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Inland Revenue

Report of the Comptroller and Auditor General

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executive summary

- 1 Section 2 of the Exchequer and Audit Departments Act 1921 requires me to examine the accounts of the Inland Revenue to establish that adequate regulations and procedure have been framed to secure an effective check on the assessment, collection, and proper allocation of revenue and to examine the correctness of sums brought to account. This report sets out the results of audit examinations carried out by the National Audit Office in fulfilment of these requirements.
- 2 The Inland Revenue is managing a major change programme. Following the implementation of self assessment for income tax and corporation tax, 1999-00 saw the transfer of the Contributions Agency to the Department, along with policy responsibility for the national insurance scheme. In August 1999 the Department introduced new arrangements for collecting tax in the construction industry affecting over 1 million taxpayers and, in October 1999, implemented an important new programme of tax credits for working families and disabled people. This change programme is set to continue.
- 3 During 1999-00, we carried out examinations on both new and existing systems. New systems examined included the construction industry scheme, tax credits and income tax and corporation tax self assessment. Reviews of existing systems included inheritance tax, PAYE, petroleum revenue tax, stamp duty, and tax deducted at source by banks and building societies. Checks on the information technology operations included reviews of the Inland Revenue's main computer installations and the Department's management of the risks associated with its information technology infrastructure.
- 4 Overall, our work provided assurance that the Inland Revenue's regulations and procedure continued to provide an effective check over the assessment, collection and allocation of tax. My report on the Inland Revenue's trust statement for 1999-00 (CM 5029) records that I was also satisfied with the correctness of sums brought to account.
- 5 My report focuses both on new systems and on the impact of change on existing systems. The key points arising from these examinations were:
 - The Inland Revenue cleared the PAYE tax records of one million people without knowing whether they had paid the correct amount of tax in 1997-98 because of difficulties in processing employers' end of year returns. The Department estimates that, had it been able to process the records in the normal way, its checks would have identified some £4 million underpaid tax and £22 million overpaid tax. The Department believes that the processing difficulties have now been resolved, but will not know for sure until it has completed work on processing 1998-99 end of year returns. It is conducting a fundamental review of its systems, and this needs to be completed quickly to provide assurance on the completeness and reliability of the entire process, particularly as the systems will have to cope with additional information on tax credits and collection of student loan repayments from 2000-01. The Department should also examine the scope to alert those taxpayers affected to the risk that they may have under or over paid tax.

- In the first six months of the new tax credits scheme, the Inland Revenue paid out more than £1 billion to around one million applicants. Implementation went smoothly, and the Department is continuing to strengthen the controls necessary for the effective operation of the scheme. In particular, it should continue both to refine its approach to managing the risk of erroneous or fraudulent applications and improve the assurance it obtains about the reliability and accuracy of the substantial amounts paid out of tax revenue.
- Introduction of the new construction industry scheme in August 1999 has led to the identification of around 100,000 people not previously registered with the Department, and produced an estimated £280 million extra tax receipts in 1999-00. But there were some teething troubles, particularly with the issue of registration cards and tax certificates to over one million contractors and subcontractors in the industry and in managing the issue and receipt of returns from taxpayers. As a result, the Department has temporarily scaled back planned work to reconcile tax paid with contractors' returns. These difficulties have increased the risk of fraud and error remaining undetected in the early stages of the scheme, when procedures are settling down and systems are at their most vulnerable. The Department is working to resolve these difficulties.
- Following a Committee of Public Accounts report in 1998, the Inland Revenue has made a number of improvements to the way it checks employers' compliance with PAYE regulations. The recent transfer of the Contributions Agency will streamline the way that checks on tax and national insurance contributions are carried out. But this, and other organisational changes, have affected the level and quality of work, and there is further scope to target resources on higher-risk employers. Having completed a major reorganisation in April 2000, the Department is now in a position to address these issues.

Part 1

Scope of the audit

- 1.1 Section 2 of the Exchequer and Audit Departments Act 1921 requires me to examine the accounts of the Inland Revenue on behalf of the House of Commons. The purpose is to establish that adequate regulations and procedure have been framed to secure an effective check on the assessment, collection, and proper allocation of revenue and are being duly carried out. The legislation also requires me to examine the correctness of the sums brought to account and to report the results to the House of Commons.
- 1.2 For 1999-00, the Inland Revenue had to prepare Resource Accounts and a Trust Statement. I have issued unqualified audit opinions on these accounts. My audit of the Trust Statement fulfils the statutory requirement in Section 2 (2) of the 1921 Exchequer and Audit Departments Act to examine the correctness of the sums brought to account.
- 1.3 Each year, the National Audit Office also carry out work to fulfil the statutory requirement under Section 2 (1) of the 1921 Act to examine those systems which the Department have put in place to secure an effective check on the assessment, collection and allocation of revenue. This work includes:
 - the examination of the Department's internal controls, including the evaluation of new systems and significant changes to existing ones;
 - periodic in-depth reviews of existing systems;
 - reviews of quality assurance work and other checks carried out by the Department on the tax systems;
 - reviews of the Department's computer installations and networks and specific information technology applications; and
 - test examinations of individual transactions and balances.

Figure 1 (overleaf) summarises our coverage in 1999-00.

1 National Audit Office examination of Inland Revenue tax systems 1999-00

Tax system	Aspects examined	Notes
Income tax and capital gains tax	Validation work carried out by Inland Revenue Internal Audit on the quality monitoring exercise which measures the accuracy of the issue of PAYE tax coding notices. Validation work carried out by Inland Revenue Internal Audit on the quality monitoring exercise which measures the accuracy of self-assessment returns processing. In-depth review of income tax and capital gains tax self assessment system. End of year checks on PAYE records. Inland Revenue checks on employers' compliance with PAYE regulations. Introduction of the Construction Industry Scheme. Tax deducted at source by banks and building societies.	Separate report to Parliament in Spring 2001 See Part 3 See Part 6 See Part 5
Corporation tax	Controls over registration of incorporated companies. Processing of corporation tax returns and selection of enquiries into returns. Initial review of quality of compliance work.	
Inheritance tax	Processing of inheritance tax returns. Inheritance tax assessments. Quality of inheritance tax compliance work.	
Stamp duty	Document stamping and collection of stamp duty.	
Petroleum revenue tax	In-depth review of all aspects of petroleum revenue tax	Separate report to Parliament in December 2000 (HC5)
Working families' and disabled person's tax credits	Application processing and assessment of awards for the period October 1999 to March 2000 Quality assurance procedures. Applicant compliance work. Payment and accounting arrangements.	See Part 4

1.4 Information technology is integral to the administration of taxes. Computers hold data on all taxpayers, process information received, and produce a range of outputs designed to assist the taxpayer and the Department to discharge their obligations accurately and efficiently. We therefore conduct regular examinations of how the Inland Revenue manages the risks associated with the operation of information technology systems.

1.5 In 1999-00, our coverage included the main computer installations, the steps taken to modify these systems to address the Millennium Threat, and progress towards the introduction of paperless systems, in line with the Modernising Government agenda. In addition, we carried out a programme of reviews of the Department's information technology infrastructure. These reviews included the Wide Area Network, which links desk top computers in local tax offices to each other and to the main computer installations, the procedures for amending tax and other software, the transfer of data between systems and the management of information technology capacity.

1.6 Overall, our work in 1999-00 provided assurance that the Inland Revenue's regulations and procedure continued to provide an effective check over the assessment, collection and allocation of tax. The main findings from our work are set out in the following parts of this report.

- Part 3: the interface between the income tax and national insurance computer systems
- Part 4: the introduction of tax credits
- Part 5: the introduction of the construction industry scheme
- Part 6: the Department's work to check employers' compliance with the PAYE scheme

1.7 In addition to my examination of tax systems under section 2 of the Exchequer and Audit Departments Act 1921, I also examine the economy, efficiency and effectiveness with which the Inland Revenue has used its resources. The results of these value for money examinations are published in separate reports to the House of Commons under section 9 of the National Audit Act 1983. Since my last report on the Department's accounts, I have reported on the award of new work to EDS under the Department's strategic partnership with the firm (HC 351, 1999-00).

Part 2

Risk management

2.1 **Figure 2** shows the net receipts from the taxes and duties collected by the Inland Revenue in 1999-00 and the cost of collection, compared with previous years.

2 Inland Revenue: tax receipts and administrative costs 1995-96 to 1999-2000

	Net receipts (1)				1999-00 £ billion	Admin- istrative costs 1999-00 per cent
	1995-96 £ billion	1996-97 £ billion	1997-98 £ billion	1998-99 £ billion		
Income tax	68.1	69.1	76.8	86.6	93.0	1.77
Corporation tax	23.6	27.8	30.4	30.0	34.4	0.76
Capital gains tax	0.8	1.1	1.5	2.0	2.11	1.49
Inheritance tax	1.5	1.5	1.7	1.8	2.0	1.46
Stamp duty	2.0	2.5	3.4	4.6	6.9	0.11
Petroleum revenue tax	0.9	1.7	1.0	0.5	0.9	0.24
Windfall tax	-	-	2.6	2.6	-	-
Total tax receipts (£ billion)	96.9	103.7	117.4	128.1	139.3	
Cost of collection (£ billion)	1.65	1.63	1.65	1.70	1.84	
Cost as a % of tax collected	1.70%	1.57%	1.41%	1.33%	1.32%	

Notes: 1. These receipts are shown net after allowing for tax credits, tax reliefs and allowances, and for repayments. Repayments in 1999-00 amounted to £13.9 billion.

2. The Inland Revenue also collected £58.7 billion national insurance contributions, the majority of which are paid into the National Insurance Funds.

Source: National Audit Office analysis of Inland Revenue data

2.2 From October 1999, the Inland Revenue assumed responsibility for the payment of tax credits to working families and disabled persons. These replaced two social security benefits, family credit and disability working allowance, administered by the Benefits Agency in England and by the Social Security Agency in Northern Ireland. The Department paid out £1.033 billion in 1999-00 and the associated administrative costs were £36 million.

Inland Revenue risk management framework

The Board of Inland Revenue

2.3 Statutory responsibility for the administration of inland revenue and the national insurance system, with cashflows exceeding £200 billion a year, lies with the Board of Inland Revenue, who are accountable to the Treasury. Members of the Board exercise their responsibility for the financial control of the Department through the Departmental Management Committee, Departmental Audit and Security Committee and Human Resources Committee. Each of these, chaired by a Member of the Board, ensures that for their area of responsibility the system of internal control encompasses policies and processes to manage risk and facilitate the effective and efficient operation of the Department.

Tax evasion and fraud

2.4 Within this framework, the Inland Revenue has established procedures to manage the risk of tax evasion and fraud. The Department's staff represent the first line of defence against this type of non-compliance. Using risk assessment procedures, staff identify cases where non-compliance is most likely to occur and target enquiries accordingly. Investigation of cases where significant tax evasion or fraud is suspected is the responsibility of the Department's Special Compliance Office.

2.5 In response to Lord Grabiner's report on the informal economy, the Finance Act 2000 introduced an offence of fraudulently evading income tax. It also provided the Inland Revenue with power to obtain papers from lawyers, accountants and other tax advisors. This power, along with existing procedures, revisions to existing schemes, and the recently established tax and benefits confidential helpline, is expected to further help the Department combat tax evasion and fraud.

Statements on the system of internal financial control

2.6 In 1997, the Treasury introduced a requirement for departmental accounts to include a statement by the Accounting Officer about the organisation's system of financial control. The introduction of this statement stemmed from the initiative to improve the management and governance of companies begun by the Code of Practice from the Cadbury Committee. The purpose was to confirm that the Accounting Officer had satisfied the responsibility to ensure that effective management systems, including financial monitoring and control systems, had been put into place.

2.7 Statements were included for the first time in the Inland Revenue's accounts for 1997-98. Since then, the Department has extended the scope of its financial control statements in line with the level of disclosure sought by the Treasury.

2.8 In September 1999, the Turnbull Committee issued "Internal Control: Guidance for Directors on the Combined Code". This new guidance requires boards of listed companies to produce a statement on the system of accounting control for accounting periods ending on or after 23 December 2000. Key features to be covered by the statement include:

- that the board has maintained a sound system of internal control to safeguard investment and the body's assets;
- acknowledgement that the board is responsible for the body's system of internal control and for reviewing its effectiveness;

- that the adequacy of any aspects of review work delegated to others has been considered by the board;
- the existence of a strong internal audit function with sufficient lines of communication to report weaknesses on a timely basis, whose remit and resources are reviewed annually by the board. Where such a function does not exist, the need for one should be reviewed annually; and
- acknowledgement that the body has disclosed in their annual reports that (a) a system of risk identification, evaluation and management exists; (b) the process for reviewing its effectiveness; and (c) how any significant internal control aspects arising from other disclosures in the account have been addressed.

The Treasury has decided that the guidance should be adopted by central government. Accordingly, proposals have been developed which require bodies to produce a statement on the system of internal control in their 2001-02 accounts.

- 2.9 The Inland Revenue is developing an assurance framework to meet the disclosure requirements. They also have in place a system of annual self-certification, by Directors, covering financial regularity, propriety and physical security. Guidance on the degree of scrutiny and acceptable level of evidence for this latter process and the wording of certificates are currently under review. It is important that these considerations are completed timeously and the requirements communicated to key staff, so that appropriate systems can be implemented in April 2001, the start of the 2001-02 accounting period.

Part 3

The interface between the income tax and national insurance computer systems

3.1 This part of my report examines difficulties which have arisen in transferring information on employees' pay and income tax deductions from the national insurance recording system (NIRS2) to the computerisation of PAYE system (COP) and the impact of these on the Inland Revenue's administration of income tax.

Background

3.2 Under PAYE arrangements, employers are required to deduct tax and national insurance contributions from their staff's earnings and to pay over these sums to the Inland Revenue. At the end of each tax year, employers are obliged to complete a return for each employee showing the gross amount earned and the total amount of tax and national insurance deducted.

3.3 The information is entered onto NIRS2, on which individuals' national insurance contribution records are maintained. NIRS2 produces details of pay and tax for all employees and these are transferred via magnetic tape to COP, which holds individual PAYE taxpayers' records. COP matches the information produced by NIRS2 to taxpayer records and checks that the correct amount of tax for the year has been paid. Under and over payments of tax are investigated and may then result in the issue of demands or refunds. Once this process has been completed, the taxpayer's record for that year is formally closed.

3.4 The transmission of data from NIRS2 to COP and the subsequent matching of details is, therefore, an important process. This is because it allows the Inland Revenue to check that the correct amount of tax has been paid for a particular year without the need for sending annual tax returns to the 20 million PAYE taxpayers not covered by income tax self assessment.

Data transfer difficulties

1997-98

3.5 The first year's data processed by NIRS2 and transferred to COP related to the 1997-98 tax year. A number of difficulties affected the transfer of data, and the Inland Revenue was unable to close off pay and tax details for a significant number of taxpayers. The difficulties included:

- a late start to processing;
- the NIRS2 data validation process rejecting more records than expected, which delayed the transfer of information to COP;
- tapes containing data that was incorrectly labelled, incomplete or unreadable; and
- an omission in the design of NIRS2, since corrected, which meant that data could not be matched automatically to COP records where there had been a change in national insurance number.

These difficulties delayed the matching of 1997-98 pay and tax details to taxpayers' records and the subsequent closure of those records.

- 3.6 Significant administrative effort was needed to identify, quantify and resolve the difficulties associated with transferring the data so that tax records could be closed. This work included:
- development of special programs to detect and delete erroneous data from the COP database, as NIRS2 initially produced invalid data;
 - matching open cases on COP with NIRS2 to identify cases where taxpayers pay and tax details were on NIRS2 but not on COP;
 - submission of fresh computer tapes from NIRS2; and
 - development of special software to allow the Department, exceptionally, to process data for 1998-99 alongside data for 1997-98.
- 3.7 Despite this work, at the time of our initial examination, the Inland Revenue had still to complete its end of year checks on an estimated 2.5 million records for the 1997-98 tax year. The Department told us that these records included 0.4 million records not previously provided by NIRS2 that needed to be processed. Of the remainder:
- 1.4 million records had no pay or tax details at all; and
 - 0.7 million records had some pay and tax details, but had been flagged up by the Department's validation checks for review.
- 3.8 The existence of cases without pay and tax details following the processing of employers' end of year returns is not unusual, but in the past has been on a much smaller scale, typically around 300,000 cases. In these circumstances, the Department would normally approach the taxpayer or the employer for the relevant information.
- 3.9 The Department considered that adopting this option for the 1.4 million 1997-98 records without pay and tax data would involve costs which were disproportionate to the amount of tax involved. On the basis of previous experience, the Department considered that the net tax at risk from failure to match the records was about £2 million, whereas reviewing the cases, including approaching taxpayers for the missing information and dealing with the results of that exercise, would have cost around £9.5 million. It also believed that extending the processing of 1997-98 information for a further year would risk destabilising the processing of 1998-99 and 1999-2000 data.
- 3.10 The Department's experience indicated that, where pay and tax details were available, the COP record would normally be cleared automatically in the majority of cases because the correct amount of tax had been paid. In view of this, and the risks and costs associated with pursuing the cases, the Department decided in March 2000 to clear most of the records for which there was no 1997-98 pay and tax information without checking whether the correct amount of tax had been paid by the people concerned. However, it excluded cases identified as likely to have tax overpaid or underpaid and those still open for earlier years.
- 3.11 The Department commissioned EDS to write software to review each case, close the relevant cases, and produce a list of taxpayer records cleared in this way for future reference. This automatic process cleared 1.04 million of the 1.4 million cases of records with no pay or tax details. Following further work to quantify the likely tax at risk, the Department estimated that, had it been able to process the cases in the normal way, it would have identified underpaid tax of £4 million and overpaid tax of £22 million. The Department continues to review these cases on an individual basis where further information becomes available or if a taxpayer makes a repayment claim.

3.12 In view of these difficulties, the Department commissioned an internal review of the data transfer process between the NIRS2 and COP systems. The report, issued in February 2000, noted that EDS had been unable to test fully the new interface between the systems before it went live, as COP did not have details of the test cases used by NIRS2 in its database. Consequently, EDS could do no more than satisfy itself that the resulting input files looked reasonable.

3.13 The report recommended improvements to the way the Department and its information technology service providers addressed issues of mutual interest, including procedures for dealing with problem and incident management. In response, the Department set up a forum that meets every fortnight to monitor the position. In addition, the Department and Accenture (formerly Andersen Consulting), who operate NIRS2, have introduced a revised operational working agreement to define and manage the end of year processing on NIRS2.

3.14 While the report did not focus on the processing difficulties, it made a number of recommendations for improvement including the simplification of end of year returns, reducing the number of permissible variants for returns on magnetic media, passing validated information directly to the COP system and, generally educating employers.

1998-99

3.15 At the end of May 2000, NIRS2 had processed over 98 per cent of employers' end of year returns data for 1998-99. Although the Department was confident that both NIRS2 and COP were processing information reliably, at this point there were still some 5.2 million cases on COP without pay and tax details. By the end of November 2000, the number of such cases had fallen to 2.1 million. The Department told us that it expected to achieve further significant reductions by March 2001.

3.16 The Inland Revenue has set up a working group to review the entire process for dealing with employers' end of year returns, from receipt by the Department to entering pay and tax details on COP. This is taking into account issues raised in our report on the National Insurance Fund account for 1998-99 (HC 146, 1999-00), the review carried out in February 2000 (paragraphs 3.12 to 3.13 above), and issues arising from the Department's fortnightly forum. The Department expects to have considered its findings by early 2001.

Conclusions

3.17 The PAYE system underpins the majority of revenue collected by the Inland Revenue. The information technology systems which enable the Department to ensure that individuals have met their tax obligations each year therefore need to operate effectively. The automatic clearance of 1 million individual income tax records for 1997-98 represents a failing in the normal operation of the PAYE system and the quality of service to the taxpayers involved. It is too early to assess the extent to which the Department will be able to complete its checks on 1998-99 tax records.

3.18 As a result of these difficulties, some taxpayers may be unaware that they are due a repayment for 1997-98, and others may owe tax. Although the Inland Revenue believes that the overall amounts at risk are likely to be small, the impact on individual taxpayers could be significant. The Department should examine the scope to alert those taxpayers affected to the risk that they may have under or overpaid tax.

3.19 The Inland Revenue needs assurance about the completeness and accuracy of processing of end of year returns. Its work to review the entire process for dealing with employers' end of year returns needs to be completed quickly, and any outstanding difficulties resolved. This is particularly important in view of the additional information on the payment of tax credits and collection of student loan repayments to be included in employers' end of year returns from 2000-01, which will need to be reconciled with Departmental records to provide assurance on the operation of these new schemes.

Part 4

Tax credits

Introduction

4.1 This part of my report looks at:

- the background to the introduction of the working families' tax credit and disabled person's tax credit in October 1999 (paragraphs 4.2 to 4.7);
- how tax credit applications are processed and how the Inland Revenue accounts for expenditure (paragraphs 4.8 to 4.9);
- the way the Department manages the main risks in the system (paragraphs 4.10 to 4.27); and
- performance monitoring and management (paragraphs 4.28 to 4.31).

Background

4.2 In the 1998 Budget, the Chancellor of the Exchequer announced the introduction of working families' tax credit and disabled person's tax credit as part of the government's programme of tax and benefit reforms to make work pay. The tax credits are designed to enable working families and disabled people to receive financial assistance through the tax system rather than through social security benefits. While payments in the initial six months were made directly by the Inland Revenue, the intention was that from April 2000 the majority of people would receive tax credits via their employers with their pay. Self employed and non-earning applicants would continue to receive their tax credits direct from the Revenue. In the longer term, the government plans to introduce a new integrated child tax credit and employment tax credit to build on, and replace, the working families' tax credit and disabled person's tax credit.

4.3 Working families' tax credit and disabled person's tax credit replaced family credit and disability working allowance, administered by the Department of Social Security Benefits Agency, and in Northern Ireland, by the Social Security Agency. **Figure 3** (overleaf) provides a summary of the main tax credit rates and entitlements, compared with those for family credit and disability working allowance. Just over £1 billion tax credits were paid out by the Inland Revenue in the first six months of the scheme and it expects spending to rise to over £4.5 billion in 2000-01, the first full year of operation.

3 Comparison of tax credit rates and entitlements with those for the social security benefits they replaced (figures relate to October 1999)

Element	Working families'/disabled person's tax credit entitlement per week		Family credit/disability working allowance entitlement per week	
Basic entitlement	WFTC	£52.30	FC	£49.80
	DPTC - single	£54.30	DWA - single	£51.80
	DPTC - couple/lone parent	£83.55	DWA - couple/lone parent	£81.05
Applicant working > 30 hours	Additional	£11.05	Additional	£11.05
Each child	Under 11	£19.85	Under 11	£15.15
	Aged 11 to 15	£20.90	Aged 11 to 15	£20.90
	Young person 16 to 18	£25.95	Young person 16 to 18	£25.95
Child care costs	Credit of 70% of childcare costs up to a maximum cost of £100 for one child or £150 for two or more children.		Earnings disregarded of up to £60 for the childcare costs of one child or £100 for the costs of caring for two or more children.	
Disabled child's allowance	DPTC (only)	£21.90		£21.90
Taper applied to income in excess of disregarded income threshold (£90 per week)	55%		70%	
Income threshold	WFTC	£90.00	FC	£80.65
	DPTC - single	£70.00	DWA - single	£60.50
	DPTC - couple/lone parent	£90.00	DWA - couple/lone parent	£80.65

Sources: *Decision Maker's Guide, Inland Revenue*

4.4 The main differences between the tax credits and the social security benefits they replaced relate to the introduction of greater assistance with child care costs, the disregard in full of maintenance payments, and a reduction in the rate (taper) at which an award is reduced when an applicant's earnings exceed the appropriate threshold.

4.5 The effect of these changes has been to increase the number of applicants entitled to support and to provide a generally higher level of award than those made under family credit and disability working allowance. In March 2000, the Inland Revenue was paying working families' tax credits awards averaging £72 a week to 1,057,000 applicants, compared to some 817,000 family credit awards averaging £63 a week by the Benefits Agency in August 1999.

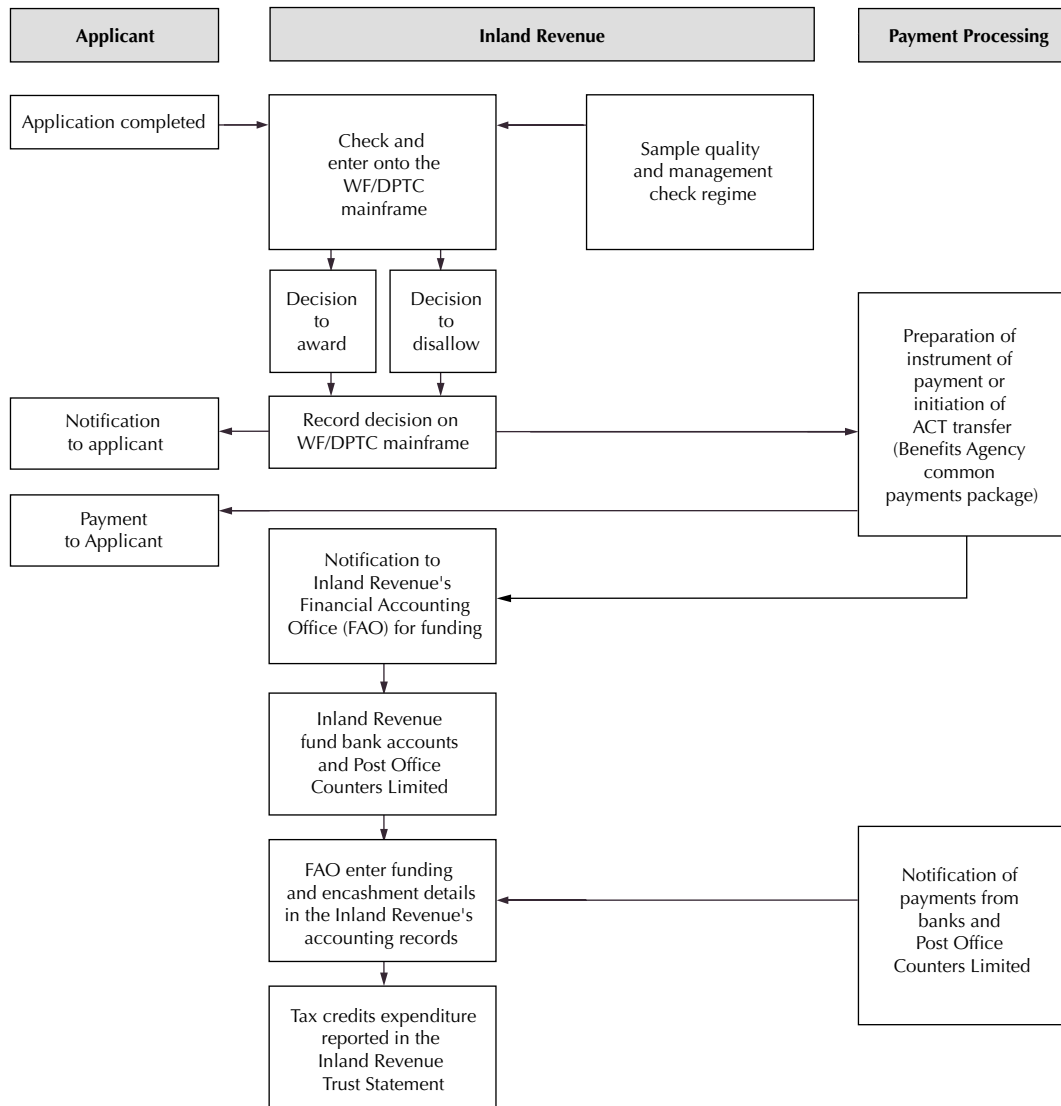
4.6 The Inland Revenue adopted a phased approach to implementation by continuing the previous direct payment arrangements operated by the Benefits Agency, while making preparations for the introduction of payment via employers from April 2000. This enabled the Department to meet the objective of introducing tax credits as soon as practicable, whilst allowing employers sufficient time to revise their payroll systems for payment through the wage packet. The approach also provided time for the Department to introduce information technology to handle payments via employers and to provide funding to enable employers to meet tax credit payments, where appropriate.

4.7 My examination focused on the operation of the direct payment phase up to March 2000. I plan to examine the payment of tax credits via employers in subsequent audits.

Application processing and accounting arrangements

4.8 Processing of applications for tax credits began in August 1999 and payments directly to applicants commenced on 5 October 1999. The payment process uses the Benefits Agency's Common Payments Package computer system. **Figure 4** provides a summary of the key features of the tax credit system.

4 Key stages in the administration of tax credits



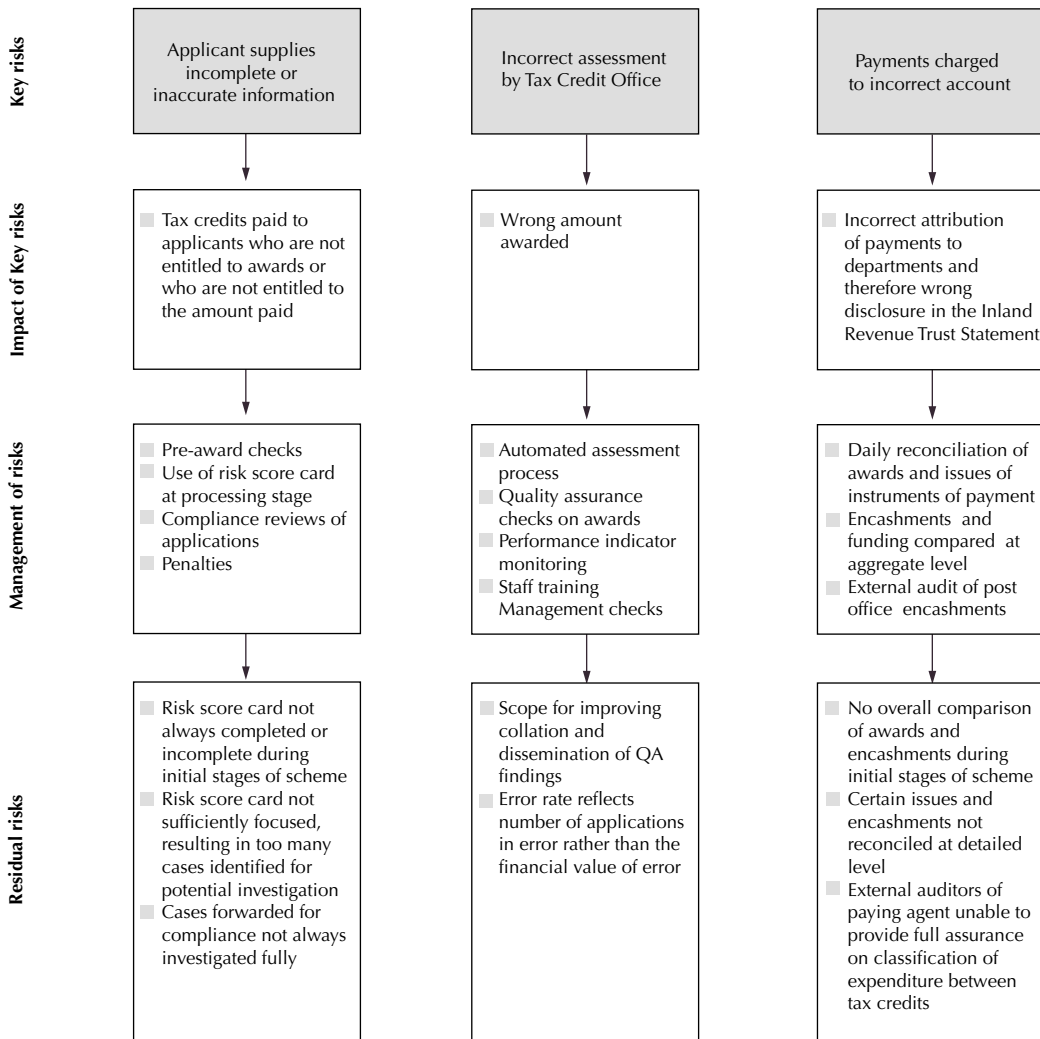
4.9 The Tax Credits Act 1999, the legislation governing the scheme, introduced new powers allowing the Department to fund tax credit payments out of revenue receipts rather than from monies specifically authorised by Parliament through the annual Appropriation Acts. The Act also requires the Department to maintain accounts of tax credit transactions showing payments, receipts, and administrative expenses, distinguishing between working families' tax credit and disabled person's tax credit. The amounts involved are disclosed in the Department's Trust Statement.

Risk management

4.10 The main risks affecting the accuracy of awards include the accidental or deliberate misstatement of information by applicants for tax credits, and the misinterpretation of rules and regulations by staff in the Tax Credit Office in assessing an award. The main risks in accounting arise from reliance on third parties, such as the Benefits Agency and Post Office Counters Limited, for payment and accounting services and include the misposting of expenditure between social security and revenue accounts.

4.11 The Inland Revenue has developed a number of measures which should help manage the risks (see **Figure 5** overleaf).

5 Tax credits: risk management

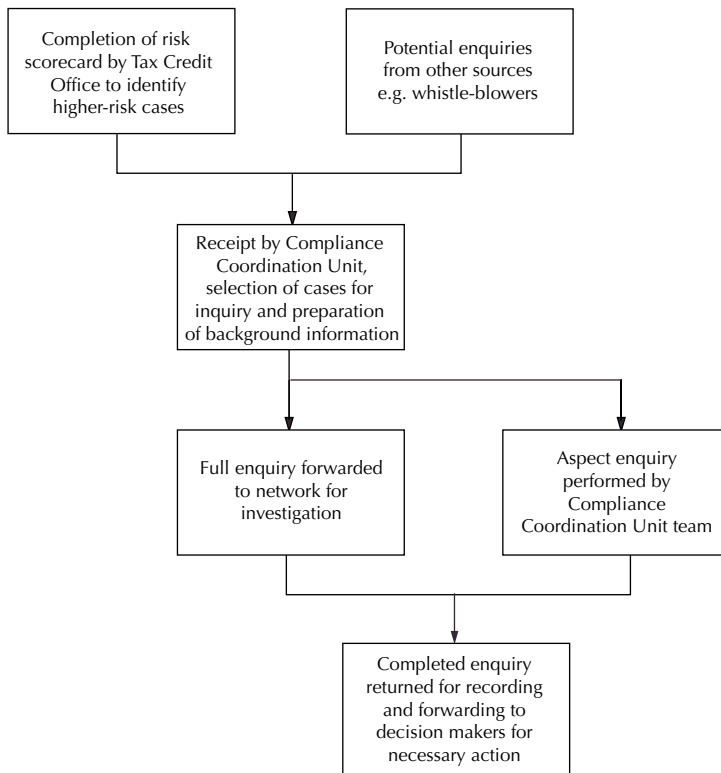


Applications

4.12 Before an award is made, staff confirm that the application is complete and check the information supplied, making cross-checks to Department of Social Security records, where appropriate. Managers are required to verify a sample of applications and the resulting award before releasing the award for payment.

4.13 By and large, the Inland Revenue adopted arrangements applied by the Benefits Agency in processing family credit claims. The Department has also introduced arrangements to identify higher-risk applications for more detailed scrutiny. On reviewing an application, staff complete a risk score-card. Once the award has been made, a specialist Compliance Co-ordination Unit uses these cards and other information to identify higher-risk cases for further checking. **Figure 6** provides an overview of the compliance strategy.

6 Higher-risk applications - compliance process



4.14 The risk score card is fundamental to the compliance strategy. Our investigation showed that the card was not always completed nor fully utilised in the initial stages of the scheme and the process identified too many applications for potential further investigation. In response, the Northern Ireland Tax Credit Office piloted a revised version of the card. This also failed to deliver the desired focus, and a third version is in course of preparation. The Department told us that it could have carried out trials of possible risk assessment systems but decided to go ahead with live running, knowing that this would mean changes as it identified potential improvements.

4.15 Where a case has been selected for further investigation, the Compliance Coordination Unit carry it out if there is only one aspect of the application to follow up. Where a comprehensive investigation is required, the case is referred to the appropriate field force team. Staff told us that initially they had been unable to progress some inquiries because the Tax Credit Office had not provided them with sufficient information. In others, they had returned the cases to the Tax Credit Office because they did not think them worth pursuing. A number of these returned cases were not being closed, however, as staff in the Tax Credit Office felt that future clarification could result in some form of recovery. By March 2000, this situation was improving. The Department told us that it was continuing to keep the new system under review to iron out any difficulties and to refine processes.

4.16 Where the investigation shows that applications are invalid, the Department seeks an agreement with the individual to reimburse the amounts overpaid. Where there is evidence of negligence or fraudulent conduct, a penalty with interest may be imposed. The penalty which can be equivalent to the amount of the overpayment is abated to take account of the size and gravity of the offence and the co-operation and disclosure by the applicant.

Assessment

- 4.17 The assessment of tax credits awards is automated. Provided staff check that an application is complete and contains sufficient supporting information, the main risk of error at this stage is if the information necessary to calculate the award is miskeyed into the computer system.
- 4.18 The Inland Revenue has continued the arrangements adopted by the Benefits Agency of accepting certain information without written corroboration for some claims. For example, where copies of payslips are not provided with certain types of applications, staff at the Tax Credit Office ring employers to confirm the information. We noted that in many cases the verification action taken and details of the information supplied was not recorded on the application form. These omissions made any subsequent checking of assessments difficult. The Department informed us that action is being taken to address these deficiencies.
- 4.19 Self-employed applicants have the choice between submitting accounts or completing a self assessment enquiry form as evidence of earnings. The additional risk inherent in this approach is reflected in the risk assessment.
- 4.20 In addition to the management checks described at paragraph 4.12 above, the Department carries out detailed quality assurance work on around 170 awards each week. In 1999-00, these checks on awards of working families' tax credit showed that the Tax Credit Office achieved an accuracy rate of 93.6 per cent compared to its target of 91 per cent. The Department estimates that, overall, £13.4 million may have been overpaid and £9.9 million underpaid during the six month period to 31 March 2000, representing approximately 1.4 per cent of the overall amount awarded.
- 4.21 Our examination of the quality assurance process showed that the recording of the results of checks could be improved and that the Department could add value to the processing of applications and reduce common errors in assessment work by improving the collation and dissemination of its findings on why errors had arisen. The Inland Revenue began to produce a quarterly report, from April 2000, summarising the quality assurance findings, including common errors, to strengthen its existing practice of issuing technical advice circulars and other guidance on errors.

Accounting

- 4.22 The Department's Trust Statement records that in 1999-00 it paid out £1,013 million in respect of working families' tax credit and £20 million in respect of disabled person's tax credit.
- 4.23 In the period before payment via employers commenced in April 2000, the Inland Revenue continued using the payment systems adopted by the Benefits Agency. Applicants were therefore given the choice of weekly payment by order book, encashable at a Post Office, or automated credit transfer to a bank or building society account. Girocheques were used for one-off payments. An analysis of the payments reported in the Department's accounts is shown in **Figure 7**.

7 Tax credit encashments - October 1999 to 31 March 2000

Instrument of Payment	Working families' tax credit £m	Disabled person's tax credit	Total £m
Order book	689.89	11.63	701.52
Girocheque	0.84	0.04	0.88
Automated credit transfer	322.67	8.07	330.74
TOTAL	1,013.40	19.74	1,033.14

Source: Inland Revenue Financial Accounting Office

4.24 The use of order books does not permit Departments to reconcile issues with encashments at a detailed level. In common with the approach adopted by other Departments which make payments by order book, the Inland Revenue has based the amounts reported in its accounts on encashment statements prepared by Post Office Counters Limited. These summarise weekly returns of payments compiled by individual post offices. The external auditors of Post Office Counters Limited examine these statements and provide an opinion to their client, which is made available to the Departments concerned. I take assurance from their work in forming my opinion on Departmental accounts.

4.25 In the case of tax credits, however, the scope of the external auditors' work in 1999-00 was limited because they had been unable to assess the overall impact of errors detected by the Post Office's internal checks. What work they had been able to carry out suggested that the level of error within the reported figure for working families' tax credit was unlikely to be material. However, they were unable to provide an opinion on disabled person's tax credit because there were £1.8 million transactions in suspense awaiting classification which could have a material impact on the amount reported as encashed. In addition, there were indications of possible misclassifications of expenditure by post offices between working families' tax credit, disabled person's tax credit, and other allowances paid by order book which could have had a material impact on the figure for disabled person's tax credit.

4.26 We sought additional assurance on the amounts disclosed in the Inland Revenue's accounts from a comparison of awards and encashments. Although the Department compares daily totals of awards with issues of payable instruments, it did not carry out routine comparisons of awards and encashments. We therefore requested information to enable us to carry out such an analysis, which provided further assurance on the sums involved.

4.27 Preparing this type of analysis on a routine basis would be of value to the Department, as it could give them early warning of trends pointing to imbalances in the system, arising, for example, from fraudulent activity or accounting errors. Such analyses would also help provide assurance to the Accounting Officer in support of the new disclosure requirements required by the Treasury on risk management (see paragraphs 2.8 and 2.9). The Department confirmed that, following our examination, its Financial Accounting Office had begun work in autumn 2000 to develop routine monthly reconciliations between encashments and awards, starting from April 2000.

Performance monitoring and management

4.28 The Tax Credit Office's initial performance targets represented a continuation of existing Benefits Agency targets for family credit and disability working allowance. The business aims of the Tax Credit Office, set out for the first time in the Inland Revenue Plan for 2000-01, are "to assess accurately and in due time claims for working families' tax credit and disabled person's tax credit, ensuring that the right money is paid to the right person at the right time every time". Targets for 1999-00 and 2000-01 were generally commensurate with these aims, although they did not include specific targets for the timeliness of individual payments or the correctness of payees.

4.29 The performance targets and results for 1999-2000 and targets for 2000-01 relating to applications are set out in **Figure 8**.

4.30 The Department reviewed the targets inherited from the Benefits Agency and concluded that they did not fully allow for the fact that the information accompanying applications was sometimes incomplete or inaccurate, and that pressure to check applications quickly could put quality at risk. In particular, the target for express application processing placed considerable pressure on decision-making. The targets for 2000-01 recognise these drawbacks.

4.31 Financial accuracy is a key target. For 1999-00 and 2000-01 this was set in terms of numbers of applications in which error occurs, rather than the financial impact of such errors, reflecting the Department's view that applicants would be interested in whether their award was accurate rather than the extent of any inaccuracy.

8 **Figure 8 Performance targets and results 1999-2000 and targets 2000-01**

Performance Indicator	Target 1999-00 %	Result 1999-00 %	Target 2000-01 %
Working families' tax credit applications	90	92	-
Express cleared within 5 working days	60	87	-
Non-express cleared within 13 working days	95	99	-
Non-express cleared within 42 working days	-	-	95
All complete applications to be decided within 5 days	-	-	90
All applications to be decided within 30 days			
Processed accurately to the nearest penny	91	93.6	92
Disabled person's tax credit applications			
Cleared within 17 working days	60	82.4	-
Cleared within 43 working days	90	97.9	-
All complete new applications to be decided within 5 days	-	--	95
All applications to be decided within 30 days	-	-	90
Processed accurately to the nearest penny	94	94.4	92

Source: Inland Revenue Plan 2000-01

Conclusions

- 4.32 Risk assessment is the cornerstone of any compliance strategy. In managing the risk of tax credits awards being based on inaccurate or incomplete information, the Inland Revenue has built on previous arrangements by making a formal risk assessment of each application to identify cases which may require further investigation. The Department is refining its initial approach to target resources on applications which present the highest risk.
- 4.33 One of the key determinants of the amount of tax credit awarded is the level of income declared by the applicant. Firm evidence to support the declaration is often not provided by the applicant, particularly in the case of the self-employed, and a significant proportion of applications are referred for detailed inquiry. The Inland Revenue should consider whether links could be made to other databases containing details of income to provide an alternative source of assurance.
- 4.34 Investigations of tax credit applications are time-critical because delay can lead to financial loss. There is some evidence that inquiries into higher-risk applications by the Inland Revenue's field force are not being completed promptly, because investigators have been provided with insufficient information, or because they take a different view from the Tax Credit Office on the value of further work. It is important that applicants are convinced that fraudulent or incomplete claims will be identified and appropriate action taken, if the administration of tax credits is to be successful. The Department is improving the information provided to investigators and providing greater guidance to the Tax Credit Office and field force staff on investigations.
- 4.35 The performance targets set for the Tax Credit Office generally reflect its business aims and have been adjusted in the light of experience to provide a better balance between speed and accuracy. In developing its targets further, the Department should seek to cover all aspects of its business aims. This would mean adding targets to address the timeliness of payments and payments to the right people.
- 4.36 Existing targets for financial accuracy focus on the proportion of cases in error, not the financial impact of mistakes. The Department acknowledges that it needs to analyse errors detected in awards to provide an estimate of overall sums at risk and has incorporated this into its quality assurance work. As well as improving accountability, this will encourage financial ownership of tax credit expenditure by the Tax Credit Office.
- 4.37 The use of order books to make payments limits the information available to Departments and represents a weakness in control over expenditure on tax credits. We recommend that the Inland Revenue explores how it can improve the assurance it obtains about information on encashments provided by Post Office Counters Limited. We also recommend that the Department uses the reconciliations between tax credit awards and encashments currently being developed to give early warning of potential fraud or accounting errors.
- 4.38 The reconciliation process will become more complicated in 2000-01 with the introduction of tax credit payments via employers. The Department needs to introduce checks which will provide it with sufficient assurance about the completeness, accuracy and validity of payments made in this way.

Part 5

Construction industry scheme

Introduction

5.1 This part of my report looks at:

- the way the Inland Revenue collects tax from people working in the construction industry, and implementation of the new construction industry scheme introduced in August 1999 (paragraphs 5.2 to 5.6);
- how the Department manages the main risks to non-collection of tax from individuals and companies operating in the construction industry (paragraphs 5.7 to 5.26); and
- performance monitoring and management (paragraphs 5.27 to 5.30).

Background

5.2 Taxation of the 1.4 million people working in the construction industry generated approximately £1.5 billion in income tax in 1999-00. The administration of tax in this sector has always been difficult due to the highly mobile nature of the industry, practical difficulties in determining whether people are employed or self-employed, and a culture of non-compliance.

5.3 To minimise the effect of these factors, the Inland Revenue introduced the Construction Industry Tax Deduction Scheme in 1972. Under this scheme, self-employed subcontractors either received payments from contractors net of tax, which was deducted at source, or they could obtain an exemption certificate, which allowed the contractor to pay them gross, with any tax due being paid by the individual at a later date.

5.4 While this system reduced the amount of tax at risk within the industry, a number of practical difficulties arose. In particular, the criteria governing the availability of exemption certificates were subjective. This led to gross payments being made to individuals who could not be relied upon to declare their income and settle their tax and national insurance contribution liabilities. In addition, the availability of stolen exemption certificates and collusion between contractors and subcontractors increased the risk of tax evasion.

5.5 The Department estimated that abuse of the system was costing the Exchequer in excess of £100 million each year through non-declaration of taxable income and from false claims for repayment of tax deducted at source. Some sub-contractors also claimed benefits while working. Ministers therefore decided to strengthen the arrangements. The costs of the changes were met from funds provided under the spend to save initiative announced in the November 1996 Budget.

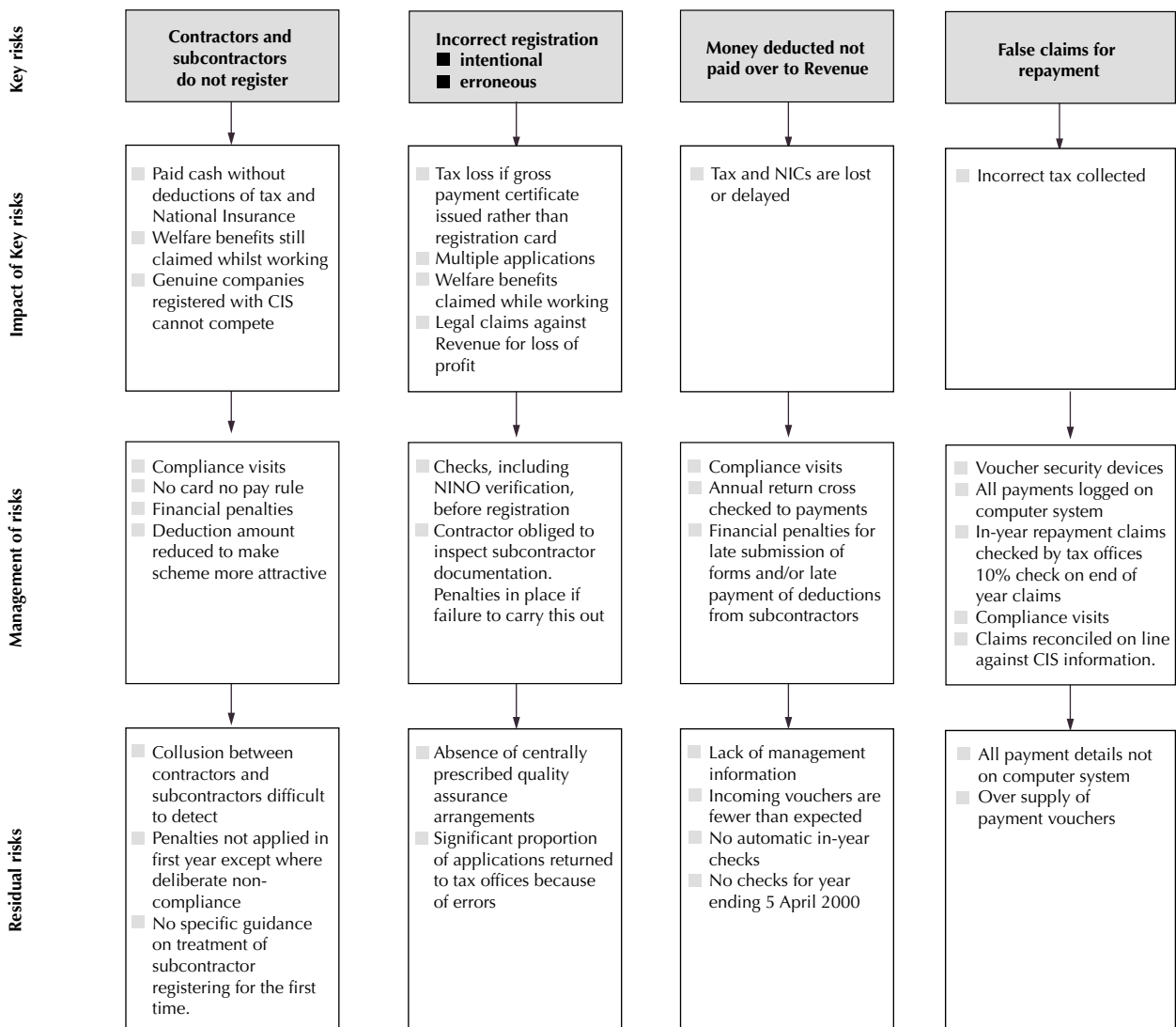
5.6 The main changes under the new scheme, which became operational in August 1999, include:

- tighter rules governing the entitlement of individuals to a tax certificate allowing them to be paid without deduction of tax at source;
- the introduction of a registration card for subcontractors who are not entitled to be paid without deduction of tax at source;
- a requirement for contractors to send vouchers detailing payments made under the scheme to the Inland Revenue each month; and
- new powers for the Inland Revenue to penalise contractors who use unregistered subcontractors.

Risk management

5.7 The main risks of non-compliance include: failure to register; the accidental or deliberate misstatement of information when registering; failure to pay over money deducted from subcontractors; and false repayment claims. The Inland Revenue has established a number of measures which should help to minimise the amount of tax at risk (see **Figure 9**).

9 Inland Revenue: management of risks attached to construction industry scheme



Contractors and subcontractors do not register

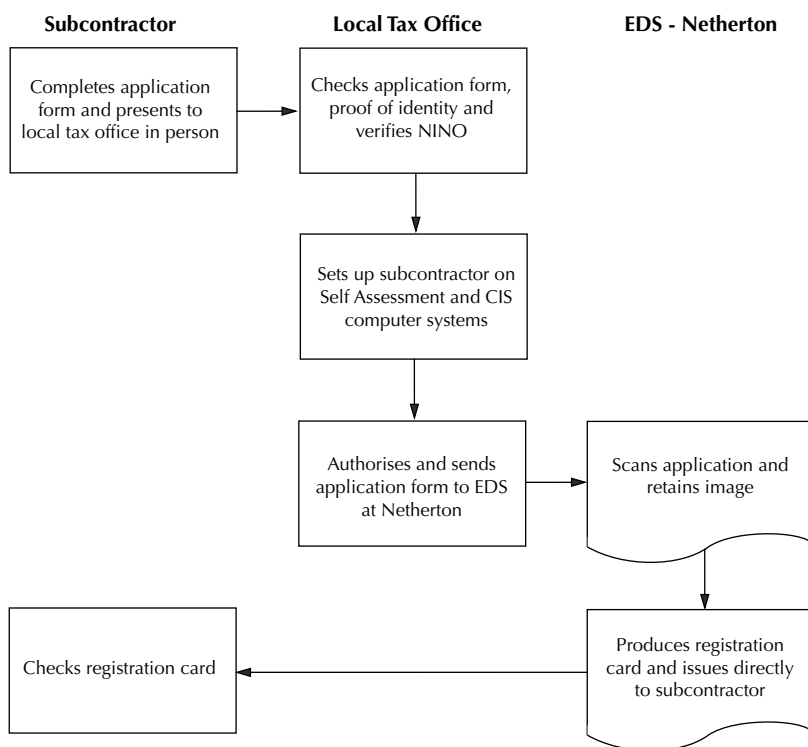
- 5.8 Non-registration is probably the single greatest threat to tax revenue. Some elements of the construction industry have a reputation for using casual labour, paid for in cash without any deductions for tax or national insurance. Such arrangements improve the profitability and competitiveness of firms. Any scheme that sets out to challenge this culture needs to have strong, equitable controls, strict enforcement and appropriate penalties for non-compliance.
- 5.9 It is the contractor's responsibility to establish whether a construction worker is employed, and subject to PAYE, or self-employed, and subject to the construction industry scheme. In the latter case, contractors are required to ensure that they only use individuals, partnerships or companies that hold a tax certificate or registration card. Failure to comply with this requirement may result in financial penalties, the non-renewal of the contractors' own subcontractor certificates or in serious cases, criminal prosecution. The Inland Revenue checks that the requirement is met by visits to sites and by scrutiny of contractors' records through its employer compliance work (see Part 6). Until the scheme beds in, the Department has decided to apply sanctions only in cases where there is clear evidence of deliberate non-compliance.
- 5.10 Around 100,000 subcontractors have registered for the first time under the scheme. Staff in local tax offices told us that, in these cases, subcontractors would be asked to complete a notification of self-employment form, to state when they started trading and to give details of their previous employment. The individual's file would then be requested from their previous tax office. The taxpayer would be sent income tax self assessment returns for any missing periods. If there were inconsistencies in the information provided, the case would be referred for investigation. The Department told us that this was the usual procedure where someone registers as self-employed, and that it had not considered it necessary to issue any additional specific guidance on handling cases arising out of the introduction of this new scheme.

Incorrect registration

- 5.11 Incorrect registration may occur if either the applicant or the Department make a mistake in completing or processing the application, or if the applicant deliberately falsifies information. In the first case the applicant may have little to gain from the mistake, but in the second the intention would be to secure some form of pecuniary advantage. Fraudulent applications could involve:
- The overstatement of turnover to qualify for a tax certificate rather than a registration card, entitling the subcontractor to receive payment without deduction of tax. This arrangement would improve the subcontractor's cashflow and increase the risk of non-payment of tax.
 - The submission of multiple applications for registration cards to the same or different local tax offices, using different identities. If the applications were successful, subcontractors could restrict the amount of work carried out under each identity and thereby reduce their tax liability. In addition if an individual was in receipt of social security benefits, it could help secure their continuing entitlement.

5.12 The Inland Revenue manages this risk by requiring contractors and subcontractors to attend a tax office in person and by carrying out a series of identity checks, including validation of their national insurance number. Subcontractors who do not have a valid national insurance number receive a temporary registration card, valid for three months. The risk that individuals might claim benefits while working is addressed by the Benefits Agency, which matches claims against data held by the Inland Revenue. **Figure 10** shows the arrangements for issuing registration cards.

10 Construction industry scheme: issue of registration cards



5.13 Tax certificates permit the contractor to pay the subcontractor without deduction of tax. Subcontractors who require a tax certificate are subject to similar checks to those for the issue of a registration card but, in view of the greater level of risk attached to the taxation of payments made in this way, tax certificates are subject to additional, more stringent, conditions. These include:

- a business test, to confirm that the subcontractor is running a proper business carrying out construction work in the United Kingdom;
- a compliance test to establish the likelihood that the taxpayer will complete all tax returns and pay all tax and national insurance contributions due; and
- a turnover test, which is designed to restrict the issue of tax certificates to subcontractors with turnover exceeding £30,000 a year.

5.14 Under normal circumstances, these systems should pick up mistakes made by subcontractors and identify cases where false information is supplied. Due to a combination of factors, including difficulties and delays in the completion and submission of applications, the absence of centrally prescribed quality assurance arrangements for the checks carried out, and competing work pressures, the initial checking of applications did not progress as smoothly as it might have done.

5.15 As a result, in the period 1 December 1998 to 31 December 1999, over 10 per cent of the 1 million applications sent for processing were rejected, mainly because staff in local tax offices had not identified errors in application forms or had not indicated that they had carried out the required validation checks. The level of rejections, allied to the work we carried out at local tax offices, indicates that the initial checks on applications were not fully in accordance with instructions and that some registration cards and tax certificates may have been issued erroneously to subcontractors, increasing the risk of non-compliance. In addition, during the initial registration period, there were no set procedures for correcting and resubmitting applications and the absence of systematic checks may have further increased the risk of incorrect registration. The rejection rate has since fallen to under 5 per cent.

Deduction of tax

5.16 When a subcontractor with a registration card is paid, the contractor deducts a percentage of the payment, less the cost of any materials, to cover tax and national insurance contributions. The rate of deduction was initially 23 per cent, but this was reduced to 18 per cent from 6 April 2000. Contractors are required to pay over the deductions to the Inland Revenue Accounts Offices at Shipley and Cumbernauld within 14 days of the end of the month.

5.17 Contractors must complete a voucher for every payment made under the scheme, whether gross or net of tax. These vouchers, which are serially numbered and record the identity of the contractor, the subcontractor and the amount paid, have to be sent to the Processing Centre at Netherton each month. At the end of the year, contractors are obliged to complete a summary of all payments made under the scheme.

5.18 The Department manages the risk that contractors may fail to comply with these requirements, by accident, or deliberately in order to improve their cashflow or with fraudulent intent by:

- Monitoring the receipt of sums deducted and the submission of payment vouchers.
- Imposing financial penalties for late submission of returns or payments.
- Using the monthly and annual returns of payments and supporting payment vouchers to verify that contractors have paid over all the tax deducted under the scheme and that subcontractors have made a complete declaration of their income in their tax returns.
- Visiting the offices of contractors to examine their records for the construction industry scheme. These are carried out as part of the Department's employer compliance work (see Part 6).
- Pursuing outstanding tax through its Integrated Debt Management System.

5.19 The way in which the scheme has been set up should provide sufficient information to check that contractors are paying over the money deducted from subcontractors. It also provides the facility to check payments reported by contractors against income reported by subcontractors on their income tax self assessment returns.

5.20 In practice, the flow of payment vouchers from contractors in the initial months of the scheme was substantially lower than the Inland Revenue had forecast. By January 2000, some 1.4 million vouchers had been returned against a projection of over 6 million. In addition, errors in the security numbering of forms and other factors led to some 30 per cent of vouchers being referred to the Department's Exceptions Handling Unit for investigation because of

potential errors or other anomalies. The Department established a second Unit to assist in clearing the cases. The referral rate has since fallen to under 20 per cent and system changes are in prospect which are aimed at reducing this level further.

5.21 The Department established a Voucher Pursuit Unit to contact contractors who were submitting fewer vouchers than expected. It delayed starting work until February 2000 because of the number of vouchers being referred for investigation. There were then further delays because of difficulties in producing information identifying contractors to follow up and work did not commence until May 2000, some 8 months after the start of the new scheme.

5.22 We found that there was also confusion on the part of contractors over where to send amounts deducted from payments to subcontractors. Money has sometimes been sent erroneously to the Processing Centre with the payment vouchers rather than to the Accounts Office. A backlog of payment voucher processing that had built up at Netherton led EDS to stockpile post without opening it. When we reported this to the Department, it immediately asked EDS to open the backlog of envelopes and send any cheques to the Accounts Office, which they did. The backlog contained over 2,600 cheques with a value of around £3 million. The encashment of cheques was delayed for up to four weeks, resulting in a loss of interest to the Exchequer. The Department told us that all envelopes are now opened on the day of receipt and any cheques are sent to the Accounts Office immediately.

5.23 These factors have meant that the Department has so far been unable to carry out automatic in-year checks between the amounts paid over by contractors and the amounts reported to have been deducted on the supporting vouchers. The Department also told us that for the year ended 5 April 2000 it will not carry out arithmetic checks on contractors' year end returns, reconcile the data with information extracted from the payment vouchers, or reconcile it with data from complementary systems. One of the reasons for not doing this were the complexities caused by the in-year switch to the construction industry scheme, which meant that information on amounts paid by contractors prior to August 1999 was held on a different computer system than later payments.

Tax repayment claims

5.24 Subcontractors with registration cards who receive payments net of deductions in respect of tax and national insurance are able to reclaim any amounts overpaid. Claims are normally submitted with corporation tax or income tax self-assessment returns, but can also be made during the course of the tax year. The main risk is that a subcontractor may submit a tax return claiming that more tax has been deducted than was actually the case.

5.25 The payment vouchers completed by contractors should help address this risk. The name of the subcontractor and the amounts paid and deducted are recorded on each voucher, which is serially numbered to control its use. This control addresses a key concern about the previous scheme that forged documents would be submitted. For subcontractors entitled to payments without deduction of tax, the sub-contractor issues a voucher which reports the amount received to the contractor, who checks and forwards it to the Inland Revenue. This provides the Department with an independent source of information against which to assess the accuracy and completeness of the subsequent tax return.

5.26 In addition to the difficulties noted at paragraphs 5.20 and 5.21 above relating to the submission and accuracy of payment vouchers, the operation of the system for distributing and controlling blank payment vouchers has not worked as smoothly as anticipated. The estimated number of each type of voucher that contractors and subcontractors estimated that they would need were inaccurate, the net effect being that considerably more were issued than required. By May 2000, of 30 million vouchers issued, only 4.4 million (14.8 per cent) had been returned. In view of the large number of vouchers in circulation, there is a risk that subcontractors could obtain copies and use them to support false claims for repayment. In response to this risk, the Department has put reconciliation procedures in place, and intends to carry out a ten per cent check of vouchers submitted with year end repayment claims against the corresponding information supplied by contractors.

Performance monitoring and management

5.27 The Inland Revenue made a decision not to publish formal targets for the first six months of operation to give the scheme a chance to settle down. The Department did, however, set its local tax offices indicative targets for dealing with applications for registration cards and tax certificates and for entering details from contractors' end of year returns on the computer system, but no targets were set for the dedicated Voucher Pursuit Unit and Exception Handling Units in the Accounts Offices. Although extra money had been allocated to the construction industry scheme, the lack of formal targets made it difficult to ring-fence resources, because the work had to compete with that on other schemes for which such targets had been set.

5.28 The agreement between the Inland Revenue and EDS for the provision of information technology contained performance targets for issuing registration cards and tax certificates and processing vouchers. In the year ended 30 June 2000, the Department paid EDS £2.25 million for the service, £0.8 million more than estimated. The increase in costs was partly due to variations from planned volumes of work. Service delivery costs were also affected by the fact that productivity levels were lower than expected. In accordance with its normal working practice, the Department did not subject EDS to financial penalties in the first year of operation if they failed to meet the targets, to allow the system time to settle down. The Department is working on a new service level agreement with EDS, which will include processing targets.

5.29 The Inland Revenue initially planned to have a dedicated management information system for the construction industry scheme, but later decided to await the introduction of its new corporate management information system rather than adopt a piecemeal approach. When the corporate management information system is implemented, staff will be able to obtain a range of basic management information, including the numbers of registration cards and tax certificates issued and the number of businesses using the construction industry scheme. This information should help the Department allocate resources to activities at regional and local level in line with anticipated workloads.

5.30 Initial indications are that the construction industry scheme has been successful in encouraging compliance. Since the start of the scheme, 186,000 tax certificates and 857,000 registration cards had been issued and, as noted at paragraph 5.10 above, of these, an estimated 100,000 relate to subcontractors who had not previously registered for tax. The Inland Revenue have estimated that £280 million additional tax and national insurance contributions accrued as a direct result of the scheme in 1999-00.

Conclusions

- 5.31 The construction industry scheme has increased the number of individuals and companies registering with the Inland Revenue, and the number of subcontractors subject to tax deductions at source. The evidence is that these impacts are already helping reduce the risk of tax loss.
- 5.32 The Department's arrangements for processing applications for tax certificates and registration cards were not always followed properly during the initial stages of the scheme. Although the proportion of rejections has now declined, five per cent of applications sent for processing are still being rejected. The Department should identify the key areas where tax may continue to be at risk as a result of these failings and devise measures to investigate cases and take corrective action. In addition, it should take steps to ensure that, when tax certificates have to be renewed in 2002, local tax offices have sufficient resources to deal with the peak in workload.
- 5.33 Around 100,000 subcontractors have registered for the first time under the scheme but the absence of specific guidance to prompt staff on the action to be taken to investigate their previous tax record may result in the Inland Revenue not pursuing amounts properly due. The Department should consider issuing guidance reminding staff of the action to be taken in such cases.
- 5.34 The construction industry scheme is designed to provide the Department with sufficient information to enable it to carry out automatic checks between amounts deducted from subcontractors and amounts paid over. The risk of loss to the Exchequer is greatest at the start of a new scheme and we are therefore concerned that the Department has been unable to carry out any systematic cross-checks, and plans to carry out only limited reconciliation work at the year end. This means that the main source of assurance in the short-term will be drawn from compliance visits.
- 5.35 One of the key aims of the construction industry scheme was to control and restrict the availability of payment vouchers in order to reduce the risk of fraudulent tax repayment claims. This aim has been undermined by the over-supply of vouchers. In order to maintain the integrity of the scheme we recommend that the Inland Revenue should monitor closely the results of its checks on a ten per cent sample of vouchers submitted with repayment claims, and should consider increasing the sample if the work identifies a significant level of incorrect claims.
- 5.36 Formal performance targets were not set during the first year of the construction industry scheme but the Department should now set specific targets covering the primary business objectives of the scheme - compliance, efficiency and customer service.
- 5.37 The Inland Revenue deferred developing a comprehensive, free-standing management information system because it wished to await the introduction of a new corporate management information system which is being developed. However, as a general rule, management information requirements and performance criteria should be integral to the development of a new scheme, not features incorporated at a later date. We therefore recommend that, in future, the Inland Revenue ensures that, where practicable, these elements are built in at the planning stage of new schemes.

Part 6

Employer compliance

Introduction

6.1 This part of my report examines:

- how the Inland Revenue monitors employers' compliance with PAYE and national insurance contributions requirements (paragraphs 6.2 to 6.6);
- the way the Department manages the main risks in employer compliance work (paragraphs 6.7 to 6.19);
- the impact of the transfer of former Contributions Agency staff (paragraphs 6.20 to 6.24); and
- performance monitoring and management (paragraphs 6.25 to 6.32).

Background

6.2 As noted at paragraph 3.2 above, the regulations governing PAYE and national insurance contributions require employers to collect income tax and national insurance contributions in respect of their employees and pay these over to the Inland Revenue. Similar requirements apply to contractors in the case of certain subcontractors operating under the construction industry scheme (see Part 5). As part of its strategy to encourage employers to comply with their legal obligations, the Department conducts compliance reviews by visiting employers' premises. The main objectives are to:

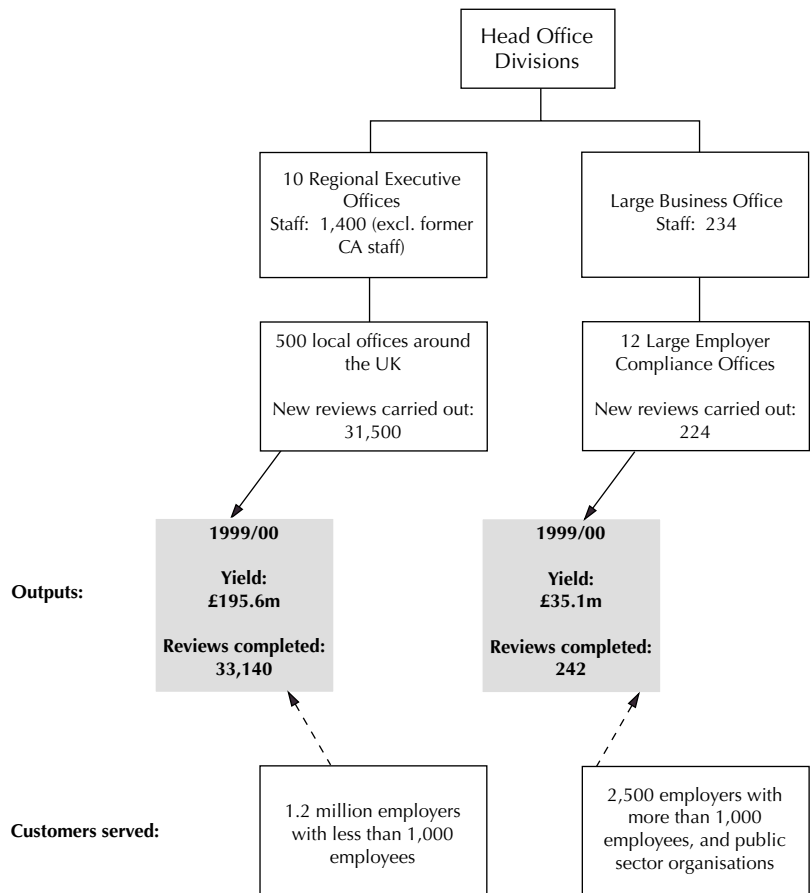
- encourage and improve compliance with the law;
- identify and put right non-compliance; and
- recover any unpaid tax and national insurance contributions.

6.3 **Figure 11** (overleaf) shows how the department was organised to achieve these objectives during 1999-00, the number of reviews carried out, and the additional tax yield that these identified.

6.4 In 1997, the Committee of Public Accounts considered my report on the Department's employer compliance activities (HC 51, 1997-98). The Committee concluded (31st Report, Session 1997-98, HC 357) that the Department's compliance reviews had become increasingly successful, but could improve further by:

- making more effective use of information technology through setting up a national database of employers to help target those trades and employers most likely to be non-compliant, and to help it plan and carry out work more cost-effectively; and
- making better use of management information to establish why some employer compliance teams seemed to be more efficient and effective than others.

11 Summary of the structure and organisation of employer compliance



- Note:
1. The structure of local office employer compliance work changed from April 2000 with the full integration of former Contributions Agency staff into the employer compliance teams. Until then these staff carried out separate work to check employers' compliance with national insurance requirements under parallel arrangements operated by the former Contributions Agency.
 2. The 2,500 employers covered by the Large Employer Compliance Office operate around 18,000 separate PAYE schemes.

Source: National Audit Office

6.5 Major changes since then include:

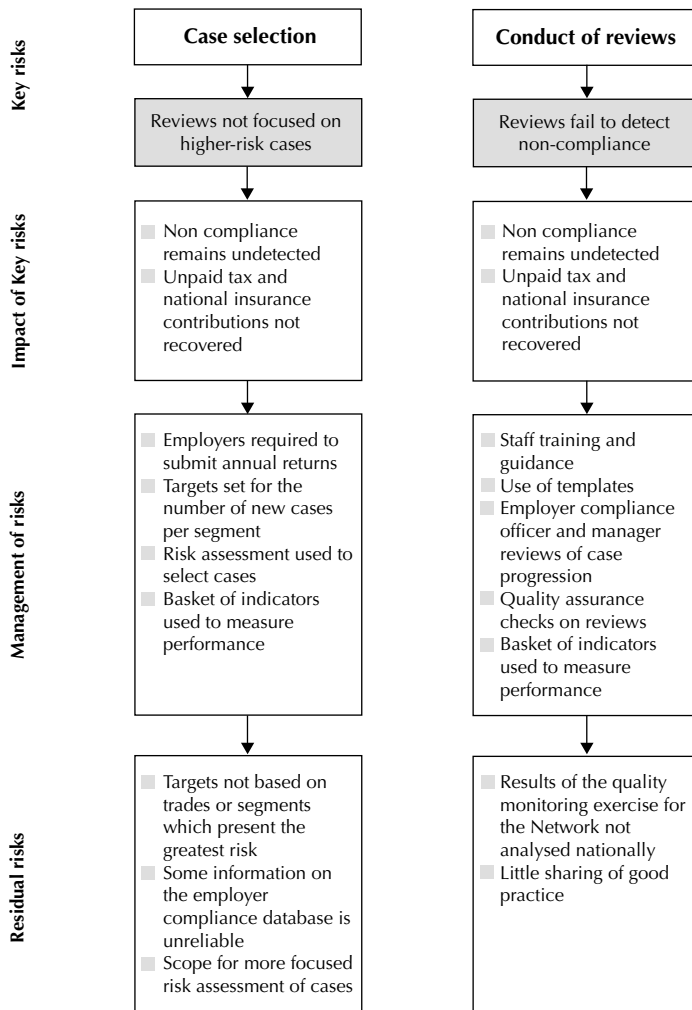
- The introduction of the employer compliance computer system.
- The transfer in April 1999 of the Contributions Agency to the Inland Revenue, resulting in one organisation having responsibility for policing compliance with tax and national insurance contributions legislation.
- Integration of Contributions Agency and Inland Revenue staff into a new structure from April 2000.
- A reduction in the number of employer compliance staff, some of whom went to support new work such as the establishment of Business Support Teams, the introduction of tax credits (see Part 4) and monitoring the national minimum wage.
- New procedures to monitor the quality of employer compliance reviews.

6.6 The role of employer compliance is a balance between identifying and putting right non-compliance and supporting and educating the employer. The latter has been, and continues to be an important strand of the Department's work. Our examination this year, however, focused on activity directed at identifying non-compliance during 1999-00, but we also examined preparations for introducing the new structure from April 2000.

Risk management

6.7 The Committee of Public Accounts expressed concern at variations in the success of the Department's local offices in identifying non-compliant employers. Variations may reflect differences in the types of employer covered by individual tax offices, but they may also reflect the Department's management of the main risks associated with employer compliance work: the failure to target higher risk employers and reviews failing to detect non-compliance. The Department has established a number of measures, which should assist it in managing these risks (see **Figure 12**).

12 Employer compliance risk management



Case selection

- 6.8 When the Committee of Public Accounts examined the Department's employer compliance work in 1997, staff in local offices did not have a national database of employers to help them select cases to review. They were reliant on a variety of sources, including referrals from other parts of the Department and from external sources such as the former Contributions Agency. The Department told the Committee that it was planning to introduce a new employer compliance computer system.
- 6.9 The Department introduced the new system in April 1998. In addition to basic details about each employer and any directors, the system is used to record:
- the aggregate amounts of pay, tax and national insurance contributions in respect of employees and directors reported on employers' end of year returns; and
 - information about expenses and benefits provided to directors and higher-paid employees.
- 6.10 Referrals from other parts of the Department continue to be a significant source of cases identified for examination by local offices. However, interrogation of the employer compliance system database, using graphical query language software, provides the opportunity for a more risk-based approach to identifying potentially non-compliant employers.
- 6.11 During our examination we found that the extent to which the interrogation facilities were used varied between offices and regions. Reasons for this included lack of expertise in using the interrogation software and difficulties in producing manageable reports quickly. There were also errors in the data on the system, for example, trade classification numbers, which limited the usefulness of the system in analysing trades that were more likely to be non-compliant and in selecting cases from those trades. The Department has been tackling these issues.
- 6.12 From April 2000, each employer compliance unit has had a specialist team which is responsible for assessing the risk of non-compliance across employers within their geographical area and for making recommendations on whether a case should proceed. Previously, decisions were made by individual compliance officers.
- 6.13 As a longer-term aim, the Department is planning to improve the operation of the employer compliance system to enable it to interrogate other information about employers and employees held on other systems, for example income tax self assessment and PAYE. When this has been completed, the Department is planning to explore the potential for a more robust approach to assessing cases including an automated risk scoring system.
- 6.14 With respect to the employer compliance interrogation facilities, new Departmental guidance issued in Autumn 2000 should give staff more confidence in using the system. The Department is also carrying out a review of how it processes end of year returns, which is likely to recommend national quality assurance arrangements for the capture of information about employee expenses and benefits. This should help improve the reliability of information on the system.
- 6.15 As regards larger employers, the Large Employer Compliance Office sifts the 500 to 600 employers that come up for review each year under its cyclical review arrangements, using basic risk factors to arrive at a more manageable case load. The Department has recognised that this approach could be refined and has commissioned an internal review on how to improve case selection.

Conduct of reviews

- 6.16 In our previous examination, we concluded that there was scope to improve the planning and conduct of reviews by achieving greater consistency in the key elements that make up a successful review. These elements included: research into the tax history of the employer being reviewed; liaison with other people in the Department with an interest in the tax affairs of the employer; the use of specified checks; and clear documentation.
- 6.17 In response, the Department extended its quality monitoring system in 1999-00 to cover employer compliance work. Around seven per cent of cases from local tax offices and all Large Employer Compliance Office cases were selected for quality monitoring. The results of a sample of cases are independently validated by peer review.
- 6.18 While local tax offices, in aggregate, exceeded their quality target in 1999-00, the Large Employer Compliance Office fell short of its target, following substantial adjustments on validation. It considered that one of the main reasons for this was the pressure arising from the Contribution Agency transfer. To improve its performance, the Large Employer Compliance Office issued an information bulletin to staff summarising good and poor practice highlighted by the work. It had also organised a training session to improve consistency between managers' and validators' scores.
- 6.19 Within the Department's employer compliance review procedures there is considerable scope for caseworkers to use their initiative. In the Large Employer Compliance Office we found examples where staff shared good practice. Within the local tax offices, however, while national and regional managers meet to take forward developments and to discuss operational issues relating to compliance, during 1999-2000 these discussions tended to concentrate on managing the transfer of the Contributions Agency work, rather than on good practice. There also appeared to be less exchange of ideas at local level. We also continued to find little evidence of sharing of good practice between the Large Employer Compliance Office and local tax offices.

Transfer of Contributions Agency work

- 6.20 In April 1999, the Contributions Agency transferred to the Inland Revenue. This meant that businesses would only have to deal with one organisation about tax and national insurance contributions. The Large Employer Compliance Office and its counterpart in the Agency, the Large Employers Unit, integrated fully in the first year, but full integration at the local level did not take place until April 2000.
- 6.21 During 1999-00, ten experimental offices were set up to trial ways of integrating the two workforces at local and regional level. Out of the experimental offices, a new model emerged of dedicated employer compliance units headed by an employer compliance manager reporting to the regional office. The Department believed that the creation of pro-active compliance teams with dedicated managers would place greater emphasis on employer compliance activity than before and would raise performance and quality standards.
- 6.22 The complex legislation governing tax and national insurance contributions means that it takes around two years for employer compliance staff to become fully effective. From April 2000, employer compliance visits to employers have covered both income tax and national insurance contributions. This has required Inland Revenue staff to master more fully the national insurance contributions scheme and former Contributions Agency staff to learn more about income tax. Both the Large Employer Compliance Offices and a number

of local offices we visited had experienced high staff turnover over during 1999-00. This had reduced the average experience level of staff. An analysis carried out by the Large Employer Compliance Office indicated that 50 per cent of staff had less than two years of experience.

6.23 Training courses have been developed for these purposes and the training programme is expected to be completed by October 2000. To supplement the formal training, an informal mentoring programme of "buddying" has also been introduced where staff with a tax background provide day to day guidance to former Contributions Agency staff.

6.24 Access to information technology is an essential part of employer compliance work. During our audit we found that:

- staff located in former Contributions Agency offices do not have on-site access to Inland Revenue computer systems and therefore have no access to the employer compliance system, the Inland Revenue's intranet, or other departmental systems;
- three Large Employer Compliance Offices had not yet gained access to the Inland Revenue's systems, over a year after the transfer; and
- some staff are having to hot-desk due to a lack of sufficient computer terminals.

The Inland Revenue told us that it was developing a plan to provide all such staff and areas with the information technology equipment and infrastructure used in the rest of the Department by the end of 2001-02.

Performance monitoring and management

6.25 The Inland Revenue sets annual overall targets for employer compliance work. **Figure 13** shows performance in 1999-00 and targets for 2000-01.

13 Employer compliance: targets and results

	1999-00 target	1999-00 result	2000-01 target
Local Offices			
Number of reviews	35,000	31,625	29,000
Reviews completed to a satisfactory or better standard (per cent)	72	85	85
Large Employer Compliance Office			
Number of reviews	280	224	265
Reviews completed to a satisfactory or better standard (per cent)	70	63	70
Completion of on-site investigation work within 9 months of first visit (per cent)	100	98	95
Settlement of review cleared in:			
- 2 years (per cent)	75	79	75
- 3 years (per cent)	95	91	95

Source: Inland Revenue plan 2000-01

Number of reviews

6.26 As the year progressed it became apparent that the impact of the transfer of the Contributions Agency was affecting coverage. As a consequence, the Department agreed that offices could work to 90 per cent of their original target. This revised target was achieved nationally, but there were regional variations. Targets for 2000-01 have been reduced to allow staff to focus their efforts on settling cases and to concentrate on training and on implementing the reorganisation.

6.27 The Department aims to maintain an active compliance presence across the employer population in the interests of equity and deterrence. My previous report noted that the Department did not set targets for the number of employer compliance reviews by size of employer or by trade sector. The Department has now analysed the employer population into seven segments based on the number of employees. In 1999-00, local offices set informal targets for the number of reviews to be undertaken in each segment, consistent with the overall national target. We found that the targets for individual segments were generally based on coverage in previous years or proportionally on the number of businesses in each segment.

6.28 The Department told us that it is in the process of setting up a team to examine the results of reviews conducted in 1999-00, to inform the target setting process.

Performance variations

6.29 One of the main recommendations of the Committee of Public Accounts was that the Department should make better use of its management information to establish why some local employer compliance teams were apparently more efficient and effective than others. As **Figure 14** shows, these disparities still exist.

14 Variation in non-compliance detection rates across local offices

	Percentage of reviews identifying non-compliance	Range variation	Average number of reviews identifying non-compliance
1995-96	69% - 82%	13	76%
1999-00	65% - 82%	17	75%

Source: Inland Revenue Business Operations Division

From September 1999, the Department has been measuring the performance of its regions centrally through a "basket of indicators". This comprises a series of performance indicators designed to examine particular aspects of employer compliance activities, for example the percentage of reviews identifying irregularities and yield per settled case.

Performance monitoring at regional and local level

6.30 During our visits we found that:

- Local office managers considered the process for extracting data from the employer compliance system cumbersome and believed it could not produce all the information they required. They relied on other means of creating management information to monitor the performance of their units. They also questioned the reliability of the data extracted. For example, at one office the local records of the number of completed reviews differed from those on the system.

- At regional level, inconsistencies between the Regional Office Management Information System and data on the employer compliance system prevented Regional Offices from using their system to extract data about the performance of their local offices. Instead, they had to rely on information provided centrally.

Many of the difficulties experienced by the local and regional offices should have been addressed with the introduction of its Infonet in July 2000, which enables local, regional, and headquarters offices to draw more easily upon a wider source of information than before to monitor and manage their work.

Tax yield

6.31 The department does not set targets for the amount of additional tax and national insurance contributions it expects employer compliance work to yield. This is because its aim is to ensure that the correct amounts are paid and setting yield targets could send the wrong signals to staff. It nevertheless records the yield achieved by its work. **Figure 15** compares yield from employer compliance activity in 1999-00 to that of previous years.

15 Employer compliance yield 1995-96 to 1999-00

Employer Compliance Yield	1995/96	1996/97	1997/98	1998/99	1999/00
Network	249.5	241.7	227.8	151.0	195.6
LECO	41.2	47.1	69.3	27.6	35.1
Total	290.7	288.8	297.1	178.6	230.7

Source: Inland Revenue

6.32 The Department has not carried out a specific analysis of trends in employer compliance yield from local office work but, reading across from analyses of yield from other compliance work, it told us that it was likely that there were several reasons for the variations. There were probably two underlying themes: less active management of compliance work, and the number of fundamental changes affecting the organisation. The Large Employer Compliance Office attributed the decrease in its yield during the last two years to a reduction in staff experience.

Conclusions

6.33 The Department has taken action to improve the risk assessment process underlying its employer compliance work but a database of employers designed to assist staff in identifying higher-risk cases for investigation has yet to achieve its full potential because some of the information it contains is unreliable and staff lack confidence in using it to select cases. In view of the continuing variation between local office non-compliance detection rates, the Department needs to monitor progress on action being taken to address these deficiencies.

6.34 The Department has taken action to strengthen the case selection process by establishing specific teams to carry out this work, rather than leaving decisions to individual staff. This, together with plans to access a wider range of information and to develop an automated risk scoring system, should help improve case selection in the longer term.

- 6.35 While there is evidence that there are exchanges of information about good practice within the Large Employer Compliance Office, there is less evidence of this between the Large Employer Compliance Office and local offices and within the local office network. We recommend that the Department examines the scope for disseminating lessons learnt from its employer compliance activities.
- 6.36 The Inland Revenue has put considerable effort into the planning and organisation of the transfer of work from the Contributions Agency but the new arrangements will take some time to bed in and in the short-term have adversely affected the quantity and quality of employer compliance work. In the longer term, the integration offers significant potential benefits both in terms of improving the efficiency and effectiveness of employer compliance work and reducing the burdens on business.
- 6.37 We endorse the Department's work to develop a more sophisticated approach to target setting and the establishment of a "basket of indicators" to assess regional performance. It should use its analysis of the results of 1999-00 compliance work to inform and develop its approach. While additional tax yield is the tangible outcome from employer compliance work, we recognise that setting yield targets might send the wrong signals to staff. However, we recommend that the Department should investigate significant variations in yield to identify the need for improvements in the way it manages risks.

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