charity has.

The Scottish Charities Office

7 The supervision and regulation of charities in Scotland is governed by the terms of Part 1 of the Law Reform (Miscellaneous Provisions) (Scotland) Act 1990 and supporting regulations. The implementation of these provisions is the task of the Scottish Charities Office, which is a division of the Crown Office operating under the authority of the Lord Advocate. The main requirements of the Law Reform Act 1990 are as follows:

- a)** only a body recognised by the Inland Revenue may represent itself as a Scottish charity;
- b)** the Inland Revenue will provide specified information to members of the public about bodies which are recognised as charitable. (The information which the Inland Revenue gives out is as supplied to it by charities: it is not responsible for satisfying itself that the information is accurate);

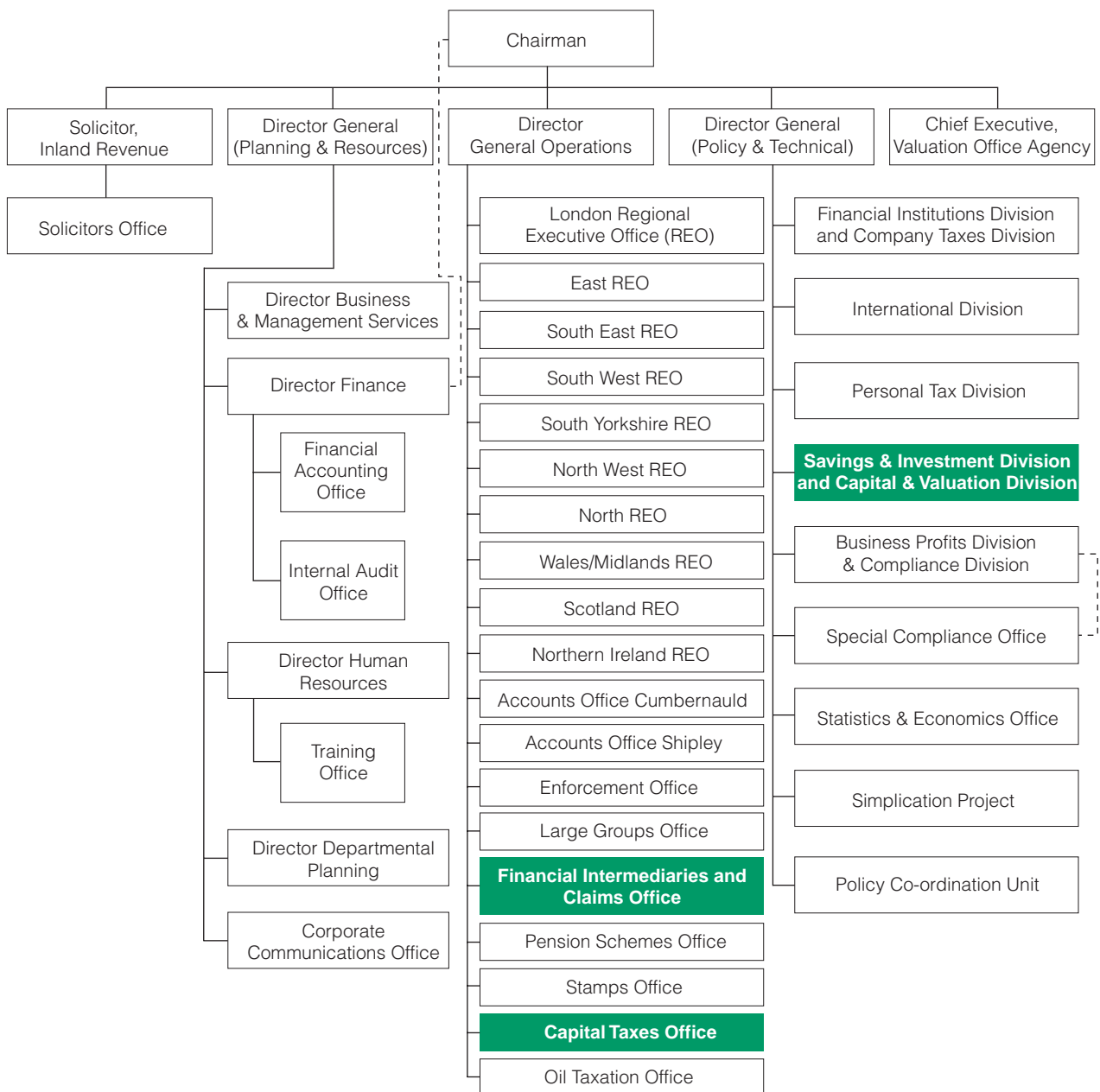
- c) all charities must produce annual accounts and provide these and the trust deed, or other document constituting the body and stating its charitable purposes, to members of the public on request; and
- d) where misconduct or mismanagement is alleged, the Lord Advocate is empowered to investigate and, where necessary, seek remedies in court.

The Lord Advocate also has the power to investigate the activities of non-recognised bodies which appear to represent themselves as charities.

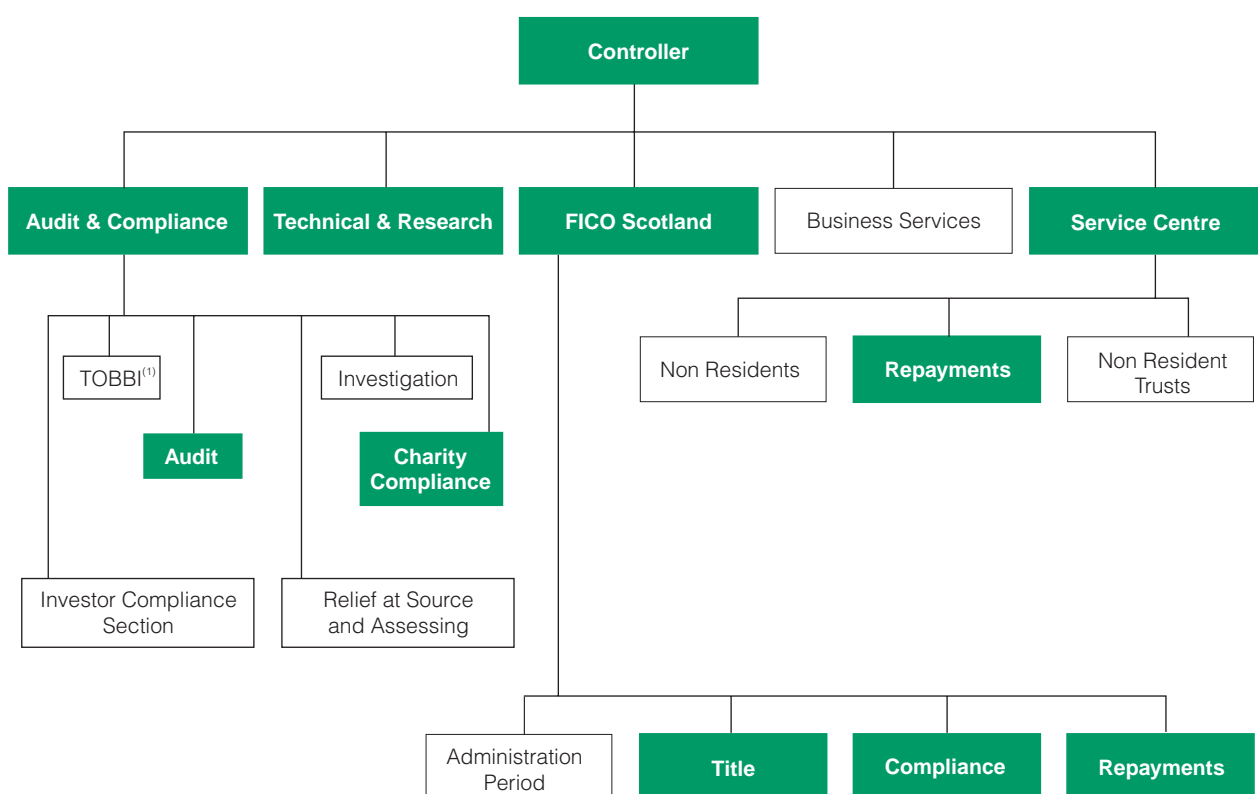
The Financial Intermediaries and Claims Office (Inland Revenue)

8 Charities are exempt from tax on most types of income and capital gains provided that these are applied solely for charitable purposes. FICO are responsible for assessing applications for tax exemption on the basis of charitable status. FICO Scotland discharges the Inland Revenue's responsibilities for Scottish charities described in the previous paragraph.

Appendix 3: Inland Revenue organisation chart



Appendix 4: Organisation chart – Financial Intermediaries and Claims Office



■ The highlighted boxes indicate the sections of FICO involved in charity work

Note: (1) The Taxation of Bank and Building Society Interest (TOBBI)

Appendix 5: Sampling methodology

Introduction

1 The National Audit Office examination of FICO's charity function focused on four main issues: the management of charities eligibility for tax exemptions; targeting compliance work; the conduct of compliance work; and, voluntary compliance (paragraph 1.10). In undertaking this examination, the National Audit Office selected random samples of recently completed cases (where possible from the 12 months October 1995 to September 1996) to identify current working methods. Details of the samples selected from each of FICO's charity sections are provided below.

Status checks

Approval of tax exemptions

2 The National Audit Office examined 30 case files from FICO Bootle and 30 from FICO Scotland to ensure the eligibility checks for tax exemptions were sufficiently rigorous and properly documented. The samples were randomly selected from the population of charities awarded tax exemptions between October 1995 and September 1996.

Deletion from FICO database of charities no longer eligible for tax exemptions

3 The National Audit Office liaised with the Charity Commission to receive a list of charities which had been deleted from the Charity Commission register in 1996 because they were no longer deemed to be entitled to charitable status. The 22 charities listed were checked to the FICO database to identify whether their right to tax exemptions had also been removed.

Repayment checks

Adequacy of repayment checks to ensure repayments are correct and only made to eligible organisations

4 The National Audit Office examined 220 repayment claims to ensure that reviews were adequately undertaken and documented. FICO review three separate populations of claims: all first claims submitted by charities; all claims over a certain amount; and, a small sample of other claims received. The National Audit Office examined cases from each of these populations, dividing the final category into two: those where recoveries were made by FICO; and, those where no recovery was made. The review populations and the number of claims examined by type and office are shown in Table 1.

Repayment populations
and sample sizes

Table 1

<i>Review Population</i>	<i>FICO Bootle</i>		<i>FICO Scotland</i>	
	<i>Population</i>	<i>Sample</i>	<i>Population</i>	<i>Sample</i>
First claims from charities	5,000	30	Not known	30
Claims over a certain amount	600-1000	30	30	10
Other claims selected in the sample check - cases where a recovery was made	1,600	30	100% check	30
Other claims selected in the sample check - cases where no recovery was made	Part of the 1600 above	30	100% check	30
Total		120		100

Source: FICO Management
Information and National Audit
Office

Charity audit and Accounts examinations

Adequacy of charity audit and accounts examinations to ensure all relevant issues are reviewed and appropriate action taken.

Charity audits

5 The National Audit Office examined 45 audit case files to review working methods and to identify examples of best practice. The case files were taken from three separate populations representing the three main types of charity audit. The population and sample sizes are shown in Table 2.

**Charity audit populations
and sample sizes**

Table 2

<i>Review Population</i>	<i>FICO Bootle</i>		<i>FICO Scotland</i>	
	<i>Population</i>	<i>Sample</i>	<i>Population</i>	<i>Sample</i>
Visit based church audits	525	10	204	10
Visit based non-church audits	175	10	17	5
Desk-based audits	125	10	NIL	NIL
Total	825	30	221	15

Source: FICO management
information and National Audit
Office

Accounts examinations

6 The National Audit Office examined 143 sets of accounts and 95 worked cases to identify whether the work done by Accounts Section was well documented, sufficiently rigorous and that appropriate action was taken. Samples 1 and 2 relate to the selection of accounts for scrutiny and Samples 3 to 5 cover completed technical review and investigation cases. The types of review and the number of accounts examined by type and in each office are shown in Table 3.

**Accounts populations
and sample sizes**

Table 3

<i>Population</i>	<i>FICO Bootle</i>		<i>FICO Scotland</i>	
	<i>Population</i>	<i>Sample</i>	<i>Population</i>	<i>Sample</i>
1) Accounts received but not scrutinised	600 ⁽¹⁾	53	135 ⁽²⁾	20
2) Scrutinised accounts	3,831	50	314 ⁽²⁾	20
3) Technical review cases with no recovery made	143	18	115	12
4) Investigation cases	63	22	26	13
5) Trading subsidiary accounts	142 ⁽³⁾	30	–	n/a
Total		173		65

Notes: 1. Accounts received in November 1996 but not screened.

2. Four separate weeks selected at random.

3. Cases where the parent charity was over-repaid at least £5,000 on a profit shedding deed tax repayment claim.

Source: FICO management
information and National Audit
Office

Appendix 6: List of national organisations contacted by the National Audit Office

Charities Aid Foundation

Charity Commission

Charity Finance Directors' Group

Charity Forum

Charity Law Research Unit

Charities Tax Reform Group

Institute of Charity Fund-raising Managers

National Council for Voluntary Organisations

Scottish Charities Office

Appendix 7: Charity compliance staffing and activity levels - 1992-93 to 1996-97

1 The staff resources available for the different types of compliance activity is set out in Table 4. This shows that around 80 staff were devoted to charity compliance work by FICO Bootle and FICO Scotland at the beginning of 1997.

FICO staff resources
devoted to charity
compliance in
January 1997

Table 4

FICO office	Staff in charity functional section [yearly equivalents]		
	Repayments	Audit	Accounts Inspector ⁽¹⁾
Bootle	37 ⁽²⁾	13 ⁽³⁾	8.5
Scotland	6	1	0.3

Notes: 1. There is also a small group of ten case-workers and five clerical support staff within the accounts section who carry out checks on profit-shedding deeds, legacy claims, transitional relief payments, 'tax to cover' and 'time charities'.

2. 12 additional staff were involved in work relating to the processing of repayments claims rather than compliance.

3. 2 and 3 of these staff were stationed, respectively, at offices in Worthing and Nottingham.

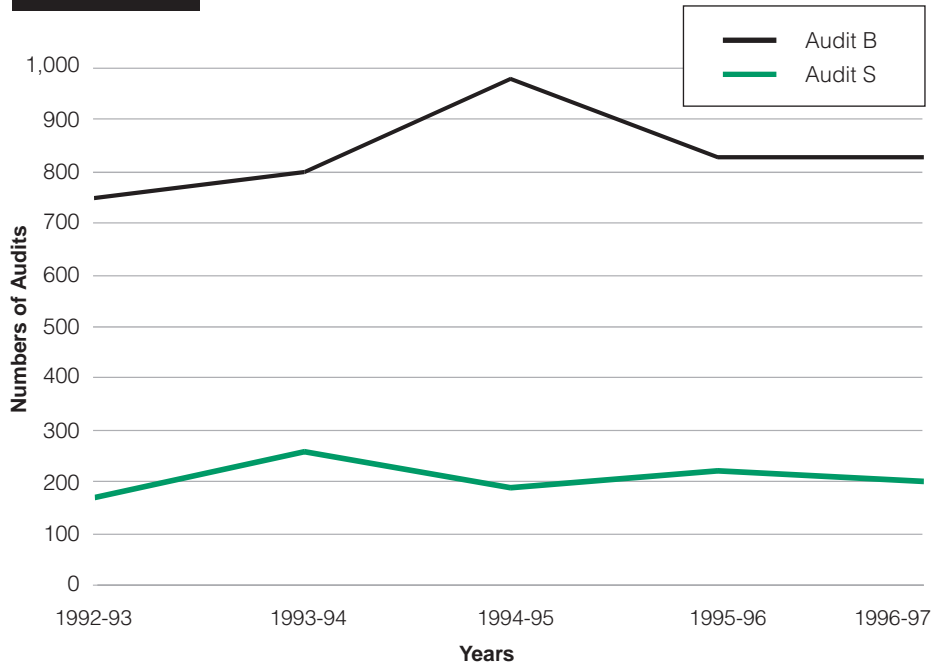
Source: National Audit Office
analysis of FICO management
information

2 Table 5 shows that the annual number of charity audits has increased by 11 per cent between 1992-93 and 1996-97.

3 Table 6 shows the numbers of technical reviews and investigation cases in FICO Bootle and FICO Scotland between 1992-93 and 1996-97. The numbers have more than halved from totals of 779 and 204 to 358 and 99.

FICO Bootle (B) and Scotland (S) number of charity audits completed, 1992-93 to 1996-97

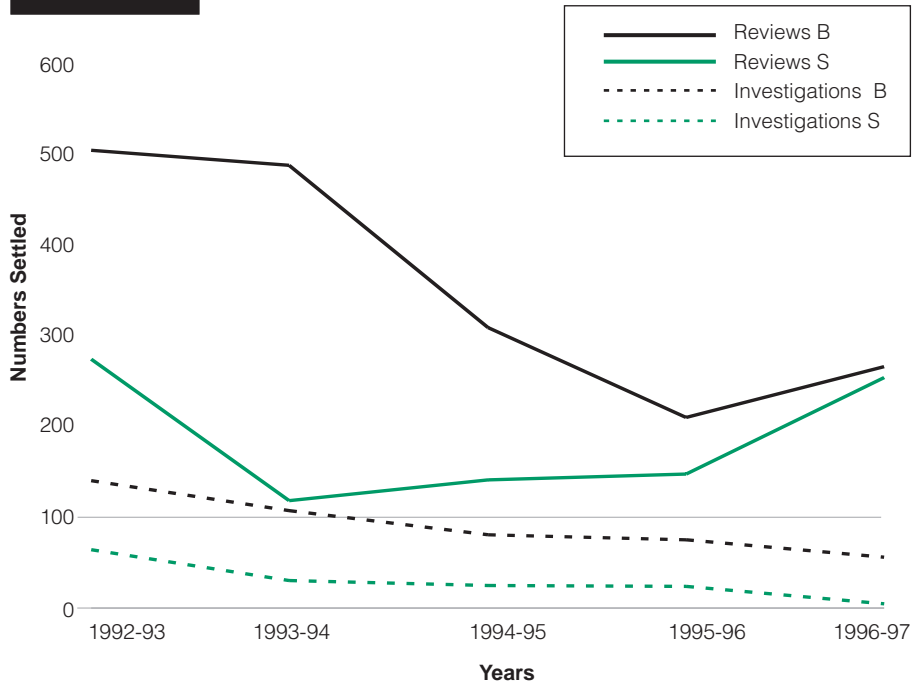
Table 5



Source: FICO management information

FICO Bootle (B) and Scotland (S) number of accounts, reviews and investigations, 1992-93 to 1996-97

Table 6



Source: FICO management information

Appendix 8: List of charity information leaflets produced by the Inland Revenue

Giving to charity: How businesses can get tax relief (IR64), 1993 (Available in English and Welsh)

Companies and individuals in business can get tax relief for payments made to charity. This leaflet describes how the relief is given.

Giving to charity: How individuals can get tax relief (IR65), 1993 (Available in English and Welsh)

A brief explanation of how you can get tax relief on gifts made to United Kingdom charities through the Payroll Giving Scheme, Deeds of Covenant and Gift Aid.

Tax reliefs for charities (IR 75), 1987

Charities benefit from important tax reliefs. This booklet describes how they can qualify and explains tax exemptions and charitable expenditure.

Setting up a charity in Scotland [CB(1)], 1993 (Available in English and Gaelic)

This leaflet is for anyone thinking of setting up a charity in Scotland. It answers some of the most common questions asked of FICO.

Deeds of Covenant: Guidance for charities (CS1), 1993 (Available in English and Welsh)

This leaflet is designed to help charities who use covenants to get their arrangements right for tax purposes. It includes simple forms of covenant for individual donors which charities can use if they wish.

Gift Aid: A guide for donors and charities (IR 113), 1994 (Available in English and Welsh)

Gift Aid is a tax relief for single cash gifts made to charity. The booklet explains how individuals and companies can use the gift aid scheme.

You and the Inland Revenue: Financial Intermediaries and Claims Office (IR 120), 1996 (Available in English and Welsh)

This leaflet tells you about the standard of service you can expect from FICO.

Guidelines on the tax treatment of disaster funds, 1989

After a disaster, people often want to offer practical assistance by contributing or raising money to help the injured or bereaved. This leaflet, issued jointly with HM Customs and Excise, is designed to help people organising such appeals. It explains the sort of tax issues which can arise and ways in which they might be handled.

Payroll Giving Scheme. A guide for employees, 1994

This leaflet explains how easily you can give to the charity of your choice and get tax relief too.

Payroll Giving Scheme. A guide for employers, 1994

There is no obligation on an employer to run a payroll giving scheme, but, if you do, you will have the satisfaction of helping your staff to give to a charity in a very simple way and to get tax relief on their donations. This leaflet explains how easy it is for you to run a scheme.

Code of Practice 5 - Inspection of charities' records

This booklet advises charities of FICO's procedures and charities' rights when FICO inspect their records.

Charity Fund-raising Pack*

Trading by charities: Guidelines on the tax treatment of trades carried on by charities (CS2), 1995

Many charities carry on trades, either as part of their charitable activities or to raise funds for those activities. This booklet explains how FICO treat the trading profits of charities for tax purposes. It describes the exemptions from tax available for these trading profits, both by statute and by concession.

Fund-raising for charity: What to look out for on tax (1996)

This leaflet provides guidance on how the Inland Revenue treat the profits of fund-raising activities for charity. In particular, it explains the circumstances in which, by concession, FICO will not seek to tax the profits of certain events arranged to raise funds for charity.

* This pack, which is produced jointly with the Charity Commission and HM Customs and Excise, also contains a Charity Commission leaflet, 'Charities and fund-raising: A summary' (1995), and a HM Customs and Excise leaflet, 'Value Added Tax: Charities'.