National Audit Office

Corporation Tax: companies managed by HM Revenue and Customs' Area offices

LONDON: The Stationery Office
£9.25

Ordered by the
House of Commons
to be printed on 9 January 2006

REPORT BY THE COMPTROLLER AND AUDITOR GENERAL | HC 678 Session 2005-2006 | 13 January 2006

EXECUTIVE SUMMARY

1 Corporation Tax is charged on the profits of around a million companies conducting business in the UK. The tax is levied at a rate of 30 per cent for companies making profits above £1.5 million, with lower rates for smaller profits. There is currently a nil-rate for profits below £10,000, but this is planned to be removed from 2006-07.[1] Corporation Tax is charged after certain adjustments to profits presented in a company's accounts, and various reliefs applied. Once registered with Companies House, companies become liable for Corporation Tax when they begin business. In 2004-05 HM Revenue and Customs (the Department) collected from them £33 billion in Corporation Tax.

2 Companies submit company tax returns[2] to the Department, which processes and checks them and collects the tax. It undertakes detailed enquiries on some returns, resulting in further tax revenue where taxpayers have not complied with their obligations. Such non-compliance might involve submitting a return with genuine errors or with inaccuracies aimed at paying less tax than is legally due. Companies may also seek to organise their affairs in ways that reduce their tax liability legally. The legality of different avoidance practices is often a matter of interpretation which ultimately may only be determined by the courts.

3 The Department manages Corporation Tax payers in two groups:

- A Large Business Service dealing with the direct and indirect tax affairs of the largest businesses, comprising some 900 groups of companies, who paid £18 billion in Corporation Tax in 2004-05. The Large Business Service also carries out audits of the compliance by larger businesses with their tax obligations as employers.
- A network of 68 Areas, which deals with around 1.1 million returns from the majority of companies, who paid £15 billion in Corporation Tax in 2004-05. The Areas also deal with Income Tax, PAYE and National Insurance contributions.

4 With the merger of the Inland Revenue and HM Customs & Excise in April 2005, their functions and organisations were combined, and are being restructured:

- Corporation Tax compliance work will continue to be managed in two groups. For those taxpayers dealt with locally, a new Local Compliance business unit will combine the local office networks of the two former departments. A new Strategic Zone structure is also being considered to allow some work to be concentrated in particular locations.
- Some risk-assessment work previously undertaken by Inland Revenue and Customs & Excise local areas is being brought together and centralised within a new Risk division. Company tax returns processing may also be centralised.
- The Department has created new business units to give a stronger focus on taxpayer customers and the design of tax processes; so that new customer units are managing the needs of small and medium enterprises and employers and of large enterprises and employers, and a new product and process unit is managing Corporation Tax and VAT systems.

1 In the 2005 Pre-Budget Report, the Government announced its decision to remove the nil rate band, and an associated 'non-corporate distribution rate', from 2006-07 onwards, and replace it by extending the current 19 per cent band to cover profits from zero to £300,000.
2 Company tax returns cover not just Corporation Tax but other taxes which affect companies such as tax on loans to directors and owners ('Section 419 tax').

5 The NAO examined the management of Corporation Tax for those businesses dealt with by local Areas. The examination centred on how the Department ensures that companies comply with Corporation Tax obligations and helps them to do so, and its efficiency in administering the tax, highlighting lessons and good practice to help the Department improve performance and achieve its efficiency targets. Appendix 1 provides details of our methodology.

Tackling non-compliance

6 Detailed enquiries by Areas on some taxpayers' returns have secured significant additional Corporation Tax that would otherwise have been lost, and increasingly so in recent years. Areas concluded 43,700 enquiries on 4 per cent of active companies in 2004-05. From these, they secured £602 million of additional yield (tax, interest and penalties); four per cent of the tax paid by companies dealt with by Areas. Since 1999-00, when the Department introduced self-assessment for Corporation Tax, it has almost halved the number of enquiries as it has sought to focus on higher risk cases while increasing the total additional tax yield by 42 per cent in real terms. [paragraph 2.7]

7 Aspect enquiries on average produce about half the yield of full enquiries, but they give a better pay-back because they need less staff input. The proportion of enquiries that change the tax or profit assessment has increased since 2002-03. Nevertheless, across the network 40 per cent of all Corporation Tax enquiries produced no additional tax yield or taxable profit adjustment, which we estimate cost £9 million in staff time. 'Aspect enquiries' concentrate on one or more element of the return where there are questions around the tax treatment of particular transactions. 'Full enquiries' tend to be undertaken on less complex companies where the focus may be on the disclosure and accounting for the entire income and assets of a business and its owners. Some 39,000 aspect enquiries secured yields of £12,000 on average – nearly 23 times their cost. 4,500 full enquiries, on the other hand, secured on average £27,000, five times their cost. Aspect enquiries had a higher no-change rate than for full enquiries. [paragraph 2.8]

8 Areas use penalties to help tackle non-compliance, mainly on full enquiries. Areas applied £11 million in penalties for negligently or fraudulently inaccurate returns in 13 per cent of the enquiries that resulted in an increased tax assessment in 2004-05: 51 per cent of full enquiries, but only 5 per cent of aspect enquiries. On aspect enquiries an important constraint in applying penalties against companies is that they often indicate they have relied in good faith on advice from external accountants or agents, and in such cases neither the company nor the agent can be penalised. The Department does not centrally collect details on the type of cases that are penalised or the extent to which penalties are abated to reflect the company's voluntary disclosure and cooperation, or the gravity of the offence. Fixed-penalties for failure to supply requested information are small when compared to business incomes – £50 plus daily penalties of up to £30. [paragraphs 2.9-2.10]

9 The extent of non-compliance identified and rectified through enquiries has to be set within the wider context of the 'tax gap' for Corporation Tax – the difference between the total tax that is theoretically payable and what is actually paid. The Department's random enquiry programme is now beginning to provide information on the extent and nature of that gap. The random enquiry programme for company tax was started in 2001. It has detected errors by companies in around 40 per cent of company tax returns dealt with by Areas, and identified common types of error, but the Department needs more time to produce sufficient data for it to draw robust conclusions on the likely amount of the tax being lost. [paragraphs 2.11-2.12]

10 The Department has performance indicators and targets for Corporation Tax which focus on Areas' enquiry work. It has developed these to provide a closer link with the Department's new Public Service Agreement target for reducing the level of underpaid tax. In 2002-03 the Department expanded the range of performance indicators and targets used for monitoring performance on Corporation Tax, having previously concentrated only on the numbers of enquiries completed. In 2004-05 it outperformed all of its Corporation Tax targets except for the yield:cost ratio on its full enquiries and the length of time its aspect enquiries are open. The Department has introduced new targets for 2005-06 which focus on total yield across the tax-streams. Areas are expected to contribute to meeting these Department-wide targets, which could encourage them to consider risks across the various taxes they manage. The main drawback of targets based on yield is that it could prompt Areas to concentrate on enquiries with firmer prospects of an immediate pay back at the expense of preventive work, including enquiries on loss-making companies which secure tax yields if subsequently a company moves into profit. [paragraphs 2.3-2.6]

11 There are variations in enquiry coverage so that companies of a similar size and compliance risk are more likely to be the subject of an enquiry in some Areas than in others. This uneven coverage stems from imbalances across Areas in the number and experience of tax inspectors compared to the number and complexity of the companies dealt with by each Area. The number of companies subjected to Corporation Tax enquiry ranged from 2 per cent of returns in one Area to 9 per cent in another. The number and type of enquiries is largely determined by the number and experience of staff in each Area. To achieve a better balance between caseloads and staff resources, the Department has moved some cases between Areas. [paragraphs 2.14-2.16]

12 There are also large variations across Areas in the additional tax yield they secure from their Corporation Tax enquiries. Overall, the average yield from full enquiries was £27,000, but ranged from an average of £13,000 in one Area to £60,000 in another. Yields on aspect enquiries were £12,000 on average, and Area averages ranged from £4,000 to £36,000. There was significant variation even when yields were weighted to reflect the size and complexity of the company caseload dealt with by each Area. The variations in the staffing, risk assessment, coverage and results of enquiry work suggest there is scope to achieve higher yields overall. An illustration of the broad order of magnitude of these variations is if Areas with below average yields in 2004-05 (weighted for each Area's company tax base) could have secured the network average yield, the total yield might have been around £60-100 million more. [paragraphs 2.13-2.15, 2.23]

13 The Department has over the last four years encouraged Areas to take a more structured approach in risk assessing returns to select cases for enquiry. This has involved making greater use of databases and a central catalogue of risk-profiling projects alongside the traditional technique of manually screening the returns and supporting documents. Higher performing Areas tended to make more extensive use of these techniques. Returns and their supplementary documents can run to many pages, and 'screening' them for non-compliance depends heavily on the skill and experience of staff. Some Areas continued to review all returns from companies above a particular level of turnover. Most, however, used a system for scoring the complexity of companies, a range of the databases available and risk-profiling 'projects' to select cases for enquiry or to reduce the pool of cases requiring screening or review. Some Areas considered they were unable to take full advantage of such techniques because of a lack of staff trained in the use of available databases. [paragraphs 2.18-2.22]

14 Areas have made increasing use of risk profiling projects, but as yet these do not appear to be significantly increasing the yields on full enquiries. Evaluating the results of project work will help in refining their design or improving the way they are applied. Since 2002-03, the Department has required Areas to use its catalogue of centrally defined risk-profiling 'projects' to generate at least 40 per cent of their full enquiries. Our survey of Areas found that such projects, along with projects devised locally, had helped to generate two-thirds of full enquiries in 2004-05. Areas which were making greater use of projects have not all recorded higher additional tax yields from their full enquiries. Some Areas using projects to select all of their full enquiries had recorded the lowest yield rates, although this might in part be because the project cases so far completed may be simpler than those still underway, involving lower potential yields. The Department's requirement for Areas to collect data on the results of projects should in time provide a means of evaluating which are the most worthwhile. [paragraph 2.21]

15 In setting targets for the number of Corporation Tax enquiries, the Department expects a minimum level of coverage of smaller companies. The Department plans to carry out further research on the deterrent effect of this coverage and the compliance risks associated with different sizes of companies to establish a baseline. The tax yields from small or less complex cases are low and under a risk based approach such cases might warrant little attention. The main purpose of setting a minimum level of coverage is to deter non-compliance amongst this group. The Department currently sets the minimum level of coverage without a detailed assessment of the relative compliance risk of different sizes of business. [paragraph 2.20]

16 The Department is examining how it can follow a more joined up approach for its compliance work on the different business taxes, which could bring benefits for both the Department and business taxpayers. The Department has initiated an analysis of the causes of non-compliance and errors that feature most commonly in company tax returns to inform its overarching risk strategy for direct taxes. The risks posed by a particular company on Corporation Tax may also be indicative of risks in other taxes such as PAYE. Our survey of Areas found that for full Corporation Tax enquiries, which could be most suitable for joint review, nine per cent also covered other taxes paid by the companies. The Department is undertaking pilot projects in four Areas to examine how enquiry teams can focus more on the business rather than each tax. [paragraphs 2.24-2.25]

17 Planned improvements in the databases available and further development of the company tax returns online filing system should help the Department enhance its risk assessments. Online filing enhancements should also contribute to more efficient processing of returns and greater convenience for many businesses. The 'Better Data for Corporation Tax' initiative, which is combining existing databases and making them more readily accessible, should help Areas to strengthen their risk assessments. In time, the Department expects to be able to process and analyse data in the accounts and tax computations filed electronically, and this should improve the availability and utility of data for risk assessments. [paragraphs 2.26-2.27, 3.9]

Enabling companies to comply with their Corporation Tax obligations

18 There is relatively little research on the administrative burden and costs for businesses in meeting their Corporation Tax obligations, although some studies suggest that these might be less in the UK than in some other countries. The level of errors in tax returns suggests that the complexity of the tax may be contributing to the difficulties some companies appear to face in complying with the regulations. Research suggests that Corporation Tax has the least compliance burden of the three main types of business taxes. Nevertheless, the business community and representative tax bodies have raised concerns over the compliance burden of Corporation Tax as well as of other business taxes. Academic and other research indicates that the burden arises principally from the complexity of the Tax structure, which requires various adjustments to the way in which assets, income and expenditure are presented in company accounts to arrive at taxable profit, and a growing volume of frequent legislative change. [paragraphs 3.2-3.3, 3.10]

19 The Department has introduced new measures to help Corporation Tax payers to submit compliant returns. Companies may use an electronic return which has in-built checks and provides an automatic acknowledgment of its receipt. The Department has also introduced a shorter paper form for those companies with simpler financial affairs. In recent years Areas have negotiated 'enabling' relationships with some of their largest companies, to deal with tax issues and to review companies' working papers before they submit their tax return. The benefits are convenience for companies in arranging their dealings with the Department and simple points can be clarified without the need for a formal enquiry. [paragraphs 3.7-3.9]

20 Enquiries are being carried out more quickly but they still take many months to complete. A Department trial of new methods for sharing data and communicating with companies suggests that the elapsed times for enquiries could be significantly reduced. Aspect enquiries which resulted in no additional tax yield or profit adjustment take on average 33 weeks to complete, and full enquiries 71 weeks. Enquiries in some Areas take much longer than this. The time taken to complete enquiries is affected by the time needed to check aspects of the return as well as the time taken by companies or their agents to respond to inspectors' questions. A trial in one Area using web-based technology to communicate and work with agents more effectively has indicated that elapsed times might be reduced by up to 20 per cent. [paragraphs 3.11-3.13]

21 The Department is taking steps which could reduce the obligations on companies and make it easier for them to meet their Corporation Tax obligations. The Department has been consulting on ways for smaller companies to file less data on a range of taxes less often and more easily. It outlined responses to the consultation in November 2005. In parallel with the Hampton initiative on reducing the impact of government regulation, it is mapping Corporation Tax and other tax requirements placed on companies to set a baseline for tracking and reducing the costs of compliance. As part of its restructuring, the Department has set up a business unit for small and medium enterprises and employers to focus more clearly on the needs of this taxpayer customer group. [paragraphs 3.4-3.5, 3.14]

Efficiency in managing Corporation Tax

22 The Department spent £320 million on Corporation Tax work in 2004-05, including central overheads, two-thirds of which related to Areas' work. Around 1,900 of some 39,000 staff in Areas work on Corporation Tax. About 800 staff processed company tax returns and other administrative and compliance tasks and another 1,100 undertook Corporation Tax enquiries. [paragraph 4.1]

23 There were wide variations in Areas' efficiency in processing company tax returns, indicating scope for efficiency savings. Areas have coped with a major surge in new incorporations over the last three years. Nevertheless, some Areas had six times the ratio of processing staff to returns processed as other Areas, although the range of tasks undertaken by these staff varied between offices. Our analysis of the Department's data indicated that if all Areas had undertaken tasks they recorded as processing work at the average rate nationally, staff costs might have been up to £2.2 million (13 per cent) lower. Because some Areas include some compliance activities in their 'processing' figures, however, any such improvement in processing rates might involve increased off-setting costs for enquiry work. The Department's plans to develop e-filing should reduce the cost of processing returns, and potentially greater savings might be possible if that allowed the Department to no longer have to process returns at the same locations as those undertaking enquiries. [paragraphs 4.2-4.3]

24 There were also wide variations in Areas' efficiency in undertaking enquiries, again indicating potential for greater efficiency. Average enquiry costs were twice as high in some Areas as in others, although this reflected in part the additional tax yields achieved. Broadly speaking £13 of yield required £1 of enquiry staff cost. Yields to some extent reflect the size of the companies each Area deals with. Taking this into account, some Areas were more efficient than others in terms of achieving their potential yield, with some incurring costs two or three times higher than others to secure similar weighted yields. [paragraphs 4.5-4.6]

25 An important factor in the variations in enquiry efficiency appears to be differences in enquiry coverage, noted above, which causes Areas to cover their higher-risk companies to different degrees. But other factors are also involved. The Department has initiatives underway to improve the efficiency of enquiry work, and is currently reviewing the number and location of local offices as part of its restructuring. The Department's trial on electronic communications with companies during enquiries (paragraph 20) could reduce enquiry costs. It has also developed a 'team working' system to allocate enquiry tasks more closely to staff with the appropriate level of experience, and a new planning system to balance local workloads and resources more closely across tax-streams. Further improvements could also be made from wider use of working practices that only some Areas use at present. [paragraphs 4.7-4.10]

Overall conclusions

26 The management of Corporation Tax in the network has improved in recent years with the introduction of a more structured approach to risk assessment, better management information, and a new framework of performance indicators. Over the last five years the Department has significantly increased the additional Corporation Tax yield that Areas secure while carrying out fewer enquiries which take less time to complete.

27 Significant variations in performance remain across the 68 Areas, however, providing scope for savings in the cost of Corporation Tax processing and enquiry work, together with still higher yields. Much of the variation arises because resources are not matched to risks sufficiently closely throughout the network.

28 The Department's plans for reorganising local compliance work into fewer but larger offices, on which it is consulting staff, provides an opportunity to improve the effectiveness and efficiency of its work. Thus, it should be possible for the Department to match staffing levels and experience more closely to local compliance risks and workloads. It should also be easier to provide staff skilled in using risk-assessment databases across all new local offices. And best practices and experience of new techniques ought to be more easily shared if staff work together in bigger units.

29 At a more fundamental level, the scope for compliance improvements hinges not just on the way enquiries are managed but on being able to tackle some of the underlying reasons for non-compliance. The Department is taking steps to address some of those factors. Its random enquiry programme should help it identify the nature and risks of non-compliance. The Department's stronger focus on taxpayers' needs, together with any tax simplification from the current consultations and initiatives to reduce compliance burdens, should help to increase levels of compliance. These should make it easier for companies to understand and meet their requirements, and enable the Department to concentrate its work on those that seek to evade the tax.

RECOMMENDATIONS

On tackling non-compliance

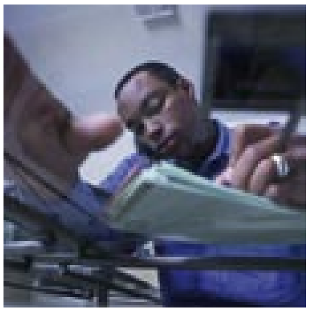
a Given the lower yields generally achieved from enquiries on small companies, and the time and cost these impose on the companies themselves, the Department should establish the extent and nature of non-compliance risks in this sector to formulate a reasonable minimum 'policing' coverage.

b Risk-profiling projects have the potential to help the Department to target quickly and effectively higher risk Corporation Tax cases for possible enquiry. To realise their full benefits, and to eliminate less productive work, the Department should analyse the results of centrally-defined projects to identify the most promising for further development and wider use. For risk assessing returns more generally, the Department should also use the results of the NAO's survey of Areas to target efforts to expand the use of available databases.

c In devising its new local office structure, the Department should aim to provide the skills needed to develop project work in local offices, and that each office has access to sufficient expertise in using databases and other analytical tools for risk assessment. It should also consider the benefits and costs of building up specialist knowledge on different business sectors to help improve its risk assessments and targeting of enquiries.

d Electronic filing of company tax returns should bring various benefits to the Department including opportunities for more effective risk-assessment. With further development, the Department will be able to process and analyse the data in the accounts and tax computations filed electronically, and should then encourage companies and their agents to file their tax returns and accounts online, and set targets for increasing take-up.

e Penalties applied should be sufficient to encourage companies to comply and to obtain appropriate advice from any third-party agents. But the Department first needs to improve its understanding of how it applies penalties in practice by analysing its use of negligence penalties and the abatements it makes.



On enabling compliance

f The Department should publicise the main types of non-compliance it rectifies, particularly for newly incorporated businesses.

g To encourage Areas to carry out preventive work that helps companies to comply, the Department should extend its current range of performance indicators to recognise the benefits also of this work, and consider how it might quantify the revenue benefits achieved from this type of work. It should also take account of the less-immediate benefits for tax yields from enquiries on loss-making companies which later become profit-making, to ensure this type of enquiry is accorded appropriate priority.

h The Department should reduce the time taken to complete enquiries, building on the encouraging results of its trial of an electronic 'shared workspace' in one Area, and the practices of those Areas with the lowest average elapsed times.

i In developing the role of its new customer business units, the Department should explore ways of obtaining more direct feedback on businesses' tax compliance burdens and possible improvements through the appointment of 'business ambassadors' from the business community.

On the efficiency of managing Corporation Tax

j As it seeks to reorganise local office structures, and in anticipation of greater use of electronic filing of company tax returns, the Department should explore the costs and benefits of concentrating returns processing in fewer locations.

k The Department should redistribute Corporation Tax enquiry workloads across Areas to even out the way risk is covered through its enquiries, building on existing local work-sharing arrangements. In reorganising the local office structure, it should build a sufficient critical mass of work for all offices to allow it to balance resources with risk more closely. This is also likely to require a fundamental reassessment of the workload norms and the way staff resources are allocated to enquiry work to improve productivity. It might also include widening the approach of enquiry work, by embracing more cross tax-stream enquiries.

l The Department should track the efficiency of Areas' enquiry and other compliance work, not just of the work actually undertaken but also in terms of Areas' relative efficiency in securing additional tax yield compared with the size of their local company caseload.