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.