Comptroller and Auditor General's Standard Report on the Accounts of the Inland Revenue 2002-03

Issued under Section 2 of the Exchequer and Audit Departments Act 1921 as amended by the Government Resources and Accounts Act 2000

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Comptroller and Auditor General
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Executive Summary

1. Section 2 of the Exchequer and Audit Departments Act 1921 requires me to examine the accounts of the Inland Revenue on behalf of the House of Commons to ascertain that adequate regulations and procedure have been framed to secure an effective check on the assessment, collection and proper allocation of revenue, and that they are being duly carried out. I am also required by that Act to examine the correctness of sums brought to account and to report the results to the House of Commons.

2. This report fulfils my responsibility under Section 2(2) of the 1921 Act. No tax collection system can ensure that all taxpayers and potential taxpayers comply with their obligations. As part of the Department's Public Service Agreement targets they aim to reduce the number of individuals and businesses who do not comply. Subject to:

    - the major reservations I have recorded about tax credit error;
    - recognising that it is not possible to secure full compliance;
    - other specific matters raised in this report, and matters outstanding from earlier years' reports,

    the National Audit Office's work in 2002-03 provided overall assurance that the Inland Revenue's regulations and procedure continued to provide an effective check on the assessment, collection and proper allocation of revenue, and that they are being duly carried out.

3. The Inland Revenue prepared Resource Accounts and a Trust Statement account of taxes and tax credits. I qualified my audit opinion on the latter in respect solely of error rates on tax credits (see paragraphs 2.5 - 2.7). I gave an unqualified opinion on the Resource Accounts.

4. I also present to Parliament Value for Money reports on the economy, efficiency and effectiveness with which the Department have used their resources. Since my last report on the Department's accounts in December 2002, I have reported on External Fraud against the Inland Revenue (HC 429) along with a similar report on the Department for Work and Pensions. I shall report later in 2003-04 on the Strategic Transfer of the Estate to the Private Sector - STEPS - project.

5. This report records audit observations on certain developments in corporate governance, Tax Credits, Employer Compliance with tax requirements and Capital Gains Tax. The main points arising from these examinations were as follows.

Working Families' and Disabled Person's Tax Credits

6. The Working Families' and Disabled Person's Tax Credit schemes began in 1999, ended on 6 April 2003 and spent some £17.8 billion. The Department were able only in August 2003 to provide me with the results of their examination of samples of tax credit applications made during part of 2000-01. Error rates were 10-14 per cent by value and the estimated level of overpayment for a full year was between £510 and £710 million.

7. The Department have not undertaken similar exercises for 2001-02 or 2002-03. The Department emphasise that they had incorporated the lessons learned into their design of the new tax credits. For these tax credits the Department must consider undertaking an exercise each year to determine the effectiveness of their controls in detecting error and ensuring that payments are properly calculated to reflect claimants' circumstances.

8. The level of overpayment identified by the Department is cause for serious concern and as a result I have qualified my opinion on the Trust Statement for 2002-03. The improved controls in the new tax credit system should help to reduce overpayments. But the Department are not yet able to assess the likely extent of that reduction.

New Tax Credits

9. New tax credits represented for the Department a major challenge in an area of work which was relatively new to them. The level of the problems caused to tax credit claimants and employers as the systems went live demonstrated that there were undetected gaps in the design of the testing regime for the systems.

10. In July 2003 the Department received from EDS an explanation of the technical problems that had delayed payment to claimants. The results of the audit by independent consultants should enable the Department to check whether there are any other technical issues outstanding so that they can be sure that they have learnt the lessons sufficiently to give assurance that similar problems will not occur as the tax credit systems are expanded.

11. The Department's consideration with EDS of the underlying technical problems had to have regard to the discussions between them about compensation for the unsatisfactory performance of the system, and the possibility of legal action. In November these discussions were continuing and the Department hoped to resolve them shortly. Once they are resolved I shall return to these aspects.

12. The Department must pay particular attention to ensuring that recovery from the problems with the introduction of new tax credits does not undermine their reputation for integrity of processing of taxpayers affairs, which is essential to the effective assessment and collection of tax.

13. In addition to the significant challenges of maintaining day to day running of the system and catching up on backlogs, there are many major issues for the Department in controlling tax credits for 2003-04. These include ensuring that:

- they have a rigorous approach to deciding how many, and which applications are "higher risk" as they require only those applications to be checked against prior-year income records before payment;
- they can manage the risk if claimants delay reporting changes in their circumstances;
- the problems with the start of the new tax credit systems and recovery from that position, have not led to errors in detailed information about claims or payments.

Employer Compliance

14. The Department's employer compliance activities provide assurance that employers are collecting PAYE Income Tax and National Insurance Contributions correctly. These activities are important to the collection of some £155 billion, or 68 per cent of total revenue. The Department have introduced many new initiatives to target more effectively their compliance resources and to help employers. The Department should develop further their methods to measure the impact of their compliance activities, including enabling activities designed to improve employer compliance.

15. Departmental statistics suggest significant geographical variations in employer compliance performance, such as in the percentage of cases where penalties are levied. The rate of penalties levied for large employers have been applied consistently. The Department need to consider ways in which they can monitor and report more effectively on the equity of treatment of smaller employers and consistency of performance. The Department should also continue to consider the overall effectiveness of the penalty regime.

16. Employer Compliance checks on aspects of payroll administration such as tax credits may not be sufficient to provide adequate assurance to the Board and to Parliament on the proper treatment of those items by employers overall. Employer Compliance and tax credit claimant compliance teams, worked separately in 2002-03. Following a National Audit Office suggestion, the Department are to undertake a joint review to consider the opportunities of a more co-ordinated approach to tax credit compliance. They should consider the sufficiency and validity of the current checks and the need for quantifiable assurance on tax credits.

Capital Gains Tax

17. Capital Gains Tax contributed £ 1.6 billion – around one per cent of the total taxes collected by the Inland Revenue in 2002-03. Some 32 per cent of Capital Gains Tax payers provided just one per cent of that collected, whilst one per cent of taxpayers contributed some 34 per cent. Recent initiatives to enhance the effectiveness of the Capital Gains Tax systems include the creation of teams specialising in Complex Personal Returns and, in some geographical areas, small specialist teams. The Department are undertaking internal reviews to improve the information available to management to help them target resources to best effect.

18. The Department are developing their research into areas of non-compliance but do not consider it practicable to measure the tax gap specifically attributable to Capital Gains Tax. Most Capital Gains Tax arises from taxpayers with high net income or high worth and so it is likely that non-compliance on the part of those taxpayers covered by Complex Personal Returns teams would have the biggest impact on the Capital Gains Tax yield. The Department should ensure that their research explores as fully as possible the scope for detecting, estimating and minimising non-compliance with Capital Gains Tax obligations in this particular customer group.

Part 1: Scope of the Audit and Corporate Governance

1.1 This part of my report covers the scope of the National Audit Office's work and observations on corporate governance at the Inland Revenue (the Department) as reflected in the Accounting Officer's Statement on Internal Control. It also covers developments in certain tax streams.

1.2 In 2002-03, the Department collected some £219 billion. Figure 1 shows the trends in collections from 1999-2000 to 2002-03. Income Tax, National Insurance and Tax Credits have increased again in 2002-03 whilst Corporation Tax, Capital Gains Tax and Petroleum Revenue Tax have decreased as a proportion of total revenue, and in absolute terms.

Figure 1: Inland Revenue - Tax and National Insurance receipts and Tax Credit payments 1999-2000 to 2002-03

	Net Receipts and Tax Credit Payments			
	1999-2000 £bn	2000-01 £bn	2001-02 £bn	**2002-03 £bn**
Income Tax	94.0	106.0	108.7	**110.3**
Payment of Tax Credits (Working Families' and Disabled Person's)	(1.1)	(4.6)	(5.7)	**(6.4)**
Corporation Tax	34.4	32.4	32.0	**29.1**
Capital Gains Tax	2.1	3.2	3.0	**1.6**
Inheritance tax	2.0	2.2	2.4	**2.4**
Stamp Duty	6.9	8.2	7.0	**7.5**
Petroleum Revenue Tax	0.9	1.5	1.3	**1.0**
Total	**139.2**	**148.9**	**148.7**	**145.5**
National Insurance Contributions	58.4	62.7	65.3	**67.3**
Total	**197.6**	**211.6**	**214.0**	**212.8**

Note: These receipts are shown net after allowing for tax reliefs and allowances, and for repayments. Repayments totalled £14.7 billion (£13.2bn in 2001-02).

Source: Inland Revenue accounts

Audit approach and Coverage

1.3 The National Audit Office review periodically existing and new systems and significant changes to them, and undertake test examinations of individual transactions and balances as necessary. The audit approach seeks to emphasise aspects of management control over business and tax streams, as set out in Figure 2.

Figure 2: Emphasis of National Audit Office Audit Approach

Who is accountable, and how is accountability formally documented, reviewed and used to improve performance?
How does the tax or business stream owner assure that all is in order with regard to corporate governance concerns?
How effective are the quality assurance procedures upon which management relies?
What risk analysis has there been for the tax or business stream and what risks has the stream owner and the Department identified?
How do the Department demonstrate routinely the sufficiency of their management of risk?
What obstacles to the assessment and collection of the tax in question have the Department identified and how are those obstacles tackled?
How are operational issues assessed, prioritised and their impact managed so as to minimise disruption to tax flows?
What management information does the tax or business stream owner and the Department receive and use to check the quality of tax assessments and taxpayer compliance work, and to judge the success of the business stream?

Source: National Audit Office

1.4 The National Audit Office also review Departmental progress in response to recommendations for business and tax streams arising from my reports and those of the Committee of Public Accounts. Figure 3 summarises the coverage of the work of the National Audit Office in 2002-03. The results of work not detailed in this report and suggestions of further improvements in controls that could be made, have been notified to the Department in management letters.

1.5 Information technology (IT) is essential to the administration of taxes and increasingly so as tax returns are filed on-line and payments made electronically. The National Audit Office examine each year aspects of how IT related risks are managed. Most Departmental IT services are operated by private sector IT service providers, in partnership with the Department. They are re-tendering these services in a major project called ASPIRE, as the current contract will expire in 2004. A formal announcement of the ASPIRE partner is planned for the end of 2003, with new arrangements operating from mid 2004. Two of the bidding consortia were selected as preferred bidders in July 2003.

Figure 3: National Audit Office coverage 2002-03

	Areas Examined
Corporate Governance and Information Technology	• Examination of the Department's internal controls, including the development of governance arrangements and the management information available to support the Statement on Internal Control • Follow up of progress in implementing previous National Audit Office and Public Accounts Committee recommendations • Management of IT related risks
Working Families' and Disabled Person's Tax Credits	• Payment and compliance arrangements • Plans for the closure of these schemes
Child Tax Credit and Working Tax Credit	• Introduction of Child Tax Credit and Working Tax Credit
Employer Compliance with tax and Tax Credit obligations	• Progress and developments in Employer Compliance • Opportunities to enhance the assurance provided by Employer Compliance
Income Tax	• Progress and developments in Self Assessed Income Tax • Take up of e-filing of Self Assessment Tax returns
Capital Gains Tax	• Progress and developments in Capital Gains Tax
Construction Industry Scheme	• Proposals to change the Construction Industry Scheme and consultative process
Inheritance Tax	• Progress and developments in Inheritance Tax
Debt Management	• Integrated Debt Management System
Petroleum Revenue Tax	• Review of developments since the C&AG's report on this tax in 2000

Source: National Audit Office

Compliance and Enforcement Initiatives

1.6 As announced in the Chancellor's Budget 2003, the Department are introducing a new compliance and enforcement package for tax and National Insurance Contributions (NIC) which should generate an additional £1,370 million over the three years to 2005-06. Additional staff in new specialist teams, backed by new IT and the use of outside legal and other expertise, are being deployed in three areas where the Department have identified significant risks to revenue:

- protecting the Exchequer from non-payment of tax and NIC debt and from failure to file tax returns;
- tackling fraud involving concealment of undeclared income or profits offshore;
- countering avoidance of Corporation Tax and of NIC and tax on earnings.

1.7 Under Sections 156 and 157 of the Finance Act 1998, the Chancellor asked me to determine whether the revenue impact of the package estimated was reasonable and cautious. I noted that it would be important that the Department's monitoring and evaluation arrangements were implemented as planned and concluded that overall the approach to projecting the revenue benefits of the package were reasonable. The National Audit Office will monitor progress and management's supervision of this package of measures.

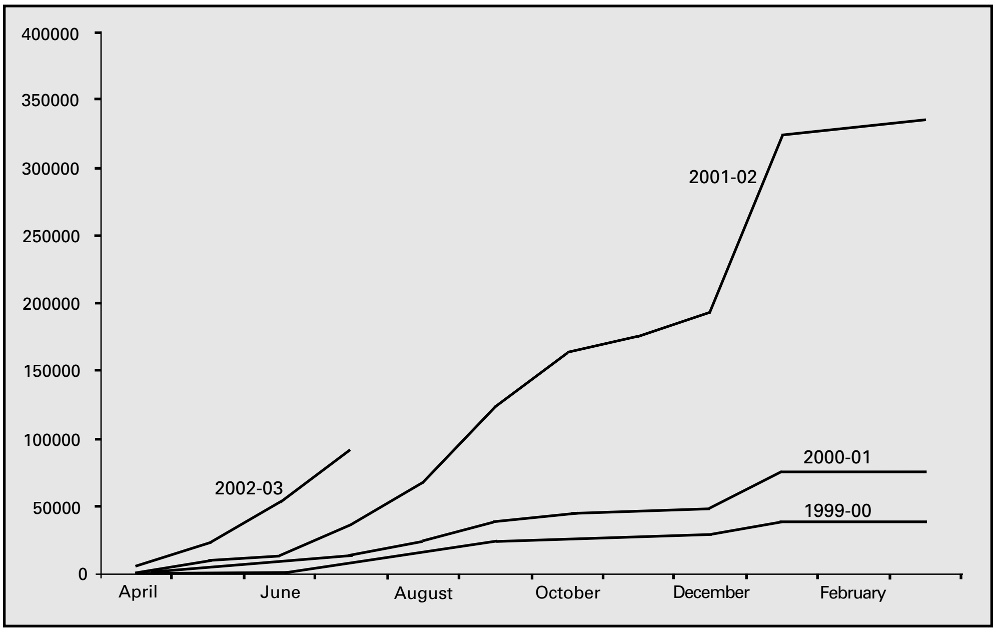
Self Assessment Returns

1.8 Self Assessment returns are received from some 8.8 million individuals. They declare some £16 billion of tax due representing 11 per cent of net tax receipts.

1.9 The Department encourage taxpayers to submit their tax returns electronically, but the level of take up of this option is dependent on a variety of factors including taxpayer confidence in security over the Internet. In May 2002 there were a very small number of reported cases where taxpayers filing returns electronically were able to see other taxpayer's data. The Department reacted promptly by closing down the service. The seriousness of the situation was apparent to the Department, who, with the IT service providers and other interested parties, initiated an exhaustive investigation of the underlying causes which were technical and complex. When they had been fully diagnosed, remedial measures were designed and implemented. The Department used IT and Internet security specialists to help test the amended systems, then the service was resumed. The Department wrote to all taxpayers who had been affected or who could possibly have been affected to explain what had happened and that the problem had now been remedied. The Department shared the lessons learnt from the events with other Government Departments and agencies, and beyond. There has been no repetition of these technical problems with internet filing since Summer 2002.

1.10 From 6 April 2002 to 31 January 2003, some 325,000 Self Assessment returns for the 2001-02 tax year were submitted over the Internet, more than four times the number for the same period in the previous year. For the same tax year, electronic returns lodged by agents on behalf of self assessment customers grew to some 365,000.

Figure 4: Numbers of taxpayers filing returns via the Internet



Source: Inland Revenue

1.11 The Department have developed a shortened, four page, version of the standard tax return for the tax year ending 5th April 2003. This has been issued as a pilot to 50,000 taxpayers who in previous returns have indicated that they had relatively simple tax affairs. Initial indications are encouraging in terms of completed returns received and feedback from both users and the media. If the pilot is successful, the Department will consider extending it to more taxpayers. They estimate that some 1.5 million individuals could benefit from this initiative.

1.12 The shortened tax return pilot exercise also offers taxpayers the option to file by telephone, as it requires far less information than a standard form. The system operates using voice recognition software and taxpayers can also speak to staff if they need help. This initiative is being evaluated as part of the short return pilot. Initial feedback has been good and take-up to June 2003 accounted for approximately 2.2 per cent of pilot returns received.

1.13 Taxpayers may fail to comply with their tax obligations by not submitting a return, or failing to submit it on time; alternatively they may not provide the correct details; or fail to pay tax due at the right time. The Department have researched taxpayer attitudes towards compliance, and are also looking at barriers to compliance. They are considering ways to influence behaviour to increase compliance for specific customer groups.

Construction Industry Scheme – New proposal

1.14 In the past, the Construction Industry Scheme has been of particular interest to members of the Committee of Public Accounts. Since 1972, a special tax deduction scheme for the construction industry has existed. This was established to deal with problems, endemic in the industry, of engaging workers on a "cash in hand" basis, coupled with a poor record of complying with tax obligations. The current Construction Industry Scheme was introduced in 1999. Tax and National Insurance Contributions are deducted directly from payments to subcontractors. The Scheme is intended to benefit businesses and sub-contractors since it encourages tax compliance across the industry and reduces the likelihood of non-compliant businesses benefiting from tax evasion.

1.15 The majority of subcontractors apply for a Registration Card to obtain all payments for labour from the contractor after a deduction of 18 per cent in respect of Income Tax and National Insurance Contributions. The Inland Revenue also issue Subcontractor Tax Certificates which allow subcontractors to be paid gross if they meet certain qualifying conditions, including recent compliance with taxation processes.

1.16 Since its introduction, this Scheme has suffered from problems, for example over contractor voucher supply, and businesses are concerned about the costs of complying with the Scheme. In 2000-01, the Department began preparations for introducing a new scheme designed to:

- reduce the regulatory burden of the scheme on construction businesses;
- improve the level of compliance by construction businesses with their tax obligations; and
- help construction businesses to get the employment status of their workers right.

1.17 In order to ensure the success of the new scheme and to gain industry-wide acceptance, a consultation document was issued in November 2002 requiring comments by the end of February 2003. Responses from the Industry show that there is sufficient support and justification for a new Scheme.

1.18 The main proposals of the new Scheme are:

- To replace the Registration Cards and Gross Payment Certificates with an e-verification service and alternative more traditional methods;
- To introduce a new employment status declaration;
- To replace the contractor vouchers with periodic returns;
- To create a new system to support e-services, including communication over the Internet.

1.19 The Department plan to introduce the new Scheme for the tax year 2005-06. The National Audit Office will continue to monitor progress in developing and implementing the Department's proposals.

Accounting Officer Responsibilities, his Statement on Internal Control and Departmental Performance Measurement

1.20 The Treasury require each Accounting Officer to make a Statement on Internal Control in their accounts covering operational, policy-making and financial systems. The Statements assert the Accounting Officer's responsibility for maintaining a sound system of internal control that supports the achievement of departmental policies, aims and objectives, whilst safeguarding public funds and departmental assets for which he is personally responsible.

Compiling the Statement on Internal Control

1.21 The Accounting Officer's assessment of the effectiveness of the system of internal control is based on the work of the internal auditors and reports from the Chair of the Departmental Audit and Security Committee, and is also informed by wide consultation across the Department in the form of regular reports and updates from key contributors. The Internal Audit Office provide the Accounting Officer with an independent and objective opinion of the effectiveness of risk management, control and governance. They provide specific Assurance Reports twice a year to the Departmental Audit and Security Committee.

1.22 The Accounting Officer's Statement on Internal Control complies with Treasury requirements and sets out in a public document his view on the control framework. Under Treasury's current requirements, the Department had until 1 April 2003 to complete all development work necessary for a full statement on internal control to be made for 2003-04. Figure 5 summarises progress made in particular aspects of the control environment this year, compared with 2001-02. Further detail on certain of these aspects is provided in the paragraphs which follow.

Figure 5: Progress in aspects of the control environment

	2001-02	2002-03
Accountability Framework Clarifies generic corporate accountabilities and complements business operating plans and individual performance agreements.	In place for operational areas of the Department such as Regions and business streams and being developed for non-operational areas such as Head Office functions.	As for 2001-02, development ongoing. Frameworks for policy and head office Directors were issued on 6 June 2003.
Committee Structures Ensures decisions are made properly on a corporate basis.	Clearly defined structures in place for the existing Departmental Audit and Security; Departmental Management; and Project Investments Committees, all with basic terms of reference. New Departmental Finance Committee to be established.	As for 2001-02, plus Departmental Finance Committee established as planned. Recommendations made by internal review of committees to be implemented 2003-4. This will be taken forward by the Director General, Corporate Services, a Board member.
Risk Management Processes Ensures risks to the Department and the Department's business are identified, owned and managed.	Risk management processes still under development. Bi-annual stock-takes with the Departmental Management Committee are held to review top risk, with risk ownership at Board level.	Continued development of risk management processes across the whole Department, with increased formalisation. Model of risk management adopted requiring upward reporting of risks. A new Risk Review Group established to meet from September 2003.

	2001-02	2002-03
Performance Indicators Demonstrate the Department's performance against stated objectives and targets and how the business has been managed.	Range of indicators in place, including key indicators linked to Public Service Agreements (PSA), some of which cannot be measured reliably. Some results are validated by Internal Audit.	As for 2001-02, a range of indicators in place, some of which cannot be measured reliably. Some results are validated by Internal Audit. Delivery plans are in place for each revised PSA target, 2003-06. PSA objectives are allocated to Board members and Directors.
Departmental Balanced Scorecard A system to manage and monitor the Department's performance against its strategy and objectives.	Began process of developing a Balanced Scorecard. Twenty four scorecard measures were agreed by the Board.	Continued development. Some scorecard targets being measured. Scorecard made available at Board meetings. Some business streams have developed their own performance measures based on a balanced scorecard, for example the Large Business Office and Service Delivery Support (Compliance).

Source: National Audit Office

Accountability

1.23 In 2002, the Department reviewed existing accountability arrangements to develop a framework supporting more consistent and effective decision-making, leading to the introduction of an "Accountability Framework". This initial Framework was developed for operational Directors, who agreed a generic list of corporate areas of accountability, such as responsibility for leadership, financial management, human resources, diversity, health & safety and managing risks.

1.24 The Accountability Framework is designed to complement a Director's specific business accountabilities or responsibilities for their business stream, which should be recorded in Operating Plans and individual performance agreements agreed with line managers. The Department do not intend for there to be a single document recording all accountabilities for individual Directors. The Accountability Framework overall is still under development and specific Accountability Frameworks for Board Members are to be developed during 2003-04. The issue of how to implement and monitor the Framework is currently under consideration.

Committee Structures

1.25 In July 2002 an accountabilities review team reported on Departmental Committee accountabilities. They noted that committees' terms of reference did not focus on who the committees were accountable to; how accountabilities would be manifested; and how the committees would delegate work downwards. This lack of focus could undermine the effectiveness of decision-making within the Department. The report also recommended the development of a process of approval for new committees, and that terms of reference should clarify links with other committees and incorporate critical aspects of performance review.

1.26 In mid June 2003, the Director General, Corporate Services, a Board member, agreed to take forward work on the Department's committee structures. This work may need to take account of the Government's review of Customs and Excise and the Inland Revenue, which is due to report before the Chancellor's Pre-Budget Report in November 2003.

Risk Management

1.27 The National Audit Office examination of the Department's risk management processes found that they were better developed in some areas than others. For example the Large Business Office identify top risks to their business and to the delivery of Departmental objectives; assign ownership of risks to senior management, who report regularly against risks and key objectives; and update the risk register quarterly. However, in some areas, risk registers were being compiled reactively providing more of an issues log.

1.28 The Accounting Officer says in the Statement on Internal Control that the Department continue to build on progress made in embedding risk management processes. During 2002-03 the Department's Internal Audit Office commissioned an external independent review of the central risk management processes being put in place. The majority of the issues raised by this review are in hand or are intended to be addressed by new measures such as the Risk Review Group. In early June 2003, the Finance Director agreed proposals for establishing this group, aimed at improving corporate risk management. The first meeting was scheduled for September 2003 to be chaired initially by the Finance Director, with a view to passing that role to a non-executive Board member. The Internal Audit Office plan to undertake in 2003-04 a series of reviews of individual business streams and key areas to evaluate the level of maturity in their risk management arrangements.

Measurement of Performance against Indicators

1.29 The Department have made progress in performance measurement and monitoring, especially in relation to Public Service Agreement (PSA) objectives and Service Delivery Agreement (SDA) targets. A Board Member now owns each PSA objective and the Director of Strategy and Planning has oversight responsibility for the agreement and coordination of PSA objectives and SDA targets, across the Department. The Department have developed Delivery Plans for each PSA objective. These outline ownership, an overview of the PSA objective, delivery strategy for individual SDA targets, information systems availability and reporting lines.

1.30 PSA performance results are published in the Department's Annual Report and are validated by the Department's Internal Audit Office. The Office validate some of the results but for others their work is limited to developing an understanding of the system, reviewing controls and building an audit trail of data, in order to carry out full validation in future years. The National Audit Office recommended that the Department disclose more fully the extent of validation work when presenting performance results in their Annual Report.

Conclusion

1.31 The Department have in hand several important initiatives, including developments in corporate governance arrangements, the full benefits of which should be demonstrated in future years.

Part 2: Working Families' and Disabled Person's Tax Credits

2.1 This part of my report examines four aspects of Working Families' and Disabled Person's Tax Credits: applicant compliance; the accuracy of awards; payment via employers; and employer compliance. It also examines the Department's plans to close those schemes.

2.2 Working Families' Tax Credit and the Disabled Person's Tax Credits started in October 1999 as part of the Government's reforms to make work pay ended on 6 April and spent some £17.8 billion. Figure 6 shows the number of recipients and average weekly award during the four years of the tax credits. From 6th April 2003 they were superseded by the Child Tax Credit and the Working Tax Credit (Part 3).

Figure 6: Average Value of Weekly Award and Number of Recipients

	1999-00		2000-01		2001-02		2002-03	
	Weekly Award (£)	Recipients	Weekly Award (£)	Recipients	Weekly Award (£)	Recipients	Weekly Award (£)	Recipients
Working Families' Tax Credit	71	1,026,000	80	1,226,000	83	1,317,000	87	1,377,000
Disabled Person's Tax Credit	66	21,017	73	27,954	77	32,815	78	38,164

Note: Figures for 2002-03 are indicative only.

Source: Inland Revenue.

2.3 Working Families' Tax Credit was available to couples with children and single parents who worked at least 16 hours per week but were on low incomes. Similarly, Disabled Person's Tax Credit was available to people with disabilities who were in work but on low incomes. The amount payable was based on the net weekly income of the applicant's household and comprised a basic entitlement, with additions, for example, for children and childcare costs. Awards were reduced by 55 pence for every pound of income above a prescribed threshold (£94.50 per week for Working Families' Tax Credit awarded in 2002-03).

2.4 The methods of payment of Working Families' and Disabled Person's Tax Credits were: automatic credit transfer; order book; girocheque; or via the claimant's employer. The Department paid out some £4.7 billion in 2002-03 (2001-02, £3.44 billion) through the first three methods and some £1.7 billion (2001-02, £2.2 billion) via employers.

Applicant Compliance

2.5 My report for 2000-01 detailed how the Department were taking steps to improve their intelligence on the likely level and types of non-compliance amongst applicants for Working Families' and Disabled Person's Tax Credit. For this purpose they had examined a representative sample of applications made between August 2000 and August 2001 but they were unable to provide me with the results of the exercise when I finalised my 2001-02 report. At the Committee of Public Accounts hearing in June 2003 on my report on External Fraud against the Inland Revenue, the

Department reported the most common types of non-compliance in tax credit applications identified by this exercise. They told the Committee that they had incorporated the lessons learned into their design of the New Tax Credits. The full results of the exercise on 2000-01 data were made available to me in August 2003.

2.6 The Department estimated that some 10-14 per cent of tax credit payments by value in 2000-01 may have been overpayments due to applicant non-compliance. This represents between £510 million and £710 million for that year. Very few underpayments were detected. The main reasons for the errors were: understated or undeclared income (13% of all applications); understated or undeclared capital (3% of all applications); undeclared partner (3% of all applications).

2.7 The Department regard the 2000-01 exercise as a one-off and have not repeated it for 2001-02 or 2002-03. The results from the 2000-01 exercise do not necessarily reflect the levels of error in 2002-03, as some changes have been made to the compliance regime. But I have seen no evidence to demonstrate that those changes will have produced a significant reduction in the rate of error. I have therefore concluded that the probable rate of error in 2002-03 remained unacceptably high, leading me to qualify my audit opinion on the Trust Statement account for 2002-03 in respect of tax credits payments.

Accuracy of Tax Credit Awards

2.8 In addition to the risk from incorrect information from applicants, Inland Revenue staff made errors when processing applications and calculating awards, resulting in under or over payments. The levels of errors made in processing and calculating awards are shown in Figure 7 below.

Figure 7: Accuracy of processing and calculating awards

	2000-01 %	2001-02 %	2002-03 %
Target Accuracy	92	92	93
Working Families Tax Credit	93.7	87.1	85.2
Disabled Persons Tax Credit	98.0	95.0	90.9

Source: Inland Revenue (these figures are for Tax Credit Office (GB) only).

2.9 As Figure 7 shows, the accuracy in processing tax credits in 2002-03 was lower than in previous years and did not meet the Department's Public Service Agreement target. The value of financial errors made in awards is shown in Figure 8. The rate of error in 2002-03 was much higher than in 2001-02. Although the net cost to the Exchequer of overpayments and underpayments was small, the effect on tax credit recipients increased significantly in 2002-03.

Figure 8: Errors in Tax Credit awards

	2000-01	2001-02	2002-03
Rate of error in awards by value	1.22%	1.73%	3.29%
Potential Overpayment	£27.2m	£53m	£90.8m
Potential Underpayment	£30.4m	£42.6m	£87.6m

Source: Inland Revenue (these figures are for Tax Credit Office (GB) only).

Payments via Employers 2000-01 and 2001-02

2.10 The amount of tax credit expenditure shown by the Department in their Trust Statement account is based on awards made by the Department. The Department can only know that the amount shown as spent reached beneficiaries by checking that employers made payments in accordance with awards. For 2000-01 and 2001-02, I reported that in-year employer compliance work did not enable the Department to evaluate the level of error in tax credits payments by employers. The Department were therefore unable to provide sufficient assurance that employers were paying the amounts awarded by the Inland Revenue.

2.11 As an alternative, the Department sought to obtain assurance by reconciling amounts reported as paid by employers to Departmental records of awards made. This exercise undertaken in respect of 2000-01, identified a number of discrepancies and the Department investigated a sample of 50 of these to see if they could be reconciled. There were 15 outstanding cases which indicated a total overpayment of £9.7 million at the time of my report on 2001-02. The National Audit Office reviewed progress on this exercise as part of their audit for 2002-03 and found that by the end of June 2003 the Department had reconciled these cases to within £0.6 million and had decided to do no further work in respect of 2000-01. The main reasons for the discrepancies were errors in employers reporting tax credit payments and overlaps of payroll periods at the beginning and end of the tax credit year.

2.12 For 2001-02, the Department took a substantial sample of tax credit awards and checked them to the statutory return from employers for individual employees rather than reconciling to employers' end of year tax returns which cover all employees. The Department also traced the original awards from a substantial sample of forms submitted by employers. This work was underway when I reported last year and the final reconciliation rate was over 99 per cent, as notified at the Committee of Public Accounts in January 2003. The Department have found that the main reason for discrepancies remained the overlaps of payroll periods at the beginning and end of the year. In two cases there was no explanation for a significant discrepancy and the employer compliance teams are to investigate further, with a view to recovering any overpayment from the employer.

Payment via Employers 2002-03

2.13 For 2002-03, the Department again reconciled employers' end of year tax returns for individual employees to award notification to gain assurance about the tax credit expenditure reported in the Trust Statement account and the regularity of payments made by employers. The reconciliation exercise will not be competed until later in 2003 in line with the annual cycle of PAYE returns from employers. The Department consider that their initial results are promising, with a high overall reconciliation rate. The National Audit Office will monitor completion of this exercise.

Employer Compliance

2.14 Since my report on 2000-01, the Department's employer compliance teams have increased the information recorded about their visits and improved the documentation of testing. For 2002-03, the Department can identify the number of employers visited who paid tax credits and for large employers, can identify the number of employees checked and the number of errors found. The Department do not, however, quantify or extrapolate the results of their testing so as to estimate the overall level of error, partly because risk-based cases cannot provide an accurate picture of overall compliance. However the Department consider that the reconciliation exercise described in paragraphs 2.11 and 2.12 provides assurance.

Closure of the Working Families' and Disabled Person's Tax Credit Schemes

2.15 In December 2002, the Department produced an outline "decommissioning strategy" for Working Families' and Disabled Person's Tax Credits which focussed on arrangements to wind-down the IT systems. The strategy is closely linked to the Department's emerging Information Strategy. Work has commenced and will continue to progress throughout 2003 and into 2004.

2.16 New instructions for employers to pay tax credits had ceased in August 2002, but payments under those instructions could continue into 2003 depending on the frequency of payroll. This was to allow employers to make preparations for the new tax credits. All payments by employers would have ceased by April 2003. The Department will only know whether employers acted in accordance with their instructions, after they have reconciled employers' end of year returns and awards. This work will not be finalised until the end of 2003. The Department then will assess the level of discrepancy between directions to employers and amounts recorded on employers' end of year tax returns, and decide how to proceed. Any overpayments of Tax Credit to individuals as a result of employer error will be recovered directly from the employer.

2.17 Claims for Working Families' Tax Credit could be backdated for a maximum of three months, but only in exceptional circumstances. Claims could also be backdated for up to one month but only for good administrative reasons. Claims for Disabled Person's Tax Credit followed similar rules, although it was possible to get further backdating if the claim was linked to another sickness or disability benefit. Except for a very few situations, which are specified in regulations, the award of tax credits will not change, whether it is a 26 week award, or an extended award due to the wind down of the old tax credit scheme. This means that changes to family circumstances, earnings or savings that occur during the duration of an award do not affect the amount a family is paid. However, to provide support for ongoing work (for example, associated with appeals) the systems will not be decommissioned until April 2005.

Conclusions

2.18 The Working Families' and Disabled Person's Tax Credit schemes began in 1999, ended on 6 April 2003 and spent some £17.8 billion. The Department were able only in August 2003 to provide me with the results of their examination of samples of tax credit applications made during part of 2000-01. Error rates were 10-14 per cent by value and the estimated level of overpayment for a full year was between £510 and £710 million.

2.19 The Department have not undertaken similar exercises for 2001-02 or 2002-03. The Department emphasise that they had incorporated the lessons learned into their design of the new tax credits. For these tax credits the Department must consider undertaking an exercise each year to determine the effectiveness of their controls in detecting error and ensuring that payments are properly calculated to reflect claimants' circumstances.

2.20 The level of overpayment identified by the Department is cause for serious concern and as a result I have qualified my opinion on the Trust Statement for 2002-03. The improved controls in the new tax credit system should help to reduce overpayments. But the Department are not yet able to assess the likely extent of that reduction.

Part 3: New Tax Credits - Child Tax Credit and Working Tax Credit

3.1 This part of my report examines some aspects of the introduction of Child Tax Credit and Working Tax Credit in April 2003 and important considerations for future developments of the management of these schemes. The Department received some 4.5 million applications and paid some £2.6 billion by the end of June 2003. These two tax credits are expected to cost some £16 billion per year.

3.2 Claimants encountered problems when the new tax credits were introduced. Claims for the tax credits could be submitted from August 2002, and the Department intended that all who claimed by 31 January 2003, were eligible and had provided all necessary information, would receive payment on the relevant payment dates from the start of the schemes in April 2003.

3.3 On 28 April 2003, the Paymaster General made a statement to the House of Commons on the introduction of the new tax credits. In the subsequent debate Members of Parliament expressed concern that: many claimants who had complied with the Department's request to submit application by the 31 January 2003 had yet to receive an award; applications were taking up to seven months to be processed; claimants opting for weekly payments had not received payments three weeks after the first payment date; the helplines supporting claimants and MPs were not able to deal with the number of calls received; and that there were staff concerns over the IT system introduced for the new tax credits.

Child Tax Credit and Working Tax Credit

3.4 There are around 7 million families with children in the UK and the Department estimate that nine out of ten families with children will be eligible for Child Tax Credit. A total of 5.75 million families are expected to benefit from Child Tax Credit during 2003-04, including 1.2 million families on Income Support and Jobseekers Allowance receiving extra support for their children through their benefits. Some 1.35 million families are expected to benefit from Working Tax Credit this year, including 250,000 families without children or a disabled worker, who previously did not qualify for in-work support.

3.5 Tax credits must be claimed and there is a single form for both credits. The Department verify claims and arrange payment to successful claimants. The main features of the tax credits are summarised in Figure 9 below. A tax credit award runs until the end of the tax year, unless the claimant ceases to be eligible and the award is brought to an end earlier. Awards can be adjusted during the year to take account of changes in circumstances. Certain changes in circumstances must be notified to the Inland Revenue within three months, for example those that would bring an award to an end or which are likely to have a large effect on the amount of the award. Other changes do not have to be reported during the year, although the Department encourages claimants to report them if their award would be affected, to keep awards in-line with entitlement. Any increase in entitlement can be backdated for up to three months. Any reduction in entitlement will be backdated to the date when the change in circumstance occurred.

Figure 9: Main Features of Child Tax Credit and Working Tax Credit

Child Tax Credit is:

- available to those aged 16 or over, ordinarily resident and present in the UK, and who are responsible for at least one child, whether working or not
- paid direct to the main carer
- composed of several elements:

Element	Maximum (annually)
Family Element (one per family)	£545
Higher Family Element (in first year of child's life)	£545
Child Element (for each child)	£1,445
Disability Element (for each disabled child)	£2,155
Severe Disability Element (for each severely disabled child)	£865

Working Tax Credit is:

- available to working people aged 16 or over, working at least 16 hours per week, with dependent children or a disability **or**, for those without children or a disability, aged 25 years or over and working at least 30 hours per week
- paid via the employer, with the childcare element paid direct to the main carer
- composed of several elements:

Element	Maximum (annually)
Basic Element	£1,525
Second adult and Lone Parent Element	£1,500
30 Hour Element	£620
Disabled Worker Element	£2,040
Severe Disability Element	£865
50+ Element 16-29 Hours	£1,045
50+ Element 30+ Hours	£1,565
Childcare Element - childcare costs cannot exceed £135 per week for one child and £200 per week for two or more children	70 per cent of costs

Source: National Audit Office

Preparations for the Introduction of Child Tax Credit and Working Tax Credit

3.6 The Government's intention to go ahead with Child Tax Credit and Working Tax Credit was announced in the 2000 Budget. The Department recognised this to be a large and complex undertaking to be completed to a challenging yet achievable timetable so as to go live in 2003. It included advising Ministers on detailed policy and legislative issues; designing and implementing business and IT systems; and recruiting, training and accommodating staff. The Department started to distribute claim forms for the new Tax Credits in August 2002. They conducted routine and risk-based checks on the completed forms before approving them for payment. The Department intended to carry out this work and put into payment by April 2003 all claims that they had received by 31 January 2003 and that required no further information from claimants. Figure 10 shows their progress in processing claims.

Figure 10: Claim Processing volumes (millions)

	31/01/03	09/04/03	28/04/03	02/07/03
Received	2.7	3.9	4.0	4.5
In payment or ready for payment	1.4	2.8	3.2	4.2
Being processed	1.3	1.1	0.8	0.2
Rejected or identified for rejection	0	0	0	0.1

Source: Inland Revenue

3.7 The Department's IT service provider, EDS, created the new IT systems for processing tax credits. The central component, known as NTC Core, uses links to other Inland Revenue databases and electronic exchange of data with the Department for Work and Pensions to conduct verification checks on claim forms. The NTC Core also calculates awards and where payment is due sends instructions to the Department's payments software. The Department are improving the system to support management information and end of year activities including annual renewals of tax credits.

3.8 The Office of Government Commerce have a central role overseeing major system developments that are critical to government programmes, and conduct Gateway reviews during project development. Their Gateway 3 review in January 2002, which was limited to reviewing governance arrangements, found that the Tax Credits Programme had highly effective governance arrangements which the Office considered set a benchmark for this type of Programme. In December 2002, the Gateway 4 review, "Readiness for Service" described the Programme as "an exemplar of good Programme management", while noting that a large amount of work remained against a tight schedule. The Office of Government Commerce noted throughout these reviews that the Tax Credit Programme was already well advanced when the full Gateway review process was introduced by them in February 2001, hence it was not possible to introduce the Gateway process at project initiation. This meant it was not possible to realise many of the benefits the process brings, which for example covers business justification, scope and modularity.

3.9 The implementation of new tax credits and the systems to support it were overseen by a Programme Board, chaired by a Deputy Chairman of the Inland Revenue, with senior representation from Inland Revenue and Department for Work and Pensions and EDS. It received regular reports about progress from Inland Revenue and EDS teams. But individual software problems were recorded on 'trouble tickets' and these were managed at working level. During the second half of 2002-03 the Programme Board was actively monitoring progress towards implementation and it did not consider that any of the issues raised with it would be likely to prevent delivery of a working system. However, the Programme Board recognised that when the system went live there would still be a number of trouble tickets to be corrected.

Operation of the Child Tax Credit and Working Tax Credit

3.10 There was some slow running and system downtime from January 2003 which the Department considered could be addressed by redeploying resources. When the software release for April went live a number of known IT errors required clerical interventions. The Department and EDS did not consider this to be unusual for IT developments. However, serious problems with system performance from April meant that some processing was delayed. When these performance problems arose they affected the system's:

- stability – staff could not complete the processing of claims and had to start again;
- speed – staff had to wait too long to access information and records;
- availability – significant time in the working day was lost when the system was closed down to clear internal queues.

3.11 Analysis of the technical problems by EDS and "tuning" the system to perform more reliably took several weeks. By mid-June 2003 the Department felt that the system was performing at a reasonable level. In July 2003, the Department told the National Audit Office that they intended to ensure that by autumn 2003 the lessons from the experience on New Tax Credits during the first part of 2003-04 would be learned fully for the benefit of future developments. At the same time they engaged consultants to conduct a review to provide further, independent assurance as to the analysis of the technical problems and the action being taken to address them.

3.12 The Department's consideration with EDS of the underlying technical problems had to have regard to the discussions between them about compensation for the unsatisfactory performance of the system, and the possibility of legal action. In November these discussions were continuing and the Department hoped to resolve them shortly. In the light of this, my report documents in summary the two parties' position and their overall interpretation of events. It was also relevant that EDS were competing for the Department's overall IT service provision, in a project called ASPIRE, a decision on which was due by the end of 2003.

3.13 The Department and EDS told me that in their view:

"The Inland Revenue and EDS worked together with other parties involved, on testing to make sure that key functions needed for April were ready. This was a complex task. To ensure robust IT functions were available at the time they were needed, the testing strategy was to prioritise the functionality needed first, and to delay less urgent testing. The period of instability in the early months of the live service was caused by queues building up in the channels between system components. The causes of these queues were not detected during testing. The nature of the particular testing regime meant that the underlying technical faults could not have been discovered and corrected in testing although more testing might have reduced the effects of some of the problems. The Department and EDS are considering what lessons can be learned about technical system design and testing strategy, including the effects of a compressed testing timetable."

Recovery plans

3.14 The Department transferred many staff from other work in response to the problems with new tax credits. They subsequently revised their business plans and targets to take account of the effects on the areas concerned and made arrangements to catch up on the backlogs where possible. They consider that they will have recovered much of the lost ground by March 2004 but will not be fully back on track until the end of 2004-05.

3.15 Employers had a significant workload preparing for the new tax credits schemes. They and providers of payroll software were engaged closely by the Department as they devised the flows of tax credit data and forms between the Department and employers. Nonetheless, some employers experienced many problems with the notifications they received from the Department, for example those instructing them to start paying tax credits to individual employees, to vary the amounts and to cease payments. The timing and frequency of notifications was a particular problem at the start of the new schemes. The Department have standing arrangements to log the detailed problems and to discuss them and broader concerns with employers' representative bodies.

3.16 The Department need to resolve as soon as possible in 2003-04 the problems for employers, to ensure that underlying causes are removed and that individual recipients are paid correctly with their wages where appropriate. It will be particularly important for the system of entitlement notifications to be working reliably to enable the Department to check payments by employers.

Making the Tax Credit Payments

3.17 The Government intended that Child Tax Credit payments and payments of the childcare element of the Working Tax Credit would generally be made by automated credit transfer directly into claimants' bank accounts. However, at the end of September 2003 over 500,000 claimants were being paid by giro cheque where bank account details were missing or mis-stated on claim forms to avoid delaying payments whilst the correct details are obtained. Claimants currently being paid by giro cheque and who require a Post Office Card Account will be progressively moved to those new arrangements over the coming months. By mid September around 2,500 claimants were being paid via these accounts. Issuing the additional giro cheques cost some £2.2million over the first three months of the new tax credits.

3.18 The Department had arrangements to provide by giro cheque interim payments to claimants in cases where an expected payment had not been received. In the light of the difficulty caused by slow running IT systems, and in anticipation of high numbers of personal callers, the Department revisited their plans and provided extra resources in Enquiry Centres to deal with the expected rise in requests for interim payments.

3.19 Claimants could claim a payment of up to five weeks' worth of tax credit at their local tax office if they had not received a payment or their claim had not been processed. In April 25,000 interim payments were made, in May 175,000 and in June 75,000. The peak of these payments in May was short-lived and the significant drop in June reflected the growing stability of the IT system and the clearance of the backlog as claims were processed. The Department did not expect to be able to estimate the value of interim payments until the end of November 2003 because of the backlog in processing the manual records of the payments made.

3.20 When a local office made a payment it needed access to the NTC core IT system to update records. The slow running of the system prevented this access in some cases, leading to manual lists of payments made, which had to be transferred to the NTC system when available. The Department face a considerable challenge in ensuring that payments reconcile retrospectively to awards, claimants and eligibility.

Controls over tax credit awards and payments

3.21 When the new tax credits payment cycle was designed, it provided for automatic daily reconciliations between payments authorised and payments made. None of these reconciliations were able to take place because the IT systems could not support the reconciliations. The Department aim to put in place detailed arrangements for catching up with this reconciliation work and for resolving any discrepancies detected by their reconciliations. They told me in September that they were still working with EDS on the reconciliation issues and had not yet finalised their plans. Their work had already identified a large number of cases of apparent underpayments and overpayments.

Conclusions

3.22 New tax credits represented for the Department a major challenge in an area of work which was relatively new to them. The level of the problems caused to tax credit claimants and employers as the systems went live demonstrated that there were undetected gaps in the design of the testing regime for the systems.

3.23 In July 2003 the Department received from EDS an explanation of the technical problems that had delayed payment to claimants. The results of the audit by independent consultants should enable the Department to check whether there are any other technical issues outstanding so that they can be sure that they have learnt the lessons sufficiently to give assurance that similar problems will not occur as the tax credit systems are expanded.

3.24 The Department's consideration with EDS of the underlying technical problems had to have regard to the discussions between them about compensation for the unsatisfactory performance of the system, and the possibility of legal action. In November these discussions were continuing and the Department hoped to resolve them shortly. Once they are resolved I shall return to these aspects .

3.25 The Department must pay particular attention to ensuring that recovery from the problems with the introduction of new tax credits does not undermine their reputation for integrity of processing of taxpayers affairs, which is essential to the effective assessment and collection of tax.

3.26 In addition to the significant challenges of maintaining day to day running of the system and catching up on backlogs, there are many major issues for the Department in controlling Tax Credits for 2003-04. These include ensuring that:

- they have a rigorous approach to deciding how many, and which applications are "higher risk" as they require only those applications to be checked against prior-year income records before payment;
- they can manage the risk if claimants delay reporting changes in their circumstances;
- the problems with the start of the new tax credit systems and recovery from that position, have not led to errors in detailed information about claims or payments.

Part 4: Employer Compliance

4.1 This part of my report examines the Department's Employer Compliance function. Employer compliance reviews provide assurance to the Department on whether employers are meeting their statutory obligations in operating and collecting Pay As You Earn (PAYE) and National Insurance Contributions (NIC) correctly. Reviews also consider compliance relating to: Construction Industry Scheme deductions; Employee benefits; Statutory Sick Pay and Statutory Maternity Pay; tax credits; and student loan deductions.

4.2 In 2002-03, the Department collected £155 billion from employers in PAYE and Class 1 National Insurance Contributions. This represented around 68 per cent of the total gross tax and National Insurance revenue for the year.

The Structure of Employer Compliance

4.3 Employer Compliance is carried out by two parts of the Department, the Large Business Office and the Regional/Area Office network, referred to as the Employer Compliance Network. Figure 11 shows key operational statistics for the two functions for 2002-03.

Figure 11: Key Operational Statistics 2002-03

	Large Business Office Employer Compliance	**Employer Compliance Network**
Number of offices	12 offices operating in 5 clusters	69 Employer Compliance Units operating in 7 Regions
Number of staff	230	2,160
Employer base	3,000 employers operating 20,000 PAYE schemes	Over 1.2 million employers operating 1.6 million PAYE schemes
Reviews taken up	260	35,000
Additional tax and NI collected, interest and penalties as a result of employer compliance reviews	£50.9 million	£258.8 million

Source: Inland Revenue

4.4 The Large Business Office Employer Compliance team, (the Large Business Office), reviews the UK's largest employers (over 1,000 employees), large public sector bodies and smaller, specialist entities such as foreign banks and Lloyd's of London underwriting syndicates.

4.5 The Large Business Office and the Employer Compliance Network carry out two types of compliance review on employers: full or aspect. A full review covers all elements of an employer's operations and includes mandatory checks relating to statutory payroll obligations including PAYE, NIC, Statutory Sick Pay, Statutory Maternity Pay, tax credits, etc. Aspect reviews focus on one or more perceived risks relating to a statutory payroll obligation such as tax credits or to a wider aspect of an employer's operations such as the treatment of expenses and benefits.

Previous Recommendations

4.6 My earlier report on Employer Compliance (HC25, 1999-2000) followed the merger of the Department with the Contributions Agency, bringing together the compliance functions for PAYE and National Insurance. Since the report, the Department have addressed the major issues raised and the Large Business Office and Employer Compliance Network have also reviewed their employer compliance strategies.

Large Business Office Strategy

4.7 For the Large Business Office new developments have been driven by key reviews such as "Review of Links with Business" and "Bridging the Gap between Large Business Office Employer Compliance and Corporation Tax". The "Review of Links with Business" report looked at how the Department could be more supportive to large businesses. Extensive consultations with businesses, accountants, advisers and representative bodies have led to many recommendations and improvements, including:

- developing a "ringmaster" role whereby Large Business Office Case Directors will coordinate all compliance activities, to provide a more consistent service to large businesses.
- establishing a Large Business Office Technical Team, to provide guidance on specific complex technical issues.
- creating Large Business Office Enabling Teams to provide coordinated advice and support to large businesses.

4.8 The "Bridging the Gap" report focused on how the Employer Compliance and Corporation Tax teams of the Large Business Office could work together more closely to support the wider "ringmaster" role of the Case Director.

4.9 The aim of the Large Business Office is to align the customer bases of employer compliance and Corporation Tax to provide a more focused service to large businesses. Some employers currently reviewed by the Large Business Office will transfer to the Employer Compliance Network, for example local authorities and hospital trusts which tend to be single-site employers with less complex tax issues than large corporations.

Employer Compliance Network Strategy

4.10 The Department published in March 2003 a strategic review of the Employer Compliance Network (the Network), which made ninety recommendations being considered during Summer 2003, including:

- the Large Business Office and the Network should work more closely together to ensure consistency of operations and treatment of employers.
- a number of roles in the Network and specific specialist teams should be reviewed and redefined.
- resources should be targeted more effectively on the basis of risk analysis, for example to Areas with higher concentrations of "risky" employers.

4.11 Like the Large Business Office, the Network have also been redeveloping compliance processes facilitated by Department-wide programmes such as the "Modernising of PAYE Processes for Customers". The Carter "Review of Payroll Services" report on improving support provided by the Department to small employers, recommended that:

- compliance reviews should concentrate on major problems in the operation of PAYE and National Insurance, rather than narrower issues.
- there should be more emphasis on improvements employers need to make to ensure compliance in the future.
- employers should be encouraged to agree with the Department treatment of particular expenses or benefits in kind to make tax administration easier (known as a "dispensation").

Recent Developments in Employer Compliance

4.12 Figure 12 summarises some of the recent developments in both the Large Business Office and the Network. Some of these developments are covered in more detail in the paragraphs that follow.

Figure 12: Recent Developments

	Large Business Office Employer Compliance	**Employer Compliance Network**
Enabling	Introduction of Enabling Teams, including dedicated Customer Account Managers.	5% of Network resources dedicated to enabling activities.
Performance Measures and Management Information	Introduction of more balanced compliance measures focusing on qualitative as well as quantitative outcomes. Some improvements to the integrity and reliability of data have been made. Data interrogation facilities have improved.	
Communications and sharing best practice	Greater degree of joint-working and communication between the Large Business Office and the Network and also across the Department	
Planning and Conduct of Reviews		
• Risk Assessment	Introduction of a formal risk assessment process to select employers for review.	Central Risk team provide analysis and risk assessment criteria for reviews. Area Risk Intelligence and Analysis Teams provide local, specialist risk analysis and support to review teams.
• Systems-based audit approach	Currently being developed for implementation in Autumn 2003.	Currently being developed with planned roll out in 2004.
• Quality monitoring	The Large Business Office Technical Team provide technical advice, support and training to review teams. Refinement of quality monitoring processes.	Extension of quality monitoring to all employer compliance reviews. Introduction of regional Compliance Audit Programme.

Source: National Audit Office

Enabling Activities

4.13 Compliance activities are increasingly focused on encouraging employers to correct payroll processes for the future, helping improve compliance in the medium term. The Large Business Office have introduced a dedicated Enabling Team, whose responsibilities include:

- acting as a single, permanent contact point for employers and supporting the “ringmaster” role.
- post-review monitoring of employers and completion of a post-review questionnaire.
- ensuring consistency in technical matters and assisting employers with tax dispensations.
- facilitating communication between employer compliance and corporation tax teams.

4.14 The Network have deployed 5 per cent of resources on specific proactive enabling activities, such as post-review visits. Current reviews include some reactive enabling activities but the Department are further developing processes to have a greater focus on enabling, such as a more systems-based audit approach and emphasis on helping employers. The Department plan to have the necessary changes and training in place by April 2004. The National Audit Office support the greater focus on enabling but note that the Department will need to closely monitor and clearly communicate the strategy and required activities. This will allow the Department to measure the benefits of allocating specific resources to enabling and inform business decisions.

Performance Measurement and Management Information

4.15 In 2002, the Large Business Office and the Network introduced new, wider performance measures for employer compliance, based on the Department’s balanced scorecard. The National Audit Office welcome the development of a wider range of indicators, but consider that further enhancements are needed to measure more fully the effect of their activities and whether they are improving compliance.

4.16 In 1998 the Department introduced the Employer Compliance System, a database of employer information including details of employers’ tax returns and the benefits and expenses provided for their employees which the Large Business Office and Network use to record the outcome of employer compliance activity. The Department have made improvements to the range of information held in the Employer Compliance System and plan further enhancements, including the migration of data from the Employer Compliance System onto the Department’s Corporate Data Warehouse - a central repository of shared information - to enable more flexible analysis of data. The Large Business Office have also introduced new processes for recording and monitoring of enabling activities, risk assessments and the results of assurance checks, which have been developed outside of the Employer Compliance System.

4.17 The Department produce standardised reports of regional performance against the national performance measures, accessible at Area, Region and national level. Several Regions produce their own more detailed statistics on performance for each of their Area Offices, which include a number of additional performance measures such as the percentage of cases where penalties are levied. National compliance performance at a regional level is compared centrally whereas compliance performance at Area Office level is compared regionally. At present, extracting performance information at Area Office level centrally is done infrequently because the regular collation of data across all Area Offices would be very time-consuming. With the migration of information from the Employer Compliance System to the Data Warehouse in 2004, the Department are considering the business benefits of creating standardised reports of performance data additional to the national performance measures.

Equity of Treatment and Penalty Rates

4.18 The "settlement" stage of a compliance review requires the Department to negotiate and agree with employers any additional tax, accrued interest and penalties due. Penalties are only due on errors made by the employer in the operation of a PAYE system (known as "culpable" tax), and not where the tax liability is deemed to lie with the employees, for example employee benefits. The penalty is not automatic and at a maximum is 100 per cent of the culpable tax owed, but the penalty charged is abated in the light of the extent of cooperation and disclosures made by the employer, and size and gravity of the errors.

4.19 The Large Business Office ensure equity of treatment through supervision, quality monitoring and authorisation of settlements. Their rate of penalties has averaged around 10 per cent of culpable tax over the last four years. Culpable tax collected has increased over the last four years from £12.7m to £17.4m, which could be due to several factors, such as more widespread non-compliance or more effective review processes. The Department have not analysed formally whether penalties provide an incentive for compliance or deterrent against non-compliance. They have however considered their effectiveness in more general terms as part of the continuing development of the Department's compliance strategy. In that context, the Department should pay specific attention to the impact of penalties.

4.20 The Network also have a quality monitoring regime and management review of settlements. Each Area Office and Region is responsible for ensuring equitable treatment of employers. The National Audit Office found there was some inconsistency of treatment of employers across Area Offices. On the basis of indicators such as penalties and additional tax collected, there are significant variations in performance. The percentage of cases where penalties are levied in some Area Offices is more than double the rate in others. Some variations such as additional tax collected can be explained by specific demographic factors in particular Areas, but differences in the percentage of penalty cases cannot be explained. The lack of readily available comparable data between Area Offices nationally, as noted in paragraph 4.17 above, means the extent of differences cannot be fully evaluated at national level.

4.21 The Department are concerned about the consistency of performance across the Network and have started to tackle variations in performance with initiatives to improve knowledge and understanding of penalties and the sharing of best practice. The introduction of the regional Compliance Audit Programme and the extension of quality monitoring to all reviews, may also improve consistency of performance across Regions and Area Offices.

The Planning and Conduct of Compliance Reviews

4.22 Since 1999-00, the Department have made improvements to the planning and conduct of reviews. Standardised working papers record work done, documents reviewed and conclusions reached. More integrated quality monitoring procedures help ensure each stage of the review is undertaken in accordance with defined standards and requirements.

4.23 Until 2003-04, the Large Business Office operated a very limited form of risk assessment. Under the recently introduced more comprehensive system, a proportion of employers are risk-assessed annually, based on cyclical coverage of the customer base. In the future, when the customer bases of the Large Business Office are aligned, all large employers will be risk scored annually. This alignment is already in place for 250 large employers and the Department expects to complete the alignment for all large employers by July 2004. In order to evaluate this and other revised processes, the Large Business Office are recording and monitoring separately data on identified risks and outcomes from compliance reviews.

4.24 The Network are developing a more systems-based approach to reviews, similar to that developed by the Large Business Office. In 2004-05 they plan to have more structured reviews, based on an assessment of the risks in the processes and systems operated by employers. The Network have an established risk assessment process, led by a central risk team who undertake very detailed analysis of employers and compliance review results. They determine the characteristics and types of employer likely to be non-compliant and provide criteria for the selection of 40 per cent of all employer compliance reviews. The Network is also supported by local Risk Intelligence and Analysis Teams providing local risk and intelligence services. Risk Intelligence and Analysis Teams work in partnership with the Network employer compliance teams to ensure reviews are focused on risky employers. In addition, random reviews are undertaken, which act as a deterrent across the employer population and enable better understanding of the nature and extent of non-compliance.

4.25 A great deal of research and analysis has been undertaken by the Network, for example on the effectiveness of random reviews compared to risk-based reviews. The National Audit Office recognise there is an inherent delay between review completion and collection of resulting data, but found that little analysis had yet been undertaken on the different types of employer compliance review. Evaluation of Risk Intelligence and Analysis Teams' selection is particularly important, to ensure consistency of performance across the Network. The National Audit Office also noted that no evaluation of Aspect reviews had been undertaken to date. The Department plan to carry out further evaluations in 2003-04, such as geographical analysis of employers and Aspect reviews.

Opportunities to enhance assurance provided by Employer Compliance

4.26 The Large Business Office and the Network are required to provide assurances to the Chairman and Board of the Inland Revenue that employers are meeting their statutory obligations in correctly operating and collecting PAYE and National Insurance Contributions. Assurances are also given on the operation and administration of Statutory Sick Pay and Statutory Maternity Pay, student loan deductions, tax credits and the Construction Industry Scheme.

4.27 The National Audit Office found that the number of records selected for some of the assurance checks at employers is very small and not based on statistical methods. Hence it is not possible for the Department to extrapolate reliably and to draw quantified and reasonably precise levels of assurance from this work. For example, only three employees are checked for tax credits compliance in a large employer, whilst in the Network at least one employee is checked. With the introduction of new tax credits the Network will increase the number of employees checked to five per employer, in 2003-04.

4.28 The National Audit Office also found that only limited information on the results of these checks was recorded or available to provide readily accessible management information. The Large Business Office report the number of employees tested and volume of errors found. The Network record results on the Employer Compliance System only if the checks led to additional tax collected. They know the number of employers reviewed that pay tax credits, but not the number of employees tested or types of error found. Planned enhancements in 2004 aim to allow more detailed information on testing undertaken and errors found. The limited information held on the results of these checks which can be easily interrogated further reduces the level of evaluation which can be undertaken to provide assurance.

4.29 The National Audit Office looked at checks carried out by the Department on Tax Credits paid via employers. During a review, the following checks for a sample of employees are undertaken:

- whether the employer is paying Tax Credits to employees in accordance with the notification from the Department's Tax Credits Office.
- tax credit start dates and stop/cancellation notices issued by the Tax Credits Office to employers.
- reasonableness of any Departmental pre-funding requested by the employer to help with their cash flow.
- Large Business Office officers are instructed to do a reasonableness check on an individual's Tax Credit entitlement by looking at the employer's records on pay and hours worked and any indications of possible collusion or fraud.

4.30 Employer compliance teams work with other sections of the Department such as the Tax Credits Office, Special Compliance Office and Risk Intelligence and Analysis Teams. Where there is any evidence of possible fraud or collusion, employer compliance teams will refer the case to the Special Compliance Office. Similarly, the Tax Credits Office make referrals to Employer Compliance Investigation Teams, to carry out an Aspect review on tax credits for that employer.

4.31 The National Audit Office believe there is merit in considering further opportunities for the employer compliance and claimant compliance teams to work more closely together on tax credit compliance. At present, employer compliance teams check that the employer complies with Tax Credits Office notifications, whilst claimant compliance officers check entitlement to tax credits. There may be duplication of effort, inefficient use of available information and an inconsistent approach under the current regime of separate testing carried out by different teams. For example, employer compliance teams could check whether hours and pay declared by an employee on a tax credit application form are consistent with the employer's records.

Conclusions

4.32 The Department's employer compliance activities provide assurance that employers are collecting PAYE income tax and National Insurance Contributions correctly. These activities are important to the collection of some £155 billion, or 68 per cent of total revenue. The National Audit Office found no major weaknesses in the systems relating to employer compliance.

4.33 The Department have introduced many new initiatives to target more effectively their compliance resources and to help employers. The Department should develop further their methods to measure the impact of their compliance activities, including enabling activities designed to improve employer compliance.

4.34 Departmental statistics suggest geographical variations in employer compliance performance, such as in the percentage of cases where penalties are levied. The rate of penalties levied for large employers have been applied consistently. The Department need to consider ways in which they can monitor and report more effectively on the equity of treatment of smaller employers and consistency of performance. The Department should also continue to consider the overall effectiveness of the penalty regime.

4.35 Employer Compliance checks on aspects of payroll administration such as tax credits may not be sufficient to provide adequate assurance to the Board and to Parliament on the proper treatment of those items by employers overall. Employer Compliance and tax credit claimant compliance teams, worked separately in 2002-03. Following a National Audit Office suggestion, the Department are to undertake a joint review to consider the opportunities of a more co-ordinated approach to tax credit compliance. They should consider the sufficiency and validity of the current checks and the need for quantifiable assurance on tax credits.

Part 5: Capital Gains Tax

5.1 This part of my report examines arrangements for assessment of Capital Gains Tax. The amount of tax collected is relatively small compared to other tax streams. In 2002-03 £1.6 billion was collected representing some 1 per cent of gross Inland Revenue receipts (excluding National Insurance Contributions). Capital Gains Tax was introduced in 1965 and is chargeable on the disposal of certain assets by individuals, personal representatives and trustees. The main assets incurring a charge on disposal under Capital Gains Tax are shares in companies (70 per cent of total gains) and land and property (23 per cent of total gains) (based on figures for 2000-01 the latest data available).

5.2 The capital gain is the difference between the sale price and allowable expenditure on the asset including the cost of acquisition. This capital gain may be reduced by a number of statutory reliefs and deductions to give the "chargeable" gain. For 2002-03, tax is payable on chargeable gains exceeding a minimum threshold of £7,700 for individuals and £3,850 for Trustees. Companies account for capital gains in a similar manner but the amount chargeable is subject to Corporation Tax rather than Capital Gains Tax.

5.3 Between 1992-93 and 1999-2000 the numbers of taxpaying individuals declaring capital gains on their tax returns increased considerably, from some 60,000 to 186,000 (Figure 13). The amount of gains recorded on asset disposals also increased significantly reflecting movements in company share values over the period. Increases in the value of shares after purchase are traditionally the largest generator of Capital Gains Tax. The latest statistics indicate that the number of taxpayers peaked in 1999-2000, reducing to 179,000 in 2000-01 and 123,000 in 2001-02. The number of Trusts declaring capital gains has increased by a similar proportion but the total number and amounts involved are smaller than for individuals.

Figure 13: Numbers of taxpayers declaring capital gains and amounts involved (estimates)

Year	Individuals			Trusts		
	Number (000)	Gains (£bn)	Tax (£bn)	Number (000)	Gains (£bn)	Tax (£bn)
1992-3	60	1.9	0.5	9	0.3	0.1
1993-4	77	2.7	0.8	12	0.4	0.1
1994-5	64	2.2	0.7	10	0.4	0.1
1995-6	86	3.1	0.9	13	0.8	0.2
1996-7	97	3.9	1.2	20	1.0	0.3
1997-8	142	5.4	1.7	28	1.6	0.4
1998-9	135	6.0	1.9	25	1.0	0.3
1999-0	186	8.8	2.8	29	1.5	0.5
2000-1	179	7.8	2.4	25	1.3	0.4
2001-2	123	4.5	1.3	17	0.8	0.3
2002-3	Detailed figures are not yet available for 2002-03					

Source: Inland Revenue

5.4 The amount of Capital Gains Tax received in 2002-03 was some 44 per cent less than 2001-02. The main reasons for this significant diminution in receipts were the reduction in capital value of companies on the Stock Market and resultant losses rather than gains being made on the disposal of shares.

5.5 For 2001-02, Figure 14 shows the numbers of individual taxpayers and amounts of tax paid stratified by range of gains. Similar results occurred for the two previous years. Of the 123,000 taxpayers liable to Capital Gains Tax, 32 per cent of taxpayers in the lowest range contribute only 1 per cent of the tax yield whilst the top one per cent of taxpayers account for 34 per cent. Analysis of capital gains by the amount of individual taxpayers' income shows that those with an income in excess of £50,000 account for some 49 per cent of all gains.

Figure 14: Analysis of taxpayers (individuals only) by amounts of capital gains made (2001-02)

Range of gain (lower limit in £)	Individuals		Tax paid	
	Number (000)	Percentage	Amount (£m)	Percentage
1	39	32	12	1
10,000	51	42	118	9
25,000	18	15	158	12
50,000	8	6	179	14
100,000	4	3	234	18
250,000	1	1	164	12
500,000	1	1	147	11
1,000,000	-	-	300	23

Source: Inland Revenue

Accountability and Capital Gains Tax management

5.6 Different management areas within the Inland Revenue are collectively accountable for the administration of Capital Gains Tax. The Capital Taxes business stream is responsible for policy advice to Ministers regarding legislative changes and for technical guidance on the operation of the tax including specialist advice to operational staff on difficult issues. The operational work is undertaken by staff in Area Offices and the Complex Personal Return teams. A 'virtual' Capital Gains Tax Board has been formed to provide a single strategic view of the tax stream. The Board provides a forum where those with the main responsibilities for the tax can co-ordinate their actions to achieve Government objectives.

5.7 The Policy Group within Capital Taxes was reviewed recently by Internal Audit who found that the effect of policy changes was not always being evaluated after implementation. Without evaluation it is difficult to assess the effect of changes. Internal Audit recommended that, in future, the effect of policy changes should be monitored. Capital Taxes have accepted this recommendation and are working to improve their evaluation of new policy.

Capital Gains Tax Avoidance

5.8 Tax avoidance is a term used to describe actions taken by taxpayers and their advisors to reduce tax liability by exploiting loopholes in legislation. When the Department identify a capital gains avoidance scheme, it is referred to the Capital Taxes Technical Group for analysis and guidance. The Group is staffed by Capital Gains Tax specialists who undertake complex technical work and act as a centre of expertise for compliance staff. They also liaise with and provide assistance to Departmental teams tasked with combating avoidance schemes. If significant amounts of Capital Gains Tax are being lost due to the use of a scheme which is legally sound, the Technical Group consults with the Policy Group about amending legislation.

Compliance

5.9 Declarations of Capital Gains Tax are made annually on Self Assessment returns and are covered by the same quality procedures. The processing of capital gains information on the returns and any subsequent enquiries follow the procedures for Self Assessment. Cases for enquiry are selected by assessing the risk suggested by the information on returns and identifying cases where misdeclarations may have occurred. Where the value of an asset disposal is in doubt, details are referred to a specialist section within the Inland Revenue for verification of the value used.

5.10 If Inland Revenue enquiry staff suspect that the stated disposal value of an asset is incorrect they refer the details to an area known as “Shares Valuation”, who use internal expertise and specialist information sources to provide an open market valuation on the item in question. Referrals are also made in respect of transactions which will be declared on future returns, usually in response to a query from the taxpayer. If the value cannot be readily calculated from information supplied, or the estimate differs from that shown by the taxpayer, they will negotiate and come to an agreed figure. Most valuations concern the sale of unquoted company shares but the area also covers a wide spectrum of other assets including foreign property, boats, aeroplanes, wine collections, mineral rights and bloodstock. Valuations on UK property are provided by the Valuation Office Agency, property in Northern Ireland is valued by the Valuation and Lands Agency.

5.11 In 2002-03 the Shares Valuation area received a total of 20,943 valuation requests, of which 11,357 were in respect of capital gains by individuals and Trusts resulting in increases to valuations totalling £487million - an average of nearly £43,000 per case. Where the Department considered it necessary to negotiate with the taxpayer, some 36 per cent of the cases resulted in agreed adjustments to the original value.

5.12 The Department have developed considerable expertise in determining which types of asset disposals are most likely to be incorrectly stated by taxpayers. This information is of considerable interest to staff in Area offices who select returns for enquiry. During 2002, Shares Valuation staff initiated a programme of liaison visits with the intention of sharing best practice. By the end of March 2003, most Area offices had been visited and the number of valuations which they queried in relation to capital gains tax had risen by 15 per cent.

New Initiatives

5.13 Staff from the Capital Taxes area and the Department's Service Delivery Support organisation meet regularly and are jointly responsible for a project known as the "Capital Gains Initiative". The objectives of the initiative include:

- improving the understanding of Capital Gains Tax by taxpayers and their advisors;
- improving co-ordination of compliance activities;
- assisting consistency of approach nationally; and
- making more effective use of resources.

5.14 During 2002-03, the Department had:

- commenced the Capital Gains Tax manual revision;
- issued new guidance for area compliance staff;
- provided specialist guidance and training for staff on the new Complex Personal Return teams; and
- introduced targets for initiating Capital Gains related enquiries.

5.15 In 2002-03 the number of adjustments made to taxpayer Capital Gains calculations as a result of enquiry work increased from the previous year by 28 per cent. The total amount of adjustments to declared gains increased by 117 per cent to over £465 million.

5.16 The tax affairs of individuals with high income and/or net worth are generally more complex than other taxpayers. These taxpayers were monitored by the national network of area offices but in February 2000, an internal review team recommended that specialist teams should be formed so that the Department could better manage the tax and provide better customer service to these taxpayers.

5.17 During 2002, "Complex Personal Return" teams were set up throughout the United Kingdom managing the most complex 40,000 Self Assessment taxpayers. The intention is that the teams should accumulate knowledge on the complexities of these taxpayers' arrangements and as a result, improve customer assistance and compliance, and maximise the value of available resources. Internal Audit assisted implementation and have subsequently reviewed the arrangements, giving assurance that the enhanced training and guidance has been effective. The teams were fully operational from April 2003 and the Department will undertake a post implementation review to evaluate the effectiveness of the initiative overall.

5.18 Outside of the Complex Personal Return teams, compliance work on Capital Gains Tax is undertaken by regional Income Tax Self Assessment enquiry staff. In some Areas small specialist teams have been formed to concentrate on Capital Gains Tax. Adjustments to taxpayer returns were significantly higher when Areas used specialist teams. As part of their review of Capital Gains Tax, Internal Audit have recommended, and the National Audit Office support, that the use of such teams should be encouraged.

Performance and Management Information Systems

5.19 Performance measures for Capital Gains Tax do not contribute directly towards the Department's Service Delivery Agreement targets. They are, however, used by management to monitor effectiveness and efficiency of the administration of the tax stream. The management information available to staff engaged on Capital Gains Tax work is currently not as extensive as it could be.

5.20 Taxpayers are required to submit detailed information on transactions relevant to the tax on their Self Assessment forms but the Department do not record all of this information. Internal Audit's recent review recommended improvements to the system to increase the amount of information available to staff engaged on Capital Gains work. Inland Revenue staff are currently studying options for improvement.

5.21 The Department do not believe that a reliable estimate of the amount of capital gains which taxpayers do not declare could be prepared, because of the absence of an independent measure of total liability and the difficulties in gathering enough pertinent data. Instead they target compliance effort using an approach based on risk assessment. The absence of such an estimate may constrain the Department's ability to assess the effectiveness of capital gains compliance.

Conclusions

5.22 Capital Gains Tax contributed £ 1.6 billion – around one per cent of the total taxes collected by the Inland Revenue in 2002-03. Some 32 per cent of Capital Gains Tax payers provided just one per cent of that collected, whilst one per cent of taxpayers contributed some 34 per cent. Recent initiatives to enhance the effectiveness of the Capital Gains Tax systems include the creation of teams specialising in Complex Personal Returns and, in some geographical areas, small specialist teams. The Department are undertaking internal reviews to improve the information available to management to help them target resources to best effect.

5.23 The Department are developing their research into areas of non-compliance but do not consider it practicable to measure the tax gap specifically attributable to Capital Gains Tax. Most Capital Gains Tax arises from taxpayers with high net income or high worth and so it is likely that non-compliance on the part of those taxpayers covered by Complex Personal Returns teams would have the biggest impact on the Capital Gains Tax yield. The Department should ensure that their research explores as fully as possible the scope for detecting, estimating and minimising non-compliance with Capital Gains Tax obligations in this particular customer group.

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