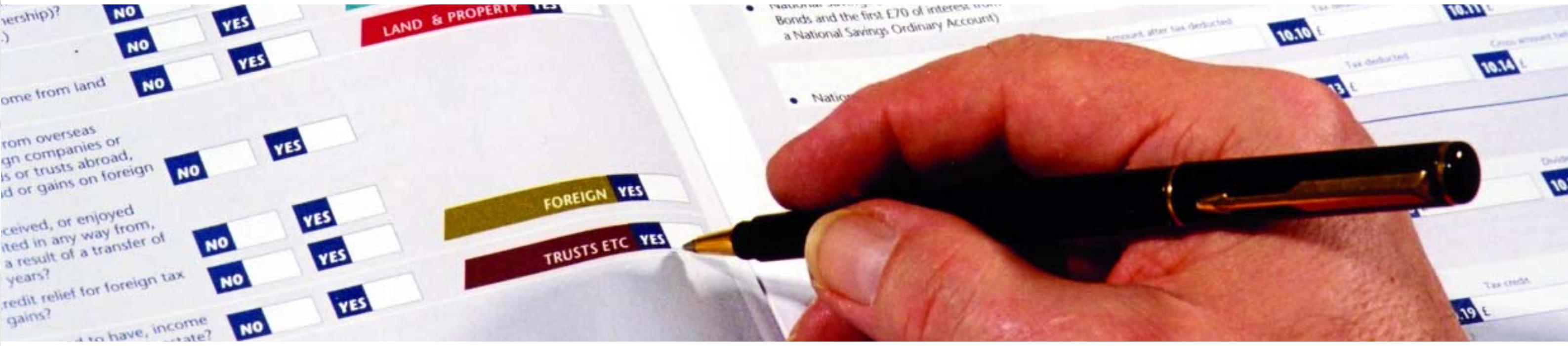
Inland Revenue

Income Tax Self Assessment



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executive summary

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.

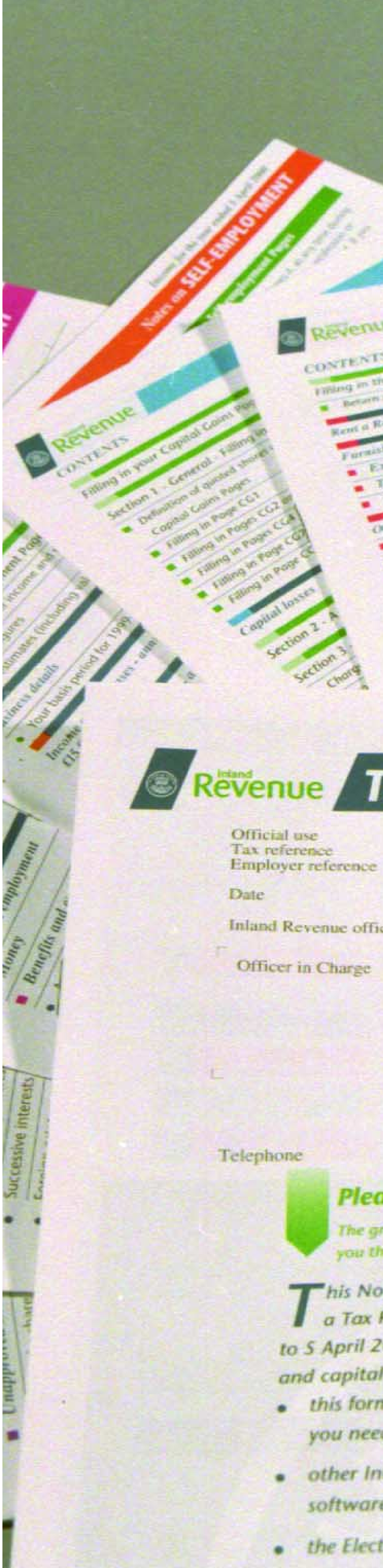
Main findings and conclusions

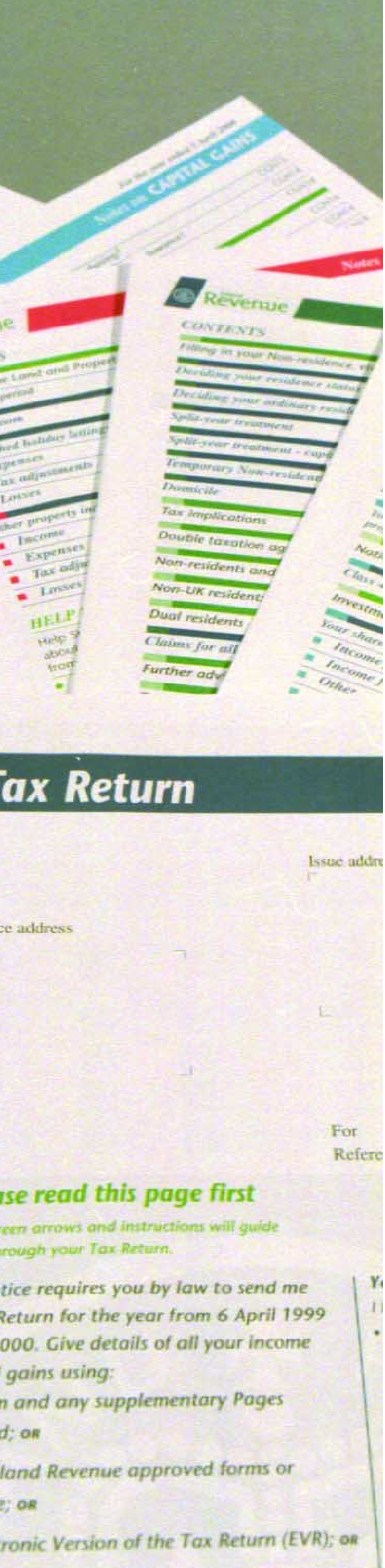
7 Our overall conclusion is that self assessment has improved the administration of income and capital gains tax. It has made assessments more straightforward and allowed a more focused approach to compliance work.

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.