Comptroller and Auditor General's Standard Report 2003-04

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

John Bourn
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 No tax collection system can ensure that all those who have a tax liability 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. The National Audit Office's work in 2003-04 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 subject to the following reservations:

- those I have recorded about tax credit error;
- other specific matters in this report.

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 2.24 - 2.26). I gave an unqualified audit 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 November 2003, I have reported on External Fraud against the Inland Revenue (HC 429), on the Strategic Transfer of the Estate to the Private Sector - STEPS – project (HC 530), and on the Recovery of Debt by the Inland Revenue (HC 363).

5 This report records audit observations on Tax Credits and Stamp Duty Land Tax. The main points arising from these examinations were as follows.

Child and Working Tax Credits

6 I concluded in my report on last year's Inland Revenue accounts that the new Tax Credits represented a major challenge for the Department, and the level of problems caused to claimants and employers as the system went live in April 2003 demonstrated that there were undetected gaps in the design of the testing regime for the system. I noted that the Department's consideration with EDS – its then IT service provider - of the underlying technical problems had to have regard to the discussions between them about compensation for the unsatisfactory performance of the new Tax Credit system, and the possibility of legal action. Those discussions were still continuing in November 2003 at the time of my report for that year and the Department then hoped to resolve them shortly.

7 The Department had not resolved the discussions on compensation when I concluded this year's report. The Department and EDS told me that a structured process of confidential discussions on these matters was continuing as I concluded this report. In order not to prejudice their discussions I have not examined these matters further.

8 In planning the major annual exercise to renew Tax Credit awards, which took place mainly from April to September 2004, the Department aimed to address the lessons learned from the system problems of the previous year. The extent of its success in that renewal process and in avoiding significant problems, will be seen fully only later in 2004-05 when the renewals process is finished and reviewed.

9 The new Tax Credits have proved relatively easy for people to access but many have found it difficult to understand exactly how much they are due - a problem made worse for those who have been paid the wrong amounts. The administration of the new Tax Credits has proved complex in parts, reflecting the underlying design of the new Tax Credits and the desire to provide support that is responsive and tailored to a wide range of circumstances.

10 I qualified my audit opinion on the Department's Trust Statement account for 2002-03, in respect of Working Families' and Disabled Person's Tax Credit payments, as a Departmental exercise had estimated that overpayments resulting from claimant error and fraud amounted to 10–14 percent by value. The Department told the Committee of Public Accounts that error rates under the new Tax Credits might be half of those under the previous Tax Credit schemes. They have not yet estimated the level of financial error on the new Tax Credits and so I have no evidence that error has yet been reduced significantly to enable me to give an unqualified audit opinion. I have therefore qualified my audit opinion on the 2003-04 Trust Statement account in respect of the new Tax Credit payments.

11 The Department plans to test Tax Credit claims and to quantify the financial implications of claimant error and fraud. They expect a result in respect of 2003-04 to be available by July 2005 in time to inform the Accounting Officer when considering the accounts for 2004-05. The Department could undertake work earlier than that so as to have a broad indicator of those levels. In 2003-04 the Department undertook an exercise on the 2003-04 provisional Tax Credits awards which helped inform their understanding of claimant error and fraud and the strategies for tackling them. The Department, however, was not able to draw reliable quantified estimates from this exercise.

12 Some essential controls over the new Tax Credits did not work in 2003-04, including the daily reconciliation of payments authorised with payments made, which was planned as a fundamental daily check on processing. The Department retrospectively completed reconciliations for 2003-04 in September 2004 and this work has resulted in the correction of a significant number of claimants records. The Department plan to introduce fully automated daily reconciliations in the second half of 2005.

13 The Department had to move staff from other tax work to help when the new Tax Credits system problems arose in the first half of 2003-04. It plans to recover fully from the impact of the initial Tax Credits problems by the end of 2004-05. It will need to ensure that the recovery plans are not frustrated by further extensions of the new Tax Credit IT systems. Business as usual collecting taxes must not be allowed to suffer and the Department must ensure that their responses to system problems do not undermine their reputation for integrity of processing taxpayers' affairs.

Stamp Duty Land Tax

14 The Department modernised stamp duty on land and buildings with the introduction of Stamp Duty Land Tax on 1 December 2003. New legislation, together with regulations and consequent administrative procedures and checks, sought to minimise recognised stamp duty tax avoidance. These measures, however, did not fully close all the known tax avoidance opportunities.

15 There was a tight timetable for consultation, legislation and system development for Stamp Duty Land Tax. The Department properly recognised six months before the implementation date of 1 December 2003 the need to develop rapidly and deploy manual contingency arrangements, while a fully automated system continued to be developed, tested and delivered. The Department considered that deferring delivery of the automated system was necessary to meet the overall timetable. The new tax was implemented without the introduction of an automated system and the success of the interim, manual arrangements is a credit to those involved. Government departments have experienced previous problems with tight IT project timetables and there would have been advantages had the Department been able to introduce the IT system to the original timetable. There are lessons to be learnt from tight timetables which need to be allowed for when planning future projects.

16 The Department is developing IT systems to remedy the limitations in procedures and controls during manual running. During that period some compliance work was undertaken to a lower level than planned and the Department plans to introduce a more comprehensive approach. This will only be fully effective once the IT systems are in place. The Department need to remedy the current limitations and ensure that this work is undertaken comprehensively for the future.

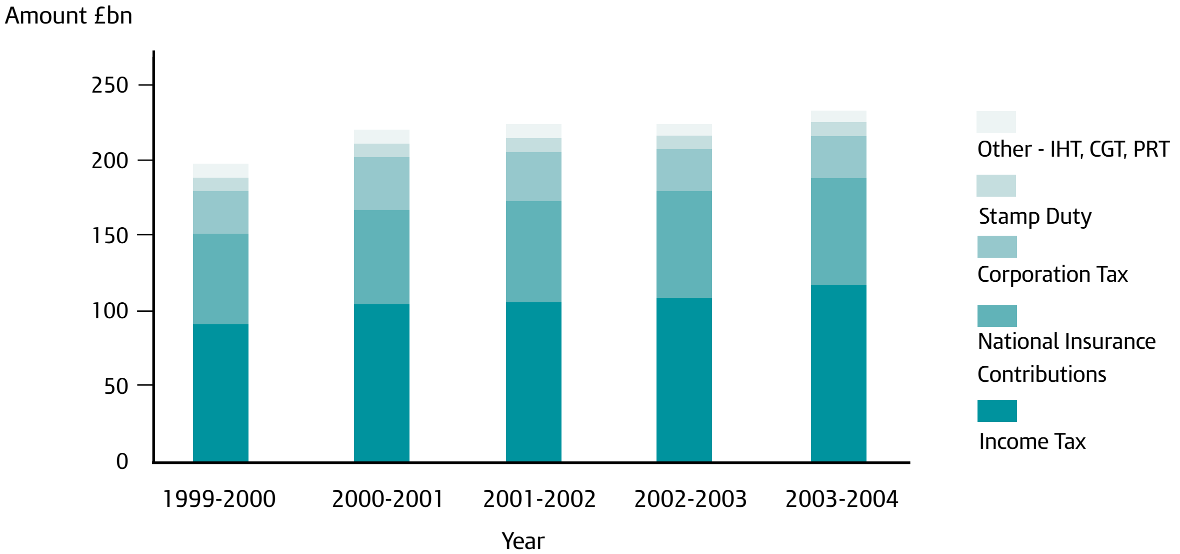
17 The Department has found difficulties in an important area where it had hoped to reduce avoidance, because EU law limits its ability to take action. The Department should continue to review the tax revenues still at risk even though they have introduced these new arrangements and identify new ways of countering avoidance of Stamp Duty.

Part 1: Scope of the Audit and Recent Developments

1.1 Section 2 of the Exchequer and Audit Departments Act 1921 requires me to examine the accounts of the Inland Revenue on behalf of the House of Commons 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 the sums brought to account; and to report the results to the House of Commons.

1.2 In 2003-04 the Department collected some £230 billion. Figures 1 and 2 show the trends in collections from 1999-2000 to 2003-04. The receipts from Income Tax, National Insurance, Petroleum Revenue Tax and Inheritance Tax have increased in 2003-04 whilst receipts from Corporation Tax have decreased in absolute terms and as a proportion of total revenue. The Government projects that the trend of declining corporation tax receipts will be reversed in 2004-05 and forecasts an increase to £34.8bn in 2004-05, in line with their projections of increases in company profits. Receipts from Stamp Taxes are similar to 2002-03.

FIGURE 1: Inland Revenue main Tax and National Insurance Receipts



Source: Inland Revenue accounts

FIGURE 2:- Tax and National Insurance receipts (net of repayments) and Tax Credit payments

	1999-2000 £bn	2000-01 £bn	2001-02 £bn	2002-03 £bn	2003-04 £bn
Income Tax (Gross of tax credits)	94.0	106.0	108.7	110.3	118.0
National Insurance Contributions	58.4	62.7	65.3	67.4	75.2
Corporation Tax	34.4	32.4	32.0	29.1	27.9
Stamp Taxes	6.9	8.2	7.0	7.5	7.5
Inheritance Tax	2.0	2.2	2.4	2.4	2.5
Capital Gains Tax	2.1	3.2	3.0	1.6	2.2
Petroleum Revenue Tax	0.9	1.5	1.3	1.0	1.2
Total receipts	**198.7**	**216.2**	**219.7**	**219.3**	**234.5**
Tax Credit payments	-1.1	-4.6	-5.7	-6.4	-13.5

Source: Inland Revenue accounts

1.3 Stamp Duty Land Tax is discussed in Part 3 of this report. Petroleum Revenue Tax, Inheritance Tax and Capital Gains Tax remain small revenue streams in comparison with Income Tax and Corporation Tax.

Audit Approach and Coverage

1.4 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, including accountability; corporate governance procedures; quality assurance procedures; risk analysis of the tax or business stream; and the Department's identification of obstacles to the assessment and collection of the management information on the tax or business stream.

1.5 The National Audit Office also review Departmental progress in response to recommendations for business and tax streams arising from my reports, those of the Committee of Public Accounts and the National Audit Office's work in previous years. Figure 3 summarises the main work of the National Audit Office in 2003-04. The results of my 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.

FIGURE 3: National Audit Office coverage 2003-04

	Areas Examined
Working Families and Disabled Person's Tax Credit	Closure of these schemes
Child Tax Credits and Working Tax Credit	See Part 2 of this Report Introduction of the schemes Payment and compliance arrangements
Stamp Duty Land Tax	See Part 3 of this Report Introduction of the duty from December 2003 Payment and compliance arrangements
National Minimum Wage	Review of the Department's procedures
Corporation Tax	Review of certain developments
Money Laundering	Review of the Department's procedures
Tax write-offs, Remissions and Standovers	Review of the Department's procedures and reporting
Corporate Governance and Information technology	Examination of the Department's internal controls, including the further development of governance arrangements and the management of information available to support the Accounting Officer's Statement on Internal Control. Management of IT related risks
Management Information	Review of progress with the Department's Performance and Management Information Strategy.
Thresholds and Allowances	Review of aspects of the Departmental procedures for setting thresholds and allowances

Source: National Audit Office

Changed IT Services Partner

1.6 Information Technology (IT) is essential to the administration of taxes and most Departmental IT services are operated by private sector IT service providers. During 2003-04 the Inland Revenue concluded its procurement exercise, ASPIRE, to establish a new technology contract and from 1 July 2004 Capgemini replaced EDS as the Department's primary supplier of IT services. The Department's contract with Accenture for IT support for National Insurance systems will be rolled into the ASPIRE contract in early 2005. The ASPIRE contract was awarded initially for 10 years and the immediate challenge was to ensure a smooth and successful transition. The Inland Revenue formed a senior team to oversee and assist with this transition to ensure that current systems and ongoing projects were not jeopardised.

Review of the Inland Revenue and HM Customs & Excise

1.7 In July 2003 the Chancellor of the Exchequer announced a major review of the organisations dealing with tax policy and administration: HM Customs and Excise, the Inland Revenue and HM Treasury. The report of the review - the Review of the Revenue Departments (the O'Donnell review) - was published in March 2004. It recommended that a new customer-focused tax service should be established, integrating the Inland Revenue and HM Customs and Excise, tasked with improving customer services, reducing compliance costs, improving compliance with tax law and increasing efficiency. HM Treasury will strengthen its responsibility for tax policy, with support from the new department. The Review's recommendations were strategic rather than a detailed blueprint for implementation.

1.8 The main recommendations of the report directly relevant to my work were that management should:

- structure the new department as far as possible around customers and functions rather than taxes, so that customer needs can be better met and compliance improved, for example by establishing an integrated large business office, and more specialised service to small businesses;
- develop a better focused PSA target on customer service and compliance costs, supported by work to develop understanding of compliance costs;
- develop a better focused PSA target on compliance across the tax stream, supported by work to develop understanding of the tax gap and other compliance measures;
- look to identify economies of scale and scope by developing new national services, and reviewing the local office network, including with other departments; and
- establish a unified information strategy, with strong information governance arrangements and a joint knowledge centre, as part of a re-engineering of business processes.

And that:

- the Treasury should have lead responsibility and accountability for tax policy and the new department should lead on policy maintenance; and
- a Framework Document should be published setting out who is accountable to whom and for what, in the new department.

1.9 The report noted that the Departments were currently engaged in significant developments that entailed risks. It acknowledged that integrating the Departments to form the new department and implementing the recommendations might cause problems for revenue collection in the short term as a result of disrupted priorities; resources focussed on change rather than delivery; customer confusion; and poor change management. Organisational changes might cause a reduction in revenues as the effectiveness of compliance activity might be impaired in the short term and there might be a reduction in deterrence. The review report said that vigilance would, obviously, need to be maintained and that the risks to revenue could be mitigated through good planning and management. Legislation setting up the new Department is expected in 2005.

Compliance and Enforcement Initiatives

1.10 As announced in the Chancellor's Budget 2004, the Department has introduced a new compliance package for direct tax and National Insurance Contributions. The Inland Revenue estimates for the purposes of the fiscal projections of the additional revenue were that the proposals should generate an additional £3,840 million over the five years to 2008-09. The package provided for additional resources to invest in a new performance and management information system which was intended to enhance and better manage the information needed for compliance work. Around two thirds of the revenue impact would depend on this system. The package would also provide for an increase in staff capacity in areas that posed particular compliance risks.

1.11 The package focused on improving compliance through:

- better use of management information to improve both the targeting and effectiveness of corporation tax and other enquiry work in the Large Business Office and the Inland Revenue network offices;
- measures to raise awareness of tax obligations, including a publicity campaign and new forms of contact with taxpayers;
- measures to identify those liable to tax who hide some or all of their sources of income from the Inland Revenue, and to work closely with them to help them become and remain compliant; and
- expanding specialist teams in specific high-risk areas such as taxpayers with complex personal tax affairs.

1.12 The Inland Revenue put in place arrangements to monitor and evaluate the new package and will also monitor the action by operational management intended to realise the estimated benefits. Given the importance of the contribution of the performance and management information system to the package of measures as a whole, I noted that it was important that the Inland Revenue succeed in their plans to convert time freed up by the system into increased effectiveness in handling tax cases and higher tax yield.

The Construction Industry Scheme

1.13 In my report on the Inland Revenue accounts last year, I recorded the Department's preparations for and consultation on the planned introduction of a new Construction Industry Scheme for the tax year 2005-06. In December 2003, the Chancellor announced that it would be introduced a year later, for April 2006. The National Audit Office will continue to monitor progress in developing and implementing the Department's proposals.

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

1.14 In April 2003, the Government introduced Child Tax Credit and Working Tax Credit to replace Working Families' Tax Credits and Disabled Person's Tax Credits. These former Tax Credits were seen as interim steps pending the introduction of the new Tax Credits. The Department paid out only some £18 million in the period from April 2003 to October 2003 in relation to backdated claims on the former tax credits. The Department is winding down the IT systems used to support the former Tax Credits, but will not fully decommission the system until April 2005 in order to provide support for any ongoing work e.g. appeals.

1.15 In my 2003 report, I commented on the extent of applicant non-compliance with Working Families and Disabled Person's Tax Credits and I 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. I discuss the introduction of the new Tax Credits in more detail in Part 2 and my conclusion that I have had again to qualify my audit opinion in respect of tax credits.

Deleted taxpayer records

1.16 The Department became aware in the autumn of 2003 that a well established and accepted housekeeping routine on the PAYE computer databases had for a number of years deleted some records before the usual final review to check whether any tax remains overpaid or underpaid for the relevant year. This means that some customers will not have received the repayment to which they may have been entitled and others may owe tax which has not been collected. As the records have been deleted there is no way of identifying those whose records were open when the process was run. This routine has been corrected. The Department is carrying out further work to establish the full effect, including a statistically valid sample exercise to determine the average level of repayment due. It will then decide how best to deal with the problem.

Part 2: Child and Working Tax Credits

2.1 The Government introduced Child Tax Credit and Working Tax Credit (the new Tax Credits) in April 2003 as part of the reforms of the tax and benefit systems aimed at relieving child and in-work poverty. They are designed to tailor support to families' specific circumstances, and to respond to their changing needs, providing most support when their need is greatest. They replaced the Working Families' and Disabled Person's Tax Credits which were introduced in October 1999, and the Children's Tax Credit. This part of my report examines the first full year of payment of the new Tax Credits and the implications of system problems in 2002 and 2003.

2.2 The Department estimated that 6 million families would benefit from one or both of the new Tax Credits during 2003-04 (5.75 million families would benefit from Child Tax Credit, including families getting the support for their children through their benefits and 1.35 million families would benefit from Working Tax Credit, with some families benefiting from both). The Department estimates that the annual cost of Tax Credits to the Government is £16 billion. The Department paid £13.5 billion in Tax Credits in 2003/04 with the remaining expenditure incurred by the Department for Work and Pensions. From April 2004, families in receipt of Income Support and Job Seeker's Allowance began to receive Child Tax Credit instead of receiving the child premia in their benefits. The administrative cost to the Inland Revenue of Tax Credits in 2003-04 was £406 million, and involved around 7,300 staff.

Child Tax Credit and Working Tax Credit

2.3 Claimants apply for Tax Credits by completing a claim form. The Department verifies information shown on claims, conducting routine and risk based checks, making more detailed examinations where they think claims are incorrect (either before payment or afterwards), and arranging payments to eligible claimants. The main features of the Working Tax Credit and Child Tax Credit are summarised in figures 4 and 5 below. A Tax Credit award runs until the end of the tax year, unless the claimant ceases to be eligible before then. Awards can be adjusted during the year to take account of changes in circumstances. Claimants must notify certain changes in circumstances to the Inland Revenue within three months, for example significant reductions in childcare costs or those changes that bring an award to an end. Other changes, for example, an expected change in household income, do not have to be reported during the year, although the Department encourages claimants to report changes likely to affect their award to keep awards in-line with entitlement. Any increase in entitlement can be backdated for up to three months. Any reduction in entitlement is backdated to the date when the change in circumstances occurred.

Adjusting Tax Credit awards and accounting for payments

2.4 After the end of the 2003-04 tax year the Department asked claimants to review their circumstances for the year on which their award was based, to notify the Department of any changes if necessary and to report their income for that year. The Department then finalised the 2003-04 award, recalculating it in the light of the circumstances and income for the year and making any adjustments necessary to the 2003-04 award and to future payments. This process is similar to the treatment of tax returns in as much as entitlement is finalised after the end of the tax year. Tax Credit underpayments for 2003-04 have been paid as a lump sum, whilst overpayments are being recovered from future awards, if possible, or directly from claimants, subject to the Department's wider procedures. Hence, Tax Credits awards made during 2003-04 were provisional until finalised after the year-end. The Department shows in its Trust Statement account for 2003-04 the amount of cash paid to claimants during the year, based on the provisional awards made. The total of final, adjusted awards cannot be known until much later in the cycle. As 2003-04 was the first year of the new Tax Credits, there was no track record of previous years on which to estimate the likely level of adjustments that would be necessary.

FIGURE 4: Main Features of Child Tax Credit
Child Tax Credit

Available to those aged 16 or over, ordinarily resident and present in the UK whether working or not, and who are responsible for at least one child.

Normally paid directly into the bank account of the main carer

Elements	2003-2004 Annual Rates	2004-2005 Annual Rates
Family Element (one per family)	£545	£545
Higher Family Element (in first year of child's life)	£545	£545
Child Element (for each child)	£1,445	£1,625
Disability Element (for each disabled child)	£2,155	£2,215
Severe Disability Element (for each severely disabled child)	£865	£890

The Family Element is reduced by 6.67p for every £1 of income over £50,000, in most cases.

For families entitled to only Child Tax Credit, the Child Element is reduced by 37p for every £1 of income over a limit of £13,230 (£13,480 for 2004-05). For families entitled to both Child Tax Credit and Working Tax Credit, the child element is withdrawn at that rate after Working Tax Credit has been fully withdrawn.

Source: National Audit Office

FIGURE 5: Main Features of Working Tax Credit
Working Tax Credit

Available to 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 if the claimant is an employee, otherwise paid direct to claimants such as the self-employed. The childcare element is paid direct to the main carer

Elements	2003-2004 Annual Rates	2004-2005 Annual Rates
Basic Element	£1,525	£1,570
Second adult and Lone Parent Element	£1,500	£1,545
30 Hour Element	£620	£640
Disabled Worker Element	£2,040	£2,100
Severe Disability Element	£865	£890
Element for claimants aged 50 and above, working 16-29 Hours	£1,045	£1,075
Element for claimants aged 50 and above, working 30+ Hours	£1,565	£1,610
Childcare Element - childcare costs cannot exceed £135 per week for one child and £200 per week for two or more children	70 % of costs	70 % of costs

A claim is reduced by 37p for every £1 of annual income over a limit of £5,060 (£5,060 2003-2004).

Source: National Audit Office

Introduction of the schemes

2.5 The Department started to distribute claim forms for the new Tax Credits in August 2002 and commenced payment in April 2003. The Government intended that Child Tax Credit payments and payments of the childcare element of Working Tax Credit would generally be made directly into claimants' bank accounts. However, large volumes of giro cheque payments were made to claimants where bank account details were missing or misstated on claim forms, and where claimants had not received expected payments due to problems with the IT system supporting the new Tax Credits.

2.6 When the claimant is an employee the elements of Working Tax Credit apart from childcare are paid via the employer. However, the Chancellor of the Exchequer announced in the 2004 Budget that this method of payment was to be phased out and replaced by direct payment by the Inland Revenue. One of the original objectives of making payments via employer was to reinforce the principle that tax credits were a reward for work. The Government has since accepted, in principle, that the benefits to business justify moving to payment direct to claimants. The intention was to reduce the cost of payroll administration, which had been a concern raised by employers. The seventh 2003-04 report from the Treasury Select Committee on the Administrative Costs of Tax Compliance estimated that this change would reduce the compliance costs for business by around £90 million a year. Consultation with employers groups about the arrangements for withdrawal of payments via employers is continuing.

System problems at the start of the new Tax Credits

2.7 My Standard Report for 2002-03 highlighted serious problems during the introduction of the new Tax Credits systems affecting stability, speed, and availability, which delayed the processing of claims. Claimants encountered problems, including delays in receiving award notices and payments. The telephone helpline was overloaded during the first few months of the new Tax Credits, however its performance improved over the remainder of the year. It took longer to process claims and changes of circumstances and the Department transferred staff from other work to help clear the backlog and to deal with the increased number of queries.

2.8 The Department engaged technical consultants in July 2003, following the problems experienced with the introduction of the new Tax Credits IT system, to assess its technical robustness and resilience and to make recommendations to help reduce the risks of similar problems as the system was further developed. EDS had already taken forward work to remedy some of the weaknesses by the time the consultants reported in October 2003.

Compensation from EDS for unsatisfactory system performance

2.9 As mentioned in my report last year, 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. The Department and EDS told me that a structured process of confidential discussions on these matters was continuing as I concluded this report. In order not to prejudice their discussions I have not examined these matters further.

Overpayments and Write-offs

2.10 The Department wrote to the Chairman of the Public Accounts Committee in March 2004 advising that in April and May 2003 a software error caused the system to generate incorrect payments resulting in overpayment of Tax Credits to some 455,000 households, amounting to some £94 million. Of this amount, the Department are to write-off overpayments individually less than a threshold of £300, affecting some 373,000 households and worth some £37 million. They are seeking recovery of larger amounts from some 82,000 households, amounting to £57 million.

2.11 The Department set the recovery threshold following extensive mathematical modelling of the likely costs of handling enquiries, recovery action, appeals, payments in cases where hardship could be argued, and complaints. These costs were balanced against estimated recoverable amounts and write-offs. The Department currently estimate their administrative costs of dealing with this system problem at around £10 million.

2.12 Of the possible recoverable amount, the Department expect further write-offs of £8 million to £ 14 million as some recipients could claim successfully that the overpayment was the result of official error (a mistake by the Department where the recipient could reasonably have thought that the payment was right). These cases are to be decided on an individual basis. For claimants still receiving Tax Credits, recovery will generally be made by deduction from the ongoing awards typically over one year and often over two years. The reduction will be by no more than 25% for claimants entitled to more than the family element of Child Tax Credits and no more than 10% if they are entitled to the maximum award. This is to avoid claimants being placed into hardship.

2.13 The Department reported to Parliament the £37 million written-off and provision for future write-offs in notes in their 2003-04 Trust Statement account. Final amounts of actual write-offs will be recorded in the accounts for 2004-05. Figure 6 sets out the currently estimated figures and costs, including those reported in the notes to the 2003-04 Trust Statement. The Department is continuing work to refine these estimates. The Department's policy for recovery of overpayments is set out in "Code of Practice 26: What happens if we have paid you too much tax credit." The relevant extracts are in Annex 1 to this Report.

FIGURE 6: Overpayments of the new Tax Credits

	Number of cases	**Value**
Overpayments	455,000	£94m
Written off cases below £300	373,000	£37m
Administrative costs	-	£10m
Cases where recovery sought	82,000	£57m
Further write-off on Official Error grounds	-	£8m-£14m
Total cost	**-**	**£55m-£61m**

Source: Inland Revenue

Interim payments

2.14 At the beginning of 2003-04, to help respond to the system problems, the Department made interim payments by giro cheque in order to prevent hardship when claimants had not received Tax Credit payments. Claimants could be paid up to five weeks' worth of Tax Credit at their local office if they had not received a payment or their claim had not been processed. In addition, the Department made interim payments in a number of other circumstances throughout the year, including situations where the normal payment mechanisms had broken down and payment did not reach individuals. They also made additional tax credits payments to prevent hardship where payments had been reduced following the adjustment of an award; the effect of these payments is that only part of an expected overpayment is recovered by the end of the year leaving the balance to be recovered in the following year. In total, the Department estimates that it made approximately 500,000 interim Giro payments with a value of £170m and that of these, around 65,000 payments with a value of £20m were made to prevent hardship following reduction of an award.

Compensation to Claimants

2.15 The Department deals with claimants who have encountered problems with their Tax Credits claims and who complain under the Code of Practice used for all complaints cases, Code of Practice 1: Putting things right. By the end of March 2004 of 32,000 complaints made, the Department had dealt with 27,500 cases and authorised compensation in 10,800 of these, totalling £370,000, an average of £34.

2.16 The fourteenth 2003-04 report from the Committee of Public Accounts on the New Tax Credits (published 22 April 2004) noted that the Department viewed their compensation arrangements for claimants as being voluntary and spontaneous. The Committee recommended that if the number compensated this way proved to be unrealistically low, the Department should draw attention to compensation available for claimants who were likely to have been most disadvantaged. The Department noted that they have measures in place to monitor compensation arrangements where claimants did not receive the service they were entitled to expect and will continue to monitor the position as claimants' awards for last year are finalised.

Controls over Processing and Error Rates

2.17 In my last report I noted that the Department had not successfully performed the planned daily reconciliations of payments authorised against payments made due to the problems experienced at the introduction of the new Tax Credits. Reconciliation work on payments from April to early December 2003 resulted in corrections of a significant number of computer records in January and March 2004. Corresponding reconciliation work on payments from December to March 2004 was completed in September 2004 and the Department planned to correct the few computer records affected in October 2004 so as not to coincide with other system developments. For 2004-05, the Department introduced revised reconciliation arrangements in August 2004. The Department plan to introduce fully automated reconciliations in the second half of 2005.

2.18 The system problems experienced during the launch of the new Tax Credits and the volume of incorrect payments discovered raises concerns about the accuracy of the Department's initial information held about claimants. The Department made checks on the accuracy of the processing of claims and changes of circumstances in 2003/04 as part of their Public Service Agreement targets. As highlighted in Figure 7, results show that the accuracy of processing the new tax credits claims in 2003-04 was lower than under the Working Families and Disabled Persons Tax Credits and did not meet the Departments' Public Service Agreement target.

FIGURE 7: Accuracy of processing and calculating awards

	2000-01 %	2001-02 %	2002-03 %	2003-04 %
Target Accuracy	92	92	93	90
Working Families Tax Credit	93.7	87.1	85.2	n/a
Disabled Persons Tax Credit	98.0	95.0	90.9	n/a
The new Tax Credits	n/a	n/a	n/a	78.6

Source: Inland Revenue

2.19 The Public Services Agreement target for processing accuracy remains at 90% for 2004/05. The Department informed me that it aims to meet this target and that it is taking a number of steps to improve its performance.

- The Department has set up a dedicated team to identify and resolve issues that affect processing accuracy.
- Internal guidance and procedures have been revised, based on experience from the first year of the new Tax Credits.
- The Department now includes controlled testing of any new processing procedures as the system is extended and new functions are added.
- A number of system problems identified by the checks have been rectified.

Claimant and Employer Compliance with Obligations and Fraud Estimates

2.20 In addition to the risks from incorrectly processing claims and calculating awards, the Department needs to manage the risks of claimant and employer non compliance with tax credit obligations. The Department carries out continuous compliance checks throughout the claims process, including:

- verification of information shown in all tax credits claims and changes of circumstances before any payment is made;
- automated risk assessment of all claims and changes of circumstances before any payment is made, with in-depth investigation of selected claims and changes of circumstances where the Department considers that they may be incorrect;
- further risk assessment post-award, with in-depth investigation of selected awards
  - during the course of the year where it is discovered that they may be incorrect
  - after the year-end when they have been finalised, both where it is discovered that they may be incorrect and on a random basis.

2.21 During 2003-04 the Department had two main compliance investigation targets on high risk claims: 1500 pre-award examinations and 100,000 post award examinations. The Department met both these targets and the results of this work detected that excess tax credits of £66.7 million had been paid out, based on the information available at that time. The Department have adjusted awards to correct the claimant's error, but the money is not recoverable directly because the amount of the overpayment cannot be finalised before the year end and the figure may be amended as a result of later changes. The Department did not design this work to provide any quantification of the likely level of fraud or financial overpayments and underpayments as a result of compliance failures.

2.22 As the Department increased its knowledge about the new Tax Credits claimants, certain routine based checks were relaxed where the Department considered that the risks of improper payment were outweighed by delays in completing these checks. The Department has subsequently found that a small number of incorrect payments were made as a result of relaxing these checks, although the Department did not maintain records of the value of these in all cases.

2.23 The amount of Tax Credit expenditure paid via employers shown by the Department in their Trust Statement Account is based on awards made by the Department. The Department could only know that these amounts were actually paid out to claimants by checking that employers made payments in accordance with the instructions issued by the Department. The Department sought to obtain assurance by reconciling a sample of amounts reported as paid by employers to the Departmental record of awards. The work is continuing at the time of my report and early indications are that the reconciliation rate is around 80% in terms of the number of cases. Estimates of the overall financial errors are very much less significant and contain appreciable uncertainty because the work is continuing. Given that this is the first reconciliation exercise for the new Tax Credits, and the transitional state and early problems of the new Tax Credits for 2003/04 - the first year for both employers and staff - the Department believe the reconciliation rate is reasonable. Final results for this exercise will be available later in 2004 and the Department and the National Audit Office will consider them further at that time. They will also examine at that time estimates of the overall financial value of the overpayments and underpayments by employers, and any case for further work by the Department.

Qualified audit opinion

2.24 I qualified my audit opinion on the Trust Statement account for 2002-03 in respect of payments of Working Families' and Disabled Person's Tax Credits. This was because a Departmental exercise in 2000-01 had indicated that they had overpaid some 10-14 per cent by value, representing £510 to £710 million overpaid for a full year because of claimant error or fraud.

2.25 Payments of new Tax Credits during 2003-04 were provisional until awards were finalised during the renewals process planned to be completed mainly from April to September 2004. Only after claimants have confirmed their circumstances and their awards are finalised is it possible for the Department to undertake work to determine finally the level of claimant error and fraud. The Department has plans for a programme of work to provide more information on the level of claimant error and fraud in respect of 2003-04 by July 2005 in time to inform the Accounting Officer when considering the accounts for 2004-05. The Department could undertake earlier work than that so as to have a broad indicator of those levels. In 2003-04 the Department undertook an exercise on the 2003-04 provisional Tax Credit awards which helped to inform the Department's understanding of claimant error and fraud and the strategies for tackling them. The Department, however, was not able to draw reliable quantified estimates from this exercise.

2.26 The nature of the new Tax Credits, for example the fact that they are based on annual income for a tax year, enables cross-checking of income provided by claimants with other data sources maintained by the Department. In addition, the design of the new Tax Credits system provides for a number of automatic risk and verification checks on claims which were not present in the former Tax Credits systems. The Department told the Committee of Public Accounts in December 2003 that the checks inherent in the new systems should reduce the levels of claimant error and fraud. The Department said they would be disappointed if the move to the new Tax Credits meant that there were not an immediate halving of error rates and a subsequent constant improvement. Whilst recognising that the design of the new Tax Credits and supporting systems should result in sizeable reductions in error and fraud, no reduction can be demonstrated until the Department have done the work they plan. I have therefore concluded that the probable level of error in 2003-04 remained unacceptably high leading me to qualify my audit opinion on the Trust Statement account in respect of Tax Credit payments.

Further Development of the Tax Credits systems

2.27 The Department planned a number of major stages to the delivery of the Tax Credits systems to support new functions. Each major delivery of new software (including changes to existing software) is known as a "Release". Releases 1 and 2 allowed claims, awards and payments to be processed and figure 8 sets out the timetable and main content for each subsequent Release, which continue to pose further significant challenges. There may also be further releases of system enhancements thereafter.

FIGURE 8: Timetable and content of Tax Credits system releases

	Main content	Delivery date
Release Three Planned for Nov 2003	• Preparation of the awards renewals process • Support for the Department's Compliance Activity • Additional support for Employer Funding • Changes to accounting reports • Provision for Management Information Systems	• Nov 03 • Jan 04 • Nov 03 • Nov 03 • Part delivered Jan 04
Release Four- (awards renewal) April 2004	• Main system to support the finalisation and renewal of awards	• Apr 04
Release Five October/November 2004	• Remaining elements of the system to complete the renewals process • Additional support for transfer to Tax Credits of those receiving the child elements of Income Support and Job Seekers' Allowance (Department of Work and Pensions schemes)	
Release Six April 2005	• Additional support needed for debt recovery • Improvements in accounting arrangements for giro payments • System to support payment of Child Trust Funds	

Source: Inland Revenue

2.28 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. They carried out two Gateway reviews since the new Tax Credits went live for payments in April 2003. The first review (Review 4a) was carried out prior to the implementation of Release 3 in November 2003. It made a number of recommendations, including the need to complete detailed planning for Release 3. The review also noted that the Department faced issues in acting as an intelligent customer. It recommended a review of whether current expertise was too thinly stretched to provide an appropriate challenge and assurance on IT work undertaken by the supplier. The second review (Review 4b) was carried out prior to the implementation of Release 4 in April 2004. It found that several recommendations were outstanding from the previous review, although the Department emphasised that those appropriate to the Release 4 timeframe had either been implemented or were varied in the light of experience. It also made recommendations in respect of Release 4, including the need to complete documentation to inform decisions on implementation. The review also noted exemplars of good practice in the Programme, including the embedding of risk-based judgements to inform decision making, and a comprehensive risk and issue management process.

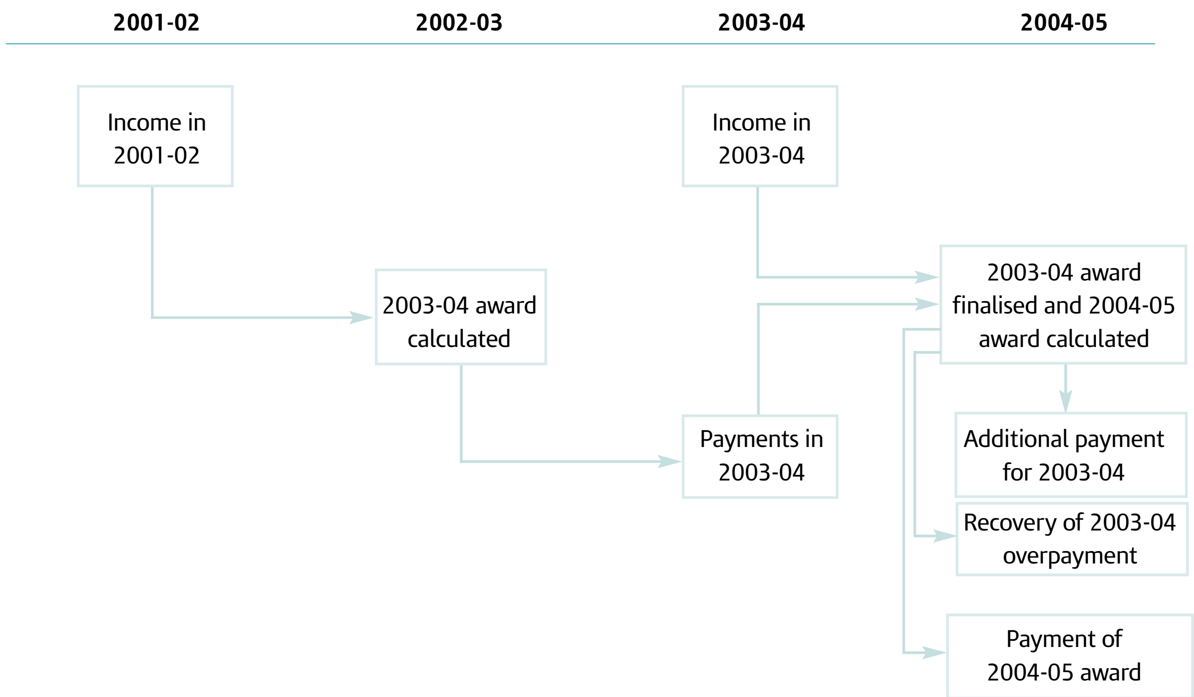
2.29 The Department felt that in general terms Release 3 was successfully implemented in November 2003, whilst recognising that planned provision of management information was delayed. The Department developed alternative solutions as interim measures that they found to work well. Some of the remaining management information functions to support Departmental compliance work were implemented in January 2004 and some in April 2004.

Tax Credit Award Renewals

2.30 Release 4 was implemented in April 2004 and introduced the main software to support the Tax Credits renewals process. The renewals process was originally scheduled to run from April - July 2004, but Ministers decided in July 2003 to extend the process until September 2004. The aim was to ensure that adequate time was allowed for the entire process - both for claimants (for example, to gather together the relevant information about income) and the Department (for example, to process the replies and deal with queries from claimants).

2.31 The Department issued renewal packs to around 5.7 million households who had received Tax Credits in 2003-04 and requested a reply in around two-thirds of those cases to confirm circumstances and give actual income for 2003-04. In the remaining cases, where the provisional award was limited to the family element (£545p.a.), no reply was required if circumstances had not changed and income had not changed enough to affect the amount of the award. These households received a notice setting out the circumstances on which their claim was based and the income range in which the award is unaffected. Some 400,000 cases related to households whose award ended during 2003-04, and a reply was required to confirm actual income for the year and circumstances during the period of that award. Figure 9 highlights the stages involved in the process of calculating and renewing tax credit awards.

FIGURE 9: Timeline for claiming, payment and renewals of the new Tax Credits



Source: National Audit Office

2.32 Following a review and learning lessons from earlier Tax Credits system releases, the Department set up two extra call centres and took on additional staff to cope with processing and enquiries about the process and finalised awards. Figure 10 shows progress in processing renewals.

FIGURE 10: Renewals Processing volumes (cumulative millions in 2004)

	April	May	June
Renewals packs distributed	2.5	5.6	5.7
Responses received where reply expected	0.2	1.4	2.3
Finalisations	0.0	0.8	1.5

Source: Inland Revenue

Employers

2.33 In my 2002-03 report I noted that employers had a significant workload preparing for and running the new Tax Credits payments through their payroll systems. Some employers initially experienced many problems with the timing and frequency of Tax Credit award notifications received from the Department. The situation improved after the early weeks on the new Tax Credits, although some employers reported further, more localised problems later in the year and said that the volume of amendments to awards was greater than anticipated. The Department holds regular formal consultative meetings with employers' representatives at which these and other issues are discussed and provides advice through its helpline for employers.

Departmental Recovery in areas other than Tax Credits

2.34 In my 2002-03 report I noted that problems with the new Tax Credits systems had adversely affected tax administration business. In 2003-04 the new Tax Credits programme was responsible for internal overtime costing some £8.1 million to support the Department's business recovery effort. Staff who would not normally have worked on the new Tax Credits were transferred from their normal duties to deal with:

- entering data from Tax Credit claim forms onto the system;
- the unexpected length of phone calls received at the Helpline as a result of system problems;
- claimant visits to the Inland Revenue Enquiry Centres; and
- to fill vacancies created by other moves.

2.35 By the end of 2003-04, recovery was well underway and the Department met most of their operational targets. Some operational targets could not be met because of the diversion of resources and were therefore reduced eg. in telephone, postal and face-to-face customer contact. The diversion of resources also meant that some aspects of quality were affected. The Department missed the Public Service Agreement target for the percentage of enquiries worked to a fully satisfactory standard.

2.36 Some targets were also reduced in other areas of the Department affected by staff transfers to support tax credit work. This included staff normally engaged on customer contact, tax compliance work and some processing. It also included work on PAYE open case clearance (the Department's final check after the tax year-end that the pay and tax details for people in the PAYE system are correct). The Department told the Committee of Public Accounts in 2002 that they had set up machinery specifically to tackle arrears of open cases. The Department had aimed to reduce the number of open cases to 5.7million on hand by the end of 2003-04. However, by the end of 2003-04, the Department had 6.9 million open cases. The Department recognise the challenge for them is to ensure that progress is made in 2004-05 to achieve substantial reduction in the number of open cases. All revised targets are published in the Board's report for the year ended 31 March 2004. It will not be clear until the end of 2004-2005 whether all aspects of recovery have been completed and the Department is back on track.

Conclusions

2.37 I concluded in my report on last year's Inland Revenue accounts that the new Tax Credits represented a major challenge for the Department, and the level of problems caused to claimants and employers as the system went live in April 2003 demonstrated that there were undetected gaps in the design of the testing regime for the system. I noted that the Department's consideration with EDS – its then IT service provider - of the underlying technical problems had to have regard to the discussions between them about compensation for the unsatisfactory performance of the new Tax Credit system, and the possibility of legal action. Those discussions were still continuing in November 2003 at the time of my report for that year and the Department then hoped to resolve them shortly.

2.38 The Department had not resolved the discussions on compensation when I concluded this year's report. The Department and EDS told me that a structured process of confidential discussions on these matters was continuing as I concluded this report. In order not to prejudice their discussions I have not examined these matters further.

2.39 In planning the major annual exercise to renew Tax Credit awards, which took place mainly from April to September 2004, the Department aimed to address the lessons learned from the system problems of the previous year. The extent of its success in that renewal process and in avoiding significant problems, will be seen fully only later in 2004-05 when the renewals process is finished and reviewed.

2.40 The new Tax Credits have proved relatively easy for people to access but many have found it difficult to understand exactly how much they are due - a problem made worse for those who have been paid the wrong amounts. The administration of the new Tax Credits has proved complex in parts, reflecting the underlying design of the new Tax Credits and the desire to provide support that is responsive and tailored to a wide range of circumstances.

2.41 I qualified my audit opinion on the Department's Trust Statement account for 2002-03, in respect of Working Families' and Disabled Person's Tax Credit payments, as a Departmental exercise had estimated that overpayments resulting from claimant error and fraud amounted to 10–14 percent by value. The Department told the Committee of Public Accounts that error rates under the new Tax Credits might be half of those under the previous Tax Credit schemes. They have not yet estimated the level of financial error on the new Tax Credits and so I have no evidence that error has yet been reduced significantly to enable me to give an unqualified audit opinion. I have therefore qualified my audit opinion on the 2003-04 Trust Statement account in respect of the new Tax Credit payments.

2.42 The Department plans to test Tax Credit claims and to quantify the financial implications of claimant error and fraud. They expect a result in respect of 2003-04 to be available by July 2005 in time to inform the Accounting Officer when considering the accounts for 2004-05. The Department could undertake work earlier than that so as to have a broad indicator of those levels. In 2003-04 the Department undertook an exercise on the 2003-04 provisional Tax Credits awards which helped inform their understanding of claimant error and fraud and the strategies for tackling them. The Department, however, was not able to draw reliable quantified estimates from this exercise.

2.43 Some essential controls over the new Tax Credits did not work in 2003-04, including the daily reconciliation of payments authorised with payments made, which was planned as a fundamental daily check on processing. The Department retrospectively completed reconciliations for 2003-04 in September 2004 and this work has resulted in the correction of a significant number of claimants records. The Department plan to introduce fully automated daily reconciliations in the second half of 2005.

2.44 The Department had to move staff from other tax work to help when the new Tax Credits system problems arose in the first half of 2003-04. It plans to recover fully from the impact of the initial Tax Credits problems by the end of 2004-05. It will need to ensure that the recovery plans are not frustrated by further extensions of the new Tax Credit IT systems. Business as usual collecting taxes must not be allowed to suffer and the Department must ensure that their responses to system problems do not undermine their reputation for integrity of processing taxpayers' affairs.

Code of Practice 26

When might we not recover an overpayment

We may decide that you should not be asked to pay back all or part of an overpayment if

- you were paid too much because of a mistake by us and it was reasonable to think your award was right, or
- it would cause hardship to you or your family if you had to pay the tax credit back. We may so accept payment over a longer period of time in a case of this kind.

If we have made a mistake

If we find that, because we have made a mistake, we have not paid you all the tax credit you are entitled to, we will pay you the extra tax credit in a single sum straightaway.

We will not ask you to pay back an overpayment if it arose because we made a mistake and you could reasonably have thought your award was right. This would include cases where we instructed your employer to pay you the wrong amount of Working Tax Credit, provided you could reasonably think you were being paid the right amount.

Some mistakes by us that lead to overpaid tax credit may happen because you gave us some information and we did not act upon it. If you tell us about a change, you can expect to get a revised award notice from us within a few days. But if you tell us something and we do not act upon it within 30 working days, and you could reasonably think your tax credit award was correct, we would not ask you to pay back the additional tax credit you were paid.

It would have to be reasonable to think that your tax credit award was correct. For example, if we were paying you tax credits on the basis of the wrong number of children, that is the sort of thing we would expect you to spot on your award notice and tell us about. And we would also expect you to tell us if your employer was paying you more tax credit than your award notice said you were entitled to.

In deciding whether it was reasonable to think your award was correct, we will consider all the circumstances of your case.

We will take the same approach where the mistake that led to the overpayment was made by another Government Department.

Cases where payment would cause hardship

After considering the facts in individual cases, we may decide not to collect all or part of an overpayment of tax credit, or to allow you more time to pay, if payment would cause you and your family hardship.

If we are collecting an overpayment from 2003-04 from your payments in 2004-05, we will not normally accept that you should be expected to pay less than the 10 or 25% of payments that applies to your circumstances. If, exceptionally, you think there are particular reasons why payment at those rates would cause you hardship, you should contact us to discuss your case.

If you do contact us to say that payment would cause you hardship, we will look sympathetically at your proposals for paying us what you owe but we must take account of all the circumstances before we make a decision. We may need to talk to you before we make a decision and may ask for more information.

Code of Practice 26 (continued)

What factors we will take into account

When we consider whether it would cause you and your family hardship if we tried to recover an overpayment, or whether we should agree to you paying back the amount over a period of time, we will take account of

- your current and future income and essential living expenses
- your savings, investments and other assets which you could use over the short to medium term to make the payments - these might make it more appropriate to delay payment than not ask for payment at all
- your other liabilities, for example, repayments of your mortgage, rent or rent arrears, overpayments of social security benefits or other debts
- whether you are due to make other payments to us, and how paying the current debt over a period of time might affect them
- how long it will take you to pay back the overpayment
- your previous payment history with us
- whether paying what you owe us would result in you not being able to afford essential services, such as gas, electricity or water, immediately or over time, because you would not be able to continue paying those bills if you were paying back your debt to us
- whether you have a child or children under five or a chronically ill or disabled person in the family whose health could be affected by your paying back the debt, even over an extended period
- any other factors which are relevant.

Source: Inland Revenue

Part 3: Stamp Duty Land Tax

Introduction

3.1 Stamp duty is a tax on documents that transfer land, buildings and shares and securities. Duty on land and buildings has existed for over 300 years. Since the early 1990s, transfers of shares and securities have also been subject to taxation, mainly Stamp Duty Reserve Tax. This part of my report looks at the Department's modernisation of stamp duty on land and buildings, with the introduction of Stamp Duty Land Tax on 1 December 2003. Stamp duty on shares and securities was not affected by this reform.

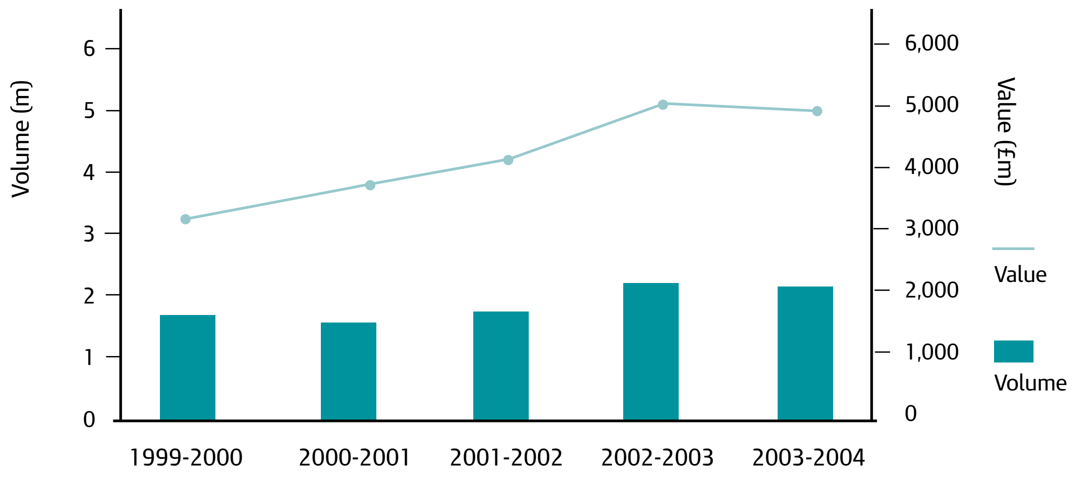
Stamp Duty on Land and Buildings

3.2 Under the former system, stamp duty on the sale or lease of land and buildings was a tax on the documents that transferred title to property. The documents were presented for stamping to the Department's Stamp Office, in order to register legal title with HM Land Registry. Prior to Stamp Duty Land Tax, the charge to stamp duty was not attached to an individual, but to documents. As stamp duty was a charge on documents, it could be avoided if the transaction was documented in a certain way. Furthermore, the charge was not attached to any particular person, making enforcement difficult even if non-payment was identified.

3.3 From the late 1990s, the Department identified an increasing risk to the stamp duty tax base. During this period, rates for stamp duty increased from a single rate of 1% for all transactions to 1%, 3% and 4% dependent on value. Avoidance of stamp duty through sophisticated tax planning techniques became more attractive, particularly in the commercial sector. By 2000, the Department found that despite the increases in tax rates, the stamp duty yield from the commercial sector was relatively unchanged, while in the residential sector it had risen in line with the increased tax rates. Together with other considerations such as electronic conveyancing and more efficient administration, Ministers decided to modernise and reform the duty.

3.4 Figure 11 shows the value and volume of stamp duty transactions on land and buildings. The volume of transactions has increased in the last five years by 26 per cent, from 1.6 million to over 2 million. Over the same period, the revenue from stamp duty has increased by 60 per cent, from £3.2 billion to £5.1 billion, reflecting the increases in stamp duty rates and rise in UK property prices.

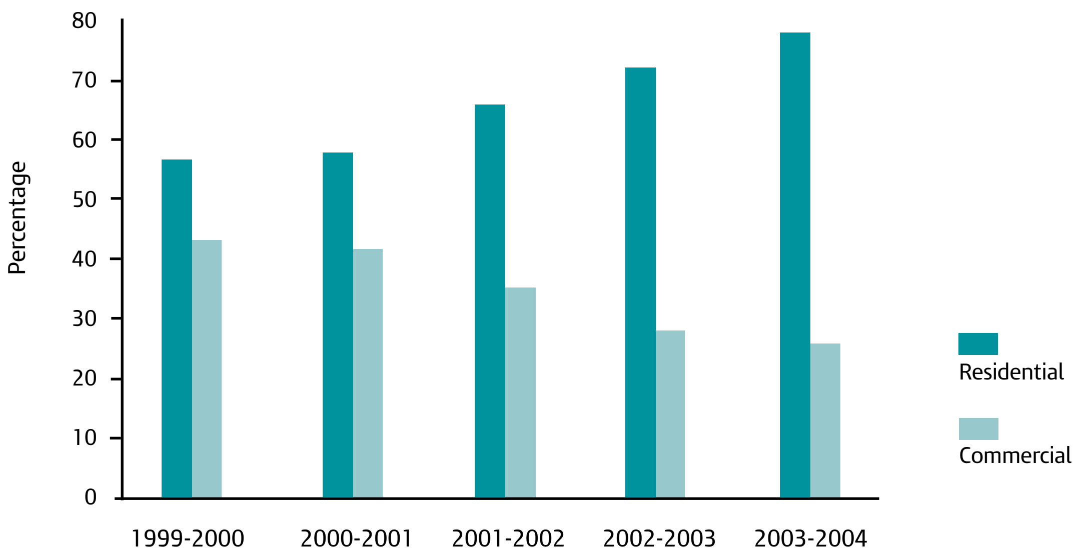
FIGURE 11: Volume and value of Stamp Duty on Land and Buildings



Source: Inland Revenue

3.5 Figure 12 shows the estimated percentage share (by value) of stamp duty between residential and commercial transactions. The percentage for commercial transactions has been decreasing, from 43% in 1999-2000 to an estimated 26% in 2003-04. This decrease demonstrates the relatively flat trend in the value of stamp duty from commercial transactions, compared with the significant increase in stamp duty from residential transactions.

FIGURE 12: Stamp Duty Share by Residential and Commercial Transactions



Source: Inland Revenue

3.6 Figure 13 shows the main stamp duty rates applicable to land and building transactions up to November 2003. A higher threshold of £150,000 for the 1% rate for all residential transactions in designated disadvantaged areas was introduced on 30 November 2001. For non-residential transactions in designated disadvantaged areas only, stamp duty was abolished in March 2003.

FIGURE 13: Stamp Duty on Land and Property to 30 November 2003

(a) Conveyance or transfer of property

Rate%	Bands
Nil	£60,000
1	£60,001 - £250,000
3	£250,001 - £500,000
4	Over £500,000

(b) New Leases

There were two elements of stamp duty on new leases:

(i) Lease Premium

The rate of duty on the lease premium was the same as for transfers of property above, with a few limited exceptions.

(ii) Lease Rental

Term of Lease	Rate (% of average annual rent)
Under 7 years	1 (Nil if annual rent less than £5,000)
7 to 35 years	2
35 to 100 years	12
Over 100 years	24

Source: Inland Revenue

Stamp Duty Land Tax

3.7 The objectives for modernisation of the tax were published in a consultation document issued in April 2002 and are summarised below:

- *Fairness*

  Ministers were concerned about the increase in stamp duty avoidance, particularly the use of artificial arrangements on commercial property transactions. This was unfair to the compliant majority, especially small businesses and individuals.

- *E-business*

  Reform was necessary to facilitate the introduction of electronic conveyancing to make the property purchasing process simpler, quicker and more efficient through the submission of just one form to pay any stamp duty and register the property.

- *Modernisation*

  A revised legal framework for stamp duty was needed to bring it in line with other taxes, with a modern enforcement and compliance regime, and creating a tax charge based more on the substance of transactions rather than their legal form.

3.8 The major changes introduced with Stamp Duty Land Tax (SDLT) are outlined in Figure 14. The primary legislation for the introduction of the new arrangements was the Finance Act 2003. More detailed regulations covering exemptions, reliefs and anti-avoidance rules were issued in November 2003, a month before the introduction of SDLT on 1 December 2003. Further provisions for SDLT covering anti-avoidance were contained in the Finance Act 2004. These included rules to deal with partnership transactions so that they would be treated, as far as possible, in a similar way to other property transactions.

FIGURE 14: Major changes introduced for SDLT

- no requirement for legal documents to be sent to the Department's Stamp Office for stamping;
- introduction of a chargeable purchaser and a chargeable transaction triggered by completion, or substantial performance, of contracts;
- bringing the enforcement and compliance regime in line with other taxes, i.e. "process now, check later";
- new compliance powers of investigation and a range of appeal rights in line with other taxes;
- specific provisions to tackle avoidance of stamp duty, particularly for leases and commercial transactions;
- a standard notification and payment procedure, processed centrally, with plans for electronic transactions and e-conveyancing at a later stage; and
- a simpler lease duty, removing distortions in the previous regime, which led to decisions being tax driven rather than business driven.

Source: National Audit Office

3.9 Under SDLT the transaction must be notified to the Department, together with the payment, if appropriate, within 30 days of completion or substantial performance of the contract. The purchaser/lessee submits a standard Land Transaction Return, in most cases via a solicitor or other professional agent. The Department then issues a certificate which allows the purchaser/lessee to register title at the land registries.

3.10 The Department is a key stakeholder in the Government's project for full electronic conveyancing, led by HM Land Registry. Full e-conveyancing is some years away, but HM Land Registry expects to start a limited pilot in 2006-07. Payment of SDLT, filing of a Return and registration of the transaction will become part of one process when full e-conveyancing is available.

3.11 Figure 15 shows the rates introduced with SDLT.

FIGURE 15: Stamp Duty Land Tax from 1 December 2003

(a) Conveyance or transfer of property

Rate (%)	Residential	Non-residential
Nil	£60,000	£150,000
1	£60,000 - £250,000	£150,001 - £250,000
3	£250,001 - £500,000	£250,001 - £500,000
4	Over £500,000	Over £500,000

The threshold for non-residential transactions was raised from £60,000 to £150,000. The rates for disadvantaged areas remain unchanged, with non-residential transactions continuing to benefit from complete exemption.

(b) New Leases

(i) Lease Premium

The rate of duty on the lease premium remains the same as for transfers of property above.

(ii) Lease Rental

The tax charge of lease rental was changed to 1% of the net present value of total future rent payments.

Rate (%)	Net present value of rent	
	Residential	Non-residential
Nil	£60,000	£150,000
1	Over £60,000	Over £150,000

Source: Inland Revenue

Consultation Process for SDLT

3.12 A consultative document on modernising stamp duty on land and buildings was published in April 2002. Subsequently, the Department established a consultative committee and several subcommittees, with delegates from the property and banking sectors, the tax and legal professions and other Government departments. The consultation process continued throughout 2002 and 2003, including the publication of draft legislation in November 2002. The Department carried out separate consultations in 2003 on the proposed duty on leases and (following the publication of draft legislation in October 2003) on partnerships. Consultation on partnerships continued into 2004 and, more generally, consultation has continued with the three Law Societies representing England and Wales, Scotland and Northern Ireland.

3.13 Consultation on the introduction of any new tax is likely to result in a variety of opinions being expressed, some reflecting particular interests. The SDLT consultation process was criticised by some sector representatives and concerns were expressed that the initial consultations ended arbitrarily in 2003. They also considered that the initial provisions had not been thought through, particularly the proposed new lease duty and that some proposals would have proved unworkable in practice. The introduction of some regulations as late as November 2003 ended a period of uncertainty for business and the professions, although this was cited in the specialist media as symptoms of the perceived rushed introduction of SDLT.

3.14 The Department considered the consultation process to have been a success overall, and that the break in the initial consultation was necessary as some issues were identified such as on lease duty, that needed further consideration by the Department and ministers. The consultation also helped in the identification of many avoidance loopholes and confirmed the relatively light stamp duty tax burden on the commercial sector.

Regulatory Impact Assessment

3.15 The Department published a Regulatory Impact Assessment on SDLT on Budget Day March 2004, to assess the costs and benefits of the proposed changes. The Department stated that the introduction of SDLT would bring many benefits to business. For example, the increased threshold at which stamp duty is payable for commercial transactions.

3.16 The Department has not estimated compliance costs of the new arrangements, on solicitors and conveyancers or on businesses. The previous form for stamp duty was one page, asking eighteen questions and requiring legal documentation to be provided to allow the Department to obtain additional information to supplement that provided by the form. By comparison, the new Land Transaction Form consists of six pages and seventy questions, with supplementary forms for particular transactions and/or further details. The Department consider that the majority of transactions are straightforward and therefore will only require completion of relevant questions, with no need to provide underlying documentation. Nonetheless, they acknowledge that some unquantified costs may arise, as shown in Figure 16.

FIGURE 16: Costs of SDLT compliance to business

- costs of notifying liability to SDLT, although the Department do not consider these to be significantly greater than previously;
- costs from complying with the Department's enquiries into transactions, especially as commercial transactions are more likely to be complex;
- Anti-avoidance provisions result in SDLT creating a tax liability on transactions that previously escaped liability. The Department estimate that this could result in up to five per cent of all commercial property deals becoming unviable where the opportunity to avoid tax has been removed.

Source: National Audit Office

3.17 The Department's Regulatory Impact Assessment describes the effect of SDLT on small businesses. The Small Business Service of the Department of Trade and Industry is clear that there are benefits to many small firms from a number of the changes introduced, such as the increased threshold at which SDLT is payable. However, they noted that although over 60% of small business leases will be exempt from tax, for some small businesses lease duty could increase three to eightfold as the tax is based on the net present value of future rent payments. The Assessment states that "a potential impact of these increases in lease duty is that some small firms may have to seek shorter leases or be less able or unable to afford rental property at all. A more comprehensive small firm impact test might have more closely identified the extent of this risk."

Anti-Avoidance Measures

3.18 The Department carried out work on the "tax gap" for stamp duty, estimating it at around £750 million per year. This estimate is based on comparisons of market data collated by property consultants with Departmental data. The Department believes that the introduction of SDLT will reduce the tax gap by about half. They estimate that the tax yield would increase by £330 million in 2004-05 and £430 million in 2005-06, through increased compliance, specific anti-avoidance measures and reform of the duty on leases. The Department is committed to keeping the tax gap under regular review.

3.19 The Department intended to close a particular avoidance loophole involving the use of "special purpose vehicles". A special purpose vehicle is created (such as a new subsidiary company controlled by the parent company) to own the land to avoid stamp duty at four per cent on the transfer of land. As the transfer occurs within a qualifying group of companies, group relief on the sale (transfer) of the land is claimed and no stamp duty is payable. The land is then transferred to a third party purchaser through the sale of the subsidiary company's shares, attracting only a half of one per cent, the rate of stamp duty on shares. The Department believed the use of special purpose vehicles was growing and represented a serious threat to the stamp duty tax base.

3.20 The Department found after the consultations in 2002, that there were legal difficulties in the proposed approach under EU law. These have limited its ability to reduce avoidance through the use of special purpose vehicles. It believes that SDLT legislation makes the use of special purpose vehicles less attractive because there are extended recovery rules. This means that SDLT will be payable if the special purpose vehicle is transferred to a third party within three years (previously two years) of the original transfer or "sale" to a subsidiary company.

3.21 The Department expects the new SDLT compliance and enforcement regime to have a more general deterrent effect, for example through the possibility of an enquiry (compliance review).

The introduction of SDLT

3.22 Early in 2002 the Department established a project board to manage the modernisation of this tax. The Office of Government Commerce and the Department's Internal Audit Office have been involved from a very early stage to review and advise on the entire process. 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. They initially reported on the management processes of the project and made several recommendations, accepted fully by the Department, including improvements to project governance, defining exactly what was to be delivered and addressing the lack of experienced project management resources. The Office of Government Commerce reported again in April 2004 and made further recommendations in respect of planning for the implementation of the automated system for processing SDLT.

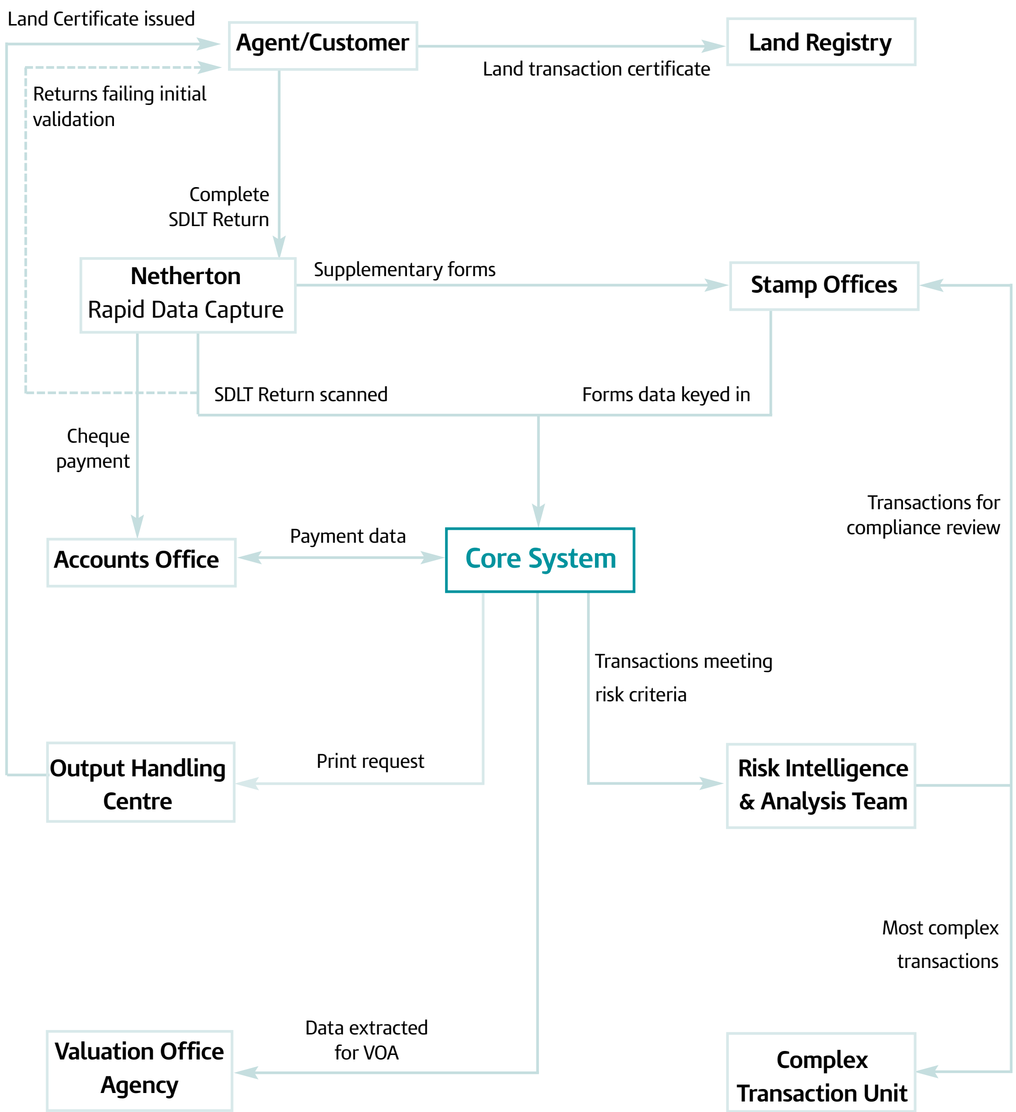
3.23 In July 2003 the Department appointed external consultants to oversee project management of the SDLT programme. The Department sought external expertise because it did not have sufficient capacity in this area. The Department stated that project managers with the right depth of experience were already engaged with other "mission critical" projects. It considered that experienced project management resource was vital due to the complexity of the project, very tight timetable and the risks of non-delivery. The Department's Internal Audit Office agreed that the consultant support was essential and that it considerably enhanced the project management process.

3.24 The Department originally intended to have in place a bespoke IT system in time for the introduction of SDLT on 1 December 2003. In June 2003, following consultation with EDS, its then IT services partner, it decided that there was a significant risk that the bespoke system would not be delivered on time. As the requirements were developed and became more clearly defined in early 2003, the Department concluded that the bespoke system would not be suitable and a package solution provided a closer match to the requirements. The Department therefore took the decision to purchase and reconfigure a software package to meet its needs. The Department believed that a package solution would reduce the risks to delivery and allow it to focus on development of key interfaces, such as for payment and accounting of transactions.

Processing SDLT returns and payments

3.25 Figure 17 illustrates the main processes for the automated SDLT system. Completed SDLT Returns are posted to the Department's Rapid Data Capture centre in Netherton, where they are scanned and the data captured. The Core system interfaces with other systems, for functions such as issuing certificates, matching Returns to payments, compliance and for transferring land/property data to the Valuation Office Agency.

FIGURE 17: Flowchart of SDLT processing



Source: National Audit Office

3.26 The Department originally intended the revised automated system to be operational in time for the launch of SDLT in December 2003. By the time of my report, this had not happened. The Department began a pilot of the automated system in July 2004, processing a limited number of freehold Returns (around 5% of transactions). Full automation for all freehold transactions (80-85% of transactions) is dependent on the results of the pilot and is now scheduled for the end of November 2004. The Department emphasised that it was following good project management practice by taking an incremental approach in order to minimise the risk of adverse impact on customer service.

3.27 Leasehold transactions have proved more problematic and system testing has revealed a high rejection rate. These problems were caused by the design of the original requirements. The Department identified necessary changes to the requirements following analysis of returns received under the manual process and test IT results. Work to resolve the problem is continuing, but a date has not yet been set for full automation of these transactions.

3.28 In view of the risk that the modified IT system would not be available by 1 December 2003, the Department began developing a manual processing system for SDLT in June 2003. The manual system generally mirrors the automated process illustrated at Figure 17, but with manually input data and manual interfaces with other functions. The NAO reviewed processes at the manual running office and found that the Department had implemented a relatively straightforward, but resource-intensive, system to process returns and issue certificates. Such a system is effective in administering the new tax as a short-term, interim measure. Moreover, it does provide a future business-continuity option if problems arise with the automated system.

3.29 Customers send Land Transaction Returns to the Rapid Data Capture centre in Merseyside, which forwards them to the manual office, where checks are performed on each Return against pre-determined criteria. Returns that are rejected outright, due to the omission of key data or payment, are returned to the customer with an explanation. Under the manual system, the Department initially set lighter criteria for rejection and a return was accepted where it would be rejected under the automated system. As part of the customer education process, these "partially correct" returns were accepted but a pro-forma letter was sent to the customer explaining the error. This light touch approach to compliance came to an end on 19 July 2004. After processing, the returns are forwarded to another area of the Department for data entry. Returns identified as high-risk are also sent to a risk and intelligence analysis team in Bristol for possible compliance review.

SDLT Compliance

3.30 SDLT gives the Department a modern enforcement and compliance regime. The legislation introduced a "liable person" and "notifiable transaction", in contrast to the charge on documents under the previous regime. The new tax gives the Department a nine-month period in which to initiate a compliance review, which may require the purchaser to produce information. The compliance strategy is based on risk criteria designed to identify high-risk transactions, such as transactions near the tax rate thresholds, non-cash consideration or where a relief is claimed. The Department intends to carry out a full compliance review of a sample of high-risk transactions. This was originally intended to cover 13,700 residential transactions and 8,000 non-residential transactions. For 2004-05, this has been significantly reduced due to the deferral of the automated system, resource considerations and the need to fully roll out training. The Department plans to cover the original number of transactions from 2005-06.

3.31 The Department has set up national compliance teams for SDLT, with specialist support from a stamp duty "Risk and Intelligence Analysis Team", which aims to identify potentially high-risk transactions for further analysis and compliance review. The Department has developed two sets of risk rules, one for the manual and one for the automated processing systems. The manual rules are less comprehensive than those for the automated system, as managing the full risk rules under manual processing would have been difficult. The Department established a Complex Transaction Unit to deal with the largest and most complex transactions.

3.32 The Risk and Intelligence Analysis Team manually sift the high-risk returns forwarded to them. Between December 2003 and April 2004 the team received around 91,000 returns representing 11.5% of total transactions in that period. Resource constraints initially limited the number of cases sent to the team. By the end of May 2004, an additional 59,000 cases had been received. The Department is developing a compliance information system, which is scheduled to come into operation in late 2004. Until that time the consistency and quality of risk assessment work undertaken on such a significant volume of returns may be at risk.

3.33 The NAO review of the compliance function found that the Department had identified transactions under many of the pre-determined risk criteria. Lease transactions are considered a risk due to their relative complexity and previous widespread avoidance, particularly for non-residential transactions. Under the new tax, leases were forecast to contribute to around half of the estimated increase in SDLT revenue. During an early stage of the manual processing arrangements, the Department identified lease transactions for compliance review by virtue of meeting other criteria and not solely because of their status as leases. This decision was taken to help manage the workload following the establishment of the new arrangements. The Department re-introduced lease transactions as a specific risk criterion in June 2004 as part of the selection process for potential enquiry cases. No statistics are yet available on the number of lease transactions forwarded for compliance review, although these will be available under the automated system. Self-certified transactions, for example purchases below the tax threshold, are notified directly to the land registries and from June 2004 the Department commenced checking around 190 self-certified transactions per month.

3.34 The Department originally considered referring all transactions greater than £1million (plus other criteria) to the Complex Transaction Unit. However, the Department found the volume of transactions too high and, on the basis of a revised risk-based approach to compliance, increased the limit to £5 million. Cases falling below the Complex Transaction Unit's threshold will be referred to other compliance teams. The NAO also noted that the Department had set very narrow criteria for reviewing transactions that are close to the SDLT tax thresholds. The Department is aware of the need to consider the impact and risks of this strategy on its ability to detect and deter non-compliance in this area.

3.35 The Department initially had a "light touch" compliance regime for the manual processing of returns. This means that some transactions were processed and certified that would be rejected under the automated system. This approach allowed time for solicitors and other agents to become familiar with the new forms and processes, prior to automation. The Department announced that, during the light touch period, penalties would not apply if the return was received within 40 days (normally 30 days). However, initially no penalties or interest were charged even for returns received after 40 days, because there was no cost effective means of automatically calculating and sending penalty/interest notices. The Department commenced a process to collect late filing (fixed) penalties on 1 June 2004. The full penalty determination and appeal process was still being finalised, as the Department had focused on the operational aspects of the new tax. The light-touch regime ended on 19 July 2004, when penalties and interest were charged after 30 days.

3.36 Some aspects of SDLT are complex, particularly the regulations on lease transactions and when they are notifiable. This reflects the complexity of tax avoidance arrangements. The complexity will challenge the ability of the Department to carry out enforcement and ensure compliance with the new rules. For instance, all new leases for seven years or more (and where consideration is payable) are notifiable transactions regardless of whether SDLT is payable. Leases for less than seven years and with a liability to SDLT are also notifiable. Figure 18 illustrates the notification requirements in certain instances.

3.37 The Department states that such rules are required to combat avoidance of SDLT lease duty, which was prevalent under the previous regime. There is widespread acknowledgement across the tax and legal professions that the new rules will significantly improve compliance rates. However, there are challenges for the Department in identifying transactions that are not notified, which will impact on its ability to tackle evasion of SDLT. An important role of the Risk Intelligence and Analysis Team will be to identify such transactions.

3.38 The new compliance regime for SDLT will involve closer working between SDLT compliance staff and others across the Department and HM Customs & Excise. Integration of the two departments should also assist in this.

3.39 The Department have introduced a wider compliance strategy for SDLT, where enquiries undertaken by tax inspectors on corporation tax or income tax self-assessment will also consider any transactions liable to SDLT. This wider compliance work in the more complex aspects of the tax, for example leases, will only be fully effective if there is active checking of transactions during tax enquiries. The Department is initially revising its training courses for tax inspectors to widen knowledge of SDLT and is actively seeking to improve procedures to highlight the importance of SDLT compliance work. The Department will keep these measures under review as the new arrangements become more established.

3.40 The NAO noted that there may be conflict between the timing of different tax enquiries. For example, SDLT has a nine-month enquiry period, whereas the timetable for other enquiries, such as corporation tax or income tax returns, is considerably longer. This conflict reflects the differing nature of the transaction-based SDLT. The Department stated that the arrangements for SDLT are more in step with the transaction-based enquiries undertaken by HM Customs & Excise and that this will be a factor for consideration as the two departments integrate. The Department also has “discovery powers” to re-open or initiate further enquiries if any additional information is received on the transaction at a later date.

3.41 The effectiveness of the Department’s enforcement and compliance regime for SDLT can only be evaluated fully at a future point in time.

FIGURE 18: SDLT rules on leases

Contingent/uncertain rents

- If the rent varies, e.g. based on a percentage of turnover, the lessee is required to submit an SDLT return based on an estimate of expected rental payments in the first five years. For the remainder of the lease term over five years, the highest amount of rent due for any consecutive 12 month period in the first five years is used in the net present value calculation. A further SDLT return will have to be submitted at the five year point, using the highest amount of rent paid in any consecutive 12 month period for the remainder of the lease term.

Rent increases within five years

- After submission of a SDLT return, any increases in rent in the first five years of a lease but not provided for in the lease are notifiable, with the lessee required to pay the additional tax.

Rent increases after five years

- All rent changes after 5 years of the lease term are ignored for the purpose of the tax calculation. For rental due after five years, the highest rent paid in any consecutive 12 month period is used in the calculation for the remainder of the term. However, if after five years the rent increases by more than 5% plus RPI, the increase is deemed the grant of a new lease and SDLT payable.

Assignment of leases

- If a premium is paid on the assignment of a lease, SDLT is also payable. Where a lease has benefited from a relief on the initial transaction, future assignment of the lease to another party is deemed as the grant of a new lease by the assignor. SDLT is payable by the assignee.

Extension of leases during their term

- The extension of a lease is treated as the grant of a new lease for the period by which the term of the lease is extended. This will be deemed a transaction linked to the original lease, requiring notification if the extended term is seven years or more.

Continuation of leases indefinitely

- Where the term of a lease ends and the landlord does not repossess the property, the continuation is treated as if the lease has become one year longer than the original term, and further years if it continues. These leases become linked transactions. Similarly, a lease granted for an indefinite period is deemed to be for an initial period of 12 months. If it continues thereafter the term is treated as increasing, a year at a time, also becoming linked transactions. All linked transactions are notifiable whenever the rents reach the SDLT threshold or the total term of the lease becomes seven years or more.

Source: Inland Revenue

Conclusions

3.42 The Department modernised stamp duty on land and buildings with the introduction of Stamp Duty Land Tax on 1 December 2003. New legislation, together with regulations and consequent administrative procedures and checks, sought to minimise recognised stamp duty tax avoidance. These measures, however, did not fully close all the known tax avoidance opportunities.

3.43 There was a tight timetable for consultation, legislation and system development for Stamp Duty Land Tax. The Department properly recognised six months before the implementation date of 1 December 2003 the need to develop rapidly and deploy manual contingency arrangements, while a fully automated system continued to be developed, tested and delivered. The Department considered that deferring delivery of the automated system was necessary to meet the overall timetable. The new tax was implemented without the introduction of an automated system and the success of the interim, manual arrangements is a credit to those involved. Government departments have experienced previous problems with tight IT project timetables and there would have been advantages had the Department been able to introduce the IT system to the original timetable. There are lessons to be learnt from tight timetables which need to be allowed for when planning future projects.

3.44 The Department is developing IT systems to remedy the limitations in procedures and controls during manual running. During that period some compliance work was undertaken to a lower level than planned and the Department plans to introduce a more comprehensive approach. This will only be fully effective once the IT systems are in place. The Department need to remedy the current limitations and ensure that this work is undertaken comprehensively for the future.

3.45 The Department has found difficulties in an important area where it had hoped to reduce avoidance, because EU law limits its ability to take action. The Department should continue to review the tax revenues still at risk even though they have introduced these new arrangements and identify new ways of countering avoidance of Stamp Duty.

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