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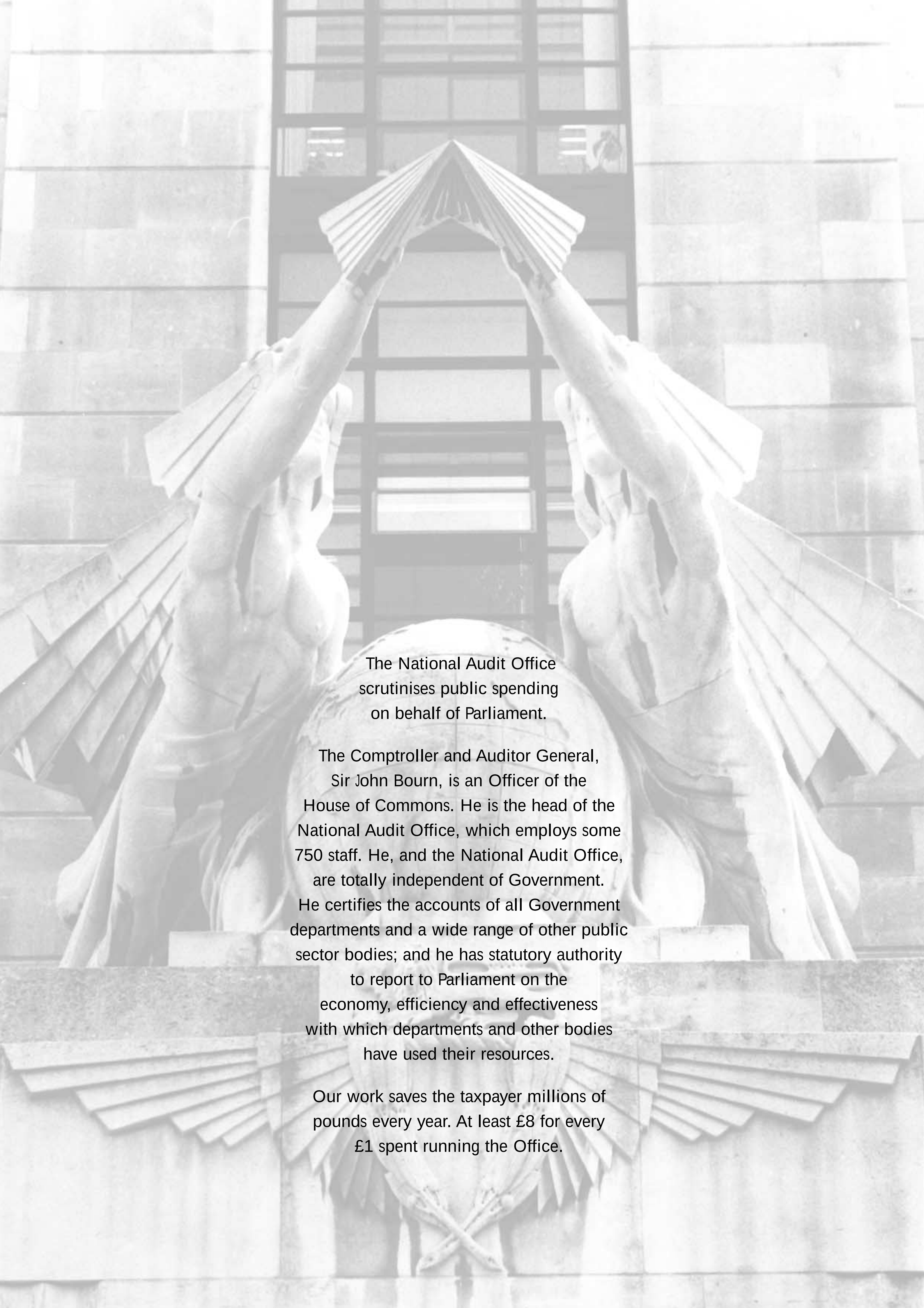
Inland Revenue

Income Tax Self Assessment

REPORT BY THE COMPTROLLER AND AUDITOR GENERAL
HC 56 Session 2001-2002: 5 July 2001



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Inland Revenue

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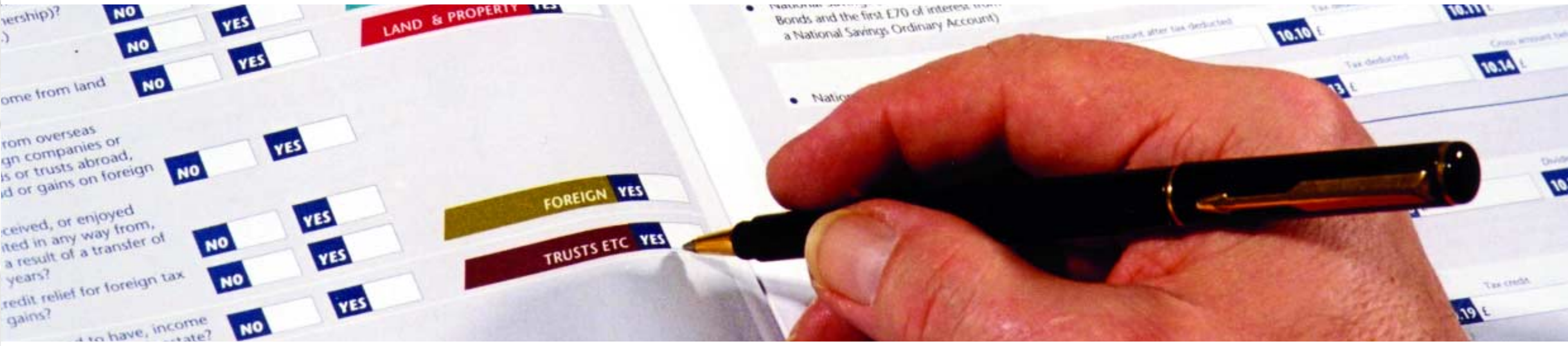

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This report has been prepared under Section 6 of the National Audit Act 1983 for presentation to the House of Commons in accordance with Section 9 of the Act.

John Bourn | National Audit Office
Comptroller and Auditor General | 29 May 2001

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Introduction

1 The Inland Revenue introduced self assessment for income tax and capital gains tax in 1996. Self assessment affects more than 8 million self employed and higher-rate PAYE taxpayers, 700,000 partnerships and 300,000 trusts. In 1999-00, these taxpayers paid more than £55 billion income tax, national insurance contributions, and capital gains tax, of which £40 billion was collected through PAYE and other forms of deduction at source.

2 The scheme represented one of the largest changes in tax administration for decades. Key changes included:

- tax liabilities being assessed by the taxpayer or their agent rather than by the Inland Revenue in the majority of cases;
- a move from a "check now/process later" approach to tax administration to "process now/check later";
- the taxation of all income and capital gains on a "current year" basis;
- the consolidation of assessments for all forms of income and capital gains and rationalisation of payment dates; and
- the introduction of a statutory right for the Inland Revenue to enquire into any tax return.

The Inland Revenue delivered the £800 million self assessment project to time. The latest forecast indicated that the Department are on track to exceed the administrative savings identified at the planning stage.

3 Under Section 2 of the Exchequer and Audit Departments Act 1921, we examined the risks to the assessment, collection and allocation of tax under self assessment, whether the Inland Revenue had established adequate regulations and procedure to address those risks, and whether they worked in practice. We did not undertake a review of how well self assessment was implemented as we had already covered this in our reports to the House of Commons on the Department's annual appropriation accounts.

4 Figure 3 on page 7 shows the processes that make up the system and summarises the main risks to the assessment, collection and allocation of tax inherent in each process. Appendix 1 provides a more detailed analysis of the risks and mitigating controls. We concluded from this work that the Department had established an effective framework for managing the risks.

5 There are recognised difficulties in attempting to estimate the size of the hidden economy and tax gap. This means that there are no precise estimates of the overall tax at risk. Based on available information (Appendix 2), we focused our study on three areas where there may be significant financial exposure if the risks are not managed appropriately: the identification of taxpayers, return management, and the conduct of enquiries.

6 We analysed data from a number of sources, including the Inland Revenue's management information systems, and also visited seven Inland Revenue network offices. We also looked at self assessment systems overseas to compare the Inland Revenue's approach with other tax administrations (Appendix 3). Appendix 4 explains our methodology in detail.

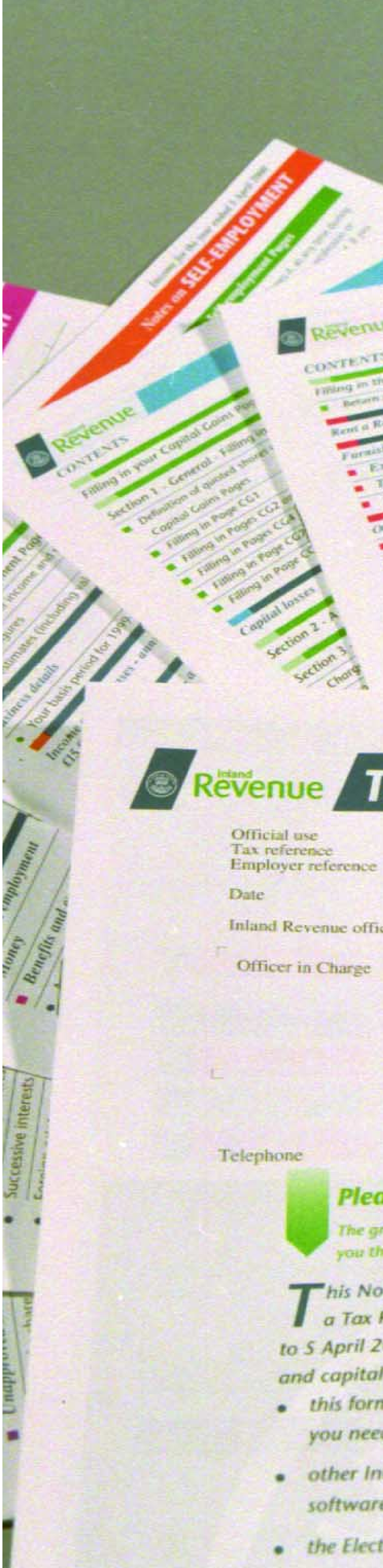
Main findings and conclusions

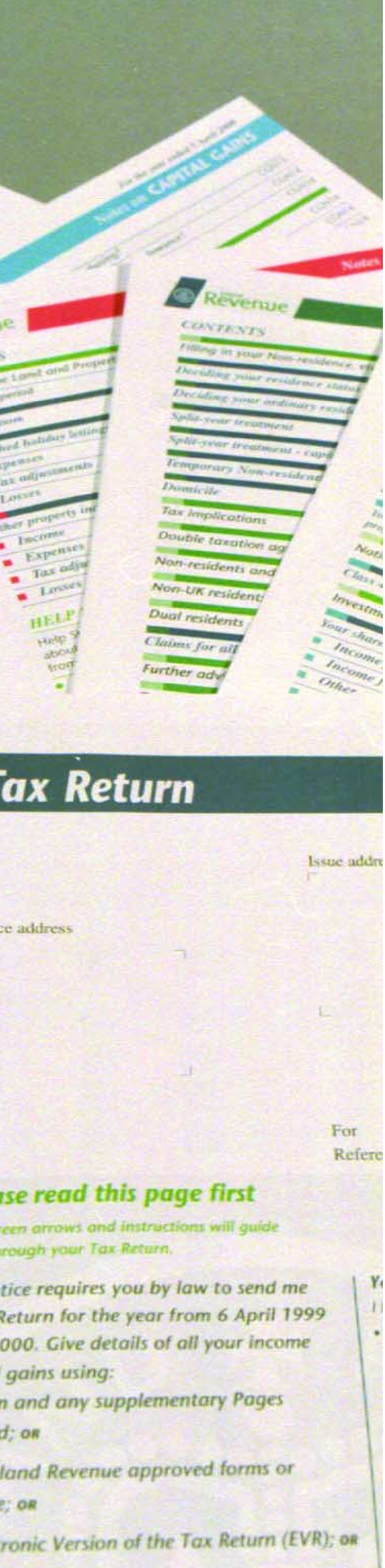
7 Our overall conclusion is that self assessment has improved the administration of income and capital gains tax. It has made assessments more straightforward and allowed a more focused approach to compliance work.

8 The Inland Revenue's self assessment compliance work identified some £350 million extra tax in 1999-00. Given the potential amounts of tax at risk, we endorse Inland Revenue measures to further strengthen their compliance activity by developing a more structured analysis of risks, including the potential financial impact from types of non-compliance, and by assessing the success of specific compliance measures. To support this, the Department are taking action to improve their management information, particularly on the effectiveness of:

- their intelligence work at national and local levels, and of specific initiatives;
- penalties and tax determinations in ensuring tax returns are filed on time; and
- the various mechanisms used to select tax returns for detailed enquiry, and different types of enquiry.

9 Our other key conclusions and recommendations are set out opposite.





Identifying taxpayers and getting in tax returns

10 All taxpayers have a legal duty to notify the Inland Revenue of taxable income and gains and to pay any tax arising. However, some will fail to do so. The Department have a range of systems and controls in place to identify taxpayers who should be using self assessment and to ensure that these taxpayers file tax returns on time.

11 The Inland Revenue estimate that their intelligence work identified at least £21.8 million additional yield in 1999-00. This includes work focusing on the hidden economy to identify people not registered for tax (ghosts) and individuals failing to declare casual work and cash income (moonlighters) and of other types of evasion. Unlike many other areas of activity, the Department have not established quality assurance mechanisms or performance targets for this work.

12 The Inland Revenue have reorganised the way they approach intelligence work and set up specialised teams in April 2001 to improve the focus of this activity. From Summer 2001, the Department plan to increase the scope and scale of automatic cross-checks between taxpayer declarations and third-party information, such as interest paid by banks and building societies, and they are currently negotiating with local authorities to secure consistent and complete information for local offices on landlords receiving housing benefit. They are also introducing a database to record the results of their intelligence work at national and local levels, and of specific initiatives. This will help them ensure that the resources used are sufficient and well targeted, and to set targets and performance measures.

13 Over the last four years, around 90 per cent of self assessment tax returns have been received by the due date, demonstrating the success of the current framework. The Inland Revenue estimate that the potential tax at risk associated with late returns could be between £150 million and £300 million a year and they are carrying out research into patterns of taxpayer behaviour, and the reasons why returns are not filed on time.

14 We endorse this development and recommend that the Inland Revenue further improve their systems for getting returns in on time by:

- reviewing the operation and effectiveness of their approach to enforcement by:
  - carrying out further work to assess the likely tax at risk from late filing;
  - using the results of their research into taxpayer behaviour, and the reasons why returns are not filed on time, to validate their approach; and
  - further developing their management information to monitor the use of fixed and daily penalties, and tax determinations, and their effectiveness in ensuring that tax returns are filed. Without this information, the Inland Revenue cannot assess whether these incentives are effective or that local offices are using the arrangements properly;
- revising their performance targets to include the length of time a return has been outstanding. This would help ensure that, once they have cleared the current backlog of long outstanding cases, they do not allow new cases to remain outstanding for a considerable time.

Conducting enquiries into tax returns

15 The Inland Revenue have new powers to enquire into tax returns under the self assessment system. They use these to deter and detect non-compliance. The requirement for local offices to prepare annual compliance plans and select cases for enquiry based upon an assessment of the risk to tax has made the process more comprehensive and structured. In addition, the introduction of mandatory reviews has introduced a greater uniformity in approach to higher risk aspects of individuals' tax affairs.

16 The Inland Revenue have used their new powers to enquire into a centrally selected random sample of tax returns. These arrangements provide valuable information about the level and patterns of non-compliance in the taxpayer population as a whole. The results from the first two years' enquiries suggest that substantial sums may be at risk from non-compliance, and the Department are undertaking further enquiries on 1998-99 returns to obtain a firmer view of the amounts involved.

17 The Inland Revenue are continuing to develop their arrangements for enquiries by:

- using specialist teams to carry out risk assessment work and to select cases for enquiry from April 2001;
- increasing the use of third party information in the risk assessment process from Summer 2001; and by
- analysing data on the tax yield from completed enquiries to identify common features which will form the focus of a centrally selected sample of enquiry cases in 2001-02.

18 We welcome these developments and recommend that the Department continue to use their "basket" of internal performance indicators to manage the risk that the external performance target, which focuses on numbers of cases, may encourage compliance staff to focus on quantity rather than quality. The Department should also keep under review the impact of the one-year window for opening enquiries on their ability to investigate potential non-compliance.

Part 1

Introduction

1.1 The Inland Revenue introduced self assessment for income and capital gains tax on 6 April 1996. Self assessment affects more than 8 million self employed and higher-rate PAYE taxpayers, 700,000 partnerships and 300,000 trusts. The Department collected tax receipts of more than £16.5 billion through the system in 1999-00 - £14.4 billion in income tax and national insurance contributions and £2.1 billion in capital gains tax. A further £40 billion was collected from self assessment taxpayers through the PAYE system and other forms of deduction at source.

1.2 The scheme represented one of the largest changes in tax administration for decades. The key changes are shown in **Figure 1**.

1.3 Despite these changes, self assessment has many similarities with the previous system. For example, higher-rate PAYE taxpayers with relatively straightforward tax affairs, who submit their return before 30 September for the Inland Revenue to calculate their tax liability, would not notice many changes, particularly where any underpayment of tax is corrected by an adjustment to their PAYE tax code. A glossary of terms is at Appendix 6.

1 Key changes under self assessment

Before		After
Inland Revenue	Calculation of tax	Taxpayer[1]
Check now / process later	Processing and checking	Process now / check later
A mix of current and previous year	Basis of assessment	Current year basis on all sources of incomes and gains
Separate assessments	Assessments for different types of income or gains	One assessment covering all incomes and gains
Range of dates for different sources of income or gains	Due dates for payment of tax	One set of due dates on all sources of income and gains
No automatic right	Enquiries into returns	Statutory right

Note: 1. The Department will continue to perform the calculation, provided taxpayers send in their return by 30 September.

1.4 **Figure 2** shows key dates in the self assessment process.

Aims and objectives

1.5 The Inland Revenue's aim is to administer the tax system fairly and efficiently and make it as easy as possible for individuals and businesses to understand and comply with their obligations. Their objectives for self assessment are to increase taxpayer understanding and compliance, to maintain the flow of funds to the Exchequer and to produce cost and resource savings.

1.6 The Inland Revenue monitor the project to ensure that planned benefits and savings are realised. They estimate that, over the 15-year period to 2007-08, the introduction of self assessment should result in administrative savings of £500 million, and that the project should break even by 2005. Total lifecycle costs are currently estimated to be £839 million.

Scope and methodology

1.7 Under Section 2 of the Exchequer and Audit Departments Act 1921, we examined whether the Inland Revenue had established adequate regulations and procedure to manage risks associated with the assessment, collection and allocation of tax under income tax self assessment and whether the Department's controls were working in practice.

1.8 Although they use risk analysis techniques in their administration of self assessment, for example in the selection of cases for enquiry, the Department had not produced an end-to-end risk analysis of the system. We therefore drew up a model of the key processes that make up the system and identified the main risks to the assessment, collection and allocation of tax inherent in each process (**Figure 3**).

2 Important dates in the self assessment cycle

This diagram shows the key action dates in the self assessment cycle.

Year	Month	Date	Required actions
Tax Year	Jan	31	Non-PAYE taxpayers must make the first payment on account, based on previous year's tax liability.
	Feb		
	Mar		
Year After Tax Year	Apr	6	Inland Revenue issue returns to known taxpayers, soon after the end of the tax year.
	May		
	Jun		
	Jul	31	Non-PAYE taxpayers must make the second payment on account, based on previous year's tax liability.
	Aug		
	Sep	30	Taxpayers who want the Inland Revenue to calculate their tax liability must submit returns.
	Oct		
	Nov		
	Dec		
	Jan	31	Taxpayers calculating their own liability must submit completed returns. All taxpayers must pay balance of liability.
	Feb		
	Mar		Taxpayers incur interest and surcharges for late payment. The Inland Revenue levy penalties of £100 for late filing. The Inland Revenue have a period of 12 months in which to open an enquiry.

Source: National Audit Office

3 Self assessment - outline risk model

This chart shows the main processes in the self assessment system and our assessment of the main risks.

Process	Potential risk	
Establishment of regulations and procedure	■ Legislation does not address tax risks ■ Regulations and procedure not in line with legislation ■ Regulations and procedure unclear and taxpayers and staff do not understand their responsibilities	
Identification of taxpayers	■ Taxpayers not identified ■ Third Party Information not used effectively	Identification of taxable income and gains
Return management	■ Returns not sent to taxpayers ■ Missing returns not identified and pursued ■ Penalties not issued for non submission ■ Penalties issued incorrectly	Identification of taxable income and gains
Processing	■ Declaration by taxpayer incomplete or inaccurate	Identification of taxable income and gains
Processing	■ Taxpayer's assessment of liability incorrect ■ Submitted returns not processed ■ Returns processed incorrectly by Inland Revenue ■ Inaccurate figures accepted in excess of tolerances ■ Provisional figures not adjusted to actuals ■ Tax calculations inaccurate ■ Computer unable to cope	Assessment of tax liability
Conduct of enquiries and identification and notification of additional liabilities	■ Failure to identify incomplete or inaccurate declarations by taxpayers because: ❑ Case selection criteria deficient ❑ Insufficient cases examined ❑ Quality of case working inadequate ❑ Issues not identified for investigation	Assessment of tax liability
Notification of liability	■ Statements not issued to/received by taxpayers ■ Statements incorrect	Collection of tax
Debt management	■ Liability not paid when due and not pursued ■ Receipt incorrectly allocated to taxpayer account ■ Inappropriate write off action ■ Interest for non payment not charged ■ Interest charged incorrectly ■ Repayments made incorrectly	Collection of tax
Sums brought to account	■ Receipts incorrectly recorded or allocated ■ Diversion of funds within the Department	Allocation of tax

Source: National Audit Office assessment

1.9 We analysed the end-to-end processes involved in self assessment (Appendix 1) and also compared them with similar systems in Australia, Canada, the Republic of Ireland, New Zealand and the United States of America (Appendix 3). We concluded from this work that the Department had established an effective framework for managing the risks.

1.10 Appendix 2 explains the difficulties associated with estimating the difference between tax collected and the amount that might theoretically be collected with full compliance - the "tax gap". As part of our overall examination of the self assessment system, we nevertheless attempted to estimate, in the broadest terms, the amounts of potential tax at risk at key stages in the process. We used this analysis to focus our study on three higher risk areas. These were:

- identifying taxpayers (Part 2)
- getting tax returns in (Part 3)
- enquiring into tax returns (Part 4)

Appendix 4 explains our methodology in more detail.

1.11 We did not look at the implementation of self assessment as we had already covered this in our reports to the House of Commons on the Inland Revenue's annual appropriation accounts. Appendix 5 outlines issues which have arisen during implementation of the project and how the Department have addressed them. We plan to examine the introduction of filing returns via the internet in a separate study of the Department's use of e-business systems to streamline tax administration.

1.12 The Inland Revenue have confirmed the factual accuracy of the report insofar as it relates to the administration of the income tax self assessment system in the United Kingdom. We have agreed the references to other countries' self assessment systems in Appendix 3 with the revenue authorities concerned.

Part 2

Identifying taxpayers

2.1 This part of our report examines the Inland Revenue's procedures for identifying those liable to income tax or capital gains tax under the self assessment system. Although there are no reliable estimates of the tax at risk from the non-identification of potential taxpayers, it is generally acknowledged that this is a key area for revenue authorities.

The identification of taxpayers

2.2 The self assessment arrangements apply to the taxpayers shown in **Figure 4**.

4 Taxpayers liable for self assessment

Self employed taxpayer

Higher rate PAYE taxpayer

Subcontractors in the construction industry

Partnerships

Trusts

Landlords, including those overseas

2.3 The key risk in implementing the new arrangements was that the Inland Revenue would not identify existing taxpayers who should be subject to self assessment. The key risk common to both the previous and new arrangements is that potential taxpayers may remain undetected. A graphical representation of the risks and the controls which mitigate them is at **Figure 5** overleaf.

Identifying compliant taxpayers

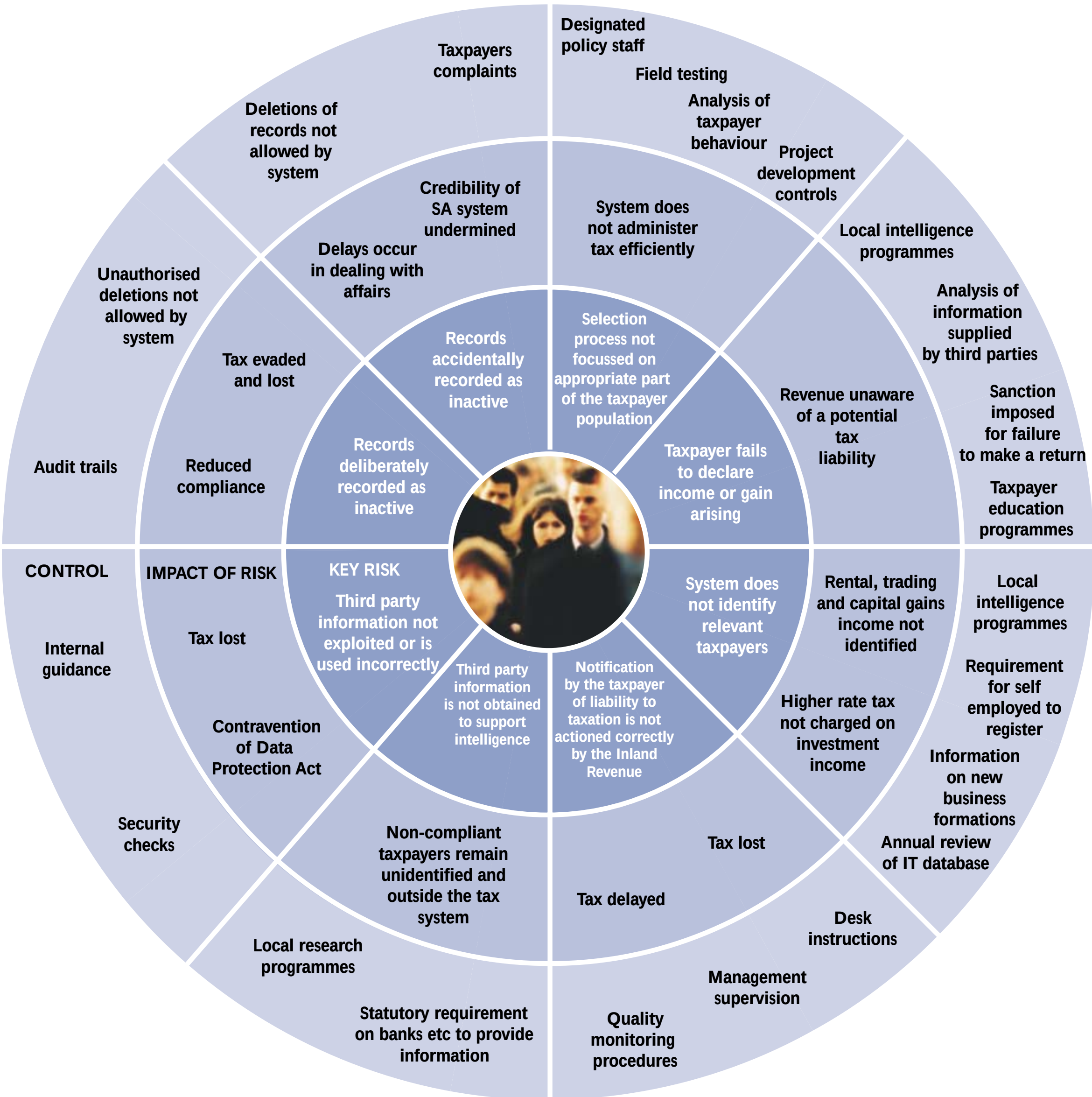
2.4 Many existing taxpayers who should have been included in the self assessment system would have already been known to the Inland Revenue, and were declaring income and gains under the previous system. The Inland Revenue identified potential self assessment taxpayers by searching taxpayer records and transferring their details to the new system.

2.5 Over time, however, the taxpayer population changes. The Inland Revenue search their database of employee records to detect those who have become higher-rate taxpayers during the year, or who have other characteristics which bring them within the scope of self assessment. Individuals have a legal obligation to notify the Inland Revenue of their chargeability to income tax or capital gains tax. For the newly self-employed, the arrangements were simplified and strengthened in January 2001 and individuals can now telephone the Department to register, with the risk of a £100 penalty if they do not do so within three months.

Identifying non-compliant taxpayers

2.6 Non-compliant taxpayers often operate in the "hidden" economy, which covers tax evasion of all kinds. This includes the failure of individuals to register for tax (ghosts), the non or under-declaration of casual work and cash income (moonlighting), through to organised crime.

5 **Identification of taxpayers and taxable events**



Source: National Audit Office

2.7 The Inland Revenue seek to identify such individuals through intelligence work. This is generally organised into projects concentrating on a particular trade or information source, as illustrated in **Figures 6 to 8** overleaf.

2.8 From a manual review of information held on their Project Support System, the Department estimated that intelligence work led to an additional tax yield of some £21.8 million in 1999-00, compared with £30.6 million in the previous year. However, this figure may understate the impact of this work as it excludes: (i) cases referred to compliance units for action, such as those described in Figure 8 overleaf; (ii) the subsequent tax yield arising from the fact that the taxpayer has been brought within the system; and (iii) the compliance effect on other taxpayers. In addition, some local offices refer to intelligence activity as research and development and do not record their results on the System.

2.9 The Inland Revenue often base intelligence work on the analysis of third party information obtained using their statutory information powers. The Department's Taxes Information Distribution Unit obtains details of transactions, for example bank and building society interest, routinely from more than 12,000 sources, and much of this information is collated in a central data warehouse. Designated staff are able to obtain information relating to individuals in their area to support intelligence work.

6 Information obtained from other public sector agencies

Using information obtained from the District Valuer on multiple or frequent property transactions, the Inland Revenue undertook a compliance review concentrating on repossessed properties, which are often sold quickly at a profit. They reviewed the tax records for the individuals involved in these transactions to identify taxpayers who may have made capital gains or were involved in property dealing which they had not declared.

From 175 cases examined in one tax office, the Inland Revenue settled 141 cases, identifying extra tax yield of £1.25 million. This work has since been carried forward on a national basis.

7 Information obtained from other sources

Using their statutory information powers, the Inland Revenue obtained details of payments made to people appearing as extras in programmes from a local television production company. Tax records for the individuals listed were then traced to ensure that the extras had declared these payments.

No additional tax yield has been identified to date.

8 Information obtained by direct observation

Inland Revenue staff visited local restaurants at various times during opening hours, without identifying themselves, and purchased meals as ordinary customers. Whilst in the restaurant, they noted the number of waiting staff on duty, the till operation and cash handling arrangements, the number of diners, the potential capacity of the restaurant, and the proportion of customers who paid their bills in cash. On completion of their meal, they settled their bill in cash, noting whether staff offered them a receipt and, if so, whether it carried an identifiable reference number.

When the returns covering the observation period were filed, the Inland Revenue opened enquiries into the returns and used the information obtained during the observation visits to determine whether the restaurant was declaring its turnover in full, and whether the other information supplied, for example on the number of staff in attendance on particular days, was accurate.

Of the 41 cases taken up, the Inland Revenue have settled 13 and identified extra tax yield of £700,000. They expect this to rise by a further £1.3 million from cases awaiting settlement.

2.10 The Inland Revenue also obtain other information in the public domain, for example property sales and the disposals of assets through auction houses, both routinely and as a result of specific local initiatives. This information is collated by the Taxes Information Distribution Unit on a central database and is made available to intelligence staff in the local office network by CD-Rom supplied to Regional Offices.

2.11 We found that limited access to certain internal and third party information sometimes hampered intelligence work.

- The Project Support System (paragraph 2.8) is a local system and does not allow staff to share new approaches to intelligence activity or to track cases referred from one office to another. Staff therefore have to follow up referrals manually. This is a slow process and staff waste time determining whether action has been taken or any additional tax identified and collected.
- Local office staff are collating and analysing some information manually, as they lack access to data collation and matching facilities.
- Some tax offices have access to all payment details held by local authorities on housing benefit, whereas others have access only to details of named persons. To improve the availability and consistency of such data in the future, the Inland Revenue are negotiating with the umbrella organisations for local authorities to agree protocols for the supply of information. The information would be processed and collated in the central data warehouse and staff would have access to it to inform their intelligence work.

2.12 The Inland Revenue are continuing to develop their central data collation and matching facilities. From Summer 2001, aggregated information from the data warehouse will be transferred to the self assessment system where it will be matched automatically against taxpayer declarations, for example, of interest received. This will identify potential inconsistencies for further enquiry. In the longer term, their aim is to collate all third party information on each individual and make it available to compliance staff and to extend the range of data collected to include information such as housing benefit payments made to landlords.

2.13 Until recently, the Inland Revenue allowed local offices freedom to develop their own systems for making best use of the information available, whilst encouraging dissemination of best practice. Unlike other areas of work, such as processing and debt recovery, they have not set targets for intelligence work, nor developed quality assurance mechanisms. While flexibility is needed to allow local offices to respond to specific risks, the lack of consistent information on the success of local offices and specific initiatives has made it difficult for managers to assess whether the resources they are allocating to intelligence work are sufficient and well targeted.

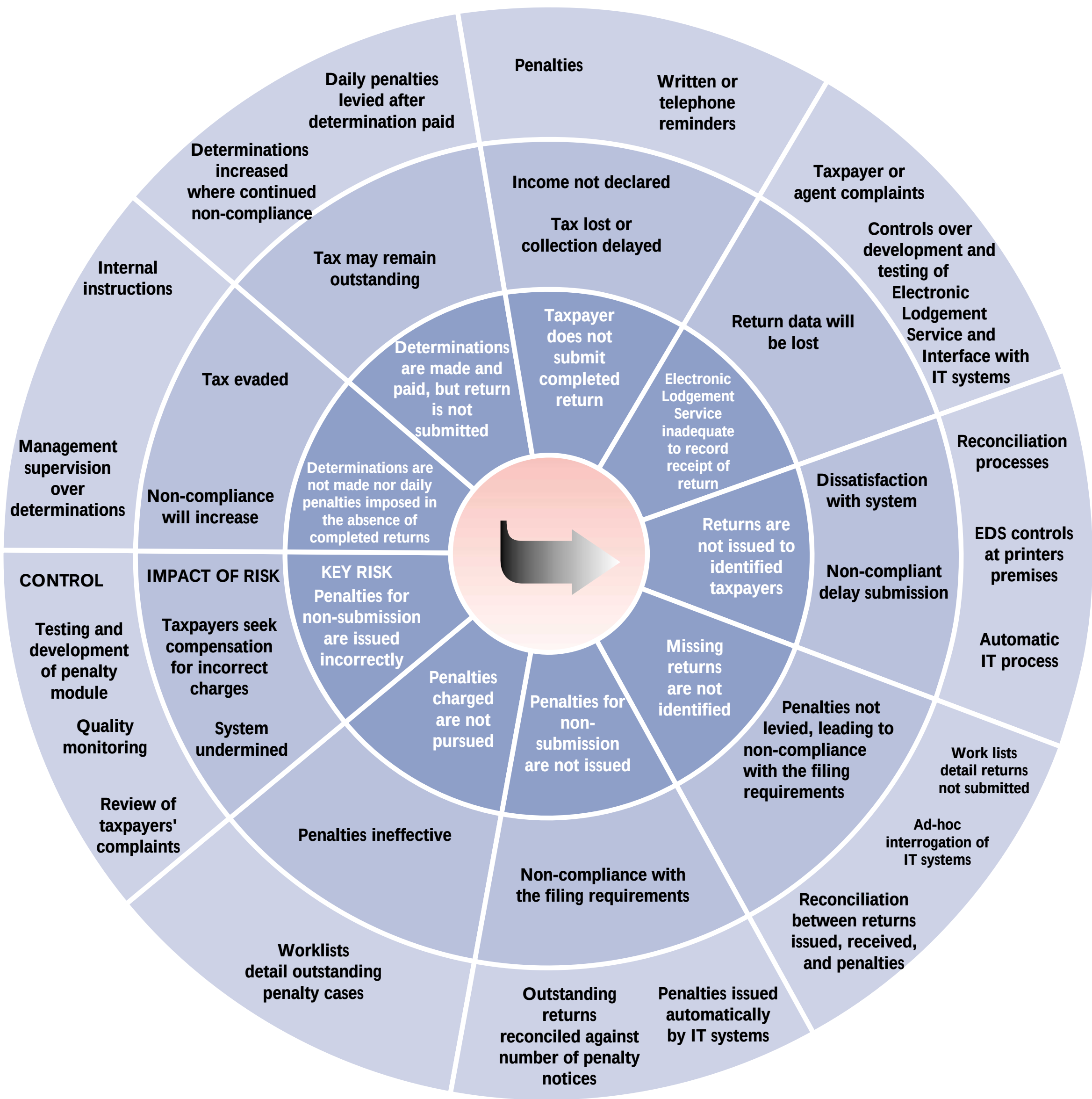
2.14 The Inland Revenue are taking a number of steps which will help improve the effectiveness of intelligence work. As part of a reorganisation of the structure of the local office network, the Department set up specialised risk intelligence analysis teams in April 2001. These teams are supported by a central unit, which is responsible for undertaking research and for developing methodologies to identify non-compliance. The Department have also developed a new database which, from April 2001, will assist them in analysing the results of intelligence work.

Part 3

Getting tax returns in

3.1 The annual tax return is the cornerstone of the self assessment system. The Inland Revenue need to obtain a completed return from each person who has been sent one, to check the amount of tax due, and unless they have received a return they cannot open an enquiry into a taxpayer's affairs. **Figure 9** summarises the risks and the mitigating controls.

9 Return management



Source: *National Audit Office*

3.2 To encourage the prompt filing of returns, the Inland Revenue have developed extensive advertising campaigns reminding taxpayers of the key filing deadlines. To deter late filing, the Department levy an automatic fixed penalty of £100 if a return is late. A further £100 penalty is charged if a return is more than six months late. If the return is more than a year late, the taxpayer may be charged a penalty of up to 100 per cent of the tax due on the return, in addition to having to pay the tax itself. The Inland Revenue can also seek the approval of the General Commissioners to impose daily penalties of up to £60 per day in cases of persistent failure to submit a return.

3.3 This framework has been successful in achieving a filing rate of around 90 per cent by the 31 January deadline each year for the 35.7 million returns despatched since April 1997 (see **Figure 10**).

3.4 If the Inland Revenue do not receive returns, this will delay the tax assessment and the Department may not collect the correct amount of tax. On the basis of an analysis of a small sample of returns filed late, the Department estimated that between £150 million and £300 million tax could be at risk from the 500,000 late 1998-99 returns which remained outstanding at August 2000, six months after the statutory filing date. There is, however, considerable uncertainty attached to the estimate as the sample necessarily excluded cases where taxpayers had failed to file a return.

3.5 If the taxpayer fails to file a return, the Inland Revenue can issue a determination estimating the amount of tax to be paid. The taxpayer has no right of appeal against a determination, and must either pay the amount demanded or submit a completed return showing why the estimated amount is incorrect.

3.6 Our examination identified concerns over the effectiveness of penalties and determinations in encouraging taxpayers to file their tax returns and procedures for chasing up outstanding returns.

The effectiveness of penalties

3.7 Between February 1998 and August 2000, the Inland Revenue issued 4.9 million fixed penalty notices. They do not monitor, either nationally or at local level, the success of these penalties in encouraging the submission of tax returns.

3.8 We found that:

- Inland Revenue statistics show that in 23 per cent of cases (1.1 million) the fixed £100 penalties related to taxpayers with residual liabilities below £100. In these cases, the penalty is reduced to the level of the tax outstanding, and therefore provides limited incentive for taxpayers to file their returns;
- the Inland Revenue have had to issue 104,000 estimates of the tax due (determinations) since January 1998. The system of determinations was put in place at the start of self assessment because it was always recognised that fixed £100 penalties might not on their own be an effective means of encouraging those with significant residual tax liabilities to file a return;
- local tax offices are reluctant to levy daily penalties, of up to £60 per day, because of the complexity of the process involved (**Figure 11** overleaf), a reluctance by local staff to take large numbers of cases to the General Commissioners, and confusion as to when these penalties should be applied. Six of the seven local offices visited had not levied daily penalties;

10 **Self assessment tax returns - filing record**

Returns	1996-97		1997-98		1998-99		1999-00	
	Millions	%	Millions	%	Millions	%	Millions	%
Sent out	8.54	100.0	9.02	100.0	9.09	100.0	9.05	100.0
Filed by 30 September	4.42	51.8	4.43	49.1	4.51	49.6	4.40	48.6
Filed by 31 January	7.87	92.2	8.20	90.9	8.21	90.3	8.13	89.8
Outstanding at 31 January	0.67	7.8	0.82	9.1	0.88	9.7	0.92	10.2
Outstanding at 31 January 2001	N/A		N/A		0.37	4.1	As above	As above

Notes: N/A: Figures not available

Source: Inland Revenue

- the management information relating to daily penalties did not allow the Inland Revenue to make an informed assessment of their effectiveness. This is because the Inland Revenue have no central record of the number of cases for which the General Commissioners have approved daily penalty applications or the number of cases where the issue of a statutory 14 day warning notice has led to the submission of a return; and
- daily penalties appear to be an effective means of encouraging taxpayers to submit completed returns. Of 30 daily penalty notices issued by one of the offices we visited, 23 had resulted in the submission of completed returns prior to the levying of penalties. Six of the remaining seven taxpayers submitted their outstanding returns after daily penalties were levied.

11 Stages involved in daily penalties

Consider case for daily penalties

Warning issued to taxpayer that the Department intend to seek approval from the General Commissioners for daily penalties

After thirty days
Apply to the General Commissioners for leave to impose penalties

Direction issued by General Commissioners
Letter to taxpayer issued to confirm direction has been obtained and penalties will be imposed in fourteen days

Fourteen days allowed to submit return
Decide on the amount of daily penalty and issue notice imposing penalties

Thirty days appeal period against amount
Penalty raised on taxpayer record by the Department and recovery office notified for pursuit

Warning issued to taxpayer of further penalties if return not received

Fourteen days allowed to submit return
Referred to senior management in Department for further penalties

The Inland Revenue are considering procedural changes and are setting up pilot schemes to test ways of making greater use of daily penalties.

The effectiveness of determinations

3.9 Similarly, the Inland Revenue do not have routine information on the use and effectiveness of determinations. As a special exercise, the Department extracted information for us from their systems on the number of determinations issued and the number of returns received in response. This showed that less than 40 per cent of the 104,000 determinations issued had led to the submission of completed returns.

3.10 The Inland Revenue's information systems could not provide the number of cases where the taxpayer had paid the determination but not submitted the return. There is a risk that the amounts paid are below the amounts which would actually be due if the taxpayer had made a full declaration of their liabilities. In such cases, the Inland Revenue do not have effective information or incentives to ensure that the taxpayer files the tax returns so that they can identify any underpayments of tax.

Pursuing outstanding returns

3.11 The Inland Revenue have traditionally accorded higher priority to pursuing large debts than outstanding returns and, as a result, a backlog of cases has accumulated. They have set targets for the pursuit of outstanding returns and require a proportion to be cleared within a specified period. These targets do not require staff to focus on the clearance of the oldest cases and, as a result, some of the cases in the backlog could date back to 1996-97, the first year of self assessment.

3.12 To speed up the pursuit of outstanding returns the Inland Revenue transferred the responsibility for chasing returns for a small number of offices to telephone pursuit units at their Accounts Offices at Shipley and Cumbernauld and their Call Centre at East Kilbride. These units succeeded in persuading 20 per cent of the taxpayers contacted to send in completed tax returns. The Inland Revenue do not know, however, the additional tax yield achieved from the submission of these returns.

3.13 The Inland Revenue established a separate Directorate of Receivables Management in June 2000 and in March 2001 transferred new return cases and certain debt management work to an outbound call centre. They are supporting their work to encourage filing, by analysing the reasons why taxpayers do not complete their returns on time. The initial results suggest that, in addition to a hard core of non-compliant taxpayers who need to be chased for returns, there are four groups who tend to file late:

- new self assessment taxpayers;
- previous taxpayers with no current liability;
- taxpayers who have never filed returns; and
- taxpayers with substantial liabilities in the previous year.

3.14 The Department are using the results of this work to shape future working practices for the units pursuing outstanding tax returns. They are setting up special teams to monitor former "ghosts" to encourage them to file returns on time for two years after they have registered as self employed.

Part 4

Enquiring into tax returns

4.1 This part of our report examines the Inland Revenue's procedures for selecting and conducting enquiries into tax returns and monitoring the performance of this work against targets.

4.2 The Inland Revenue can normally enquire into any tax return, provided they open the enquiry within 12 months of the statutory filing date. For returns filed late, the Department have up to 15 months to open an enquiry. After this, the Department cannot amend the tax assessment, unless they have grounds for making a "discovery" assessment. This occurs where new facts come to light, undisclosed in the tax return, which show that insufficient tax has been charged. **Figure 12** overleaf summarises the risks and the controls in place to mitigate them.

The selection of cases for enquiry

4.3 The Inland Revenue require all local offices to produce an annual compliance plan. These plans set out their strategies for managing the work and for selecting suitable cases for enquiry and form the basis for monitoring the effectiveness of local compliance activities.

4.4 Compliance plans include cases selected in a number of ways:

- random enquiries - the central selection of one in every thousand tax returns, which local staff must subject to a full enquiry;
- mandatory reviews - cases with specific features, for example capital gains arising from the disposal of unquoted shares, which local offices must review, although not necessarily conduct a full enquiry; and
- risk assessment - cases are assessed against pre-set criteria to produce a risk score. Local offices can set the criteria in the light of local experience, such as intelligence work.

4.5 In addition to providing a deterrent to non-compliance, random enquiries have provided, for the first time, valuable information about the level and types of non-compliance in the self assessment taxpayer population as a whole, and its financial impact. The results, for the first year of self assessment, 1996-97, indicated that, overall, 68 per cent of taxpayers were likely to be wholly compliant, with the proportion of enquiries where the additional tax yield exceeded £500 ranging from one per cent in the case of pensioners to 27 per cent for businesses. Extrapolating the results across the self assessment taxpayer population as a whole suggested that the level of non-compliance may have reduced potential yield by around £3 billion.

4.6 However, results from the 1997-98 random enquiries work - although showing similar levels of non-compliance - indicated that, if it were practicable and cost effective to achieve full compliance, the potential yield would be around £1.8 billion. Given the large variation between these two estimates, the Department consider that they do not produce an inherently stable figure of tax at risk. Of the two, they consider that 1997-98 is the more reliable, as 1996-97 was a transitional year. They will be able to form a clearer view when they have investigated the difference in more detail and have competed work on the random enquiries into 1998-99 tax returns.

4.7 The Inland Revenue can open only one enquiry into an individual's tax affairs in respect of any tax year. It is therefore important for staff to identify all aspects of the return that require investigation before they open the enquiry. If they fail to do this, they may overlook an undeclared tax liability with a resultant loss to the Exchequer. A computerised risk assessment facility and risk scores, in addition to the analysis of third party information, assist in the identification of aspects of the return for enquiry. The Department also take steps, through their training and quality monitoring programmes, to ensure that staff are able to identify higher risk aspects and that they disseminate best practice.

12 Conduct of enquiries

Source: National Audit Office

4.8 Effective risk assessment is dependent upon up to date information on the taxpayer population. The Inland Revenue's trade classification numbers that define the industry or sector into which a trading concern falls were unreliable and this has led to incomplete or inaccurate results. The Department are working to resolve this problem, but are reliant to some extent on the information supplied by taxpayers about the nature of their businesses.

Target setting

4.9 Compliance enquiries fall into one of three categories:

- full business enquiries which look at all areas of the return, and may require review of underlying records;
- business aspect enquiries which look at selected parts of the return; and
- non-business enquiries which look into non-business items on the return.

13 **Take up and results of enquiries into self assessment tax returns**

	1998-99				1999-00			
Enquiry Type	**Target**	**Actual**	**%**	**Yield £m**	**Target**	**Actual**	**%**	**Yield £m**
Business Full	36,322	35,368	97.4	24.6	44,145	44,674	101.2	80.2
Business Aspect	70,835	63,898	90.2	73.1	64,000	64,924	101.4	86.3
Non Business	512,062	209,663	40.9	81.0	277,290	288,360	104.0	168.1
Total	**619,219**	**308,929**	**49.9**	**178.7**	**385,435**	**397,958**	**103.2**	**334.6**

Notes: The targets relate to the number of enquiries to be opened each year. In the case of non-business enquiries, the figures represented forecasts of the number of cases taken up rather than formal targets.

The yield reported in 1998-99, and to a lesser extent in 1999-00, reflects the fact that a significant proportion of cases opened, particularly full business enquiries, were not settled by the year end. As there were a significant number of uncleared enquiries at March 1999, the Department reduced the same take up targets for 1999-00 to provide headroom for improving quality and performance.

The table relates to work carried out by Inland Revenue's network of local offices and excludes cases investigated by the Department's specialist offices.

Source: Inland Revenue

The Inland Revenue set quantitative and qualitative targets for compliance work, at national, regional and local level. **Figure 13** shows the numerical targets by type of enquiry and the additional yield achieved from this work. The numerical targets for business enquiries are included in the Department's formal performance targets agreed by Ministers.

4.10 From our work at regional and local level we noted that:

- initial local office compliance plans and targets were based on the resources and abilities of their compliance staff. In the process of agreeing the national targets, local plans were adjusted to match the overall target;
- some regions have fallen behind their plans part way through the year, for example because of skills and resource shortages - particularly in London. Where this has put the overall target at risk, the remaining regions have increased their take up targets to compensate; and
- the numerical targets do not take into account the size or complexity of cases investigated.

The risk arising from the focus on numerical targets is that local offices may concentrate on opening more straightforward cases at the expense of larger and more difficult cases, which are likely to produce the highest yield, particularly where the target for the total number of cases to be taken up in the year is in any doubt. Adjustments to local targets may also impact on quality and may lead to lower priority cases being examined in regions with the capacity to take on additional work.

4.11 The Inland Revenue have recognised these risks and have recently developed more rounded measures of compliance activity termed the "basket of indicators". They produce these on a monthly basis, and now measure the data shown in **Figure 14** as well as the number of cases taken up.

14 **Shows the performance measures used in the basket of indicators**

Strike rate - number of cases where additional yield recovered, analysed between tax only and penalty cases

Productivity - number of cases taken up and yield per person

Average yield per case - analysed by types of taxpayer

Resource use - actual versus plan

Duration - time to complete different case types

Workflow - month on month changes in uncleared cases

4.12 The Inland Revenue are making changes to the organisation of the local office network, and in April 2001 established 60 specialist Area risk, intelligence and analysis teams to improve the focus of compliance work. These teams are now responsible for planning compliance work and for the selection of up to 90 per cent of cases for enquiry. In addition, the Department have analysed the results of the random sample of enquiries into 1996-97 tax returns to produce profiles of higher risk cases. These, together with analyses of other compliance work, will be used to generate a centrally selected sample of enquiry cases, which will represent up to about 10 per cent of the total number of enquiries in 2001-02.

The conduct of enquiry cases

4.13 Once the Inland Revenue have selected cases for review, it is necessary to ensure that staff investigate these to a standard sufficient to ensure that they identify undeclared income and gains, and assess the appropriate amount of tax due. The Department produce detailed guidance on the conduct of enquiries in the self assessment manual and the enquiry handbook. The Inland Revenue's training and quality monitoring programmes support these procedures.

4.14 The Inland Revenue monitor the quality of case selection and enquiries through a process known as the Compliance Quality Initiative. All caseworkers have to record details of their investigations, and mark them for quality. Compliance managers aggregate these scores to assess the quality of work undertaken. Independent reviewers then examine a sample of cases to validate the results. In 1999-00, this work indicated that 93 per cent of enquiries had been settled to a satisfactory or better standard, compared with 85 per cent in the previous year.

4.15 The Inland Revenue have recently completed a review of how enquiries have been handled, in conjunction with the Chartered Institute of Taxation. The main options for change were that:

- consideration should be given to devising a means for settling minor queries, without opening a formal enquiry;
- consideration should be given to a proposal to disengage capital gains tax issues from the general income tax issues;
- the "Faster Working" provisions, where certain Inland Revenue procedures were omitted to speed up the clearance of cases, should be abolished;
- the issue of requests for bank statements should be considered further as tax agents and Inland Revenue staff have differed over whether such documents should be supplied as a matter of course; and
- the procedures for enquiries into partnership returns should be reviewed.

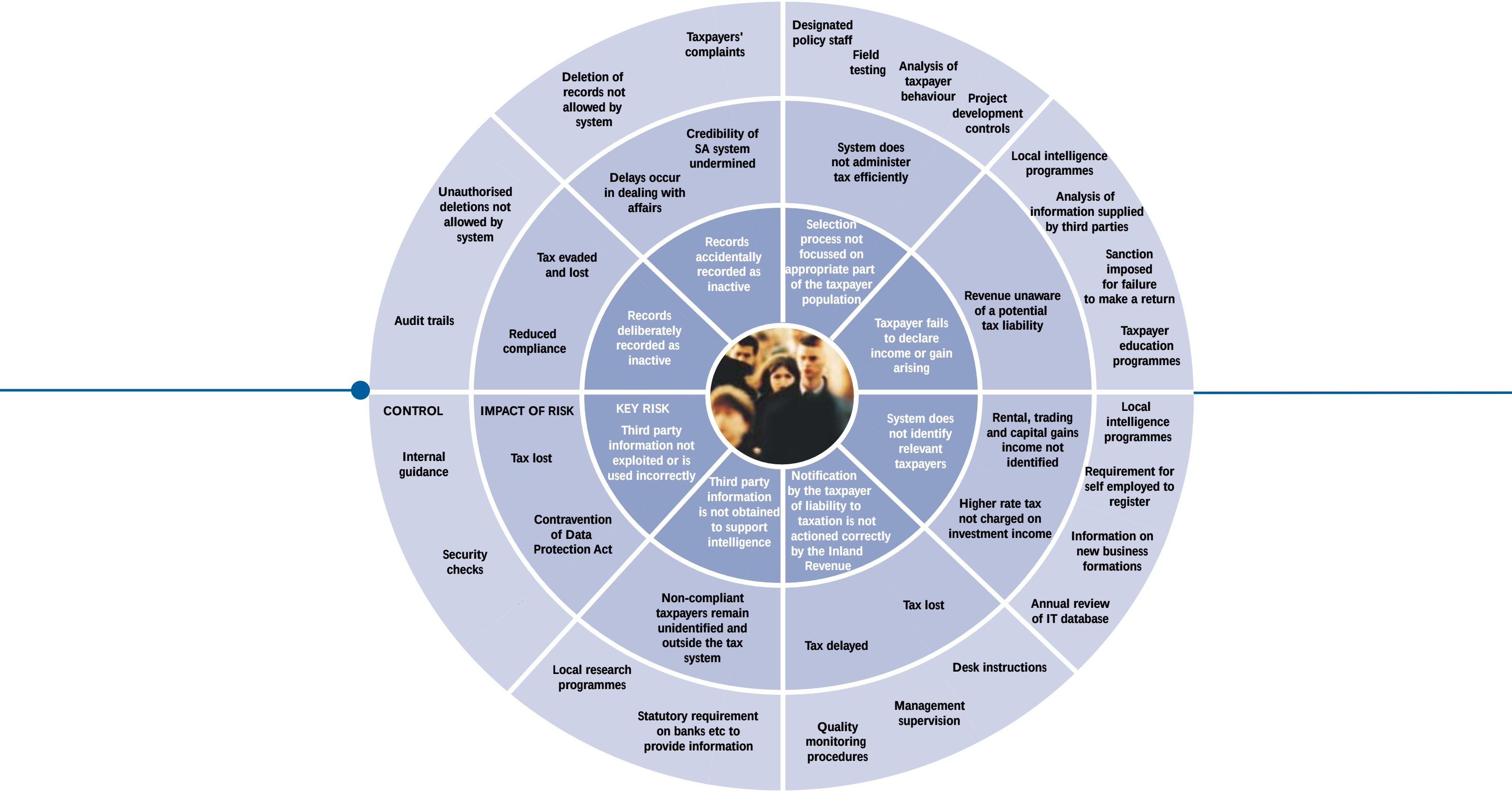
In response, the Inland Revenue intend to develop and improve their approach in some areas, for example, to opening enquiries and requesting bank details, and to seek changes in the legislation on certain other points identified by the review.

Appendix 1 Self assessment processes - risk analysis

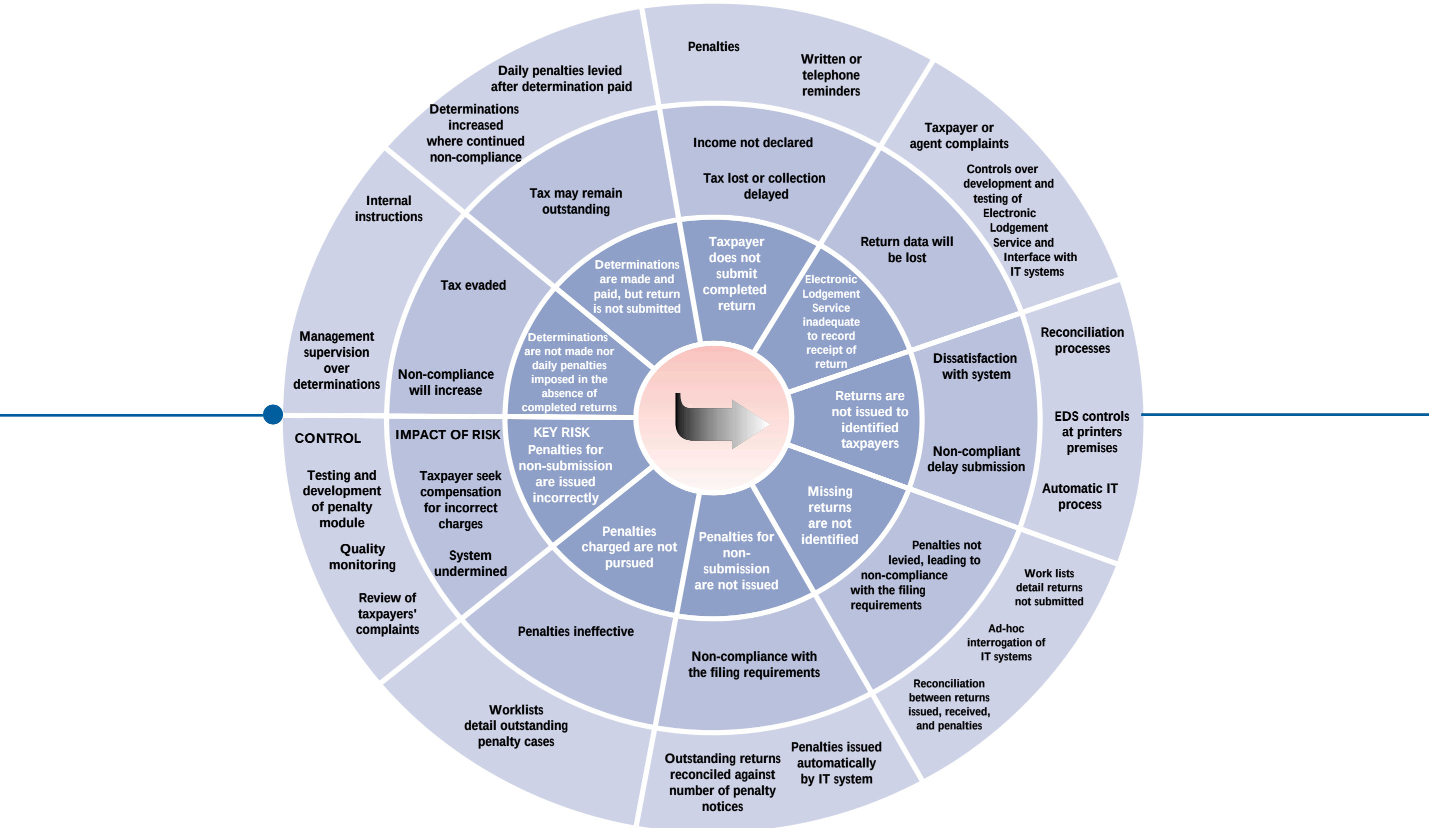
Appendix 1 overleaf

Establishment of regulations and procedure

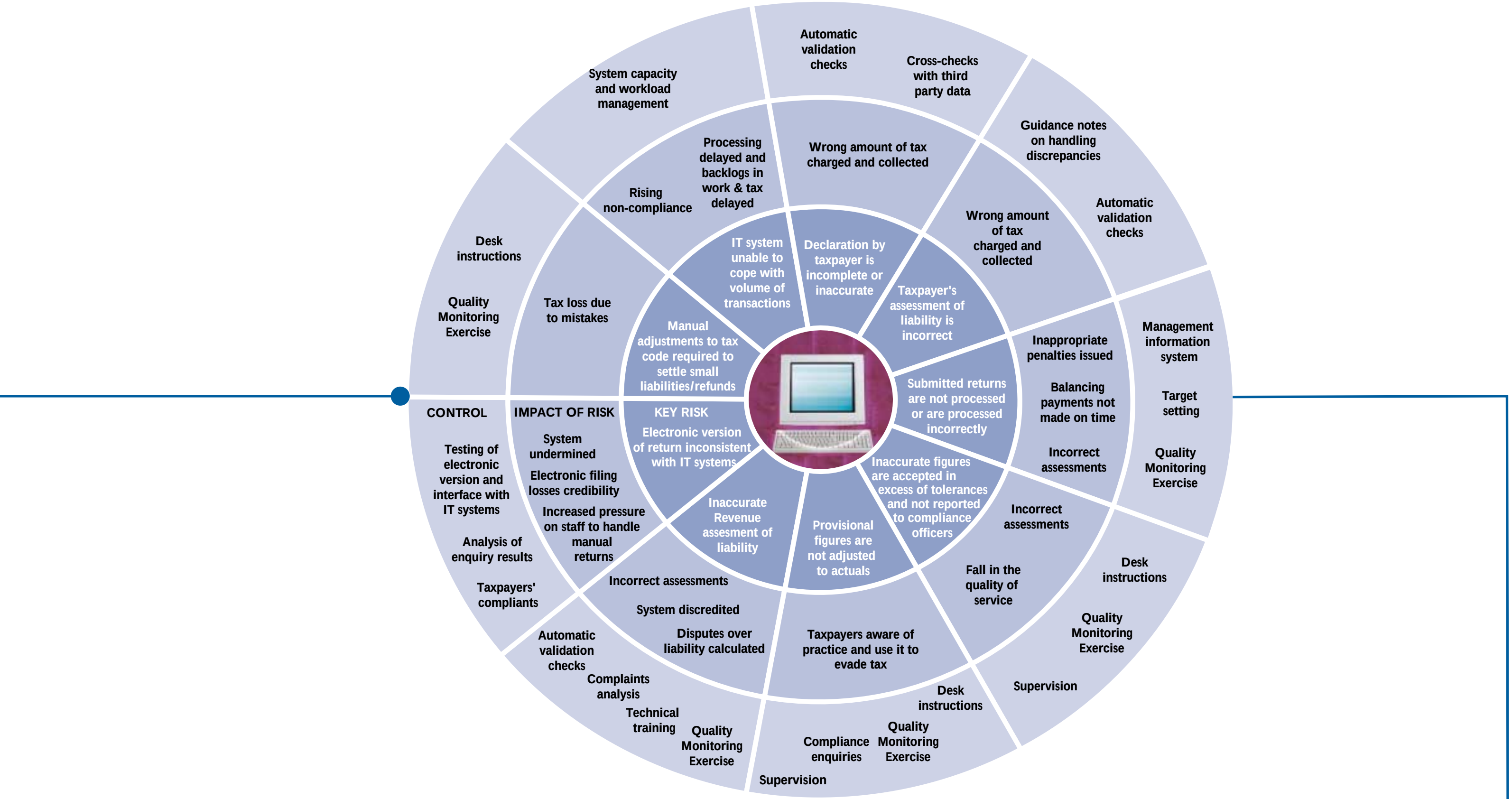
Identification of taxpayers and taxable events



Return management



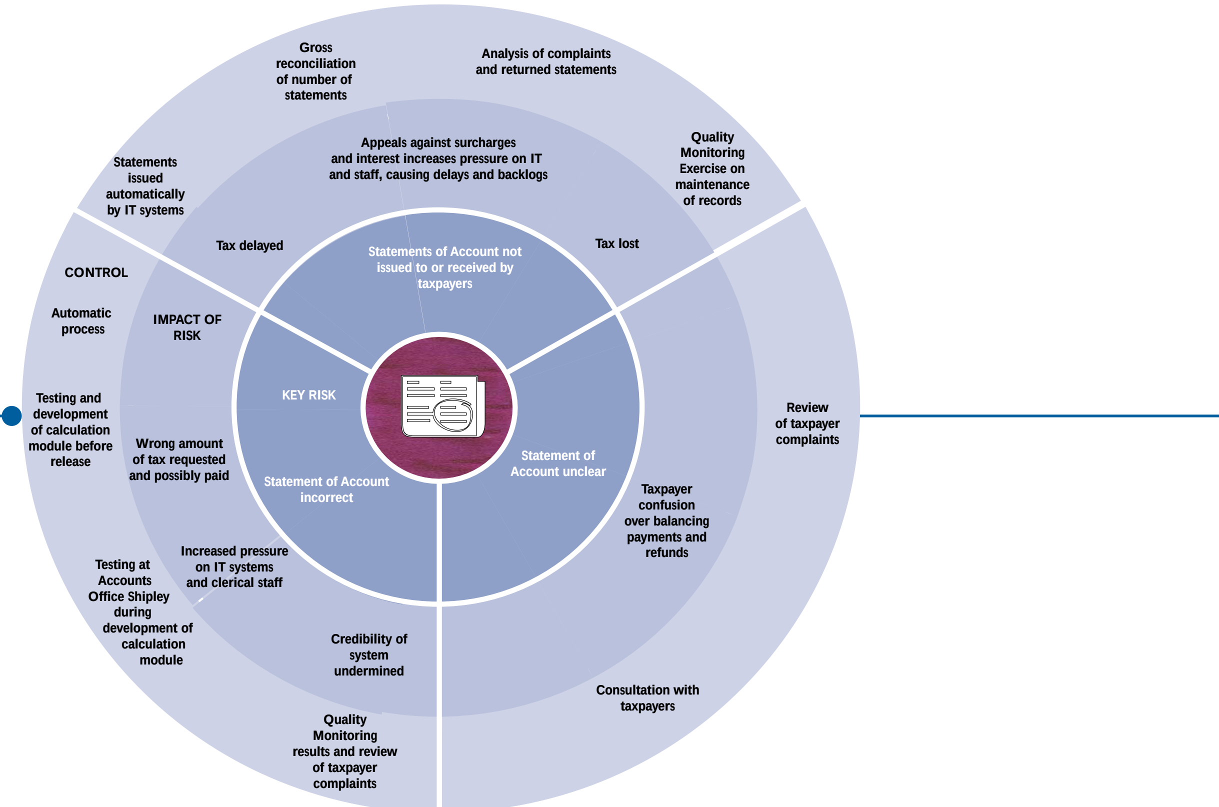
Processing



CONTROL
IMPACT OF RISK
KEY RISK
Automatic validation checks
Cross-checks with third party data
Wrong amount of tax charged and collected
Declaration by taxpayer is incomplete or inaccurate
Guidance notes on handling discrepancies
Automatic validation checks
Wrong amount of tax charged and collected
Taxpayer's assessment of liability is incorrect
Management information system
Target setting
Quality Monitoring Exercise
Inappropriate penalties issued
Balancing payments not made on time
Incorrect assessments
Submitted returns are not processed or are processed incorrectly
Desk instructions
Quality Monitoring Exercise
Supervision
Incorrect assessments
Fall in the quality of service
Inaccurate figures are accepted in excess of tolerances and not reported to compliance officers
Desk instructions
Quality Monitoring Exercise
Compliance enquiries
Supervision
Taxpayers aware of practice and use it to evade tax
Provisional figures are not adjusted to actuals
Automatic validation checks
Complaints analysis
Technical training
Quality Monitoring Exercise
Incorrect assessments
System discredited
Disputes over liability calculated
Inaccurate Revenue assesment of liability
Testing of electronic version and interface with IT systems
Analysis of enquiry results
Taxpayers' compliants
System undermined
Electronic filing losses credibility
Increased pressure on staff to handle manual returns
Electronic version of return inconsistent with IT systems
Desk instructions
Quality Monitoring Exercise
Tax loss due to mistakes
Manual adjustments to tax code required to settle small liabilities/refunds
System capacity and workload management
Rising non-compliance
Processing delayed and backlogs in work & tax delayed
IT system unable to cope with volume of transactions

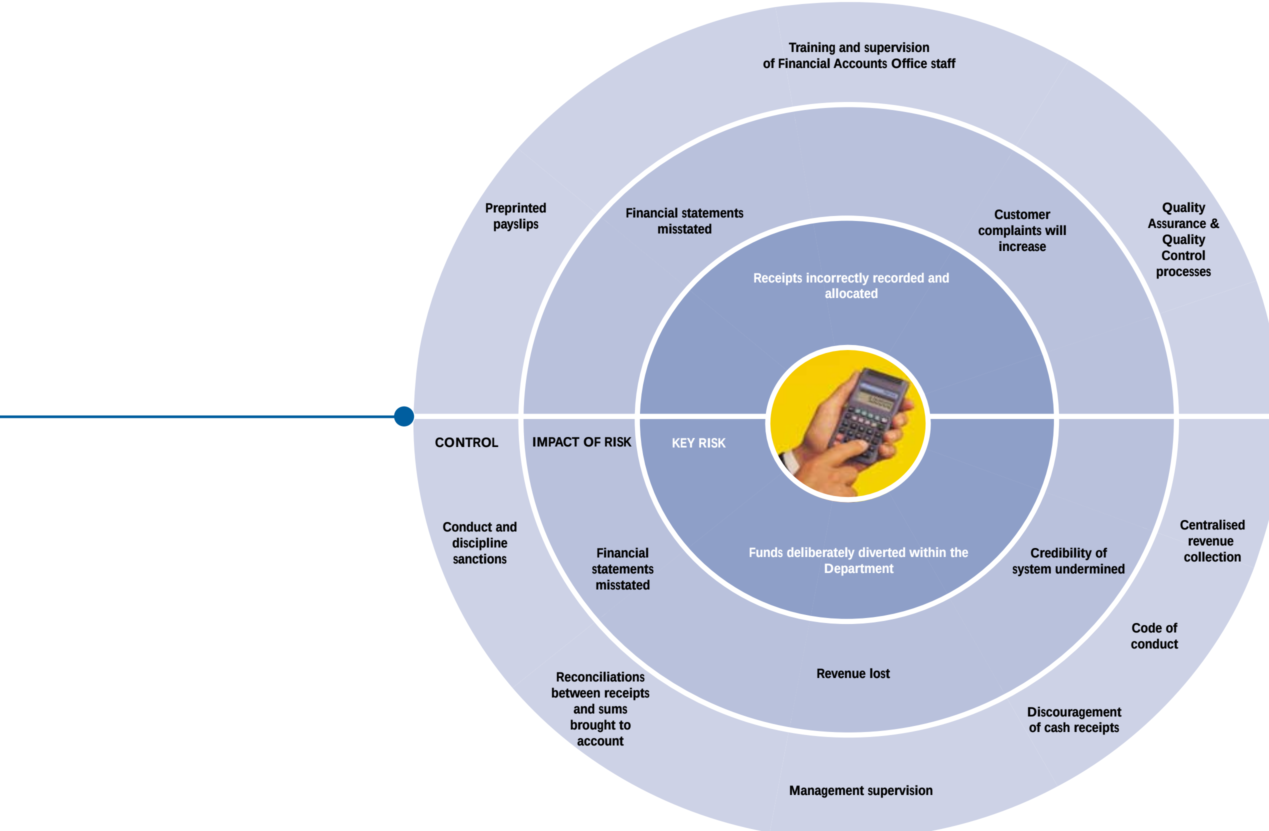
Conduct of enquiries

Notification of liability



Debt Management

Sums brought to account



Appendix 2 Tax at risk

1 In designing regulations and procedure to manage a tax system and in determining priorities when allocating resources, it is important to assess the potential tax that may be at risk at various stages in the process. This helps to ensure that administrative resources are used efficiently and effectively by targeting areas of higher risk.

2 In evidence to the Treasury Committee in 1999[1], the Department identified two relevant concepts, the tax gap and the hidden economy. The extreme definition of the tax gap is the difference between the tax collected by a revenue department and the amount that might be collected in a perfect world with 100 per cent compliance. The gap will include revenue lost through non-compliance by taxpayers, incorrect taxation treatment of declared income, and aggressive tax avoidance at the boundary of tax evasion.

3 The hidden economy is a different concept and can be defined as economic activity that results in transactions comprising payment or other benefits that are not declared to public authorities. Not all parts of the hidden economy have tax implications. Those on low net incomes, such as students doing casual work, may have personal allowances sufficient to render their income non-taxable.

4 The Inland Revenue consider that the overall tax gap would be very difficult to estimate and that it would require a great deal of time and effort to try to put a figure on it. As regards quantification of the hidden economy, the Department commissioned work in 1992 which produced results which were not inconsistent with its view in the early 1980s that the hidden economy represented between six and eight per cent of gross domestic product[2]. The Department believed that it would be impossible to make any meaningful attempt to extrapolate from it a figure for the tax gap.

5 In his March 2000 report on the Informal Economy[3], Lord Grabiner concluded that it would be impractical to arrive at a precise and meaningful figure as to the scale of the hidden economy without a considerable investment of time and resources. For the purposes of his report, he assumed that the hidden economy was a major issue involving billions of pounds.

6 Although there are difficulties in making robust estimates of the impact of the hidden economy on the overall tax gap, we attempted to make some broad estimates of the potential amounts of tax at risk from selected elements of the self assessment process. **Figure 15** overleaf summarises our analysis.

7 Our analysis was intended to provide an indication of the relative risk attached to each process in terms of potential tax loss. While the estimates are subject to considerable uncertainty, we consider that they provide a broad indication of where the main risks lie. We focused our examination on three areas where there appears to be scope to secure a significant financial impact from developing compliance activity.

1 Treasury Committee, 6th Report, Session 1998-99 (HC199)
2 Note by NAO: This would produce a current valuation of the hidden economy of over £50 billion
3 The Informal Economy: A Report by Lord Grabiner QC

15 Potential tax at risk at stages of the self assessment process

Process	Information
Identification of taxpayers	Difficult to estimate impact of hidden economy (paragraphs 2 to 5 above) but assumed to be significant although some overlap with "conduct of enquiries" estimate.
Return management	Inland Revenue estimate that between £150 million and £300 million tax may be at risk each year from returns not filed by six months after the statutory deadline (see paragraph 3.4).
Processing	The Department's quality monitoring suggests that processing errors are likely to lead to gross errors of the order of £0.1 billion.
Conduct of enquiries	The Department's analyses of random samples of returns for 1996-97 and 1997-98 produced somewhat different estimates of the annual potential tax at risk from non-declaration of income or gains (£3.0 billion and £1.8 billion). There will be some overlap with the hidden economy (see paragraphs 4.5 and 4.6).
Debt management	Financial records indicate that while substantial sums are not paid by the due dates, eventual write-offs have amounted to less than £0.05 billion per year to date.
Accounting	Annual audit work suggests very low risk of diversion of tax paid over to Department.

Source: National Audit Office

Appendix 3 Self assessment systems in other countries

Introduction

1 As part of our examination, we contacted the tax authorities in Australia, Canada, the Republic of Ireland, New Zealand, and the United States of America, countries which also operate self assessment taxation systems. Our aim was to obtain information about their approach which could be used to inform our analysis of the Inland Revenue's self assessment framework.

2 We found that the system adopted by the United Kingdom had many features in common with those operated overseas. This was to be expected, as the Inland Revenue had consulted overseas tax authorities when designing the United Kingdom system in order to identify key success factors and learn from experience.

3 Although there were many similarities between systems, there were nevertheless some variations in approach between the countries surveyed. These partly reflect differences in taxation, the structure of the revenue authorities, and decisions of the relevant legislatures in response to cultural, economic and political factors. Recognising these variations, the analysis was useful in helping us to assess whether the Inland Revenue had established an effective framework for operating income tax self assessment and in identifying issues for consideration in examining the system in the United Kingdom. The main points arising from our analysis in relation to the issues addressed in our report are set out in the paragraphs below.

Coverage

4 In the United Kingdom, income tax self assessment mainly applies to self-employed taxpayers and higher rate PAYE taxpayers. The vast majority of employed taxpayers, however, are not required to complete an annual tax return and are covered by the PAYE arrangements rather than by self assessment.

5 The scope of self assessment was wider in some of the countries surveyed. In Australia, Canada, and the United States of America, self assessment applies to all taxpayers.

Identification of taxpayers

6 In all the countries surveyed, it is the taxpayer's responsibility to declare taxable income but the revenue authorities maintain databases of individuals registered for tax purposes to assist in managing the system. The Australian Taxation Office has a schools liaison and education programme that encourages older pupils to register before they leave for university or work, which helps potential taxpayers understand how the tax system works and their obligations.

7 All the countries covered by our analysis carry out intelligence work to identify unregistered taxpayers, for example, "ghosts" and "moonlighters", using a number of techniques, including data matching, third party information, and local intelligence work.

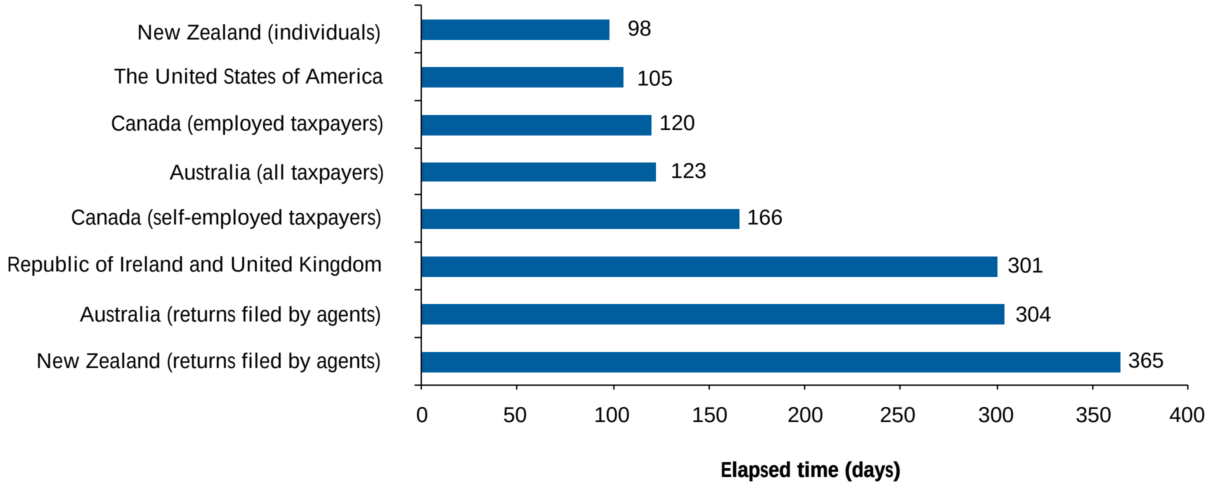
8 Australia manages risks arising from the hidden economy through a number of strategies.

- There are close links between the tax and benefits systems. It is not possible to receive benefits in Australia without a tax registration number, except in very limited circumstances. Using this single identifier, under-declarations of income can be detected by information matching between the tax and welfare agencies.
- Employees not quoting their tax registration number to their employer are taxed at the top marginal tax rate plus Medicare Levy, currently 48.5 per cent, to discourage working without registration. Also, under the recently enacted pay as you go (PAYG) legislation, businesses not providing an Australian Business Number (ABN) when delivering a service are taxed at the top marginal rate plus Medicare Levy.
- The Australian Taxation Office has a Cash Economy Task Force which oversees risk management and sets the strategies to address identified risks in this area. Special exercises on targeted industries such as building and construction have been carried out.
- Under the PAYG legislation the Australian Taxation Office will receive transaction level information from targeted industries, for example details of payments made to suppliers of goods and services.
- A special audit unit investigates income from criminal and other illegal activities.

9 The Canadian tax authority uses a variety of methods, including:

- risk analysis - census information is used to determine the degree of non-compliance in particular localities;
- third party information from various sources, for example, a contractor payment reporting system;

16 Shows the length of time between the end of the tax year and the filing deadline



- data matching (for example, income tax and sales tax declarations - possible because Canada has a combined Customs and Revenue Tax Agency; and
- modelling - potential non-compliance is detected by evaluating lifestyle indicators and comparing them to reported income levels.

10 "Ghosts" and "moonlighters" in New Zealand are identified using a variety of methods including:

- local intelligence work using bespoke case selection software;
- whistleblowers;
- comparison of taxpayer reference numbers from two or more employments;
- special exercises on taxpayer groups, for example, builders; and
- a special audit unit, which investigates income from criminal and other shady activities.

11 New Zealand also operates a similar system to Australia with respect to employees who do not provide their tax registration number to their employer. In such cases, employers are required to make deductions at a rate of 46.3 per cent, comprising an employee premium of 1.3 per cent and income tax at 45 per cent, 6 per cent above the top marginal rate.

Return management

12 All the countries surveyed issue returns to taxpayers. In some countries, such as the United States of America, forms are widely available, so taxpayers are not dependent on the Internal Revenue Service sending them one. Returns are also available from newsagents in Australia and public outlets such as post offices in Canada.

13 Of those countries where all taxpayers are required to file a return, the revenue authorities in Canada and the United States of America allow taxpayers with simple tax affairs to file by telephone. The Australian tax authority intends to carry out a trial of this technology for the 2001-02 tax year.

14 **Figure 16** above shows that there is considerable variation between countries in filing deadlines ranging from just over three months after the end of the tax year in New Zealand to over nine months in the Republic of Ireland and the United Kingdom. The revenue authorities in Australia and New Zealand operate a system under which agents are allowed up to 10 or 12 months to file a return, provided they file prescribed percentages of returns throughout the year. This approach helps manage the flow of returns and avoid bottlenecks.

15 All the countries surveyed operate systems for issuing reminder letters for returns which are not filed by the deadline, backed up by telephone-based systems in New Zealand and the United Kingdom. The Republic of Ireland follows a different approach. If the reminder does not result in the return being filed, the case is passed to the Revenue Solicitor for action. Overall, around 75 per cent of taxpayers comply voluntarily, rising to 94 per cent after the initial reminder, and over 97 per cent after the solicitor's letter has been issued.

16 In some of the countries surveyed, the tax payment structure is designed to act as an incentive to file returns by ensuring that taxpayers pay a greater amount on account than was likely to be due. In Australia, for example, some 83 per cent of taxpayers received a tax refund in 1998-99.

17 All the revenue agencies surveyed can issue arbitrary or estimated assessments if returns are not received. If these estimated assessments are higher than the likely liability, based upon prior knowledge, this can encourage taxpayers to send in returns.

18 **Figure 17** shows that penalties for late filing vary. The revenue authorities in Australia, the Republic of Ireland, and New Zealand may also prosecute taxpayers who fail to file returns.

Conduct of enquiries

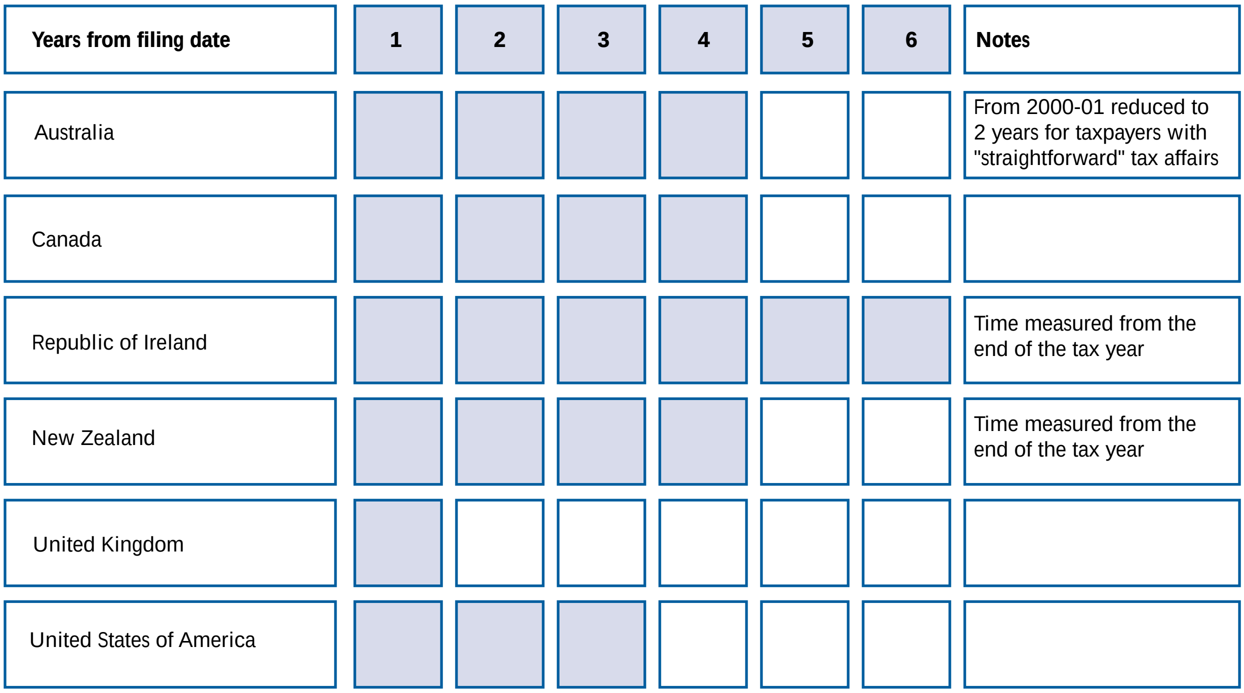
19 All the revenue authorities have wide-ranging powers to request any information necessary to check returns and used a variety of approaches, ranging from telephone contact, correspondence, formal meetings, through to unannounced visits. In common with the United Kingdom, all the countries we visited, with the exception of Australia, carried out enquiries into a large number of tax returns based on the identification of risk. All used risk assessment techniques to select cases for examination.

20 The Australian Taxation Office takes a different approach, placing more emphasis on data matching and on encouraging voluntary compliance. While it undertakes some work on tax returns, for example, on those suspected of containing significant errors or omissions or to check deductible expenses claimed by the self employed, it directs the majority of effort at a line by line statistical analysis of aggregate information. It also undertakes trend analyses to identify significant changes and probe, for example, the reasons behind a fall in a particular income stream. It then assesses the extent to which this may be due to factors such as lower levels of compliance or economic activity and implements a strategy to deal with the issue.

17 Variation in penalties for late filing

Australia	Daily penalties are charged, unless a refund is due.
Canada	Penalty of 5 per cent of unpaid tax plus 1 per cent per month (up to a maximum of 17 per cent) is incurred for failure to submit a return. A second offence incurs penalties of 10 per cent plus 2 per cent per month (up to a maximum of 50 per cent).
Republic of Ireland	Surcharge of 5 per cent of the liability (up to a maximum of £10,000) is incurred if the return is less than 2 months late and 10 per cent of the liability (up to a maximum of £50,000) if the return is 2 months late or more.
New Zealand	Penalty level is based upon the previous year's net income.
United Kingdom	Successive £100 fixed penalties, restricted to the amount of tax due, if lower, on receipt of the return, followed by a further penalty of up to 100 per cent of the tax due on the return if more than a year late.
United States of America	Penalty charged for late filing unless a refund is due.

18 **Length of time revenue authorities normally have to open enquiries**



21 The aim of the Australian approach is to inform the taxpayer education programme, to improve the drafting of explanatory notes to the annual tax return and to clarify the guidance to particular groups, such as pensioners. The Australian Taxation Office tracks the effect of these initiatives over time and, if unsuccessful, explore alternative solutions.

22 Except for the United States of America, the authorities surveyed also enquire into a sample of returns selected at random to assess potential risks and to deter non-compliance. Canada makes the greatest use of random checks, with some 100,000 cases selected annually. The United States of America selects returns to examine based on information shown on the return.

23 **Figure 18** above shows that the "window" in which revenue authorities can open enquiries varied between the countries surveyed.

24 These limits do not apply to cases where fraud or neglect are involved. Some revenue authorities, including Australia and New Zealand, also have time limits for completing enquiries. In New Zealand, the authorities have up to four years from the end of the tax year in which the return was filed to issue an amended assessment, unless fraud is involved.

Appendix 4 Methodology

Risk analysis

1 We drew up a model of key processes that make up the self assessment system and carried out an end-to-end analysis to identify the main risks to the assessment, collection and allocation of tax (Figure 3 on page 7 and Appendix 1).

2 The analysis identified the:

- specific risks associated with each process;
- likelihood of these risks crystallising;
- possible outcome and materiality (including the financial exposure) should they do so;
- Inland Revenue's arrangements for managing these risks; and
- comparative risk and exposure of each element of the system.

3 We also contacted the Supreme Audit Institutions in seven countries that operate self assessment for income tax, and obtained information about risk analyses of those systems that had been carried out. We followed up the initial contacts by visits to the five countries shown in bold below.

- **Australia**
- **Canada**
- **Republic of Ireland**
- The Netherlands
- **New Zealand**
- South Africa
- **United States of America**

4 The visits included discussions with both the Supreme Audit Institutions and the revenue authorities in each country. Appendix 3 summarises key elements of their systems.

5 We did not look in this examination at the way the Inland Revenue implemented self assessment as this had been covered in our reports to the House of Commons on the Department's annual appropriation accounts. Appendix 5 outlines major issues that have arisen during implementation and how the Department has addressed them. We are examining the introduction of filing self assessment tax returns over the internet under a separate study of the Department's use of e-business systems to streamline tax administration.

Detailed areas for examination

6 Following our analysis of the entire self assessment system, we estimated, using data held by the Inland Revenue, where available, the tax at risk from key stages in the process (Appendix 2). We selected three of the higher risk areas for detailed examination. These were:

- the identification of taxpayers;
- return management; and
- the selection of cases for enquiry.

7 We examined the sources of assurance and management information available to the Board of Inland Revenue on the management of risk in these areas. We then made visits to seven Inland Revenue offices (**Figure 19**) to examine whether the arrangements were working in practice. The Inland Revenue have been rationalising their network of offices by integrating taxpayer service and collection functions and by merging smaller local offices with others in the vicinity to form larger complexes handling processing and compliance. We selected five compliance/processing complexes and two smaller integrated offices for our visits.

19 Inland Revenue Offices visited by the National Audit Office

Type of Office	Location	Region
Compliance/ processing complex	Cambridge	East
	Dundee	Scotland
	Newcastle	North
	Portsmouth	South East
	Sheffield	South Yorkshire
Integrated offices	Bath	South West
	Lancaster	North West

8 These different types of office essentially undertake the same work, but differ in the amount of each type of work they actually carry out. We carried out the following programme of work for each area of examination at each of the offices visited.

On the identification of taxpayers

- A review of performance results.
- Discussions with office managers and staff responsible for managing compliance and intelligence work about the use of third party information and computer support, the organisation of intelligence work and targets.
- Discussions with other intelligence and compliance staff about the organisation and effectiveness of intelligence work.
- A review of files and other documentation relating to intelligence projects and other work.

On return management

- A review of return management worklists and an analysis of numbers of returns outstanding.
- The identification of the numbers of determinations issued and their effectiveness.
- Discussions with managers on the organisation of return management work, difficulties in chasing returns, the effectiveness of telephone pursuit units and training, the use of penalties, and the potential impacts of internet filing.
- Discussions with other staff involved in return management about the organisation and effectiveness of return management work.

On the selection of cases for enquiry

- A review of performance against targets.
- Discussions with managers about selection criteria, target setting, use of profiling, effectiveness of risk analysis, and the results of random and mandatory reviews.
- A review of profiling printouts and analysis of cases selected.
- A review of the results of selected profiling projects.
- An analysis of take up over time.

9 Following these visits, we discussed our findings with the Inland Revenue's Business Operations Division, noting, in particular, any initiatives in place to tackle issues identified.

Appendix 5

Issues that have affected self assessment

1 The introduction of self assessment was a huge and complex task. Completion called for:

- complex legislation in three successive Finance Acts;
- design and construction of one of the largest computer systems in the world;
- management of a project with a budget of £800 million, significant risks, and a large number of activities and inter-dependencies;
- delivery of a significant training programme for staff tackling new processes and procedures;
- adherence to an implementation date set in statute; and
- taxpayers and their representatives to face new and major challenges.

2 The Department monitor all aspects of the self assessment process through their partnership with EDS, contacts with taxpayers, their agents, and the wider tax profession to identify emerging issues. And the system has been developed, and continues to be developed, in response to feedback from taxpayers.

3 The Inland Revenue successfully delivered this demanding project to time and to budget but, as with any projects of this scale and complexity, issues arose in the early running of the system which were handled by the business and lessons were learnt for the future. Other issues, worthy of note, which emerged following implementation are set out below.

Capacity of the computer system

4 Following the introduction of self assessment, demand at peak times exceeded the capacity of the computer system which reduced response times during these periods. The Inland Revenue responded to this in 1998 by increasing the number of mainframe processors, encouraging staff to spread their use of the system over the working day, disseminating good practice on system usage and providing IT staff with improved monitoring tools.

5 The capacity of the system was further increased in January 1999 and the Department added more processing capacity in October 1999 and in early 2000 to enable the system to handle increases in the number of self assessment taxpayers. The Department have identified inexpensive ways of managing capacity, such as restricting access to functions which take up significant processing time and restricting access during periods of instability, but have not had to introduce these measures to date.

Tax calculation guides

6 There have been comments from taxpayers, their agents and the media, about the number and complexity of the taxpayer calculation guides. Prior to April 1999, there were four separate calculation guides and some taxpayers found this confusing as they were unclear which to use. In response, the Inland Revenue issued a single calculation guide for 1999-00. In the light of feedback about its size and complexity, the Department have developed a shorter, simpler version for those with more straightforward tax affairs for 2000-01.

Statements of account

7 The Inland Revenue recognised that some taxpayers found the statements of account confusing and, in 1998, changed the description and layout of entries on the statement. To further improve the content and presentation of the statements of account, the Department formed a Statement Review Group in January 1999 and have made further changes, including:

- the positioning of the amount to pay in a box at the beginning of the statement;
- the production of adjustment summaries for multiple entries of the same type;
- the introduction of a de minimis limit for calculating interest;
- the provision of a customer service message where small amounts are owed;
- the introduction of an overall balance;
- the use of plainer English; and
- the production of twice yearly statements of account for taxpayers represented by agents.

8 A software error in December 1998 resulted in 800,000 statements wrongly including the payment due on the following 31 July. An explanatory letter caused further confusion because some taxpayers mistook the tax due on an example statement included with the letter for the amount they had to pay. In response, the Department have tightened up their change control procedures.

The issue of incorrect pages with the April 1999 tax return

9 Around 9 million tax returns were issued in April 1999. Of these, approximately 495,000 (5.5 per cent) included pages showing 1998 rather than 1999. This was caused by a printing error that was not detected by quality control checks. Correct supplementary pages were issued to the taxpayers concerned. The Department reviewed the process and tightened it up for the issue of returns in April 2000, which went smoothly.

The production of erroneous fixed penalty notices in February 2000

10 An amendment to the self assessment computer program to prevent automatic £100 penalties being applied where returns were received on 1 February was not released as planned. Had this not been detected by the Inland Revenue prior to despatch of the notices, erroneous penalty charges would have been applied to 80,000 taxpayers. A special program had to be written to ensure that the incorrect penalties would not appear on statements of account, which delayed the April 2000 issue of statements.

Implementation of the software needed to process 1999-00 tax returns

11 Some of the software changes due for release in April 2000, such as those needed to process 1999-00 tax returns, were delayed by several weeks. Consequently, some taxpayers had to wait longer than normal for refunds and a backlog of returns awaiting processing built up which took some months to clear. There were a number of reasons for this delay, the most important being:

- the late notification to EDS of tax changes;
- the need to rewrite the tax computation modules to allow for more user friendly statements of account;
- changes to the infrastructure on which the self assessment programs run; and
- the introduction of filing by internet.

12 The scale and complexity of the required changes put significant pressure on EDS development resources, particularly as some of the new software skills required were in short supply. EDS worked with the Inland Revenue to mitigate the effects of the delay and modified their development procedures to ensure that the software was delivered as quickly as possible. These modifications included shortening the development time scale by "interleaving" the software development and testing processes.

Appendix 6 Glossary of terms

Term	Definition
Aspect enquiry	An enquiry, by the Inland Revenue, into selected parts of a self assessment tax return.
Capital gain	Profit arising from the disposal of goods and property (this does not apply to the sale on an individual's main residence).
Check now / process later	A system under which tax authorities check the information they receive on tax returns and claims for completeness and accuracy prior to entering it on to the computer system for processing.
Compliance quality initiative	An exercise to check the quality of work underlying the selection and working of compliance reviews carried out on a continuous basis, with annual reporting of results.
Current year basis of assessment	Tax assessments relate to all income and capital gains appropriate to the current tax year or, in the case of businesses, income for the year of account which ends in the current year.
Debt management	The process through which the Inland Revenue ensure that tax debts not paid on time are collected.
Determination	An assessment of the tax due from an individual who has not filed a tax return.
Electronic lodgement	The submission of a completed tax return electronically through a privately leased telephone line.
Full enquiry	An enquiry, by the Inland Revenue, into all the information contained in a self assessment tax return.
Ghosts	A self employed person, or business, not registered for tax, and therefore unknown to the Inland Revenue.
Hidden economy	An undeclared economic activity. It covers tax evasion of all kinds, ranging from casual moonlighting and work paid cash-in-hand through to organised crime.
Intelligence work	A programme of work by the Inland Revenue to identify those not declaring their full income.
Moonlighters	Someone registered for tax as an employee who also works on the side, usually for cash, without declaring that income.
Pay as you earn (PAYE)	The deduction, by employers, of income tax and national insurance, at source, from their employees salaries and wages. Employers pay the sums deducted directly to the Inland Revenue.
Prior year basis of assessment	Tax assessments relating to income appropriate to the preceding tax year. (This basis of assessment applied to certain types of income for individuals prior to 1996-97). Due dates for the payment of tax due depended upon the source of income.
Process now / check later	A system under which tax authorities enter information received on tax returns on to their computer systems for processing prior to carrying out completeness and accuracy checks.
Processing	The input of tax return data in the Inland Revenue's IT systems, the calculation of the liability due for the year and the production of the statement of account.

Term	Definition
Profiling	The process through which the Inland Revenue assess all submitted returns against a number of pre-defined criteria to determine the risk to tax arising from an individual return.
Quality monitoring exercise	A quality control check over the processing of tax returns.
Self assessment	The requirement for individual taxpayers to be responsible for the assessment of their annual tax liability.
Surcharges	Penalties, based upon the tax payable for the year, which the Inland Revenue impose on taxpayers who do not remit their tax on time. The surcharges are chargeable when the underlying tax is 28 days late (five per cent) and six months later (another five per cent).
Tax assessment	The computation, by either the taxpayer or the Inland Revenue, of the total amount of tax payable for a particular tax year.
Tax coding	A figure which the Inland Revenue calculate and notify to the individual and their employer. This figure is the amount that an employer can pay an individual in the year before deducting income tax under PAYE.
Tax return	A formal document taxpayers submit to the Inland Revenue, annually, which contains all the details needed to calculate their tax liability for the year.
Tax year	The period over which an individual's liability to tax is assessed.
Telephone pursuit units	Teams of telephonists, with some tax training, who are responsible for chasing taxpayers for outstanding returns and debt.
Third party information	Information, from sources external to the Inland Revenue, that the Inland Revenue use to identify taxpayers and calculate the tax due from them.
Trade classification numbers	An Inland Revenue determined number that denotes the trade sector into which each business is placed for risk assessment purposes.
Write offs	Debt due to the Exchequer which the Inland Revenue have decided not to pursue or collect.