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HM REVENUE & CUSTOMS

Filing VAT and Company Tax returns

REPORT BY THE COMPTROLLER AND AUDITOR GENERAL | HC 102 Session 2006-2007 | 13 December 2006

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4 December 2006

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SUMMARY

1 **Value Added Tax (VAT) and Corporation Tax raised around £120 billion in revenue in 2005-06.** As at March 2006, some 1.8 million businesses were registered for VAT and 1.8 million companies registered to file Company Tax returns, which cover their liability for Corporation Tax. 600,000 businesses must file both types of return.

2 **This report examines the performance of HM Revenue & Customs in securing and processing VAT and Company Tax returns from businesses which should submit them. It covers:**

- **Getting the returns in on time** and the consequences of late filing (Part 1);
- **Efficiency in dealing with the returns**, including the use of online filing (Part 2); and
- **Customer service and the compliance burden on businesses** making returns (Part 3).

3 Until March 2005, Corporation Tax was managed by Inland Revenue and VAT by HM Customs & Excise. The Departments merged to form HM Revenue & Customs. Company Tax returns[1] are dealt with at 64 Area Offices across the United Kingdom, and by 11 Large Business Service offices for the largest companies. VAT returns are processed at a single location in Southend-on-Sea.

4 Our study methodology is at Appendix 1. The main elements were:

- analysis of the Department's financial and performance data and an overview of its processing systems;
- review of other countries' processing of online and paper business tax returns;
- research into the barriers and incentives for online filing by businesses; and
- consultation with organisations with a professional interest in VAT and Corporation Tax.

This report does not cover those businesses that seek to evade tax entirely by operating within the shadow economy, which we have examined in previous reports (Appendix 1).

Conclusions

5 Getting accurate tax returns in on time is important for HM Revenue & Customs in ensuring it is collecting the right amount of tax at the right time. Over the last three years the number of Company Tax returns filed on time has remained broadly stable at 77 to 79 per cent. Following the introduction of a 'default surcharge' penalty for businesses not paying on time the full VAT amount due, the VAT return compliance rate has stabilised at 85 per cent. As at mid October 2006, there remained 230,000 assessments of business' VAT liability (which the Department made in 2004-05 and 2005-06 in the absence of VAT returns from businesses) which had not been replaced by completed VAT returns. And 160,000 Company Tax returns which were due in 2004-05 had been outstanding for 12 months or more. The Department does not have readily available information on the total number of Company Tax returns outstanding from all previous years. It also does not know the potential tax liability arising from all missing returns. At least £1.5 billion of tax is in doubt from late and non-filed VAT and Company Tax returns. The level and the way in which penalties are applied for late filing for the two tax returns has not proved effective in further improving compliance.

6 The Department's current review *'Modernising Powers, Deterrents and Safeguards'*[2], provides an opportunity to improve value for money. This can be done by rewarding those with a good compliance record and ratcheting up the measures against those that persistently fail to meet their obligations, through more effective use and collection of penalties. Such an approach is being piloted by the Department's Large Payers Unit and Large Business Service on measures to tackle all forms of tax debt collectively. To underpin this approach, the Department needs to develop a better understanding of which businesses do and do not comply and why, and the barriers to compliance so that it can target its effort to best improve compliance.

1 Key facts and figures

2005-06 data	**VAT**	**CT**
Net Receipts	£74 billion	£42 billion
Nature of the tax	A tax that VAT registered businesses charge on goods and services they sell against which they can offset the VAT they incur on their purchases	A tax on the profits and gains of companies and unincorporated associations
Registered businesses	1.8 million	1.8 million
Filing deadlines	The majority file quarterly, one month after the end of the quarter	12 months after the end of the accounting period
Returns processed	7.8 million[1]	1.3 million
Processing of returns	All returns are processed at one location in Southend-on-Sea	Returns are processed by 64 Area Offices and 11 Large Business Service Offices
Returns filed by filing deadline	85%	79%
Returns filed online *First half 2006-07*	4.9% *7.8%*	1.9% *7.2%*
Cost of processing filed returns	£4.1 million	£5.1 million

Source: National Audit Office analysis

NOTE

1 The 7.8 million VAT returns filed annually is based on businesses who file monthly, quarterly and annually and changes through new registrations and deregistrations.

7 The Department spends £9.2 million a year on processing VAT and Company Tax returns. It also incurs further costs in chasing businesses for overdue returns and correcting errors. For example, in 2005-06, the Department spent £1.2 million correcting errors on VAT returns. Online filing of returns could improve the Department's efficiency and reduce costs to businesses. In 2005-06, the take up of online filing for both returns was below five per cent but increased to 7.8 per cent for VAT and 7.2 per cent for Company Tax returns in the first half of 2006-07. Although revenue departments overseas will have different priorities and activities[3], online filing in some other countries is higher.

8 Compatibility of software packages to prepare and submit tax returns, high set up costs and the greater convenience of paper returns are some of the barriers which businesses face in using the Department's online systems. The Department has begun to develop a strategy to implement Lord Carter's recommendations for mandatory online filing, which start from April 2008 for large and new businesses filing VAT returns and March 2010 for all Company Tax returns. This strategy will need to address several priorities – including the communication, wider use of electronic guidance around compulsory online filing, educating businesses/agents on how to file online, measures to encourage businesses to switch, ensuring data security, and robustness of the online service.

9 The Department reduced the staff costs of processing VAT returns by 12 per cent in 2005-06, without affecting the speed of processing and checking returns. However, the national average unit staff cost of processing Company Tax returns across the Department's 64 Area Offices increased marginally in 2005-06. Some Area offices managed to reduce their own unit costs by restructuring the work and sharing work between locations at peak times. The Department has not tracked Area Office performance against targets on their promptness and accuracy in processing Company Tax returns.

10 The Internal Revenue Service in the United States continuously monitors workloads, processing efficiency and accuracy to identify any problems, plan staffing levels and transfer peak workloads between sites. The Department could improve efficiency in processing Company Tax paper returns by drawing on the good practices adopted by some Area offices, good practice in VAT return processing and by overseas revenue departments. In response, the Department is reviewing its logging and data capturing process for Company Tax returns to ensure best practices are used consistently.

11 Customer satisfaction in dealing with the Department is broadly the same amongst those filing VAT returns and those filing Company Tax returns. The Department has taken various steps to improve customer service. It has measured the administrative burdens the tax system places on businesses and has set a target to reduce the burden by at least 10 per cent by 2011. It plans to require businesses to provide information only once, to enable them to contact a single number and receive a comprehensive service across the range of taxes and duties – a one-stop-shop. Through the *'Modernising Powers, Deterrents and Safeguards'* review and better risk management, it would give a lighter touch to businesses with a good record of compliance and also target education and guidance to help businesses that want to comply.

12 The creation of the new Department provides new opportunities to identify and share good practices in tax return management across both taxes, for example, in reducing processing costs, and improving customer satisfaction. There are also opportunities for the Department to learn from its approaches to other tax returns. For example, the Department has a much greater understanding of taxpayers who fail to file Income Tax Self Assessment returns on time than it does for businesses that file VAT or Company Tax returns late, and it uses this knowledge to improve compliance. The Department is undertaking work to increase its understanding. It could also learn from other revenue departments that have a greater understanding of the businesses that fail to comply with their obligations across a range of taxes.

Recommendations

13 Our recommendations aim to yield efficiency savings for the Department, reduce tax at risk and improve the Department's progress towards its targets. We recommend that the Department should undertake the following which may be implemented relatively quickly and at low cost:

Getting tax returns in on time

i Analyse the tax at risk from failures to file correctly (late, non-filed and inaccurate returns) and identify by sector the hardcore of businesses responsible, focusing on those which are late with both their VAT and Company Tax returns. The analysis should be subject to rigorous quality assurance to ensure the results are accurate for risk assessment purposes. Nine per cent of VAT returns are outstanding one month after the due date and 12 per cent of Company Tax returns are outstanding 12 months after the filing date. The Department has carried out initial analysis to identify which business sectors fail to meet VAT obligations and has identified areas of relatively poorer filing performance, but it has less understanding of the problem areas for Company Tax returns. The Department plans in future to quantify the filing risks for Company Tax returns as well. A better understanding of why businesses fail to comply would help the Department target its compliance work for both taxes (paragraphs 1.7 to 1.8).

ii Track the effectiveness of any new penalty regime in changing filing patterns and incentives to encourage compliance and improve filing performance. This should include the amount of penalties imposed and paid (paragraphs 1.11 to 1.12).

Efficiency in dealing with returns

iii Continue to develop, test and implement mechanisms to achieve the new targets for mandatory online filing, in consultation with stakeholders, agents and businesses. This should draw on good practice within the Department and lessons from other tax authorities that have moved to mandatory online filing or which have a high take-up of online filing. Moving to online filing for both types of return is expected to achieve savings for both businesses and the Department. The online systems need to be reliable and easy for businesses and agents to use. The Department should work on developing electronic communication with customers which meets their needs and requirements. All systems should include adequate system testing (paragraphs 2.1 to 2.8).

iv Until full online filing is achieved, promote good practice across Area Offices to achieve greater efficiencies in processing paper Company Tax returns. The Department did not, in 2005-06, monitor whether individual Area Offices met targets for processing returns promptly and accurately. It should set quality standards for logging and data input of returns across all its sites. It should also benchmark their costs and workloads and identify the reasons for variations, to improve performance. The experience of processing VAT returns should be used to identify any opportunities to transfer good practice to processing Company Tax returns (paragraphs 2.9 to 2.14).

Customer service and the compliance burden on businesses making returns

v Improve the HM Revenue and Customs website (www.hmrc.gov.uk) so that businesses have ready access to relevant information and advice. It should provide businesses with easy access to a full range of clear, simple, accurate and up to date information and advice needed to file VAT and Company Tax returns. Various independent reviews of Government websites provide useful insights about customers' needs and how to improve website content, presentation and navigation.[4] HM Revenue and Customs has reviewed its website to understand better customers' needs and best practice. It plans to transform its website in phases by 2008 in terms of look and feel, ease of navigation and provision of customer content (paragraph 3.4).

vi Update its VAT public notices promptly to provide clear, accurate and readily understood information. Public notices should include all the relevant points instead of cross-referring to other documents that businesses may find difficult to track down (paragraph 3.3).

vii Using its Business Customer Unit, work with businesses to improve the VAT return, in particular the associated guidance to make it easier to prepare (paragraph 3.3).

viii Ensure that staff on telephone helplines and in local offices have the training and experience to provide businesses with the information requested. This needs to go beyond repeating what is already available to the businesses by tailoring support to the needs of customers such as agents. It should draw on the results of the quality assurance process and analysis of common questions and errors made to ensure consistency of the information provided by helplines (paragraph 3.6).

The following recommendations would require further policy analysis and research into the costs and benefits of implementation, consultation with businesses and possibly legislative changes, some of which the Department has started to develop. The Department should:

ix On Corporation Tax, consider whether benefits for the smallest companies, with the simplest financial affairs and with no tax liability, could be secured through policy changes removing the need to file returns. The Department should research the potential savings in its own costs and in reducing the compliance burden, together with the risks to tax revenues from such a change (paragraph 3.5).

x Following the consultation in 2005-06, continue to explore aligning the dates for payment of Corporation Tax, the filing of accounts to Companies House and the filing of the Company Tax return to HM Revenue & Customs. This would mean that over 1.3 million of the smaller companies could submit their accounts to government once instead of twice and make any tax payment due at the same time, rather than in advance of filing. Any enquiries could begin earlier making the compliance process more efficient. It would bring the filing period in the United Kingdom for these companies more into line with the international average of five months (paragraph 3.8).

xi Provide businesses with an online statement of account showing tax payments and liabilities across all taxes, building on the development work already begun (paragraph 2.8, area 2).

xii Seek powers to offset any repayments due on VAT against outstanding debts on Corporation Tax or other taxes, and vice versa. The Department is already considering this along with a reference to a single financial account which will give the Department a complete view of an entity's financial position across the range of taxes and duties (paragraph 1.14).

xiii As part of the review *'Modernising Powers, Deterrents and Safeguards'*, explore the costs and benefits of introducing non-financial incentives such as tax clearance certificates for businesses that comply fully with their tax obligations across the range of taxes (such as Corporation tax and VAT). Such measures are already used by some revenue departments in other countries and are a powerful incentive to comply with taxation obligations as they may be required by businesses before they can be awarded public sector licences, grants and contracts (paragraph 3.14).

PART ONE

Getting returns in on time

1.1 Value Added Tax (VAT) and Corporation Tax are major sources of government revenue, raising some £120 billion a year (£74 billion net receipts from VAT and £42 billion net receipts from Corporation Tax in 2005-06). Some 1.8 million businesses are registered for VAT and 1.8 million companies are registered to file Company Tax returns which cover their liability for Corporation Tax. 600,000 businesses must file both types of return. Between April 2003 and March 2006, the number of businesses registered for VAT increased by 7.7 per cent and the number of companies required to file Company Tax returns increased by 25 per cent, encouraged by the introduction in April 2002 of a zero rate of Corporation Tax on profits under £10,000.

The requirement to file returns

1.2 Businesses which are required to file VAT and/or Company Tax returns may range from those intending to start in business or with a very low turnover (the VAT registration threshold is £61,000) to large multinational companies. Smaller businesses tend to use an agent to file their Company Tax returns and some also use agents for their VAT returns. Larger companies often have their own tax departments for this purpose.

1.3 The Department processes some 7.8 million VAT returns each year. Businesses are normally required to file these one month after the end of each quarter, showing the net VAT liability. This represents the difference between the VAT incurred on purchases (input tax) and the VAT charged on sales (output tax). It takes into account any VAT due on transactions with other European Union countries or other third party countries. For nearly 30 per cent of returns, the return results in a repayment from the Department (it repaid £54 billion of VAT in 2005-06).[5] The Department currently logs and processes all VAT returns and payments centrally in Southend-on-Sea (Appendix 2 shows the VAT return filing process).

1.4 Once companies have registered with Companies House, they are required to notify the Department within three months of becoming liable to a Corporation Tax charge. Companies are required to self assess the amount of Corporation Tax payable as part of their Company Tax return which includes supporting accounts and computations. The standard return form is eight pages long. The Department has also introduced a short (four page) form for companies, clubs and societies with less complex tax affairs. The Department issues a notice for the company to deliver a Company Tax return after the end of the company's accounting period. The Department requires the return by the filing date, usually 12 months after the end of the company's accounting period. It issues over 600,000 short return forms annually.

1.5 In 2005-06, the Department logged and processed around 1.3 million Company Tax returns at 64 Area Offices and 11 Large Business Service Offices across the United Kingdom – which carry out compliance work and customer relationship management for the large businesses for which they are responsible (Appendix 2). The Large Business Service deals with the Corporation Tax and VAT of the largest businesses comprising 1,300 groups of companies. 57 per cent (£24 billion) of total Corporation Tax receipts and 37 per cent (£28 billion) of VAT receipts were from businesses dealt with by the Large Business Service.

The Department's performance in getting returns in on time

1.6 Getting accurate tax returns in on time is important for HM Revenue & Customs in ensuring it is collecting the right amount of tax at the right time. The percentage of returns filed on time has been broadly stable over the three years since April 2003. **Figure 2** shows businesses' compliance in filing returns from 2003-04 to 2005-06. In 2005-06, 85 per cent of VAT returns and 79 per cent of Company Tax returns were filed on time. And over 90 per cent of VAT returns are received within one month of the due date. However, almost 230,000 assessments (made by the Department of a business's VAT liability in the absence of a VAT return from that business) made in 2004-05 and 2005-06, had not been replaced by a late return by mid October 2006. 88 per cent of Company Tax returns received in 2005-06, were returned within 12 months of the due date. At the end of March 2006, around 160,000 Company Tax returns, that were due in 2004-05, were still outstanding.

Businesses that fail to file accurately and on time

1.7 In 2003, the Department introduced a national 'VAT Compliance Strategy'. It aims to address the risks presented by businesses across the entire VAT registered population based on their different behaviours and different types of risk - registration, declaration, filing and payment, to determine the most appropriate form of compliance intervention. The Department has a long term plan to use the lessons learned from the VAT strategy and is developing a national risk register and picture across all taxes and a Department wide compliance strategy. Its initial work to identify which businesses do not file on time focused on 19 business sectors. In the VAT section of its risk register, the Department has identified areas of relatively poorer filing performance, covering the trade sectors of agricultural production, labour provision, construction, textiles and transport/warehousing.

2 Businesses' compliance in filing VAT and Company Tax returns

	Financial year	Returns issued (millions)	Returns received by the filing date (%)	Returns received by the end of the month following the filing date (%)	Assessments outstanding at mid October 2006 not replaced by a late return
VAT return	2003-04	7.2	85	91	Not known
	2004-05	7.4	85	91	83,000
	2005-06	7.6	85	91	150,000

	Financial year	Returns due (millions)	Returns received by the filing date[1] (%)	Returns received within 12 months (%)	Returns outstanding 12 months or more at 31 March[2]
Company Tax return	2003-04	1.2	77	87	Not known
	2004-05	1.4	77	88	150,000
	2005-06	1.6	79	88	160,000

Source: National Audit Office analysis of HM Revenue & Customs' data

NOTES

1 Returns received by the Company Tax filing date are counted by the Department seven days after the statutory filing date (the extra statutory concession period allowed before a late filing penalty is charged).

2 Returns outstanding for 12 months or more at the year end relate only to outstanding returns from the previous financial year. The Department does not have data on the total number of outstanding returns from all previous years.

1.8 The Department's understanding of the small and medium sized businesses that fail to file Company Tax returns on time is at local level only – as developed by the Area Office inspectors responsible for those companies. This contrasts with the computerised procedures developed by the Tax and Customs Administration in the Netherlands that determine risk scores for each business. The Department is undertaking a feasibility study into conducting a central risk analysis to identify inaccurate (and not specifically late) Company Tax returns during 2006-07 with a view to trialling the outcome in its compliance activity during 2007-08. It is investing in improved systems to analyse companies' behaviour in filing Company Tax returns. The Department does not have a detailed understanding of the businesses that fail to comply with both taxes, or whether there is any correlation between businesses that file late and those that file inaccurate returns.[6] It has not yet carried out sufficient work to enable data matching of businesses across its business taxes to allow it to carry out risk analysis across these taxes. In contrast, the Department has a more detailed knowledge of large businesses dealt with by its Large Business Service and, more generally, of compliance behaviour in filing Income Tax Self Assessment returns. There it has identified the sectors at highest risk of late filing and non-filing and researched the reasons.

The tax consequences of late filing

1.9 Late filing leads to difficulties for the Department in confirming whether the right amount of tax has been paid. Late filing may also be linked to late payment. 74 per cent of businesses filed and paid VAT on time in 2005-06 and 60 per cent of companies filed their Company Tax return and paid their Corporation Tax on time. For Corporation Tax this was a drop from 63 per cent in 2004-05 and for VAT a slight decrease from 75 per cent in the same period. The Department does not have information readily available on the amount of tax outstanding on missing returns or the number of businesses with more than one return outstanding. At least £1.5 billion of tax revenue was in doubt from late and non-filed VAT and Company Tax returns at mid October 2006. The estimate includes:

- £340 million of VAT assessed for returns outstanding in 2004-05 and £1.05 billion of VAT assessed for returns outstanding in 2005-06. In 2004-05, the Department raised 530,000 assessments. At mid October 2006, in 83,000 of these cases the VAT return remained outstanding. The average value of assessments where the return was still outstanding was £4,100. It raised 540,000 assessments in 2005-06, of which 150,000 remained outstanding at mid October 2006, with an average value of £7,300. Any tax lost will depend on whether businesses eventually pay the Department's assessment or file a return after the assessment is made and the percentage of those which have ceased trading.
- Around £180 million of Corporation Tax for 2005-06 for outstanding Company Tax returns. The Department estimates the average liability of tax per missing return as up to £1,100. At the end of March 2006, around 160,000 Company Tax returns from 2004-05 had been outstanding a year or more.

1.10 The Department needs to develop a better understanding of the non-compliant filing population. This may include, for example, analysis by sector, location or size of business and whether the business has more than one return outstanding. The Department uses late or non-submission as indicators of risk as part of its VAT Central Risk Assessment to target undeclared VAT. In 2005-06, the Department made 44,000 revenue determinations for outstanding Company Tax returns with a value of £2.3 billion. By July 2006, £2 billion (86 per cent) had been displaced by returns and self assessments which represented 37 per cent of the determinations made. The Department has not analysed those businesses which have not filed a return and have received an assessment for VAT and or a determination[7] for Corporation Tax, to understand why businesses fail to pay their tax on time. Such analysis would enable the Department to target its compliance activities across both taxes.

Penalties to encourage on time filing of returns

1.11 The Department can impose penalties for late or non-filed returns. It imposes specific penalties for late filing of Company Tax returns **(Figure 3 overleaf)** and imposes interest on late payment of Corporation Tax. The Department applies a default surcharge penalty on VAT unpaid at the due date. If a business has not filed its VAT return on time, as well as not paying VAT due, the Department calculates the default surcharge penalty based on its assessment of the amount due. There are a variety of circumstances when the Department may decide not to raise a VAT penalty (Figure 4 notes).

3 Shows late filing penalties for Company Tax returns, the number issued and penalties issued as a percentage of the number of returns outstanding in that year.

Sequence of penalties	Value of penalty	Timing	2003-04		2004-05		2005-06	
			Penalties issued (000's)	(%)[2]	Penalties issued (000's)	(%)	Penalties issued (000's)	(%)
First flat rate	£100[1]	Day following statutory filing date	230	2	220	58	250	56
Second flat rate	£100[1]	Day following three months after statutory filing date	120	2	130	36	140	34
First tax-related	10% of unpaid tax at the date liability to the first tax-related penalty arises	Day following 18 months after the end of the accounting period	43	2	38	11	45	12
Second tax-related	10% of the unpaid tax at the date liability to first tax related penalty arose	Day following two years after the end of the accounting period	24	2	22	6.4	22	5.6

Source: National Audit Office analysis of HM Revenue & Customs' data

NOTES

Figures are based on the number of returns outstanding at the time a penalty is due to be raised. The Department may not always charge a penalty as companies may have a reasonable excuse, have an agreed extension or have declared insolvency.

1 If a company incurs a flat rate penalty for three consecutive accounting periods and was liable to a penalty for the first two, the first and second flat rate penalties increase to £500 and £1,000.

2 The number of outstanding returns at the various penalty trigger points is not available for 2003-04.

4 The number of VAT penalties issued for non payment (in thousands)

Penalty	Value of penalty	Issued	2003-04 (000s)	2004-05 (000s)	2005-06 (000s)
Default surcharge for a business not paying on time the full VAT liability declared as due[1]	First default – issue of a surcharge liability notice with a warning of a surcharge of 2% of the tax outstanding Subsequent offences – 5%, 10% and 15% of outstanding tax at the due date	Two weeks after the due date	270	240	250

Source: National Audit Office analysis of HM Revenue & Customs' data

NOTE

1 The Department does not issue default surcharge penalties to small, newly registered businesses filing for the first time, businesses requesting a repayment from the Department, those intending to deregister, local authorities, or those with a reasonable excuse for a late return.

1.12 The Department raised 710,000 penalties in 2005-06.[8] The Department does not know the cumulative value of the range of penalties it imposes for late filing of Company Tax returns. It estimates that 78 per cent of Company Tax return penalties were paid in 2005-06, based on the penalties charged and paid on a sample of 10,000 companies. The number of late filing penalties issued for Company Tax returns as a percentage of outstanding returns[9] declined in 2005-06 compared with previous years. (Figure 3) The Department imposed £270 million of VAT related penalties. The number of VAT default surcharges imposed fell from 270,000 in 2003-04 to 240,000 in 2004-05, followed by a rise in 2005-06 to 250,000 **(Figure 4)** Payments received by the due date have been increasing for VAT with nearly 50 per cent of all VAT receipts received by the due date plus seven days in 2005-06.

1.13 The Department's research has shown that the fixed penalties for late filing of Company Tax returns have limited impact on encouraging companies to file already overdue returns or in deterring those companies intent on filing late. The Department considers that the introduction of the default surcharge penalty for businesses not paying on time the full VAT amount due, has helped stabilise the VAT return compliance rate at 85 per cent. The powers to levy penalties are different for VAT and Corporation Tax, reflecting how the powers of the former HM Customs & Excise and Inland Revenue had evolved over time. Following the creation of HM Revenue & Customs, the Paymaster General commissioned a *'Modernising Powers, Deterrents and Safeguards'* review to provide a framework of law and practice for the new Department. The Department consulted with businesses during the review and its response to the consultation exercise is due by the end of 2006. If a new penalty regime is introduced the Department should assess the effectiveness by analysing when penalties are raised, how quickly businesses pay and how effective the penalties are in improving on time filing.

1.14 The Netherlands Tax and Customs Administration has a uniform penalty regime for VAT and Corporation Tax, with the same flat-rate penalties for late filing and late payment for both taxes. Its system is similar to the Company Tax returns penalty regime. The Netherlands Tax and Customs Administration can also offset any outstanding tax due from a business against any overpayments on other taxes rather than repaying these to the business. The Department is currently not able to do this, unless the taxpayer requests it.

PART TWO

Efficiency in dealing with returns

The efficiency of online filing

2.1 The Department introduced online filing for VAT returns in 2001 and for Company Tax returns in 2003. Initial take up by businesses has been slow with a modest increase each year. It has risen to 7.8 per cent of VAT returns and 7.2 per cent of Company Tax returns in the first half of 2006-07 **(Figure 5)**.

2.2 Lord Carter's report in March 2006 (*Review of HMRC online services*) recommended a number of changes and targets to increase the take-up of online filing, including mandatory online filing for VAT and Company Tax returns in phases from April 2008 to 2012 (**Figure 6** and Appendix 3). The Government has accepted these recommendations. The Department already had a Public Service Agreement target to increase the number of VAT returns filed online to 50 per cent by 2007-08, which the Department does not expect to meet, but did not have a corresponding target for Company Tax returns filed online.

2.3 To support the expansion of online filing, the Department plans to invest £340 million in its online services infrastructure between 2006 and 2015. It expects to achieve savings when almost all returns are filed electronically and through greater electronic interaction with taxpayers. It estimates the savings to be some £59 million a year from 2013-14 in processing and administrative costs across a range of taxes (VAT, Company Tax, Income Tax and Pay As You Earn). The Department estimates that online filing will save the overwhelming majority of the £9 million current costs of processing VAT and Corporation Tax returns. Businesses will have to bear their own costs of internal system changes needed to file online. But the Department estimates that a typical business will save around £5 per VAT return by filing online and that the saving on a Company Tax return filed electronically will be £20.

5 VAT and Company Tax returns filed electronically

Return	Financial Year	Number of returns received (millions)	Number of returns filed electronically	Percentage of returns filed electronically
VAT	2003-04	6.5	14,000	0.2
	2004-05	6.8	86,000	1.2
	2005-06	7.8	380,000	4.9
	First half of 2006-07	3.9	300,000	7.8
Company Tax	2003-04	1.1	1,100	0.1
	2004-05	1.2	6,200	0.5
	2005-06	1.3	25,000	1.9
	First half of 2006-07	0.6	45,000	7.2

Source: National Audit Office analysis of HM Revenue & Customs' data

The challenges to achieving full mandatory online filing by 2012

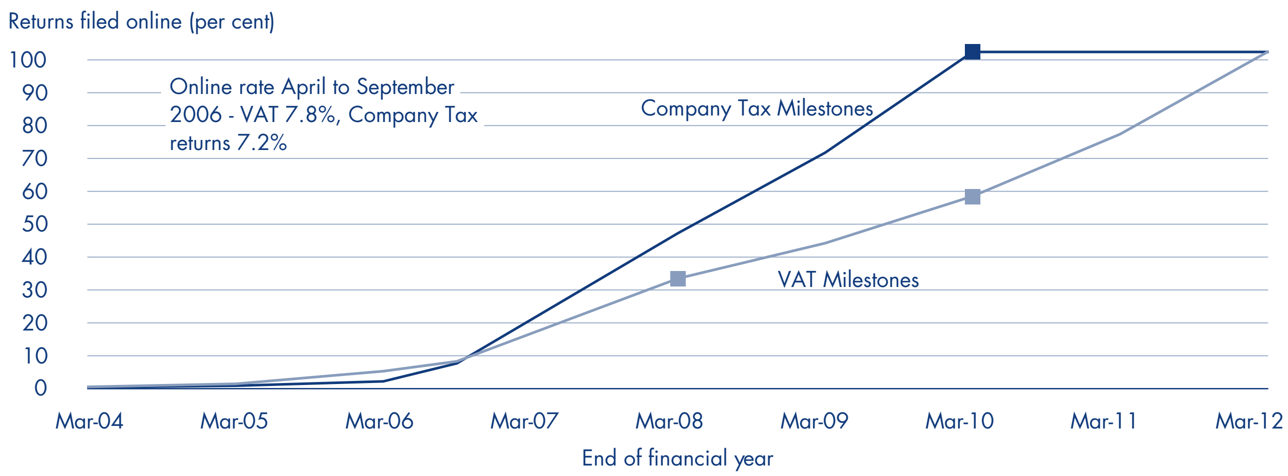
2.4 Our work, including stakeholder consultations and focus groups with businesses, showed that the Department's current online services do not fully meet their needs and expectations. Lord Carter's review identified, and the Department recognises, that there are aspects which could be improved, to address the difficulties in using the system and problems with telephone helpdesks, in the current online filing systems for VAT and Company Tax returns. Alongside work on developing a three to five year strategic plan for all its online services, the Department is also establishing a programme to deliver the mandatory filing online targets. A key element of this is to consult and work with its customers and their representative bodies and software developers to explore their communication and support needs.

2.5 The Department is improving its online services to make them more convenient for businesses. It has adopted an international data tagging language (known as 'XBRL'[10]) for accounts and Corporation Tax computations, working in conjunction with the industry. This allows the Department to accept Company Tax returns with supporting company accounts and computations as XBRL data from a business. Previously, companies had to convert their accounts and computations to a separate format (known as 'portable document format'or 'pdf') if they wanted to file the return online. Our stakeholder consultation showed that the extra time and complexity involved in producing portable document formats made paper filing more convenient than online filing. The Department introduced the ability for 'XBRL' tagged computations in November 2005.

2.6 The Department has worked with the British Standards Institution to develop a standard for VAT accounting software.[11] This is intended to introduce a voluntary standard across the software industry to help businesses get their VAT return right first time. The Department considers the software will help small businesses, which use ledger-based accounting software, to audit their own accounts and avoid some of the more common errors when completing their VAT returns. Businesses do not generally change their software regularly as they incur costs in changing it. It could take five years or more before the Department and businesses realise the full benefits of more accurate returns from using the 'PAS 76' compliant software. However, the Department considers the move to mandatory online filing will encourage businesses to obtain or upgrade to software packages that meet the standard earlier.

2.7 A similar system has been adopted in the Netherlands where online filing is mandatory for both VAT and Corporation Tax. The Tax and Customs Administration have made online filing convenient and simple by enabling businesses to submit their returns via the tax authority's website or directly through their own accounting software. When submitting a return via accounting software, businesses only have to enter figures once into the software, which then automatically creates and submits a return via a secure internet gateway. This reduces the risk of keying errors when entering the figures into the return.

6 The increase in online filing required to meet the new targets



Source: National Audit Office

NOTES

1 Data points have been forecast based on the Department's own assessment of the additional businesses affected at each stage of Lord Carter's recommendations.

2 The Department expects an exemption will be provided for groups that have a religious conscience objection to the use of computers and the internet so the number of businesses that file online may not quite reach 100 per cent.

2.8 The Department recognises the concerns of customers and is working to improve the online service. Lord Carter's Review has highlighted the benefits to both customers and the Department of online filing and recommended that compulsory online filing is the most cost effective way of delivering those benefits. We commissioned research into the barriers and enablers for businesses filing returns online; drawing on practices used in revenue departments overseas with online filing rates of more than 20 per cent.[12] We also visited the Tax and Customs Administration in the Netherlands and the Internal Revenue Service in the United States of America. Although the revenue departments in other countries have differences in structure and there are differences in the tax regimes and rates in each country, we have focused on those features which have the potential for transferability and general application. We consulted stakeholders and carried out focus groups with businesses to gain their views on online filing. From these, we have identified four main areas which are important to developing a strategy to meet online filing targets.

Area One: Tackling businesses' barriers to online filing

- Online services should be simpler, more convenient and cheaper for businesses than filing paper returns. This was a key success factor in securing high online filing rates in Austria and in the Scandinavian countries **(Figure 7 on page 18)**.
- Many businesses use software to prepare the supporting computations for their returns. The software may not be compatible with the format required by the Department. Businesses may not be inclined to change software packages, to comply with a system they perceive as more complex.
- Other than the existing incentives for paying electronically which for VAT gives businesses up to an extra seven days to pay and file, the Department is offering no financial incentives to businesses to switch to online filing. Businesses may consider that the costs of switching outweigh the benefits of more accurate returns and of the small processing savings obtained from submitting a return online. Lord Carter's report rejected the option of new financial incentives and recommended that resources would be better spent on improving services.
- If agents are not VAT registered, they are unable to file VAT returns online for their clients. Some agents are small businesses below the VAT threshold which restricts the scope for online filing. The Department has recognised this and has included expansion into the non-registered agents' market a priority for development under its implementation programme.

Area Two: Improving the convenience and functionality of online services

- Our consultation with stakeholders and focus groups with businesses indicated it would encourage online filing if an additional online function showed their tax liability statement, including past payments, calculations and outstanding tax amounts. Currently this service is only available for Corporation Tax. A business in the Netherlands can view an online statement of account across all the taxes and duties it pays.
- Using the Department's Company Tax electronic filing service means registering to use the online service. Businesses need to complete parts of the process manually before filing their returns online. Unless they use third party software, businesses are not currently able to file an online return simply by clicking a 'Send' button directly from their computer software. The Department considers this does not disadvantage businesses and to provide this service the Department's systems would have to provide full tax computations as Corporation Tax is an accounts based tax.

Area Three: Ensuring data security

- Our stakeholder consultation and focus groups with businesses indicated data security is a key factor in deciding whether to file online. In particular, they want to be confident that if they file a return or pay online, their tax record is accurately credited and that they will not incur penalties incorrectly should returns and payments be wrongly attributed to another business. This demonstrates that to encourage the switch to online filing, the Department must build business confidence in the security of filing and paying online and demonstrate the strength of its security controls, for example, that the data they sent was received uncorrupted by the Department. Businesses and stakeholders suggested the use of a password linked to the tax number to gain access to online filing and payment as a security control. This facility already exists. VAT registered businesses using the online service must access their online account using a series of 'known facts' identifiable to the business or its agent, including the VAT reference number. All companies registered to use the Corporation Tax online services are provided with a unique user identification and password that are linked to their tax reference.

- For Corporation Tax, each business has a password which is their own and for VAT, registered agents can deal with all of their clients online issues. But agents that file returns on behalf of their clients raised concerns over the ease of filing on behalf of a number of their clients at any one time. The Department has recognised the need to improve its services to agents and is taking forward work as part of implementing the recommendations in Lord Carter's report.

Area Four: Enablers to encourage businesses to switch to online filing

- The research into the barriers and enablers for businesses filing returns online, showed that most of these countries had introduced incentives and obligations to encourage businesses to make the switch to online filing (Figure 7).
- Using other electronic communications with businesses can support the Department's online filing targets, for example, by allowing communication by email with businesses and encouraging businesses to use its website as the most convenient, comprehensive and accurate source of relevant information advice and support. Wider use of electronic communications will encourage businesses to see online filing as the natural mechanism for filing returns (Figure 7).
- Our stakeholder consultation confirmed the importance of enablers to help and support businesses switching to online filing. They supported Lord Carter's recommendation for the Department to offer access to the internet to file online through, for example, internet terminals in its tax offices for the public to file returns online, particularly for small and medium enterprises, individuals and those in remote areas. These are currently available in the Department's 40 largest enquiry centres. Stakeholders would also welcome a specialist advice service for agents filing their clients' returns online. Stakeholders welcomed the helpline for online services which is open 8am to 8pm, seven days a week. Lord Carter also endorsed the incentive in VAT of an extended payment date for those who file online.

The efficiency of processing paper returns

2.9 The Department estimates that it spends around £9.2 million a year on processing VAT and Company Tax returns, including staffing, IT, accommodation, printing and stationery and postage. In 2005-06, the staff costs of logging returns and transferring or inputting data to the Department's tax systems were £1.5 million for VAT and £3.8 million for Company Tax returns. It incurs further costs in chasing businesses for overdue returns and correcting errors on returns. For example, in 2005-06, the Department spent £1.2 million correcting errors on VAT returns. These costs exclude the costs of enquiries which the Department may conduct to assess whether a business has declared the right amount of tax. Making paper based filing more efficient during the transition to mandatory online filing will help contribute to the Department's total savings target.[13]

2.10 The Department reduced its annual staffing costs of logging and inputting the data on paper VAT returns by 12 per cent in 2005-06, without affecting the speed of processing and checking returns. This followed a 15 per cent reduction in costs in 2004-05. The Department uses flexible part-time working patterns to suit the peaks and troughs of the workload. The reductions are mainly attributable to this and staff efficiency savings, attained from investment in training and development to build a multi-skilled workforce.

2.11 The Department and Area Offices do not routinely monitor the unit staff processing cost per return and total staff costs of logging and inputting the data from Company Tax returns in Area Offices, as this is a relatively small activity. The average staffing cost per return of logging and capture in 2005-06 rose by 17 per cent in Area Offices mainly from more highly graded staff to supervise processing work, manage the higher volume of work and carry out additional staff training. There is variation between Area Offices in unit staff costs **(Figure 8 on page 19)**, ranging from £0.64 to £4.60 per return. The National Audit Office report on Corporation Tax[14] examined Area Office costs of all processing related work for Company Tax returns in 2004-05. It found that some Area Offices had six times the ratio of processing staff to returns processed in other Areas and that economies of scale did not account for variations between Area Offices in the ratio of processing staff to returns processed.

7 Enablers for improving online filing and revenue departments overseas which use them

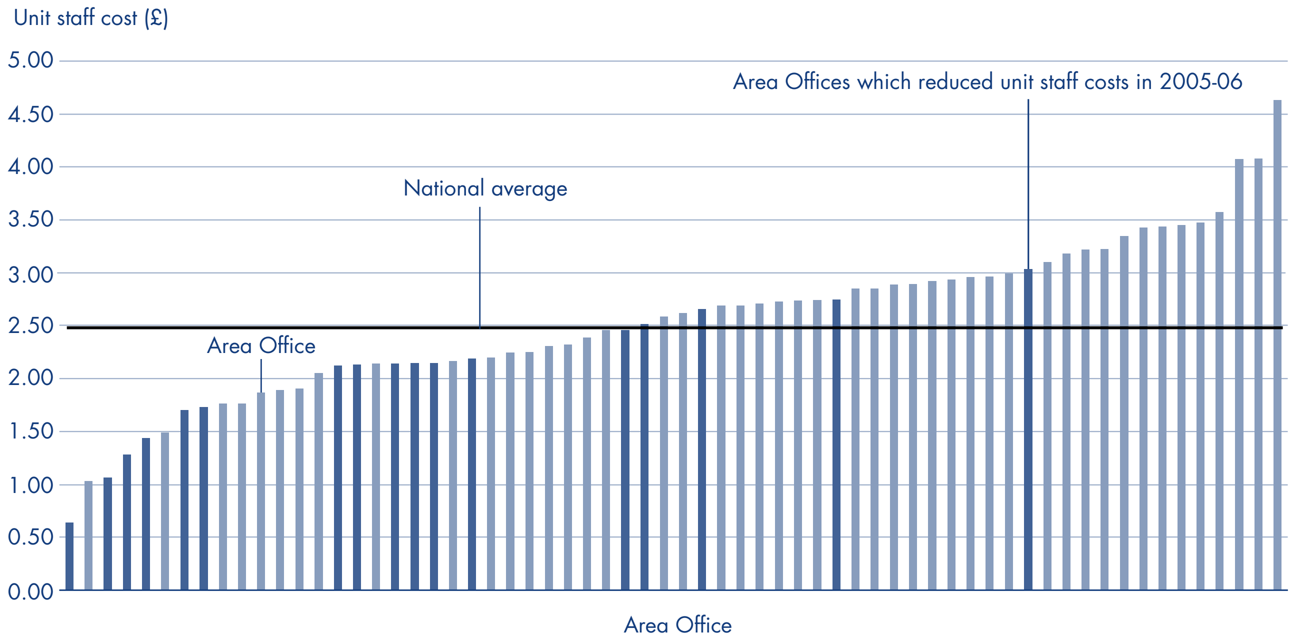
Enabler	Adopted by	Comments
Mandatory online filing	Australia, Austria, France, Germany, Greece, Hungary, Ireland, Italy, Mexico, Netherlands, Norway, Spain	Online filing rates of more than 20 per cent
Quicker refunds	Ireland, Mexico, Norway, Spain	
Longer filing period	Australia, Austria, Greece, Norway	
Monetary rewards	Mexico	
Pre-population of returns	Korea, Chile, Denmark, Sweden, Norway, Finland	Pre-populated online returns with basic information provide estimates of the business's tax liability
Electronic communications with businesses/interaction with the website	Italy, Australia and Canada collect website usage stats to drive improvements. Norway's Tax Agency website received an award for the most useful site in Norway. OECD research showed that: ■ Links with external search engines so that the tax agency website is a result for general searches for information; ■ Rotating messages on the homepage; and ■ Electronic subscriptions to tax and information alerts are ways that its member countries have considered to optimise website usage.	
Specialist services for tax agents	Australia	Tax Agents Portal – Agents can access their clients' account details online, including the current balance, interest charges, penalties, due dates and registration details. The portal also gives the facility to update basic information such as the address and bank account details for refunds.[1]
Public access to online filing facilities	Chile, Netherlands	Chile – set up a network of centres offering internet café services for businesses and individuals. Netherlands – provided internet terminals in its tax offices for the public to file returns online.
Meeting the different needs of business	Italy	It has developed two online services for taxation. 1 Provides services to individuals and small and medium enterprises 2 Provides services to medium to large businesses and intermediaries or agents

Source: *Research into barriers and incentives for businesses filing returns online – Oxford Internet Institute 2006*

NOTE

1 The examples above reflect different tax structures and cultures and their application will need to take account of that.

8 Area Office unit staff costs of logging and data capture of Company Tax returns ranged from 64 pence to £4.60 in 2005-06



Source: *National Audit Office analysis of HM Revenue & Customs' data*

2.12 17 Area Offices reduced their unit staff costs of logging and data capture in 2005-06, by restructuring logging and data inputting work, co-locating staff, using more experienced staff and sharing work at peak times between areas. If all Area Offices with a unit staff cost higher than the national average reduced their unit staff costs to the national average of £2.50, the overall saving to the Department would be over £350,000 (11 per cent) of the total staffing costs of logging returns and inputting the data. Whilst these savings are relatively small, they illustrate the advantages of analysing processing costs to identify variations and good practice.

Managing Area Office performance in processing Company Tax returns

2.13 The Department has introduced targets for timeliness and accuracy for Area Offices in logging and inputting the data from Company Tax returns and its Area Offices record their performance each month. However, the Department did not quality assure the approach Area Offices took to recording their performance. Areas recorded the data in different ways. Consequently the Department has not collated the data for 2005-06 to produce a national picture of performance against the targets or to benchmark their performance and assess the reasons for variations.

2.14 The United States Internal Revenue Service uses various performance measures to assess the efficiency and accuracy of processing. Productivity and quality are reinforced by applying standard practices in each centre which are subject to continuous quality control. The results are reflected in the assessments of staff performance. During peak periods over one third of its processing workforce is employed on short term contracts to deal with peaks in workload. The Internal Revenue Service allocates three per cent of staff resources to quality control and assurance and individual centres report their performance weekly. Continuous monitoring enables the Internal Revenue Service to take action promptly to tackle under performance, if necessary moving work between centres, and to use the results in forward workload planning.

Setting targets and managing performance on filing of returns

2.15 The Department measures most aspects of performance and has targets **(Figure 9)** which have largely been inherited from the former Inland Revenue and HM Customs & Excise and have evolved over time. There is no target for VAT return filing as the Department has found that chasing late or missing returns did not contribute significantly to its performance in closing the VAT Gap[15], which it regarded as a key priority. Therefore, the Department decided to concentrate on activities with higher priorities in terms of risk which it considered would deliver better value for money. Appendix 4 shows all targets in place and performance in 2005-06, and new targets introduced in 2006-07.

9 Whether the Department measures performance and has set a target for each aspect of processing VAT and Company Tax returns

	VAT returns target?	VAT returns performance measure?	Company Tax returns target?	Company Tax returns performance measure?
Compliance				
Timeliness of returns – % filed on time	No	Yes	Yes[2]	Yes
Overdue returns – % filing of returns after due date	No	Yes	Yes[2]	Yes
Accuracy of returns – filed without errors	No	Yes	Yes[2]	Yes (From random enquiry programme)
Efficiency				
Online filing of returns – % (for future years)	Yes[1,3]	Yes	Yes[3]	Yes
Logging and data input – timeliness	Yes	Yes	Yes[2]	No (Area Office level only)
Logging and data input – accuracy	Yes	Yes	Yes[2]	No (Area Office level only)
Costs of logging and data input	No	Yes	No	Yes
Repayments of tax	Yes[2]	Yes	Not applicable	Not applicable
Customer service	Yes[1] (from 2004)	Yes	Yes[1] (from 2001)	Yes
Compliance burden	Yes[1]	Yes	Yes[1]	Yes

Source: National Audit Office analysis of HM Revenue & Customs' data

NOTES

1 Public Service Agreement target.

2 Operational target.

3 Lord Carter report target.

PART THREE

Customer service and the compliance burden on businesses making tax returns

Measuring customer satisfaction and the compliance burden

3.1 The Department developed Customer Service performance Indicators in 2001 to measure how it was performing against its target to improve customer service by 2.5 points on its index by March 2006. The indicators showed increasing overall satisfaction by companies in their dealings with the Department about Company Tax from the 2001 baseline of 70.2 to 74.9 in 2004, but a fall back to 73.3 in 2005. VAT registered businesses were included in the survey from 2004 and showed broadly similar levels of satisfaction across a range of indicators but a higher proportion of those who were very satisfied.

3.2 The Department's Public Service Agreement targets to improve customer service and reduce the compliance burden by 2007-08 are shown in **Figure 10**.

3.3 The Department has taken a number of steps to improve customer service, for example, it has introduced Client Relationship Managers for businesses within the Large Business Service to provide them with a personal and tailored customer service and manage the Department's relationship for both direct and indirect taxes; a Business Customer Unit to promote changes to make it easier for small and medium businesses to comply with their tax obligations; and a Targeted Education, Enabling and Leverage Team to provide education and support, highlight frequently made errors on the VAT return and advise on how to correct and avoid these. The Department uses its website as both a library of information and a news service to taxpayers, alerting them to changes and advice on issues affecting the management of their tax affairs. Our consultation with businesses and stakeholders and focus groups provided favourable feedback on certain aspects of customer service, such

10 The Department's performance on customer service in 2005-06 and the 2007-08 targets

Customer service	Target	2005-06 performance
Percentage of individuals and businesses who said they achieved success at first point of contact	80% by March 2008	83% for Company Tax returns 78% for VAT queries
The accuracy and completeness of information and advice given and actions taken in respect of contact	90% by March 2008	85% for both post and contact centres (estimate)
Compliance burden		
Percentage of small businesses that find it easy to complete their tax returns	90% by March 2008	99% for VAT traders with turnover <£1m 87% for employers with up to nine employees 75% for self employed 88% overall

Source: National Audit Office analysis of HM Revenue & Customs' data as that provided by the Large Business Service, and identified areas that could be improved, such as the clarity of VAT public notices. The Department is engaging with employers, agents and representative groups to listen to future requirements. It offers an advice service for all general enquiries, including those associated with completing the VAT return with more specialist advice for more complex cases. While there are some well regarded features, the Department's online and helpline information and advice services do not always fully meet businesses' and stakeholders' needs, nor their expectations.

3.4 The Department is exploring options to transform its website in phases by 2008, so that customers can:

- quickly find what they are looking for;
- read and understand what they have found; and
- be confident that it is authoritative, accurate and up to date.

The Department intends that the core content of the website will be based on researched customer needs and that it will provide an improved search facility for users.

3.5 As part of its work to reduce the burden on businesses, the Department commissioned KPMG to carry out a consultation exercise and measure the administrative burden that the tax system imposes on businesses. This research[16] indicated that the burdens imposed by the United Kingdom taxation system compare reasonably well internationally. Our consultation with businesses and stakeholders mirrored this view. There was support for Departmental measures to help businesses comply with their obligations, such as the cash accounting scheme for VAT and the short Company Tax return form for small businesses which may help them avoid the need for an accountant and agent. They suggested that the Department could reduce the compliance burden further by removing the requirement to file returns from those businesses with no tax liability and more generally simplifying the tax systems and returns.

3.6 A report *'Progress towards a new relationship: How HMRC is working to make life easier for businesses'* was produced at Budget 2006. The consultation exercise published in March 2005, had found that businesses wanted a single point of contact, better guidance online, improved knowledge of operators at call centres and improved training for the Department's staff. Lord Carter's report also found widespread criticism of the Department's contact centres (which do not deal with Corporation Tax queries), with difficulties in getting through at peak times, advisers not always answering questions straight away, or giving incorrect advice. This was more acute for agents and businesses with more complex queries. Our consultation also indicated that the Department needs to understand and respond to the diverse needs of the many businesses required to file VAT and Company Tax returns. For example, businesses have different preferences on how they seek information and advice from the Department. Some are content to use a national telephone advice service, while others prefer designated contacts. In response the Department has moved its contact centres onto a common telephony platform to provide more efficient call handling and to handle calls even at peak times. Calls, where necessary, can be escalated to technicians to handle more complex telephone enquiries. This is supported by a quality assessment and control process to give feedback on common errors and provide guidance for internal and external users. Such a system has been used successfully by the Internal Revenue Service in the United States to handle calls and improve call handing.

3.7 Preparing the figures and computations to complete VAT and Company Tax returns can be a lengthy and costly process, particularly for larger businesses. In 2006, following the Department's research, the Chancellor introduced a further target to reduce by at least 10 per cent over five years, the administrative burdens on businesses of dealing with Departmental forms and returns.

3.8 The Department's research estimated where the administrative burden may be relatively higher or lower within the entire tax system. Although the figures are not statistically robust, they do provide an indication of the relative burden of the two taxes. The research estimated that the administrative burden of preparing and filing VAT returns costs the 1.8 million VAT registered businesses £310 million a year (£170 per registered business), 30 per cent of the total burden of dealing with VAT. On Corporation Tax, the administrative burden of filing returns is estimated to cost the 1.8 million companies required to file, £120 million a year (£70 per registered company). The self assessment computation of taxable profit is estimated to cost a further £210 million a year (£120 per registered company). These account for half the total burden of dealing with Corporation Tax. The Department is working towards reducing the burdens on businesses by requiring them to provide information only once, providing a single contact number and up to date information across the range of taxes and duties, and clear and targeted education and guidance, to help the many businesses that want to comply but are unsure of what to do and where to find help.

Helping businesses comply

3.9 The Department's developing compliance strategies aim to understand and tackle the barriers to compliance. The Department is also looking at how it can change behaviour and motivate taxpayers to comply, for example, by giving advantages to those who do. It is considering introducing a more varied range of interventions tailored to the different compliance record of businesses, and reducing its checks on compliant businesses. For example, a business with a good compliance record may receive only an education and support review before the tax returns are completed to advise it of any changes required to its procedures and how to correct any errors identified. This review could cover both VAT and Company Tax return. It would be less costly to the business than an inspection or formal enquiry. A more varied range of interventions could help the Department make more effective use of its resources and address serious non-compliance.

3.10 The Department's current review *Modernising powers, deterrents and safeguards*, aims to tackle the barriers to compliance that arise from the different laws and practices that apply to direct and indirect taxes such as different compliance checks and penalty regimes for its main taxes including VAT and Corporation Tax. Having previously focused more on detecting non compliance than on improving compliance, the Department now aims to do more to influence positively taxpayers and businesses towards compliance. It also plans to improve its targeting of sanctions and increase deterrence.

3.11 The Department is also considering whether it can recognise a business' previous good compliance record by reducing the penalty if a deadline is missed, or by suspending a penalty if the business subsequently complies. It recognises that it will need a clear definition of what constitutes a good compliance record to implement these changes.

3.12 The 12 month 'window' for the Department to launch an enquiry on a Company Tax return currently starts on the filing deadline, not on the date the return was filed, if earlier. This leaves a longer period in which businesses are exposed to the possibility of an enquiry if they file before the deadline. Lord Carter's review recommended that the enquiry window should run for 12 months from the date a return is filed to remove the disincentive to early filing and give taxpayers earlier certainty on the status of their tax affairs. The Department has accepted this recommendation although more needs to be done to consider the consequences for groups of companies.

3.13 Our consultation with businesses and stakeholders and focus groups supported the proposals in the Powers review and on changing the enquiry window. They also offered additional proposals to motivate and help businesses comply **(Figure 11 overleaf)**.

11 Businesses and stakeholders want to see proposals to encourage and help businesses comply with their filing obligations

Taxpayer behaviour

- Stakeholders would welcome the Department giving greater encouragement to businesses to comply. The Department could analyse the diversity of business sectors and their performance and behaviour on compliance to assess the range of education and assistance needed, or the penalties to impose for non-compliance.
- Businesses with an established good record of compliance should receive support to maintain their performance, while businesses with a poor compliance record should receive robust penalties.

Range of interventions

- They supported Department proposals to adapt the enquiry regime to reduce checking on compliant businesses. However, they would welcome the Department offering businesses the choice between a joint or separate review for VAT and Corporation Tax.
- Large businesses may prefer separate reviews on VAT and on Corporation Tax, as this could work better with how they structure their financial functions. Small and medium enterprises may prefer a joint review covering both VAT and Company Tax returns.

Enquiry windows

- They supported the proposal to link the enquiry window to when a Company Tax return is filed, rather than the filing deadline. However, some considered that the enquiry window could be reduced from 12 months for those returns filed well before the deadline. For example, nearly half of Company Tax returns are filed three months or more before the due date. This would act as a further incentive to early filing.

Enablers

- Review the fixed deadline for filing Company Tax returns to make it more appropriate to different types of businesses. Large businesses considered that a longer filing period would help them comply because of the complexity of their computations and returns.
- Improved channels of communication would enable compliance, with the Department increasing its one-to-one dialogue with small businesses as they prepare their returns.
- Significant simplification of the taxation systems would help businesses become and stay compliant.

Financial incentives

- The Department should offer a one-off financial incentive to businesses completing their first VAT or Company Tax return, if this is filed accurately and on time, and the business takes up Departmental advice and support in preparing its first return. The Department does not agree that a financial incentive of this kind would be good value, given that many new businesses already file their returns on time.

Media campaigns

- Reinforce the importance of corporate values by promoting a culture of compliance in businesses. The internal culture of some businesses requires their compliance with all government regulations, irrespective of the value of any penalties that would be imposed on them for non-compliance. Some businesses are also motivated to achieve a low risk rating with the Department, as part of their corporate governance. The Department's media campaigns could promote this message and the lower risk rating for businesses which comply, instead of simply communicating the penalties for failing to comply.

Source: National Audit Office analysis of business and stakeholder consultation and focus groups with businesses

Opportunities for a wider range of enablers

3.14 Revenue Departments in some other countries have introduced certificates for businesses which prove that they are fully compliant with all their tax obligations. They may be available to businesses which have paid business taxes in full and on time, filed returns on time, and paid any interest or penalties due. The certificates are updated for each tax cycle and require the revenue department to take a full view of customer compliance. Tax clearance certificates are a powerful incentive for businesses to comply with their obligations, as they need a current certificate to gain government contracts, receive grants or subsidies and obtain a range of licences. Controls are necessary to prevent businesses fraudulently claiming they have a current certificate, for example, by holding the certificate on the Revenue department's website. **Figure 12** illustrates the use of tax clearance certificates in Ireland.

12 The Irish Revenue Department uses Tax Clearance Certificates to incentivise taxpayers to comply with their obligations

Irish Revenue

The Irish Revenue produces a Tax Clearance Certificate to confirm that a person or business' tax affairs are in order at the date of issue. This means that all taxes, interest and penalties have been paid and all returns have been filed. It is required by law when taxpayers seek:

- A contract, grant, subsidy or other payment from the state of €6,500 or more
- A licence or permit to conduct a range of activities;

Applications for a Tax Clearance Certificate can be made in writing or online. The Certificates are issued electronically and taxpayers must re-apply each year, requiring the taxpayer to maintain full compliance each year. When a company applies for a tax clearance certificate, the tax affairs of any director controlling more than 50 per cent of the share capital of the company must also be in order before a certificate is issued. Public bodies and third parties can check, through the Irish Revenue's website, that a taxpayer holds a current certificate using the taxpayer's unique tax reference and an identifier.

The Irish Revenue has found that the introduction of tax clearance certificates has helped achieve greater taxpayer compliance, particularly in payment of taxes in full on time. This has contributed to reductions in the tax at risk and overdue. In setting up the certificate scheme, it initially included those business sectors that were at highest risk of not complying. It considers that the requirement for tax clearance certificates has contributed to improved compliance in these sectors.

Source: National Audit Office

APPENDIX ONE

National Audit Office methodology

Scope and parameters of this examination

1 This report examines the performance of HM Revenue & Customs in securing and processing VAT and Company Tax returns from businesses which should submit them. Firstly, it covers the Department's success in getting returns in on time, the businesses that fail to file accurately and on time, the tax consequences of late filing and the use and effectiveness of penalties to encourage on time filing. Secondly, it examines the Department's efficiency in dealing with returns, including increasing online filing, the costs of logging and inputting the data on paper returns on its systems, and how the Department measures and manages its performance. Thirdly, it examines how the Department measures customer satisfaction and the burdens on compliant businesses making returns, through its Public Service Agreement targets and the independent research it has commissioned.

2 It also includes the outcomes of our consultation with stakeholders and focus groups with members of the business community (below) on options to improve the Department's customer service, communications and advice, and reduce the burdens on businesses making returns, together with their views on measures to encourage and help businesses comply with filing accurate returns on time. It also includes the outcomes from our international liaison which identified opportunities for incentives to businesses to comply. The National Audit Office has previously examined the VAT and Company Tax return forms themselves, including the short Company Tax return form, for ease of completion, both on paper and online.[17] And the National Audit Office has previously examined the complexity of Corporation Tax itself.[18] This report does not cover those businesses that seek to evade tax entirely by operating within the shadow economy, which we have examined in previous reports.[19]

Advisory panel

3 We established an Advisory Panel to provide expert advice on the emerging findings and recommendations from our fieldwork. We selected the membership of the panel to provide a valuable spectrum of external perspectives and expertise. We would like to thank each of the members for their time and help in taking part and the contributions they provided.

Panel member	Organisation
Kathy Burrell	HM Revenue & Customs
Stephen Blakeley	ASDA
Patricia Caputo	Institute of Chartered Accountants in England and Wales
Colin Davis	Chartered Institute of Taxation
Nigel Frost	Grant Thornton UK LLP
Kevin Gale	Grant Thornton UK LLP
Sebastian Hordern	CBI
Jen Little	HM Revenue & Customs
Jim Maclean	HM Revenue & Customs
Tim Murrills	ExxonMobil
Will Parker	HM Revenue & Customs
Iain Scott-Shore	VAT Practitioners Group
James Roach	ExxonMobil
Chas Roy-Chowdhury	Association of Chartered Certified Accountants
Cathy Symonds	Association of Accounting Technicians
John Vincent	Association of Accounting Technicians
Nigel Waine	PricewaterhouseCoopers

Financial and data analysis

4 We carried out analysis of a range of Departmental financial, activity and performance data to evaluate the Department's performance in each area examined. This included a review of trend data and focused on 2005-06 data. The Department does not have data on the total number of outstanding returns from all previous years. The Department does not have information readily available on the amount of tax outstanding on missing returns or the number of businesses with more than one return outstanding. We commissioned the Department's Knowledge Analysis and Intelligence Directorate to generate an estimate of the tax liability on overdue VAT and Company Tax returns based on assessing the value of unpaid assessments and determinations. We requested the Department to carry out costings of logging in VAT returns (centrally) and Company Tax returns (across its Area Offices) filed in paper format and entering the data on these returns on its systems and wider IT, accommodation, printing and stationery and postage costs, as these are not routinely produced or monitored. We requested data on the performance of Area Offices in the promptness and accuracy of logging paper Company Tax returns and entering the data on them on its systems, but the Department were not able to provide these data due to inconsistencies and quality control problems in how Area Offices recorded their performance. We performed detailed analysis of the figures relating to penalties that the Department provided. However the Department does not collect centrally information on when penalties are raised, on how quickly businesses pay them the cumulative value of the range of penalties imposed for late filing of Company Tax returns and how effective the penalties are in improving on-time filing.

Focus groups with businesses, experts and representatives

5 We appointed PricewaterhouseCoopers LLP to facilitate three focus groups with members of the business community. PricewaterhouseCoopers LLP identified a diverse range of volunteers to participate in the focus groups which took place in June and July 2006, facilitated the discussions, and analysed and reported on the outcomes. Participants either met to comment on the areas for discussion, (an event in Newcastle upon Tyne) took part in an online webcast or gave their comments over the telephone. Respondents were from a range of geographical locations from London to Edinburgh, including small, medium and large commercial companies, unincorporated businesses, charities, public sector and other entities. We also sought to speak to diverse groups of people covering a range of tax abilities. Our respondents included blind and disabled individuals as well as the elderly, the young and those from ethnic minorities. We received twenty eight responses and eight of those participated in the event in Newcastle upon Tyne.

6 The groups were structured around a set of slides prepared by the National Audit Office study team. This allowed discussions and comments to be focused around three main areas relating to completing and filing VAT and/or Company Tax returns. These were:

- the return itself, ease of completion, the use of agents and the Department's move to online filing;
- opportunities for further improvements in the services the Department provides to businesses, for example in reducing the compliance burden and enhancing customer service; and
- improving compliance, penalties and technical advice.

7 We have drawn on the outcomes of the focus groups throughout the report in our overall evaluation of the views of businesses, experts and representative bodies – along with the outcomes from our advisory panel consultation (above) and stakeholder consultation (below). We would like to thank all of the participants for their time and help in our examination.

Performance measurement and management

8 We carried out a review of the Department's approach to measuring and managing performance on filing VAT and Company Tax returns. We identified targets relevant to each aspect of filing returns (and the nature of the target, whether public or internal), any measures of performance for each aspect of filing, and how these compared to the targets. We identified aspects of filing not currently subject to a Departmental target (VAT compliance), and/or a measure of performance (Area Office performance in the promptness and accuracy of logging in and entering the data from paper based Company Tax returns). We reviewed the Department's rationale where no target and/or performance measure is in place, and how the Department aims to manage its performance in such areas. We also examined the adequacy of the Department's strategy for managing performance to achieve agreed targets (on online filing of returns).

Process improvement

9 We appointed PricewaterhouseCoopers LLP to provide an overview of the Department's process improvement work for VAT and Company Tax returns. This involved interviews with Departmental staff, site visits and review of supporting documentation, such as process maps, between January and March 2006. We used this information and information from the Department's Southend-on-Sea office which processes VAT returns, in producing the VAT and Company Tax return filing maps in Appendix 2.

Research into the barriers, incentives and enablers for online filing by businesses

10 We appointed Professor Helen Margetts to carry out research into the barriers to businesses filing complete and accurate VAT and Company Tax returns online and the range of incentives or enablers which HM Revenue & Customs might use to encourage better take up of online filing. Her research, in early 2006, took account of Lord Carter's recommendations for future mandatory online filing. She examined revenue departments overseas for examples of good practice in countries which have achieved high take-up rates of online filing, using either compulsion or incentives. We have drawn on Professor Margetts' report in Part 2 on online filing, in analysing and identifying options to help the Department achieve the recommendations it has accepted in Lord Carter's report for mandatory online filing of VAT and Company Tax returns. Professor Margetts' work is independent research that has been drawn on for this study, which does not necessarily confer endorsement by HM Revenue & Customs. Professor Margetts' report is available on the National Audit Office website (http://www.nao.org.uk/publications/nao_reports/06-07/0607102-research-paper.pdf), alongside this report.

Revenue Departments overseas

11 We visited the Netherlands Tax and Customs Administration (www.belastingdienst.nl) in March 2006 and the United States of America Internal Revenue Service (www.irs.gov) in June 2006. The visits focused on obtaining information on how returns are filed and processed in each country to identify good practices in compliance and efficiency. We aimed to learn how the Netherlands Tax and Customs Administration managed the introduction of mandatory online filing (Part 2) and its computerised system to generate individual risk profiles for each business of compliance with filing returns; and how the Internal Revenue Service manages and records its performance in processing returns (Part 2). We would like to thank each Department for their time and help in our examination.

Review of a sample of Area Offices

12 We identified 17 Area Offices which had achieved a reduction in unit staff costs in logging and data capture of paper Company Tax returns in 2005-06, despite an increase in the national average unit staff cost. The Department contacted each office to gain an understanding of how the cost reduction was achieved. We analysed the reasons behind each cost reduction to identify common factors and themes, and to assess the potential savings to the Department from wider adoption of the good practices across all Area Offices.

Stakeholder consultations

13 We consulted a number of organisations with a professional interest in filing VAT and/or Company Tax returns to identify and discuss the issues of greatest importance to them or their members, to gain an external perspective on the issues examined in our study and their views on the Department's actions, proposals and consultations. We had a separate meeting with each organisation to go through a common structured questionnaire and the meetings took place in March and April 2006. We have drawn on the findings from our consultations throughout this report, for example, on Departmental actions to encourage online filing, on Departmental measures to reduce the compliance burden and to improve customer service, and on its proposals for incentives and enablers to help businesses comply with their obligations for filing returns. We would like to thank each organisation for its time and help in our examination.

Stakeholder	Website
ASDA	www.asda.co.uk
Association of Accounting Technicians	www.aat.org.uk
Association of Chartered Certified Accountants	www.accaglobal.com
Chartered Institute of Taxation	www.tax.org.uk
CBI	www.cbi.org.uk
ExxonMobil	www.exxonmobil.co.uk
Federation of Small Businesses	www.fsb.org.uk
Forum of Private Business	www.fpb.co.uk
Grant Thornton UK LLP	www.grant-thornton.co.uk
Institute of Chartered Accountants in England and Wales	www.icaew.co.uk/taxfac
PricewaterhouseCoopers LLP	www.pwcglobal.com

APPENDIX TWO

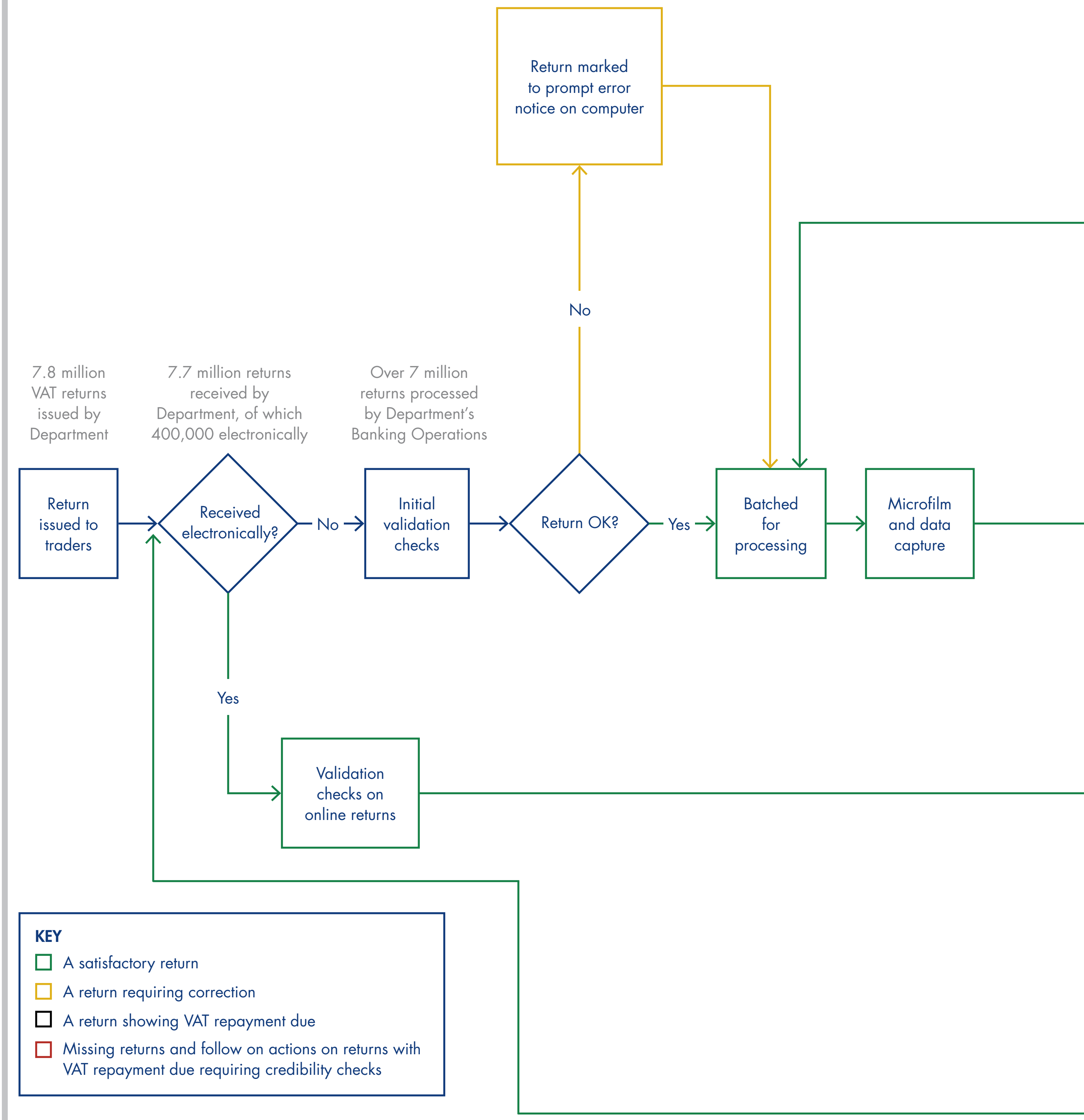
VAT and Company Tax return filing maps

Flow charts overleaf.

Figure 13 VAT returns – map of filing processes.

Figure 14 Company tax returns – map of filing processes.

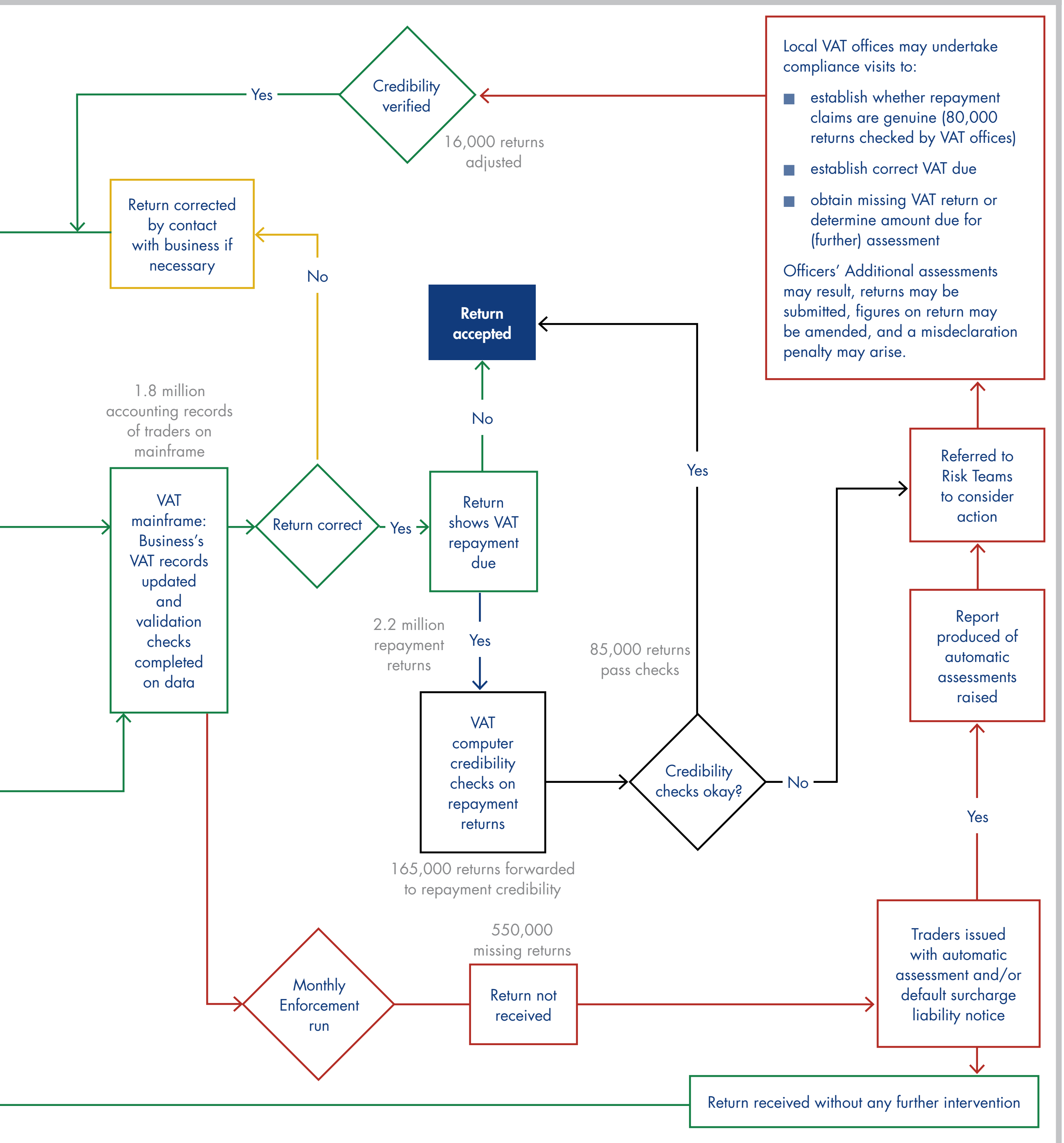
13 VAT returns – map of filing processes



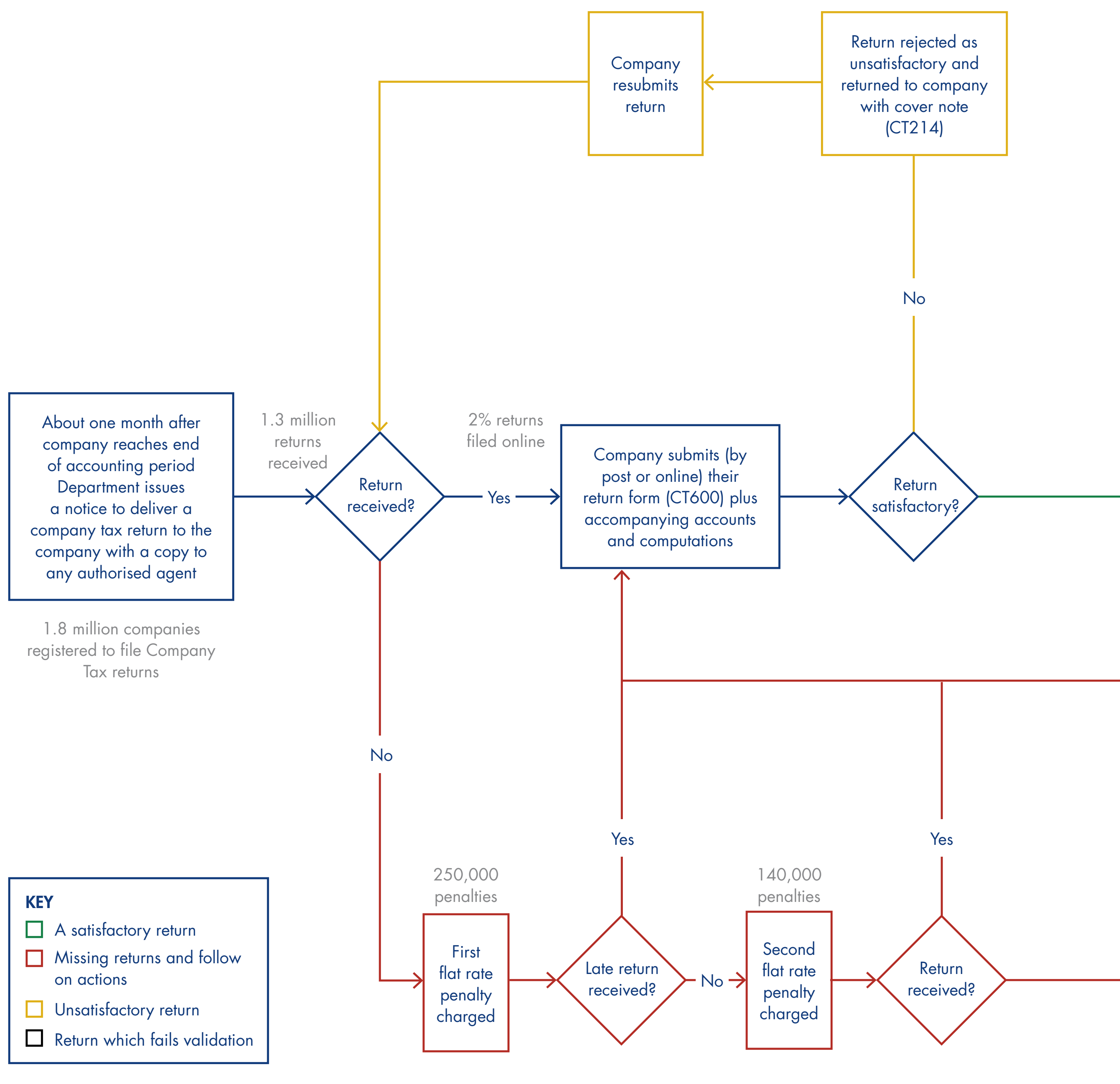
Source: National Audit Office

NOTE

1 All data are annual figures for 2005-06.


Credibility verified
Yes
16,000 returns adjusted
Local VAT offices may undertake compliance visits to:
establish whether repayment claims are genuine (80,000 returns checked by VAT offices)
establish correct VAT due
obtain missing VAT return or determine amount due for (further) assessment
Officers' Additional assessments may result, returns may be submitted, figures on return may be amended, and a misdeclaration penalty may arise.
Return corrected by contact with business if necessary
No
Return accepted
No
Yes
1.8 million accounting records of traders on mainframe
VAT mainframe: Business's VAT records updated and validation checks completed on data
Return correct
Yes
Return shows VAT repayment due
Referred to Risk Teams to consider action
Report produced of automatic assessments raised
2.2 million repayment returns
Yes
85,000 returns pass checks
VAT computer credibility checks on repayment returns
Credibility checks okay?
No
Yes
165,000 returns forwarded to repayment credibility
550,000 missing returns
Monthly Enforcement run
Return not received
Traders issued with automatic assessment and/or default surcharge liability notice
Return received without any further intervention

14 Company tax returns – map of filing processes



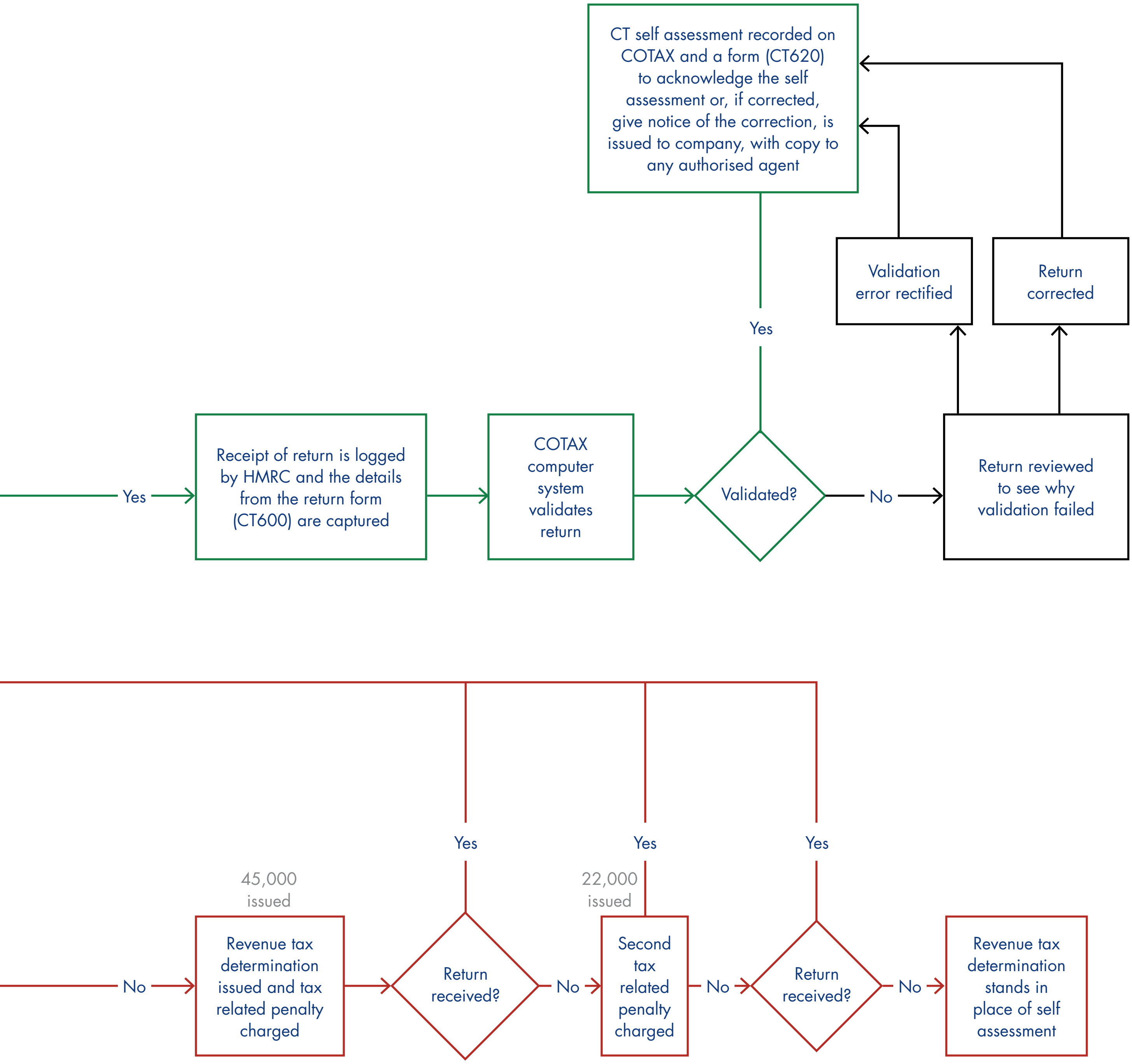
Source: National Audit Office

NOTES

1 All data shown are annual figures for 2005-06.

2 The Department may not always raise a penalty as companies may have a reasonable excuse, have an agreed extension or have declared insolvency. Companies have different accounting period end dates and filing dates, and may incur penalties at different times, overlapping financial years. The figures for each of the range of penalties charged in 2005-06 do not reflect any progression of companies through the penalty sequence within 2005-06.

3 Penalties data are for determinations made in 2005-06.


CT self assessment recorded on COTAX and a form (CT620) to acknowledge the self assessment or, if corrected, give notice of the correction, is issued to company, with copy to any authorised agent
Validation error rectified
Return corrected
Yes
Yes
Receipt of return is logged by HMRC and the details from the return form (CT600) are captured
COTAX computer system validates return
Validated?
No
Return reviewed to see why validation failed
Yes
Yes
Yes
45,000 issued
22,000 issued
No
Revenue tax determination issued and tax related penalty charged
Return received?
No
Second tax related penalty charged
No
Return received?
No
Revenue tax determination stands in place of self assessment

APPENDIX THREE

'Review of HM Revenue & Customs Online Services', Lord Carter of Coles, March 2006

1 The Paymaster General announced a review of the Department's online services in July 2005. The purpose of the review was to look at ways of increasing take up of online services for Income Tax Self Assessment, VAT, Corporation Tax and PAYE, and maximising benefits for customers whilst ensuring that the Department delivered a service that supported compliance. Lord Carter's review was published with Budget 2006 and contained a number of recommendations relating to filing VAT and Company Tax returns. The Government has accepted the recommendations in the review.

Recommendations relating to filing VAT returns

- Businesses with a turnover above £5.6 million a year should be required to file their VAT returns online and make payments electronically, for accounting periods starting after 31 March 2008. Businesses newly registering for VAT after this date should also be required to file electronically;
- Traders with an annual turnover in excess of £100,000 should be required to file their returns online, and make payments electronically, for accounting periods starting after 31 March 2010; and
- Paper filing will remain an option for traders with turnover below £100,000 but the Government should review the need for this exception in the run up to 2012.

Recommendations relating to filing Company Tax returns

- All companies should be required to file their Company Tax returns online, using XBRL, and make payments electronically, for returns due after 31 March 2010;
- The Department needs to make significant improvements to the Company Tax online service to maximise the benefits for users and for the Department; and
- The Department should continue to work with Companies House to provide a joint filing facility by 2010.

Filing period:

- Consideration should be given to reducing the filing period for Company Tax returns to bring them closer to the international norms; and
- The enquiry window should be linked to the date that the return is submitted.

Recommendations relating to filing both VAT and Company Tax returns

Payment:

- The Department should provide an electronic payment facility on its website.

Agents and software developers:

- The Department should offer agents workshops on online services;
- The Department should share with software developers, more of the risk rules used to select cases for enquiry; and
- Funds available for online services should focus on improving HM Revenue & Customs' services to better meet customers' needs.

APPENDIX FOUR

HM Revenue & Customs' targets and performance on filing VAT and Company Tax returns

1. VAT Returns	Target(s) and date(s)	2005-06 performance
Compliance – timeliness		
Percentage of VAT returns filed by due date	No target	85%
Percentage of VAT returns filed by the end of the month following the due date	No target	91%
Compliance – accuracy		
Number of VAT returns with errors made by businesses which were corrected	No target	200,000 returns
Efficiency – Online filing		
The percentage of VAT returns filed online	50% of all businesses (March 2008)[1] 100% of businesses with a turnover above £5.6 million and newly registering businesses for accounting periods from April 2008[3] 100% of businesses with a turnover of £100,000 or greater for accounting periods from April 2010[3] 100% of all businesses (paper filing will remain an option for businesses with turnover less than £100,000, but should be reviewed in the run up to 2012[3]	4.9%
Efficiency – processing		
VAT repayment declarations should be fully processed within five working days of receipt in Banking, the balance to be processed within seven working days	99%[2]	99%
VAT repayments paid manually processed and sent for payment within four working days (where repayment is automatic)	95%[2]	100%
VAT return errors received and cleared each month*	95%[2]	Achieved
Accounting cases received and cleared each month*	95%[2]	Achieved
* Discontinued in 2006-07	See 4: Targets introduced in 2006-07 for replacements.	

2. Company Tax returns	Target(s) and date(s)	2005-06 performance
Compliance – timeliness		
Percentage of companies' returns filed by due date	77.5%[1]	79%
Percentage of companies' returns filed within 12 months of the due date	87.7%[1]	88%
Compliance – accuracy		
Percentage of companies that submit accurate returns	60%[2]	No overall data the random enquiry programme found 60% were accurate
Online filing		
The percentage of Company Tax returns filed online	100% for returns due from April 2010[3]	1.9%
Efficiency		
Returns logged within five days of receipt	93%[2]	No national data (at Area Office level only[4])
Returns logged within 31 days of receipt	99%[2]	No national data (at Area Office level only[4])
Returns with data capture and self assessment recorded within 14 days of receipt	85%[2]	No national data (at Area Office level only[4])
Returns with data capture and self assessment recorded within three months of receipt	99%[2]	No national data (at Area Office level only[4])
Returns processed accurately first time with no "tax effect" errors.	98%[2]	No national data (at Area Office level only[4])
3. VAT and Company Tax returns		
Compliance burden		
Percentage of small businesses that find it easy to complete their tax returns	90% March 2008[1]	90% (2005) 99% for VAT traders with turnover <£1m 87% for employers with up to nine employees 75% for self employed 88% overall
Reduce the administrative burden on businesses of dealing with Departmental forms and returns	10% reduction between March 2006 and March 2011[1]	£5 billion a year overall, 1.1% of tax take (March 2006 baseline)
Filing the VAT return		£310 million a year
Filing the Company Tax return		£120 million a year
Computations for the Company Tax return		£210 million a year

3. VAT and Company Tax returns *continued*	Target(s) and date(s)	2005-06 performance
Customer service		
Percentage of individuals and businesses who said they achieved success at first point of contact	80% March 2008[1]	72% (2004) 83% for those dealing with Company Tax returns 78% for VAT queries
The accuracy and completeness of information and advice given and actions taken in respect of contact	90% March 2008[1]	85% for both post and contact centres (Department estimate)
Improvement in customer service	2.5 increase (between 2001 and March 2006) from 68.6 baseline overall,	68.7
	70.2 baseline for those filing Company Tax returns[1] VAT included from 2004	73.3 for those filing Company Tax returns
4. Targets introduced in 2006-07	**Target**	**June 2006 performance**
VAT efficiency		
VAT payment declarations fully processed within five working days of receipt in Banking, the balance to be processed within seven working days	99%[2]	45% - five days 98% - seven days
Nil declarations processed within 24 hours of receipt (off peak)	100%[2]	100%
Nil declarations processed within four working days of receipt (peak)	100%[2]	100%
Process VAT repayment return errors within three working days of receipt	95%[2]	87%
Process correctly completed VAT repayment return error replies within three working days of receipt	95%[2]	100%
Process correctly completed VAT payment return error replies within five working days of receipt	95%[2]	100%
Process VAT payment return errors within five working days of receipt	95%[2]	100%

Source: National Audit Office analysis of HM Revenue & Customs' data

NOTES

1 Public Service Agreement target.

2 Internal Service Delivery Agreement target.

3 Lord Carter report recommendation target on online filing.

4 Performance on logging and data capture of Company Tax returns is being reported monthly at national level in 2006-07.

ENDNOTES

1 A Company Tax Return covers self assessment of the amount of Corporation Tax in the accounting period, and other taxes which are assessable as if they were Corporation Tax. The Company Tax return is the return form, together with accounts and computations. In this report, Company Tax return refers to the form itself.

2 Following the creation of HM Revenue & Customs, the Paymaster General commissioned a *Modernising Powers, Deterrents and Safeguards* review to provide a framework of law and practice for the new Department.

3 As set out in the Organisation for Economic Co-operation and Development – Tax Administration in OECD Countries Comparative Information Series (2004).

4 E-Government Unit, Cabinet Office – http://www.cabinetoffice.gov.uk/e-government/.

5 HM Revenue & Customs 2005-06 Accounts.

6 Approximately 40 percent of company tax returns dealt with by Area Offices have errors in the computation of tax due based on HM Revenue & Customs' random enquiry programme (Committee of Public Accounts Report *Corporation Tax: companies managed by HM Revenue and Customs' Area Offices* HC 967, 2005-06). A third of VAT registered businesses may be under declaring their VAT liability (Committee of Public Accounts Report *Tackling VAT Fraud* HC 512, 2003-04).

7 A revenue determination of Corporation Tax payable is raised in the absence of a Company Tax return.

8 These are distinct from penalties for incorrect returns.

9 The percentage is based on the returns outstanding at the time a penalty is due to be raised. The Department may not always charge a penalty as businesses may have a reasonable excuse, have an agreed extension or have declared insolvency.

10 'XBRL' – eXtensible Business Reporting Language.

11 Publicly Available Specification 76, known as 'PAS 76'.

12 *Research into barriers and incentives for businesses filing returns online* – Oxford Internet Institute (2006).

13 The 2004 Spending Review required the Department to achieve efficiency savings of £507 million by 1 April 2008, including a net reduction of 12,500 full-time equivalent staff.

14 *Corporation Tax: Companies managed by HM Revenue and Customs' Area Offices* National Audit Office, HC 678 2005-06.

15 The VAT Gap is the difference between the total level of expenditure in the economy that is theoretically liable for VAT compared with actual VAT receipts, from which it is assumed that the difference represents the total revenue loss.

16 KPMG administrative burdens report, 20 March 2006 *Administrative Burdens – HMRC Measurement Project*.

17 HM Revenue & Customs: *Helping newly registered businesses meet their tax obligations* (HC 98, 2006-07).

18 *Corporation Tax: companies managed by HM Revenue and Customs' Area Offices* (HC 678, 2005-06) - Part 3: Enabling companies to comply.

19 Previous reports from the National Audit Office and Committee of Public Accounts reports have examined the shadow economy and tax evasion and fraud: *HM Customs & Excise: Tackling VAT Fraud*, National Audit Office HC 357 2003-2004) and *HM Customs & Excise: Tackling VAT Fraud*, Committee of Public Accounts, 36th Report, HC 512 2003-04, *Tackling Fraud against the Inland Revenue* National Audit Office HC 429 2002-2003 and *Tackling Fraud against the Inland Revenue*, Committee of Public Accounts 1st Report, HC 62 2003-04.

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