National Audit Office

HM REVENUE & CUSTOMS

Management of large business Corporation Tax

REPORT BY THE COMPTROLLER AND AUDITOR GENERAL | HC 614 Session 2006-2007 | 25 July 2007

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Comptroller and Auditor General
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17 July 2007

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SUMMARY

1 Large businesses are an important part of the United Kingdom taxpayer population. Because of their economic significance and complex tax affairs, HM Revenue & Customs (the Department) deals with some or all of the taxes for 2,400 of the largest businesses through its Large Business Service. The Large Business Service deals with Corporation Tax for 700 of these businesses. Of around 1,800 staff within the Large Business Service, 600 staff are engaged in managing large business Corporation Tax at a cost of £30 million a year.

2 Since the merger of the Inland Revenue and HM Customs & Excise in 2005, the Department has been reviewing how it delivers services to large businesses. In April 2006, it implemented a new operating model based around client relationship managers for each business and introduced industry sector groupings. In November 2006, Sir David Varney presented his 'Review of links with large business', produced in response to concerns about the relationship between businesses and the Department. As an outcome of the review and drawing on changes already underway, the Department has adopted proposals to transform the way it deals with large businesses. The key proposals are:

- Improved customer relations and service.
- Greater certainty for businesses over tax due.
- An efficient risk-based approach to dealing with tax matters.

Summary text continued

- Benefits for businesses that engage in low risk behaviour.
- Speedy resolution of issues and moving to a culture of 'real time' enquiries.

3 These changes are at the core of the Department's new approach to managing large business Corporation Tax. They are aimed at improving the relationship between large business and the Department, the efficiency and effectiveness of the administration of the tax system, and are directed at maintaining and enhancing the attractiveness of the United Kingdom as a place to do business. This report considers the Department's progress and specifically covers:

- Administering large business Corporation Tax (Part 1).
- Managing risks to Corporation Tax revenues (Part 2).
- Measuring and managing performance (Part 3).
- Departmental staff skills and resourcing (Part 4).

Details of our methodology are in Appendix 1. For the purposes of this report, 'large businesses' are those administered by the Large Business Service.

Conclusions

4 In 2006-07, large businesses paid £23.8 billion in Corporation Tax, representing 54 per cent of the £44.3 billion Corporation Tax raised from all 1.8 million incorporated businesses in the United Kingdom. The large business component was over £0.5 billion lower in real terms than in the previous year. The Department believes this is largely a result of changes in the economy and the impact of policy measures. The additional tax (or intervention yield) raised from the Department's compliance work has ranged from £1.9 billion to nearly £2.7 billion over the four years to 2006-07. The Large Business Service has an internal milestone of an additional £843 million intervention yield by 2007-08 above the 2003-04 baseline. In 2006-07, the Department reported an additional yield of £730 million against an internal milestone of £821 million for that year. However, the additional yield reported each year may fluctuate widely as a significant proportion of the yield comes from a small number of large cases and the total yield each year will depend on the dates when large cases are settled.

5 Businesses are entitled to plan their affairs to minimise tax liabilities within the rules. The Department aims to collect the right tax at the right time. To do so, it must verify large businesses' self-assessments of their Corporation Tax liabilities in an environment of globalisation, sophisticated tax planning and complex tax legislation. In this environment, there can be different interpretations of tax legislation and what elements of tax planning are legitimate. This creates 'greyness' around what is the right amount of Corporation Tax each business should pay and builds tension between the Department and large business. The proposals in Sir David Varney's review aim to reduce this 'greyness', improve the relationship between the Department and businesses and incentivise businesses to manage their tax affairs in a way that presents a low compliance risk.

6 The Department is in a transition phase as it continues to implement its new approach. It has appointed a client relationship manager for each business, who is responsible for managing the relationship and evaluating business risks. It has developed a structured framework for estimating Corporation Tax risks across the large business population and a management information system to record the nature and estimates of the maximum tax at risk for each large business (the tax under consideration). It has begun to reduce the number of long running enquiries. In 2006-07, it closed over 1,700 enquiries five years old or more, giving businesses greater certainty over their Corporation Tax position. The Large Business Service undertakes enquiries to validate the accuracy and completeness of some Company Tax returns. It has also begun a programme in which its senior management engage directly with management boards of businesses with high risks to Corporation Tax, to change their behaviours and approach to tax risks. As at May 2007, this programme involved businesses which collectively have several billion pounds of Corporation Tax under consideration.

7 However, the Department has further to go to implement fully its new approach. Departmental staff are still carrying out a large number of low value enquiries on businesses. In February 2007, 58 per cent of open enquiries were expected collectively to produce less than one per cent of the total additional tax yield generated from compliance activities. Departmental tax specialists have shown some reluctance to stop enquiries into low levels of tax, regardless of resource availability to manage an enquiry properly to completion, as their operational culture promoted opening enquiries whenever they saw tax at risk. Within the Department, there is some ambiguity over what is low risk and low value, which hinders the move to focus on high risk enquiries. The culture of opening enquiries even where low amounts of tax are at risk has resulted in large numbers of open enquiries (4,700 at February 2007). In addition, the Department still has significant further work in settling long running enquiries, as nearly 1,700 open enquiries are five years old or more. In May 2007, the Large Business Service issued new guidance on what constitutes low risk, and is in the process of developing targets for 2007-08 to reduce the number of low risk and old enquiries.

8 Other tax authorities face similar issues in developing and refining methods of risk assessment. The Australian Taxation Office has implemented, and the Canadian Revenue Agency is in the process of implementing, a methodology for calculating the effective tax rate of individual businesses and comparing it to the statutory rate as a means of differentiating high and low risk businesses. The effective Corporation Tax rate of a business is its Corporation Tax liability declared as a percentage of pre-tax company profit. While using effective tax rates can help identify businesses that pose higher or lower tax risks and provides a tool to assist in prioritising resources, it is still important to have a good understanding of the business, its industry, its profit drivers and its tax planning for major transactions.

9 The Department's appointment of client relationship managers is a crucial element in delivering the new approach. The role provides a single point of contact for businesses and offers the Department a means of developing detailed knowledge of each business. Large businesses support the principles behind the role and welcome a more collaborative approach. However, some large businesses believe that the Department's 'old enforcement culture' still exists. The Department recognises it needs to make significant shifts in internal attitudes and behaviours to achieve the new relationship and attain a culture of cooperation with businesses. Engaging frontline staff with the aims of the new approach is essential in implementing the changes successfully. Similarly, businesses and their tax advisers also recognise their need to work with the Department to implement the proposals and achieve the benefits from a more collaborative approach.

10 There are wide ranging attitudes among large businesses towards compliance with Corporation Tax, in their use of avoidance schemes, complexity of legal structures and cooperation with the Department. The Department is achieving promising early results from its high risk corporates' programme of engaging directly with management boards of businesses with the highest risks to compliance with Corporation Tax. This aims to change their behaviour, reduce their risk levels and resolve major enquiries. But there are opportunities for the Department to publicise this programme more widely as an example of its approach to dealing with high risk businesses. Similarly, the Department was slow to communicate its new litigation strategy, which focuses on recovering the full amount of tax where it has a strong legal case and dropping cases where arguments are weak. Some businesses within the Large Business Service were unclear about this approach.

11 It takes Departmental staff a considerable period of time and training to build up the requisite knowledge and experience to manage the issues arising from large business Corporation Tax. Large businesses attach considerable importance to Departmental staff having good knowledge about their industry and familiarity with their business. Yet they consider client relationship managers and tax specialists do not always have sufficient knowledge or expertise to liaise as equals with the staff of their tax departments. The Department considers skill levels and training to be one of the key challenges to delivering its new approach, particularly if the staff are going to tackle more difficult, complex and higher value enquiries. The loss of key senior staff over the next ten years is a concern to both large businesses and the Department. The Department does not have a long-term strategic plan to build and maintain the staff capacity and skills within the Large Business Service. However, the 'Review of links with large business', proposes staff should be equipped with the skills and competencies needed to deal with complex tax matters through technical training and joint working with the private sector and the Department has recognised the need to develop further staff skills and experience.

12 The Department needs relevant performance measures to assess the impact of its compliance work. For 2005 to 2008, the Department has a Public Service Agreement target to reduce by £3.5 billion by March 2008, the annual under-payment of direct taxes and National Insurance contributions. The Department's primary measure for large business Corporation Tax compliance work, which feeds into the Public Service Agreement target, is intervention yield. However, intervention yield has drawbacks as an indicator. It does not give any indication of the overall level of tax compliance; it captures mostly enforcement activity rather than the outcome of preventive measures that secure compliance; and most importantly, it tends to reinforce a culture of focusing on lower value enquiries, which offer greater certainty, to meet overall yield targets. The Department uses intervention yield in lieu of a robust measure of the tax gap (the difference between the amount the Department collects through routine compliance and the total theoretical liability if all taxpayers were fully compliant with Corporation Tax legislation.) It has undertaken research into estimating a tax gap, but is unable to produce robust results because of the lack of verifiable data. Its management information system, which collates the total maximum estimate of tax under consideration, offers the Department the opportunity to develop an overall measure of compliance.

Overall conclusion

13 The administration of corporate taxes in a globalised environment presents significant challenges. The Department is making progress in a number of areas. It is introducing changes to improve its working relationships with large business and to improve compliance. It is assessing Corporation Tax risks in a more structured way, is settling old enquiries, is tackling major tax risks with high risk businesses, including involving their management boards to change their behaviour, and has appointed client relationship managers. There is scope for further progress. To implement fully its new approach, the Department must continue to embed the necessary cultural and behavioural change in the everyday practice of its staff. It also needs to develop a long-term plan for building staff skills and capacity on large business activities and to develop a set of performance measures that capture the outcomes of its activities. Improving communications about its concentration on high risk businesses and the litigation strategy will help businesses understand better the Department's focus and demonstrate its new approach. In delivering the new approach, there are opportunities for the Department to increase large businesses', tax advisers' and its own staff's understanding and acceptance of the processes underway through better articulation of its goals, priorities and accountability.

Recommendations

14 Our recommendations aim to develop further the Department's effectiveness in managing large business Corporation Tax. We recommend that the Department should:

i provide an overarching framework for large business Corporation Tax to bring together the broad range of initiatives underway, to improve delivery, coordination and accountability (paragraphs 1.9 to 1.10, 2.9, 2.19 to 2.20, 2.23, 2.27 to 2.28, 2.31, 2.34, 2.40 to 2.44 and 4.4);

ii invest in a change programme delivered to Department staff to ensure they understand and implement the new approach to developing working relationships with businesses and focus on high levels of tax risk (paragraphs 2.13, 2.37 to 2.38);

iii fully implement guidance for tax specialists on when a tax risk is material, to improve the focus on high risk businesses and enquiries (paragraphs 2.21 to 2.23);

iv prevent staff opening enquiries without an estimate of the amount of tax under consideration, the resources available to complete the enquiry in a timely manner and managerial approval. This will further assist the shift towards focusing on high risk businesses and enquiries (paragraphs 2.6 to 2.11);

v through its client relationship managers, improve the relationship with tax advisers to enable and encourage their clients to change their behaviours and attitudes to tax risks and increase the proportion of businesses with a low risk status (paragraphs 2.33 to 2.35);

vi assess the usefulness of monitoring businesses' effective tax rates over time, as an indicator of potential compliance risk behaviour and to develop better understanding of the drivers behind these rates (paragraphs 2.14 to 2.18);

vii develop a set of performance measures, building on those which have been developed as a result of Sir David Varney's 'Review of links with large business'. These measures should include:

- an overall compliance measure for large business Corporation Tax. This may include using its management information system data to develop a bottom up tax gap measure (paragraphs 2.11, 3.2, 3.8 to 3.11);
- intervention yield, as a monitoring measure of compliance and enforcement activities (paragraphs 3.3 to 3.7);

- the total estimated tax under consideration in open enquiries and its distribution, to demonstrate its approach to focusing resources on higher tax risks (paragraphs 2.7 to 2.13); and
- the total number and the age profile of open enquiries, to demonstrate its approach to closing long running enquiries and dealing more quickly with new tax risks (paragraphs 2.4, 2.24 to 2.26).

viii develop and implement a training programme, in line with the proposals from Sir David Varney's review, in collaboration with both large businesses and professional institutions, to improve the technical capacity and skills of Department tax specialists (paragraphs 4.6 to 4.13);

ix to achieve and maintain the necessary complement of skilled and experienced staff, develop a Human Resources plan for Department staff working with large businesses that (paragraphs 4.4, 4.14 to 4.15):

- has at least a five year timeframe;
- outlines Large Business Service workforce capability and requirements;
- builds a career path across the Large Business Service;
- considers options for external recruitment;
- creates a formal mentoring scheme; and
- links with the training programme.

x publicise the high risk corporates' programme as an example of its approach to dealing with high risk businesses, and ensure its litigation strategy is widely understood. This would not involve releasing confidential information relating to businesses (paragraphs 2.31 to 2.32).

PART ONE

Administering large business Corporation Tax

This part provides an overview on how the Department manages large business Corporation Tax and the Corporation Tax paid.

1.1 Corporation Tax is a tax on a company's taxable profits or gains in the United Kingdom. The rate is 30 per cent (falling to 28 per cent from April 2008) for companies making profits above £1.5 million, with lower rates for profits below this threshold. Companies assess their Corporation Tax liability after carrying out relevant adjustments to profits presented in their accounts and applying various reliefs. Since the introduction of self-assessment in 1999-2000, companies are required to assess their liability, pay any Corporation Tax due and file a Company Tax return within 12 months of the end of their accounting period.

1.2 There are 1.8 million businesses in the United Kingdom registered to file Company Tax returns in which they self-assess their liability for Corporation Tax. Due to the significance or complexity of their tax affairs, the Department deals with 2,400 of the largest businesses through its Large Business Service. For 400 of these businesses, the Service deals with all their business taxes, including Corporation Tax, PAYE and VAT. For the remaining 2,000, the Service deals with only some of their taxes and local compliance offices deal with the rest. For example, a large business may have significant Corporation Tax liability but a small VAT liability. In this case, the Large Business Service would manage the Corporation Tax and the local compliance offices would manage the VAT. The Department's local compliance offices also deal with all the taxes for small and medium sized businesses. In 2006, the National Audit Office and the Committee of Public Accounts reported on 'Corporation Tax: companies managed by HM Revenue & Customs' Area Offices'[1], which are summarised in Appendix 2, along with the Department's response.

1.3 For the purposes of this report, 'large businesses' are those dealt with by the Large Business Service. Of the 2,400 businesses, the Large Business Service deals with Corporation Tax for 700 businesses. In 2006-07, the Department raised £44.3 billion in Corporation Tax, of which £23.8 billion came from those businesses within the Large Business Service.

1.4 The current population of large businesses within the Large Business Service is inherited from the Large Business Office and the Energy Group of the former Inland Revenue, and the Large Business Group of the former HM Customs & Excise. These merged in April 2005 on the formation of HM Revenue & Customs, creating the Large Business Service. The Department acknowledges the need to review membership of the Large Business Service and is currently developing criteria to decide which businesses the Large Business Service will manage and those that local compliance offices will manage in the future.

1.5 For each business, the Large Business Service carries out a structured assessment of the risks to the payment of the right Corporation Tax at the right time. This includes a review of the business's Corporation Tax position, transactions and its Company Tax return. Risks include those resulting from genuine mistakes to negligent errors or omissions. The structured assessment will also include tax planning or avoidance arrangements where the Large Business Service's view of the likely tax result differs from that put forward by the business. Such issues are often a matter of interpretation, which ultimately may only be resolved in the courts.

1.6 In light of these assessments, the Large Business Service undertakes detailed enquiries to validate the accuracy and completeness of some Company Tax returns. Such enquiries may result in additional tax payments (or refunds), known as intervention yield. Appendix 3 of this report provides additional information on the risk assessment and enquiry processes.

1 *Corporation Tax: companies managed by HM Revenue & Customs' Area Offices*, National Audit Office (HC 678, 2005-06).
Corporation Tax: Companies managed by HM Revenue & Custom's Area Offices, Committee of Public Accounts: Forty-ninth Report (HC 967, 2005-06).

The Department's new approach to managing large business Corporation Tax

1.7 Since the merger of Inland Revenue and HM Customs & Excise in 2005, the Department has reviewed how it delivers services to large businesses. The Large Business Service previously administered large businesses through a regional office structure. In April 2006, it restructured, moving to a nationally-based office with businesses grouped into sectors, each dealing with a specific industry group such as telecommunications and IT; chemicals, health and pharmaceuticals; oil and gas; and banking. It also implemented a new approach to focusing resources on key risks and managing the relationship with businesses through the appointment of client relationship managers.

1.8 In November 2006, the former Chairman of HM Revenue & Customs, Sir David Varney, led a review of the relationship between large business and the Department.[2] The Government considered that it and businesses 'have a common goal in maintaining and enhancing the attractiveness of the United Kingdom as a place to do business'. It considered that 'the relationship between the Department and large business and the efficiency and effectiveness of the administration of the tax system are important in achieving this goal'. With the accelerating pace of globalisation and economic change, the Government recognised that business and the Department needed a shared perspective and should engage in open and transparent dialogue. In the review, businesses fully endorsed the proposals and recognised that successful delivery would depend on businesses and their tax advisers working with the Department in a culture of cooperation. Appendix 4 of this report summarises Sir David Varney's report and proposals.

1.9 The Government accepted the review's proposals and the Department has placed them at the centre of its new approach to managing large business Corporation Tax. The key proposals in Sir David Varney's report are:

- a focus on customer relations and service;
- greater certainty over tax due;
- an efficient risk-based approach to dealing with tax matters, including benefits for businesses that engage in low risk compliant behaviour;
- speedy resolution of issues and moving to a culture of 'real time' enquiries; and
- clarity through effective consultation and dialogue.

1.10 In March 2007, the Department issued its 'Approach to compliance risk management for large business'[3] (see Appendix 4 of this report for further details), in response to proposals in Sir David Varney's review.

Corporation Tax revenues from large businesses

1.11 The Department raised £23.8 billion in Corporation Tax from large businesses in 2006-07, 54 per cent of all Corporation Tax raised. **Figure 1** shows, in real terms, the total Corporation Tax raised from large businesses and that raised from all other businesses over the period since 2002-03. External factors such as economic growth rates, profitability and international competitiveness affect Corporation Tax revenues over time. Over the period 2002-03 to 2006-07, Corporation Tax revenues from large business ranged from £16.4 billion (54 per cent of all Corporation Tax raised in 2003-04) to £24.4 billion (57 per cent of all Corporation Tax raised in 2005-06) in real terms. Corporation Tax receipts from large businesses fell in real terms by over £0.5 billion between 2005-06 and 2006-07. The Department believes this is largely a result of changes in the economy and the impact of policy measures.

1.12 The Corporation Tax raised from the 700 businesses within the Large Business Service is heavily skewed. For example, fifty businesses (seven per cent) contributed 67 per cent of the total Corporation Tax raised in 2005-06 **(Figure 2)**, a reflection of the small number of very large businesses within the Large Business Service. Around 220 businesses paid no Corporation Tax in 2005-06 and a further 210 businesses each paid less than £10 million. The amount of Corporation Tax paid by individual businesses may vary significantly year by year, according to their industry and individual trading conditions.

2 Although directly related to the Large Business Service customer group, Sir David Varney's report has broader application. The report covers businesses within the European Union definition of 'large'. That is businesses with: 250 or more employees, or both a turnover of more than £33 million and balance sheet total of £29 million. Around 15,000 businesses meet these criteria in the United Kingdom. The Department's Large and Complex Group in local compliance deals with businesses which meet these criteria, but which are not managed by the Large Business Service.

3 http://www.hmrc.gov.uk/budget2007/large-business-riskman.pdf.

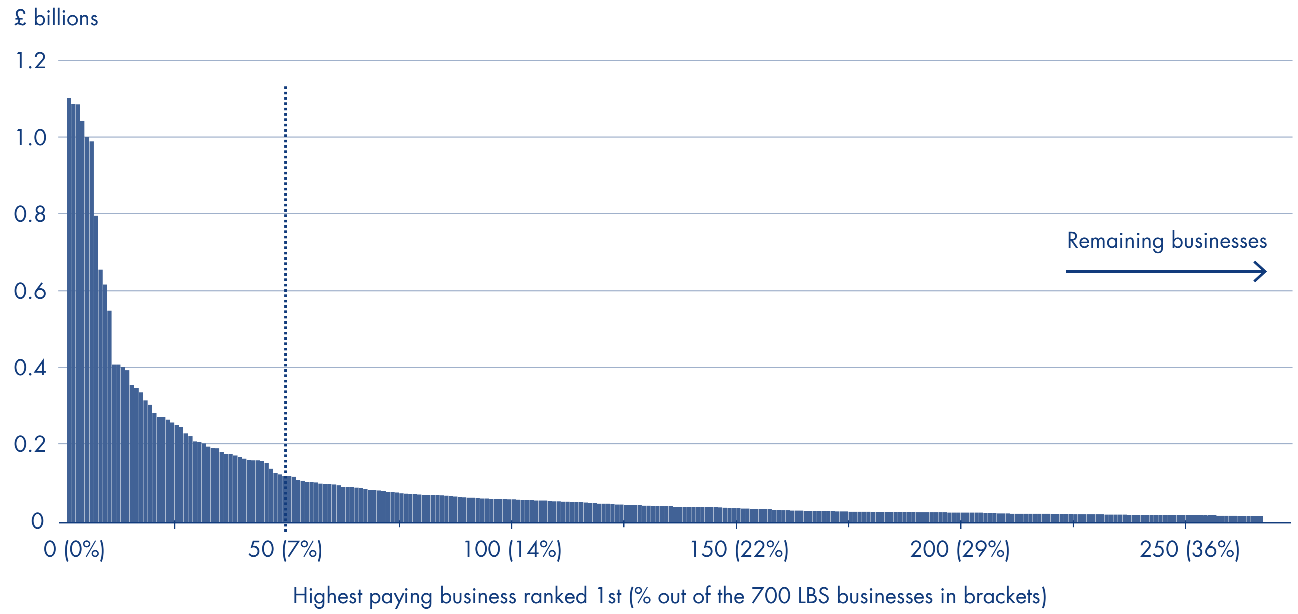
1 Corporation Tax raised from large businesses and total Corporation Tax raised from 2002-03 to 2006-07, expressed in real terms

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

NOTE

1 Real terms data, in 2006-07 terms, are derived from HM Treasury Gross Domestic Product deflators.

2 The distribution of Corporation Tax payments by large businesses in 2005-06



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

NOTE

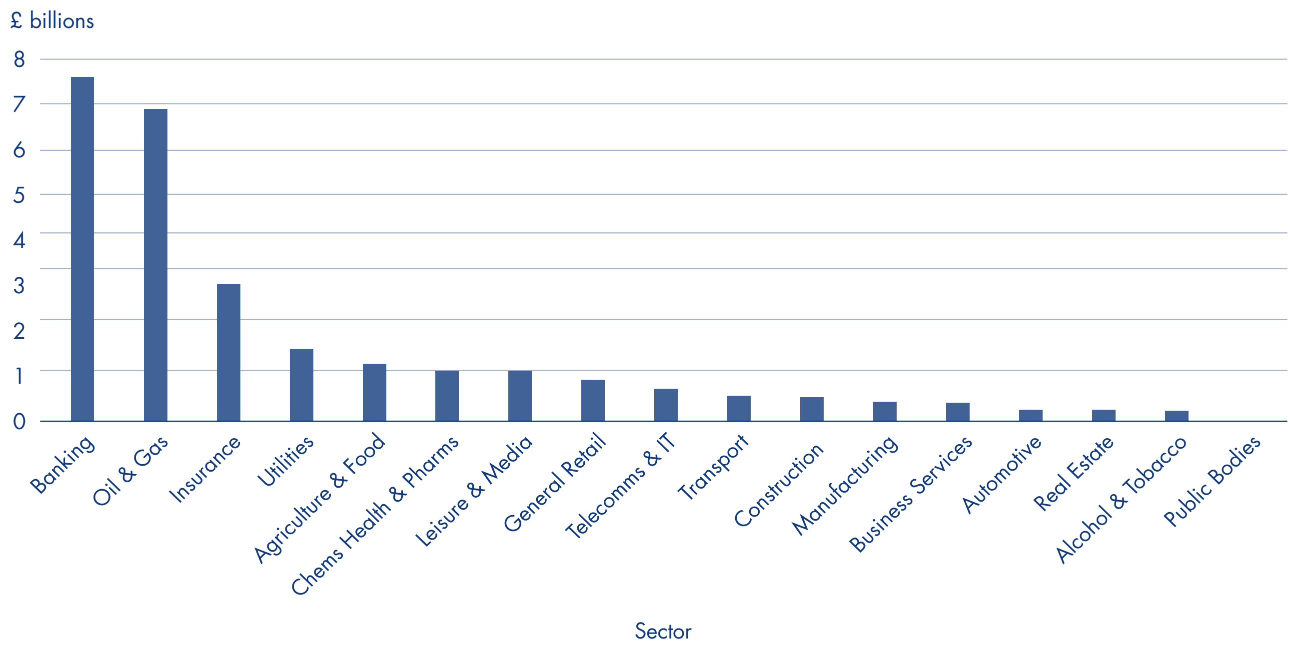
1 Analysis based on 2005-06 data, the latest available distribution by large businesses.

1.13 Corporation Tax receipts are also heavily skewed by industry sector. For example, just three of the 17 industry sectors in the Large Business Service: banking; oil and gas; and insurance raised 67 per cent of all large business Corporation Tax receipts in 2005-06 **(Figure 3)**. These sectors cover 193 (28 per cent) of the 700 businesses within the Large Business Service but include a number of very large businesses. Around 38 per cent of Corporation Tax staff in the Large Business Service deal with the banking, oil and gas, and insurance sectors.

The costs of managing large business Corporation Tax

1.14 Six hundred staff within the Large Business Service are engaged in managing large business Corporation Tax, costing £28 million a year. The Department spends a further £2 million a year on capital and other operational costs. It incurs additional costs in other specialist Departmental services, for example, legal services.

3 The distribution of Corporation Tax raised from the 17 Large Business Service sectors



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

NOTES

1 Public Bodies pay no Corporation Tax but do pay VAT and employer taxes.

2 Analysis based on 2005-06 data, the latest available for Industry Sectors.

PART TWO

Managing risks to Corporation Tax revenues

This part examines the Department's current approach to managing risks to Corporation Tax revenues and its plans.

2.1 Large businesses are often multinational organisations with complex structures. They form an important part of the national economy in terms of the range and amount of taxes they pay, their investment in research and development and their contribution to the United Kingdom balance of payments. They are also among the country's largest employers. Large businesses will assess whether the United Kingdom is a competitive economy in which they can operate. Many large businesses have specialist internal tax departments staffed with highly skilled and experienced individuals including lawyers and economists, and may use specialist external tax advisers, to operate effective tax planning and management.

The Department's approach to managing risk

2.2 The Department aims to collect the right tax at the right time. In common with tax authorities worldwide, the Department faces a challenge in verifying the accuracy of large businesses' self assessments of their Corporation Tax in an environment of globalisation, sophisticated tax planning and increasing complexity of tax legislation.[4]

2.3 There exists a degree of 'greyness' around assessing the 'right' amount of Corporation Tax, which arises from different interpretations on what is legitimate tax planning which can, in turn, create tensions between large businesses and the Department. In conjunction with the proposals arising from Sir David Varney's review, the Department has developed a new approach. The aim is to incentivise businesses to change their behaviours and manage their tax affairs in a way that presents a low compliance risk. The approach includes the following key features:

a) Focusing enquiry work on the key risks to tax revenue.

b) Speedier resolution of enquiries.

c) Tackling avoidance.

d) Working more collaboratively with large businesses.[5]

2a) Focusing enquiry work on the key risks to tax revenue

2.4 In 2006-07, the Department raised additional Corporation Tax of nearly £2.7 billion from its compliance work (known as intervention yield – paragraph 1.6) **(Figure 4 overleaf)**. At the end of February 2007, the Large Business Service had 4,700 open Corporation Tax enquiries on the 700 large businesses. The resources that it commits to each enquiry vary considerably. They depend, in part, on the availability of staff resources, the amount of Corporation Tax under consideration, the nature and complexity of the issues involved and the priority it attaches to each enquiry. The number of open enquiries also varies from business to business. At February 2007, some businesses had just one open enquiry, whilst others had over 220 open enquiries. In part, this reflects the differing size and complexity of businesses within the Large Business Service and the number of subsidiary companies, as well as their risk status and compliance behaviour. The Department opened the majority of these enquiries within the last five years, but some are over a decade old.

4 We have previously examined the complexity of Corporation Tax legislation in our report 'Corporation Tax: Companies managed by HM Revenue & Customs' Area Offices' (HC 678 2005-06), 13 January 2006, Paragraph 3.14. (Appendix 2 of this report summarises the reports' key findings.)
5 http://www.hmrc.gov.uk/lbo/operating-model.pdf.

2.5 The Department imposed penalties on large businesses for negligence[6] in their Company Tax returns in 19 cases in 2006-07, following completion of enquiries into their returns. The total value of penalties imposed was £15 million, up from 14 cases with a penalties value of £5 million in 2005-06. The increases were due to the Department seeking penalties in more cases and the imposition of two large penalties which increased the total value imposed. The Department and the business may negotiate a settlement with an agreed collective sum to cover the additional Corporation Tax due, interest on late payment, a surcharge (a percentage of tax unpaid by the due date) and any penalty for negligence. If the Department and the business do not reach a negotiated settlement, the Department may proceed to litigation. There is no statutory basis for the Department to impose separate penalties where the completed enquiry reveals the business has sought to avoid Corporation Tax. Appendix 3 of this report provides further details on enquiries and the steps the Department takes following completion of enquiries.

Focusing on high value risks to Corporation Tax

2.6 The Large Business Service has traditionally assigned tax specialists to individual businesses. Tax specialists reviewed the businesses' Company Tax returns and opened enquiries where they considered Corporation Tax was at risk. The Department has found that, because tax specialists opened enquiries on the majority of individual risks identified, it spent collectively significant time and resources on enquiries with relatively low amounts of tax under consideration, rather than concentrating on examining higher risk issues and on businesses that it considered high risk. Shown below are the main factors involved in the Department's estimation of a business's Corporation Tax risks.

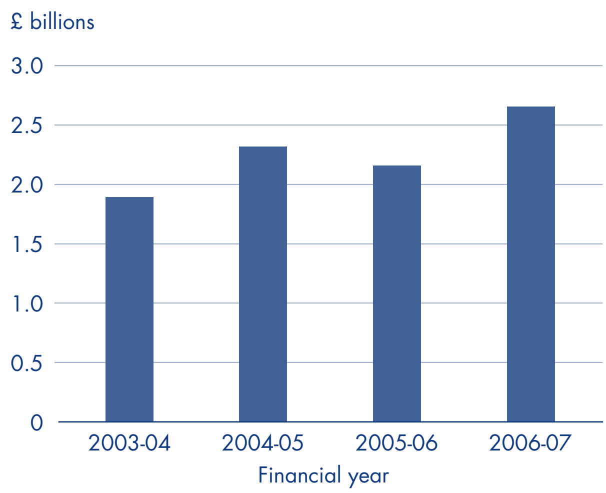
- Size, structure and complexity of the business.
- Tax governance.
- Financial arrangements.
- Avoidance schemes.
- Strength of underlying systems.
- Legal complexity and challenges.
- Cooperation with the Department.

Appendix 3 of this report further outlines how the client relationship manager and tax specialists carry out a structured assessment of a business's Corporation Tax risks.

2.7 **Figure 5** shows the enquiries on large businesses that tax specialists opened between 2002 and 2006 and the Corporation Tax under consideration in each enquiry. A minority of enquiries account for the majority of tax under consideration. Fifty eight per cent of open enquiries involve cases where the tax under consideration is less than £500,000. Collectively, these are likely to amount to less than one per cent of the total potential intervention yield from all open enquiries. Conversely, only one per cent of open enquiries involve tax under consideration of more than £100 million, but these amount to 43 per cent of the total potential intervention yield from all open enquiries. Out of 2,600 enquiries the Department settled in 2006, 220 (eight per cent) resulted in yields of less than £5,000 each, including 68 enquiries of less than £1,000 each. However this reflects, in part, the Department's efforts to settle long running enquiries (paragraph 2.26).

2.8 Similarly, there has been no strong relationship between the resources the Department commits to each business and the amount of Corporation Tax under consideration. **Figure 6 on page 16** shows the number of staff days spent in the period April to December 2005 on each business against the value of Corporation Tax under consideration for each business. This shows there is no clear relationship or focus of resources on businesses with higher amounts of tax under consideration.

4 The intervention yield from enquiry work, shown in actual values for each year



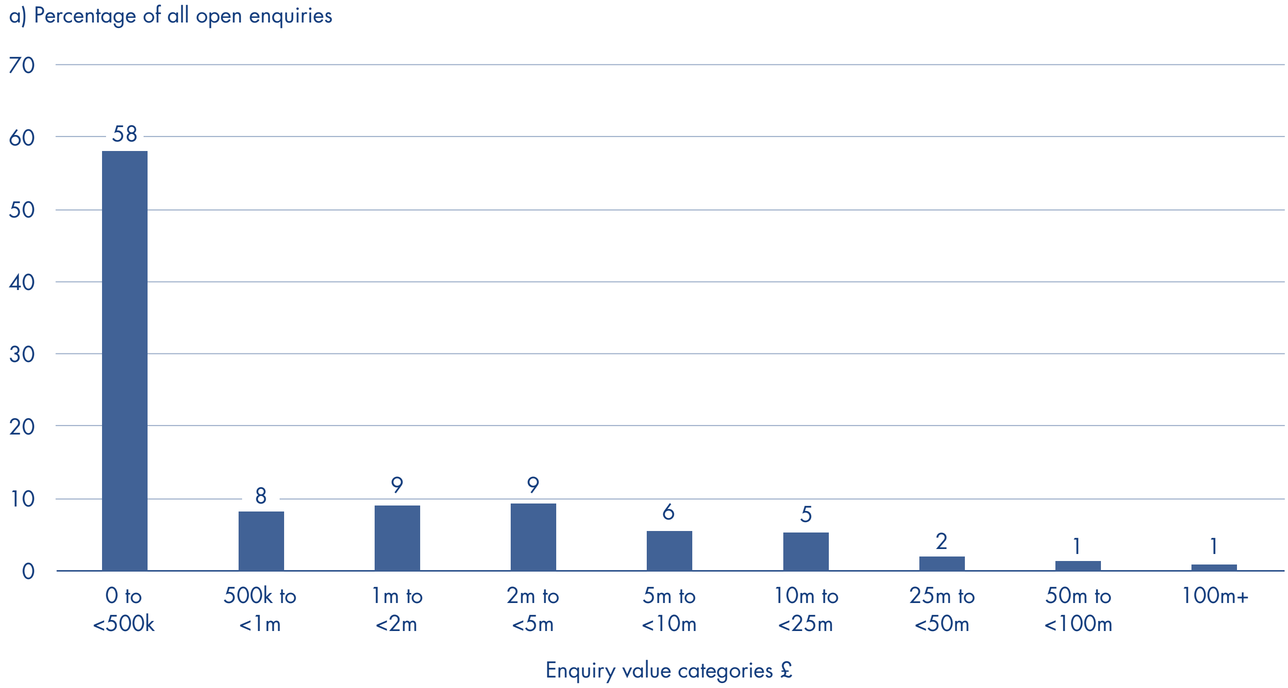
Source: National Audit Office analysis of HM Revenue & Customs' data

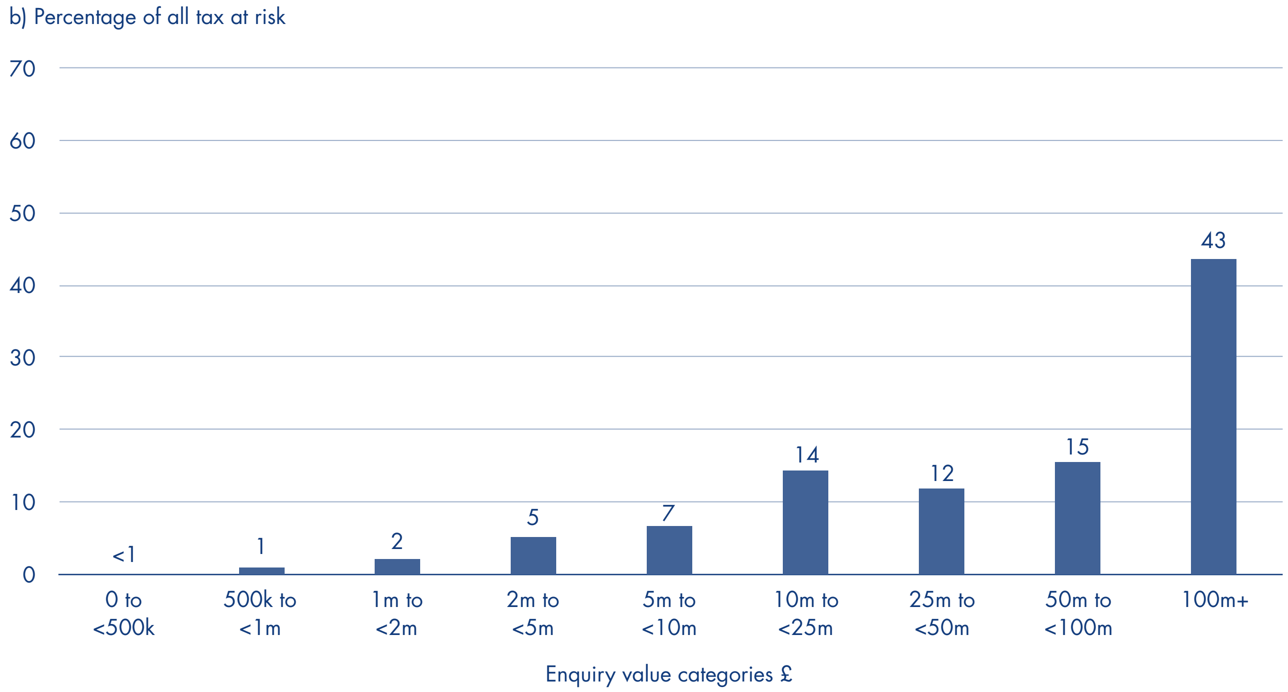
NOTE

The Department counts yield in the year that it is finalised, not the tax year to which the enquiry relates.

6 Negligence may occur where the business has not given sufficient supervision of a system, or staff, resulting in reporting errors on the completed tax return.

5 (a) the distribution of open enquiries by value band and (b) the amount of Corporation Tax under consideration by value band (January 2007)





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

2.9 In April 2006, the Department implemented a new approach across all taxes known as 'Resourcing to Risk'. This places an emphasis on estimating the maximum amount of tax under consideration and then concentrating resources to tackle the highest value, most significant risks first, and to ensure quicker resolution of major enquiries. This should enable it to differentiate its approach to low-risk and high-risk businesses and thereby implement an important part of Sir David Varney's proposals. Businesses identified as low risk can expect to receive a 'light touch' in terms of compliance activity. The Department will target its compliance resources on those businesses it has designated as high risk. Its long-term strategy is to encourage businesses to change their behaviour and to reduce their risk rating voluntarily.

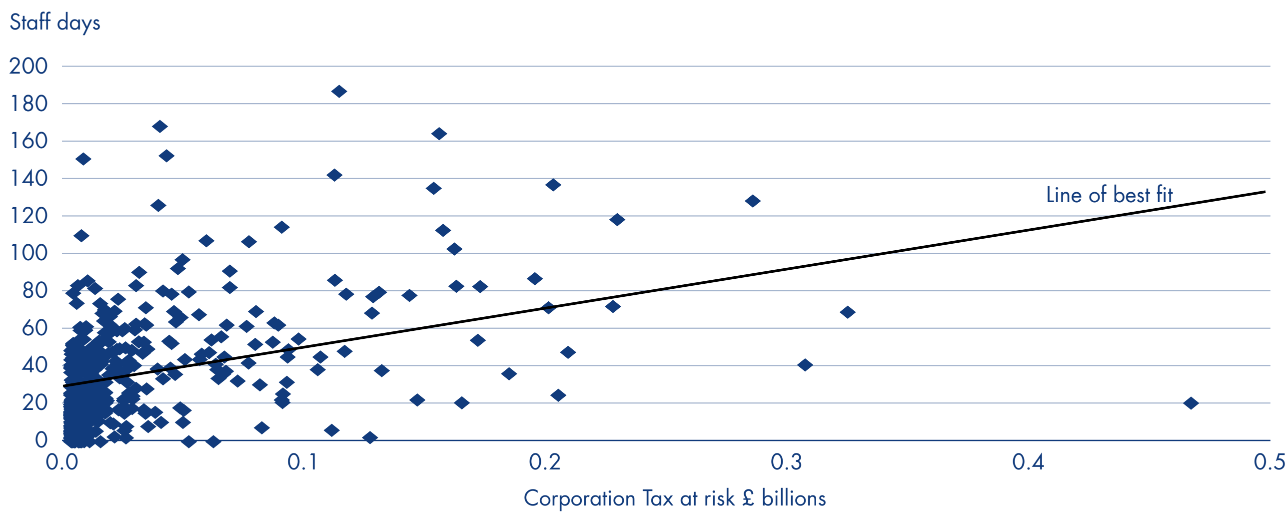
2.10 Under the new approach, the Department estimates the maximum Corporation Tax under consideration in each business against standard defined risk categories (paragraph 2.6), which it then shares with the business to gain its views. The tax specialists are required to enter all estimates onto the management information system known as the 'core system' and then carry out enquiries on the highest estimates of Corporation Tax under consideration.

2.11 The Department extracted a snapshot of data from the 'core system' in February 2007. This showed a total of £8.5 billion under consideration for all tax issues up to 12 months old, where tax specialists had concerns whether large businesses had correctly self assessed their Corporation Tax. This figure may overestimate the tax actually at risk, or collectable, as when staff make an initial estimate they do not yet have access to full information about the business. Making an estimate of the Corporation Tax under consideration requires a good understanding of the tax legislation, the industry sector and the individual business.

2.12 Once the enquiry is completed, the Large Business Service reviews the amount of Corporation Tax agreed in settlement against the original estimation. This provides an opportunity to monitor the accuracy of initial estimates and to identify where staff skills and experience may need to develop in estimating tax risks more precisely.

2.13 At the end of 2006, the Large Business Service conducted a quality assurance review of the 'core system' six months after its introduction. It found that some risks and open enquiries were missing from the 'core system' and that some staff had not accurately recorded their

6 There has been no strong relationship between staff resources deployed on each business and the amount of Corporation Tax under consideration for the business (April to December 2005)



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

NOTES

1 The figure shows the line of best fit. The R^2 is 0.42, indicating that there is not a strong relationship between the Corporation Tax under consideration on a business and the number of staff days deployed on the business.

2 The Department had more than £0.5 billion of Corporation Tax under consideration in a further seven cases. To show the dispersal of the majority of points more clearly, these cases are excluded from the above analysis, but do not affect the R^2 shown.

3 The data cover the allocation of staff days in the first nine months of 2005-2006.

time spent working on individual enquiries. Accurate recording is important in ensuring that the Department is focusing resources on enquiries with higher amounts of Corporation Tax under consideration. The 'Pacesetter' programme (paragraph 2.37) provides an opportunity to explain the value of the 'core system' to all staff within the Large Business Service.

International experience

2.14 Other tax authorities face similar issues in developing and refining their methods of risk assessment. The Australian Taxation Office considers that effective tax rates provide one useful measure of tax compliance over time, particularly for large and medium sized businesses, which helps it to compare and contrast the tax position of companies. The effective Corporation Tax rate of a business is its Corporation Tax liability declared as a percentage of pre-tax company profit, which is then compared to the statutory Corporation Tax rate. However, the Australian Taxation Office's approach also takes into consideration factors that can legitimately reduce a business's effective tax rate. For example, tax losses, company profits, capital gains, franking credits and foreign tax credits, as well as other industry based tax concessions.

2.15 The Australian Taxation Office uses effective Corporation Tax rates alongside other ratios and qualitative risk filters to assess risk.[7] The effective Corporation Tax rate ratios are:

- Company Tax: gross revenue or total income.
- Company Tax: operating profit.
- Company Tax: taxable income.
- Company Tax: total or net assets (although asset valuations may be problematic).

2.16 It also emphasises that, while effective tax rates may help it identify businesses that have tax risks, it is still important to have a good understanding of the business, its industry, its profit drivers and its tax planning for major transactions.

2.17 The Canadian Revenue Agency is also shifting its focus towards using effective tax rates and has adopted the approach of the Australian Taxation Office. It is using effective tax rates to assist in differentiating between high and low risk businesses, which will reduce the need for tax specialists to undertake detailed risk assessments for each individual business. It aims to have very little interaction with businesses it classifies as low risk.

2.18 The Large Business Service uses ratios such as effective tax rates in undertaking industry analysis. It has not adopted effective tax rates to the same degree as the Australian Taxation Office and Canadian Revenue Agency as it considers there are particular difficulties in extracting effective tax rate information from accounts that combine United Kingdom and foreign tax and profits.

The experience of large businesses

2.19 Our consultation with large businesses in early 2007 indicated they had high expectations from the Department's new approach of focusing resources on higher values of Corporation Tax under consideration. But some businesses reported that they had yet to experience the new approach and expressed frustration at the continued number of low value enquiries and additional work involved in responding to questions on a large number of enquiries. In November 2006, an internal review by the Large Business Service also found that its tax specialists were continuing to work on low value enquiries:

'…risk working is a problem in many tax specialists' minds. They find it hard to walk away from issues – even when they believe no benefit will accrue.'

2.20 Some large businesses also reported that the Large Business Service staff open a significant number of enquiries, without then having sufficient resources to progress them. This is a result of training that has encouraged staff to open enquiries where they see any Corporation Tax at risk. A high number of open enquiries spreads staff resources more thinly, risking delays in concluding each enquiry, which can extend the uncertainty for business in settling their tax affairs. The businesses consulted considered that tax specialists ask a large number of questions to gather information to spot any amounts of Corporation Tax at risk, rather than focusing on higher amounts. The Department considers that this approach may be necessary when the business has not set out its tax affairs in a straightforward or transparent way. The businesses we consulted were keen to see the Large Business Service prioritise and focus staff resources on high value enquiries, progressing them swiftly. This would provide benefits to both the Department and low risk businesses and demonstrate to all businesses and their tax advisers the benefits from transparency in tax affairs.

7 The Australian Taxation Office publishes these ratios in its 'Large Business and Tax Compliance' booklet, 2006. http://www.ato.gov.au/content/downloads/77898_N8675-08-2006_w.pdf.

Setting a materiality limit

2.21 The Department's ability to shift staff resources to higher risk enquiries is dependent on providing tax specialists with clarity over what is low risk. In May 2007, the Department issued new guidance to define lower risks and how these should be managed. It has developed priority risk scores to assign risk levels that reflect the size and impact of the risk and a probability factor. For current enquiries that have a low priority risk score, the Department guidance is that tax specialists should examine critically the reasons for pursuing these. Valid reasons include:

- clear errors that could be settled with a telephone call, letter or meeting;
- mandatory work, for example, where Department procedures require examination; and
- risks where there are potential wider consequences which must be addressed.

2.22 The Department's previous guidance on materiality caused confusion among tax specialists, as it stated there was no monetary limit below which staff should not examine risk. This gave staff the impression that it was acceptable to open enquiries whenever Corporation Tax was at risk. Our consultations with Department staff confirmed their confusion on this point, with some tax specialists reluctant to drop low value enquiries, as they believed all tax under consideration deserves investigation.

2.23 Large businesses consider that the introduction of improved materiality guidelines would focus Departmental resources on a smaller number of higher value cases, which it could then manage more effectively and speedily. Similarly, businesses should also benefit from reduced demands on their own tax department staff. In May 2007, the Department released new guidance on materiality, outlining the criteria an identified risk should meet before an enquiry can progress.

2b) Speedier resolution of enquiries

2.24 The Department is seeking to achieve speedier resolution of enquiries to address a key element of Sir David Varney's proposals. The target is to complete enquiries within 18 months. Senior management will become responsible 'for the active management and resolution of tax enquiries that remain unsettled after 18 months of enquiry'. At January 2007, 49 per cent of all open enquiries were over two years old with 13 per cent over four years old. The reasons include insufficient resources or skills within the Department to progress the enquiry, difficulties in obtaining information from the business and delays resulting from litigation.

2.25 Prolonged enquiries prevent businesses from gaining certainty about their Corporation Tax position, require businesses to continue to put resources into responding to requests for information and can hinder the working relations between the two sides. For the Department, dealing with old enquiries is more complex as information is more difficult to obtain, the businesses' tax staff may change, recollection of old events can be uncertain and the enquiries relate to tax periods where the legislation may have subsequently changed. Continuing to examine old enquiries spreads staff resources more thinly and restricts the Department's capacity to help businesses reduce their overall risk rating and to help them resolve issues as they occur, before they complete their tax returns, which is known as 'real time working'.

2.26 For these reasons, the Department is prioritising clearing its backlog of old enquiries. By 31 March 2007, it had closed over half of the enquiries that were five years old or more at 1 April 2006 **(Figure 7)**. Clearing old enquiries may involve proceeding to litigation on complex issues or, where low amounts of Corporation Tax are at risk, settling with the business.

7 Progress in closing old enquiries between April 2006 and March 2007

	Enquiries open at 1 April 2006	Enquiries still open at 31 March 2007	Enquiries settled by 31 March 2007
Enquiries opened in accounting periods in 2001 and earlier	2,115	1,025	1,090 (51%)
Enquiries opened in accounting period 2002	1,313	656	657 (50%)
Total	3,428	1,681	1,747 (51%)

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

2c) The Department's work to tackle Corporation Tax avoidance

2.27 Businesses have the right to plan their affairs efficiently to minimise their tax liabilities within the rules and thereby maintain their competitive position compared to other businesses. Businesses can legally make plans to achieve this and take up tax incentives the Government provides. However, the Department is keen to reduce the amount of tax lost to the Exchequer through tax avoidance. Tax avoidance is not easily definable but it can involve highly creative ways of using tax laws to reduce or defer tax. Interpretations of tax legislation can differ so that businesses may regard their actions as acceptable, whilst the Department may regard them as in conflict with the rules or the intention of the legislation. Ultimately, it is for the courts to decide on the legality of the arrangements. Businesses often seek help from their tax advisers, such as accounting and law firms and investment banks, in arranging their tax affairs to minimise their tax liabilities. These advisers may also develop schemes for their clients to reduce Corporation Tax.

2.28 In August 2006, the Government extended legislation to improve the transparency of businesses' tax arrangements and reduce the use and effectiveness of direct tax avoidance schemes by requiring their disclosure. This allows the Department to take swifter and more targeted action to counter deliberate abuse of the tax system (see Appendix 5 of this report for further details). The legislation requires the 'promoter' of the scheme to disclose it to the Department and the 'user' to declare the use of a scheme on its Company Tax return. This enables the Department to assess what action it needs to take to protect Corporation Tax revenues, for example, by recommending to Ministers legislation to close the scheme promptly. The Case Example in **Figure 8** illustrates how the Government used legislation to close an avoidance scheme known as 'dividend stripping'.

2.29 **Figure 9 overleaf** shows that the number of schemes disclosed to the Department has levelled out following an initial peak in disclosures between July and December 2004. At the end of February 2007, the Department had received nearly 900 disclosures of avoidance schemes covering Corporation Tax and other direct taxes. The Government had closed 350 schemes (almost 40 per cent) by targeted legislation. On the remainder, the Department considers existing legislation sufficient to prevent users of the scheme avoiding Corporation Tax.

2.30 Since the introduction of the legislation, the Department has identified a move from generic avoidance schemes to more bespoke schemes that are often specifically designed to cover large one off transactions or for companies with specific business structures. As one type of scheme becomes less prevalent, other types increase, demonstrating the dynamic environment in which both the Department and businesses work.

2.31 The Department is also tackling avoidance through its 'high risk corporates' programme, in which senior officials in the Department work directly with the management boards of businesses presenting the highest tax risks. The Department aims to influence the behaviours of these businesses by sending a message to their boards that it will give higher risk businesses its full attention. As this programme requires the Department to invest intensive resources, it has limited the action to a very small number of businesses at any one time. However, collectively these businesses have several billion pounds of tax under consideration. By May 2007, the Department had resolved significant tax issues, secured considerable additional tax and received commitments from the businesses affected to change their relationship with the Department. These include commitments to material changes in tax planning policies in future years. The Department has released little information publicly about the programme.

8 An example of an avoidance scheme quickly closed by the Government

The Government can close disclosed schemes quickly to prevent businesses avoiding Corporation Tax. In January 2005, the Paymaster General announced in Parliament that the Government proposed to repeal a section of legislation, with immediate effect, to prevent the use of current legislation for a dividend stripping avoidance scheme. The announcement effectively closed the scheme within three weeks of it being disclosed to the Department, ensuring the protection of an estimated £1 billion Corporation Tax.

The dividend stripping scheme involved a financial trader acquiring the rights to receive a dividend that has been declared but not yet paid. The trader does not acquire the shares on which the dividend is to be paid – the dividend is 'stripped' from the share. The trader claims a deduction in its tax return for the cost of the rights to the dividend. Shortly afterwards the trader disposes of the rights for an amount similar to the amount paid. The trader claims that the receipt is not chargeable to tax. The commercial result is effectively nil, as the right is bought and sold for a similar amount. However, the trader obtains a tax loss equal to the amount paid to acquire the dividend. All the money remains within the group of companies of which the financial trader is part. A number of special purpose companies have to be created for the scheme to work.

Source: HM Revenue & Customs

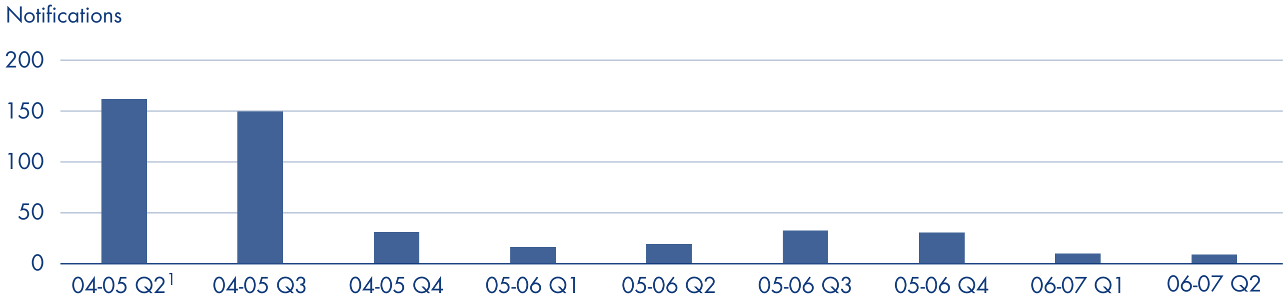
2.32 The Department has also developed a litigation and settlement strategy that aims to change the behaviours of businesses and the culture of the Department. Prior to this strategy, the Department might settle an enquiry by accepting a sum below the amount of Corporation Tax under consideration, even when it considered it had a strong case for a higher settlement value. This tended to encourage businesses to engage in riskier tax strategies. Under the new strategy, if the Department believes it has a strong legal case it strives to obtain 100 per cent of the Corporation Tax under consideration. If necessary, this may mean proceeding to litigation. Conversely, if the Department considers its chances of success to be less than 50 per cent it will not pursue legal action unless the particular circumstances justify it. The strategy aims to provide a consistent approach towards all businesses and to promote the message that where the Department is deploying strong arguments against avoidance schemes, it will not settle for less than all the Corporation Tax under consideration. The primary purpose of the strategy is to shift the long-term behaviour of businesses. However, in our consultation with businesses, they expressed confusion over the litigation strategy. They perceived that the Department litigated in all cases and they considered this ran counter to the new approach of building trusting relationships. To clarify its position, in June 2007, the Department published its strategy on its website and through the 'Tax Journal'.

2d) Working more collaboratively with large businesses and their tax advisers

2.33 One of the key drivers of Sir David Varney's review was improving the relationship between large businesses and the Department. The Department had previously recognised this need. In April 2006 it developed in consultation with large businesses an operating model for the Large Business Service. The operating model focused on:

- helping businesses comply with Corporation Tax;
- building a good relationship, through appointing for each business a client relationship manager, whose primary role is to help the business meet its tax obligations;
- improving its understanding of large businesses and the factors that drive their commercial behaviour;
- targeting its activities on high risks and those businesses which do not fulfil their tax obligations, to protect Corporation Tax revenues; and
- managing large businesses in industry sectors.

9 The number of avoidance schemes from July 2004 to July 2006



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

NOTE

1 2004-05 Quarter 2 includes data for August and September only. 2006-07 Quarter 2 includes data for July only.

2.34 At the heart of the operating model is the appointment of 150 client relationship managers across the 17 industry sectors. A client relationship manager is assigned to each business. The client relationship managers are responsible for discussing how they assess and manage the risks that apply to the business, and help the business understand what they see as the key risks. The client relationship manager is also expected to understand the relationship between the business and any external tax advisers, including accountants and lawyers, and the role of these advisers in the tax function of the business. The Department considers the client relationship manager role pivotal in improving the relationship and its understanding of the needs of large business.

2.35 A business's tax advisers are a key influence on its behaviour and compliance with tax legislation. The Department also has a strategy to improve services for tax advisers to help them support their large business clients more effectively in complying with tax legislation. It aims to work more collaboratively with tax advisers to help reduce the tax risks their client businesses present. The Department, large businesses and tax advisers see this as important in achieving the proposals in Sir David Varney's review.

2.36 In September 2006, the Organisation for Economic Cooperation and Development announced a study into tax advisers (or tax intermediaries). This includes examining the impact tax intermediaries have on tax compliance by their clients. It is also examining the factors that influence the behaviour of tax intermediaries and shape their relationship with their clients and revenue departments. The study is expected to report in November 2007 and includes members of the Department on the study team.[8]

2.37 In implementing the operating model and Sir David Varney's proposals, the Department has also recognised the need to change the attitudes and behaviours of its staff to achieve the desired culture of cooperation with large business. As a first step, the Large Business Service is running staff engagement events, using the tools and techniques developed more widely under the Department's change programme know as 'Pacesetter'. The first events have focused on ensuring senior staff with a leadership or management role understand, accept and can apply the new approach. The Large Business Service is now extending these events to cover some frontline staff such as client relationship managers and tax specialists.

2.38 To achieve the desired relationship, it is essential for frontline staff to understand fully and implement the new approach successfully. They represent the Large Business Service each day in its communications with large businesses. The Department acknowledges more work is required to embed the new approach fully. In November 2006, its review of a sample of Large Business Service staff revealed that not all had embraced the principles of the new approach and that 67 per cent of client relationship managers and tax specialist managers observed the need to change the operating culture. The review concluded that staff 'remain in their comfort zones, carrying out familiar tasks in familiar ways'.

2.39 In our consultation with large businesses, they expressed support for Sir David Varney's proposals and the operating model and welcomed the Large Business Service's more collaborative approach, which they considered a move towards best practice. They considered that the new client relationship manager role could provide a single point of contact and help develop positive relationships and a detailed knowledge of the business. But some reported that they had not experienced the more open and trusting relationships the Department was advocating and that the old enforcement culture still existed. This indicates the potential value of extending the 'Pacesetter' programme to frontline staff handling large business taxes.

Joint working across the Department

2.40 The Large Business Service calls on other parts of the Department in managing large business Corporation Tax, such as advice from legal services. These functions have to balance requests from the Large Business Service against those from other units. To achieve the Department's new approach to managing large business Corporation Tax, it must take a coordinated approach across its individual functions. The Large Business Service needs to work jointly with other parts of the Department to match priorities and resource capacities to avoid bottlenecks and prevent duplication in requests.

2.41 The large businesses we consulted considered that the role of the client relationship manager improved the management of enquiries within the Large Business Service. However, some businesses reported that when their client relationship manager forwarded enquiries to other parts of the Department, they received limited information on the expected timetable for the progress of the enquiry.

8 Organisation for Economic Co-operation and Development: Tax Intermediaries Project. Terms of Reference http://www.oecd.org/document/50/0,2340,en_2649_37427_37930802_1_1_1_37427,00.html.

2.42 In November 2006, a survey by the Large Business Service of a sample of client relationship managers and business teams showed that 90 per cent of respondents experienced problems in receiving advice from other parts of the Department in the agreed time. They considered that the main reasons for delays were inadequate resources, competing priorities, complexity of the issues and delays in assessing the impact any decision would have on other businesses. Tax specialists reported similar experiences: only 34 per cent received information from other parts of the Department on time.

2.43 In December 2006, the Department published guidance on the roles and responsibilities of client relationship managers and sector leaders, including their role in consulting technical specialists across the Department and the approach to settlement and litigation of issues.[9] This aimed to help large businesses understand when the settlement of an enquiry was outside the client relationship manager's authority. Sir David Varney's review included a proposal to resolve issues within set timeframes. This gives the whole Department a target and collective objective to provide advice on time and an impetus to enhance joint working and cooperation across different areas of the Department, and to match resources and priorities in managing large business Corporation Tax.

2.44 In our own consultation with Large Business Service client relationship managers and tax specialists, they also expressed difficulties in coordinating work with the Department's local compliance offices. The Department's survey found that 40 per cent of client relationship managers and 56 per cent of tax specialists reported difficulties in working with local compliance offices, particularly when the Large Business Service managed only some of a business's taxes and a local compliance office managed the remainder. These included a lack of communications from local offices about their activities; a lack of awareness within local offices on the role of the client relationship manager and the operating model and inadequate collaboration between the Large Business Service and local offices. As a result, businesses experienced a disjointed approach between the Large Business Service and local offices. To overcome these difficulties, the Department is considering new arrangements so that the Large Business Service would deal with the entire tax affairs of a smaller number of large businesses.

9 http://www.hmrc.gov.uk/lbo/lbs-roles-responsibilities.pdf.

Measuring and managing performance

This part examines how the Department currently measures its performance and potential measures for the future.

Departmental targets

3.1 The Department aims to reduce the level of non-compliance and minimise the burden on compliant businesses. For 2005 to 2008, the Department has a Public Service Agreement target to reduce by £3.5 billion, by March 2008, the annual under-payment across direct tax and National Insurance contributions. It has 25 internal milestones that contribute to this, including one that relates to the Large Business Service from the Department's 2004 Spend to Raise package, which is to increase the total intervention yield by £843 million (taking 2003-04 as the baseline). In 2006-07, the Department reported an additional intervention yield of £730 million against an internal milestone for that year of £821 million. However, the Department has met the cumulative milestone of £1.4 billion over the three year Spend to Raise period. A significant proportion of the additional intervention yield arises from a small number of large settlements. The dates on which large cases are settled may make a significant impact on the total intervention yield for any year and makes precise forecasting difficult. The Large Business Service is also contributing towards the Public Service Agreement target to reduce underpayments through wider legislative changes and controls.[10]

3.2 The Department is currently formulating its targets for 2008-09 and beyond with HM Treasury and is considering broader targets to capture the full extent of its work to improve compliance and quality of service. Sir David Varney's review proposed the Department introduces 'structured ways to get honest feedback from businesses on their relationship with it and how it could be improved'. The Department is putting in place customer surveys to evaluate qualitative aspects of its performance.

Intervention yield

3.3 The additional tax (intervention yield) resulting from the Department's compliance activities currently provides the only readily measurable element of performance. Intervention yield comprises three main elements:

- Direct yield – additional monies or tax liabilities identified for current and previous years with adjustments for consequential effects in the following two years.
- Accelerated liabilities – additional monies obtained from timing adjustments that are excluded from direct yield (as an example, a tax charge may be brought forward one year).
- Pre-return work – work with the taxpayer, undertaken prior to the submission of their return, which generates additional monies due to improved compliance (although this is difficult to measure).

Of the three types, direct yield contributed over three quarters of the intervention yield achieved in 2006-07 **(Figure 10)**.

10 Additional yield raised by the Large Business Service's compliance activities in 2006-07

	£m	% of total
Direct yield	2,100	79
Accelerated yield	400	15
Pre-return work	150	6
Total	2,650	100

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

10 The National Audit Office is undertaking an examination of the data systems the Department uses to monitor and report on progress against its Public Service Agreement targets for 2005-08 and will report towards the end of 2007.

3.4 The Department has used intervention yield as the primary Corporation Tax compliance measure since 1977. It uses it to understand the impact of its enforcement activity. As the Department shifts its focus on to real time and pre-return work and on to helping and supporting businesses comply, the traditional measure of intervention yield becomes less meaningful as it will not reflect the wider range of activities the Department carries out to improve compliance. For example, client relationship managers and senior management put significant effort into liaising with large businesses, understanding how they operate, and supporting compliance, the effects of which are not fully captured in intervention yield.

3.5 A small number of large payments can potentially divert attention away from the effectiveness of compliance activities across the whole population. To illustrate the impact of major settlements, in 2006 the Large Business Service settled eight cases that secured 26 per cent of its total yield for that year. The largest individual payment was £234 million.

3.6 A continuing focus on intervention yield may affect the Department's ability to shift the culture and behaviours of staff. Intervention yield targets can encourage tax specialists to work on lower value enquiries that may be simpler, more easily resolved and which provide greater certainty. This may run counter to the Department's objective of focusing resources on the highest value tax risks, with potentially higher value settlements, but which offer less certainty to the Department on the outcome of the enquiry or timing of settlement.

3.7 The Canadian Revenue Agency and the United States Internal Revenue Service have also identified limitations in the use of intervention yield as a compliance measure, although they recognise it as a useful monitoring tool. The Internal Revenue Service is currently trialling the use of pre-return assessments. This approach should increase businesses' overall compliance in the tax returns they submit, reduce the need for post return enforcement work and thereby reduce reported yield. Consequently, the Internal Revenue Service is interested in identifying measures that could assist in capturing the overall compliance picture.

The Corporation Tax gap

3.8 The Corporation Tax gap is the difference between the amount the Department collects through routine compliance and the total theoretical liability if all taxpayers were fully compliant with Corporation Tax legislation. In theory, the Corporation Tax gap is the optimal measure for gauging the Department's performance in managing large business Corporation Tax compliance over time. However, there are significant challenges in developing an estimate of the gap including lack of independent economic data and difficulties in estimating the extent of international tax planning and avoidance.

3.9 There is limited international experience in using a Corporation Tax gap to measure the performance of revenue departments. The United States Internal Revenue Service tracks progress made against a direct tax gap, but focuses on the tax gap attributable to individuals rather than businesses, as it considers this accounts for the majority of its overall gap.

3.10 Over time, the Department has undertaken some work on estimating the Corporation Tax gap. In 2005, it brought together a range of data, including risk assessments of large businesses and surveys and attempted to estimate the gap. The Department concluded that the results were not sufficiently robust to be of use and it has not repeated the exercise. However, it has carried out some background work to improve the data sources used in the exercise. The Department uses tax gap measures for indirect taxes, such as VAT and tobacco and alcohol excise duties and has an extensive research programme to improve their reliability and accuracy.

3.11 The Department's new management information system for recording estimates of maximum tax under consideration (the 'core system') provides an opportunity to develop an overall compliance measure. The Department could monitor the total value of estimates of maximum Corporation Tax under consideration to generate a broad upper boundary of possible non-compliance. Clearly, the estimate of maximum tax under consideration would need to be regarded with caution, as it is made subjectively by individual tax specialists without full knowledge of the business and its circumstances. However, as the quality of the data in the 'core system' improves over time, the Department will be able to use it to determine the trend in compliance across the large business population.

PART FOUR

Departmental staff skills and resourcing

This part examines the staff skills and resources required to work effectively with large businesses.

4.1 The largest businesses the Department deals with are complex, sophisticated and dynamic, requiring the Department's staff to have extensive skills, knowledge and industry awareness to manage their Corporation Tax. To perform effectively, the Department needs to:

- achieve staff continuity;
- build staff industry knowledge;
- provide appropriate high quality training; and
- promote staff career progression.

Staff continuity planning

4.2 Around 140 (a quarter) staff in the Large Business Service who deal with large business Corporation Tax are due to retire over the next 10 years. Although this number is not unusually high, the Large Business Service staff we consulted expressed concern over the resulting loss of industry knowledge, experience and contacts. They considered this was the key risk to the Large Business Service's ability to meet its objectives. In our consultation with large businesses, they also considered that the staff of the Large Business Service with the greatest experience and those they respected as industry experts, tended to be those approaching retirement.

4.3 The Department has filled vacancies that arise within the Large Business Service through recruiting tax specialists from other parts of the Department, mainly from local offices that deal with business taxes. During 2006, 30 tax specialists from local offices transferred to the Large Business Service to fill vacancies. Local office staff have concerns over the outflow of skilled people, many of whom are at higher grades. However, such action also indicates the Department's commitment to deploying resources to high risks and ensuring the best value, in terms of compliance, is achieved from its pool of tax specialist resource.

4.4 The Department does not have a coordinated long-term strategy for staff continuity and recruitment of tax specialists into its large business work other than through internal transfer. In our consultations with staff and businesses, participants considered external recruitment into the Large Business Service would improve the skill base, bring in relevant and up to date knowledge of industry and assist in transforming the culture to meet the principles of the operating model. Although there are challenges in external recruitment at the same time as the Department is reducing its overall number of staff, the Department has recently recruited 17 staff from the tax profession in the private sector to work on direct taxes.

4.5 As part of an expansion in its work and increased funding, the Large and Medium Sized Business Section of the United States' Internal Revenue Service is engaged in a large-scale recruitment drive for 900 staff over 12 months (there are 6,000 people within the Section). External appointments account for half the new recruits. The Section indicated that, in the past, it had been successful at recruiting private tax specialists, who were prepared to move to the public sector for lifestyle reasons. The drive to recruit externally had transformed the Section, as the external recruits had been instrumental in accelerating the management's change process and brought with them valued skills and knowledge. Some staff may be employed for only short periods.

Building staff skills, industry knowledge and experience

4.6 In our consultation with large businesses, they highlighted the importance of the Large Business Service having knowledge about their industry and familiarity with their businesses. They held the Oil and Gas Sector in the Large Business Service in high regard. This sector has been operating for more than 20 years, developing expertise and in-depth knowledge of the industry.

4.7 Large businesses considered that client relationship managers and tax specialists did not always possess sufficient knowledge of the industry. They felt this prevented Department staff from developing an accurate appraisal of the business's Corporation Tax position. The businesses we consulted believed that better industry knowledge in the Large Business Service could improve its ability to develop good working relationships with businesses and strengthen its understanding of issues where significant amounts of Corporation Tax were at risk. They felt that the Large Business Service would benefit from working with industry groups on key accounting and tax issues in each industry.

4.8 Large businesses are often multinational organisations. Some of them told us they considered that the Department often failed to appreciate the practical issues and uncertainties surrounding international factors such as controlled foreign companies' legislation, double taxation reliefs, transfer pricing and cross border-financing arrangements. They also considered that tax specialists target activities that businesses view to be normal commercial international transactions, even when the business has controls to prevent error or non-compliance. The businesses believed that the Department would benefit from a greater understanding of the practical issues companies face in tracking and managing risks in these areas.

4.9 The Department's initial training of its specialists in tax administration is held in high regard both internally and externally. But the Department has reduced the additional training it provides to enhance the skills and knowledge of frontline tax specialists. For example, in 2002 it halted the international training courses which covered issues such as transfer pricing and it has cut back on the number of technical update courses. In February 2007, international and transfer pricing risks accounted for 36 per cent of Corporation Tax under consideration. Our consultation with large businesses indicated that they felt there was a widening gap between the skill set of their tax department staff and that of the Large Business Service. In the November 2006 Large Business Service survey of its staff, a third of tax specialists and client relationship managers felt that the training they received was not sufficient to give them confidence in their role.

4.10 The Department has recognised the need to increase skill levels of staff in the Large Business Service and the importance of working with the private sector in achieving this. Sir David Varney's 'Review of links with large business' proposed the Department should 'equip its staff with the range of skills and competences needed to deal confidently with complex matters of relevance to large businesses'. The review proposed the Department should reinvigorate its technical training programme, enhance competencies and work with the private sector to strengthen the commercial understanding of staff and embed deeper knowledge, including through secondments and mentoring. It also recognised the need for staff to gain a real understanding of the economic drivers behind large businesses' decisions in a global economic environment. Since 2005, the Department has also recruited more external staff to key areas.

4.11 In 2007, the Department launched a tax professionalism programme to address training and development needs of tax specialists. This aims to improve and maintain skills and knowledge through focussed training, providing greater awareness of tax law, an improved commercial awareness and customer focus. The programme will deliver a tax professional career path, mandatory continuous professional development and new modular tax qualifications. The Department considers it will take some time to embed the programme and deliver fully the new qualifications and training. In 2007, the Department also approved an investment of £3.75 million, which it will spend on additional resources including legal and specialist consultancy services and transfer pricing expertise.

4.12 The Large Business Service is forming a network of senior staff, such as industry sector leads, to identify particular training needs and communicate these to a 'learning team' responsible for developing a training programme within the budget available. The training needs will feed through to new tax qualifications which the Department's tax professionalism team is developing. Uncertainty over the training funds has made it difficult for the Department to plan the programme.

4.13 Our consultation with large businesses indicated that there is an opportunity for the Department to use existing training programmes run by the professional institutes. They also considered that having Departmental staff and tax professionals from the private sector participating in joint training events would promote common understanding and assist in building relationships.

4.14 The Large Business Service also has legacy issues to manage in deploying staff across the Service. Before the creation of the Large Business Service, two thirds of the current staff worked on VAT or employer compliance cases. However, the proportion of staff working on Corporation Tax (600 staff, 33 per cent) does not reflect the relative risks. The total estimated Corporation Tax under consideration accounts for 85 per cent by value of all tax under consideration within the Large Business Service. On average, there is less than one member of staff for each of the 700 businesses the Large Business Service deals with for Corporation Tax. The Large Business Service has not yet been able to use its tax specialists flexibly across the business taxes, for example to transfer VAT staff to Corporation Tax work, as they do not have the training or experience.

4.15 The Large and Medium Sized Business section of the United States' Internal Revenue Service employs retired staff to act as coaches and instructors for new recruits. This aims to combat the loss of skills and knowledge built up over the years when employees retire. The Canadian Revenue Agency uses the most experienced senior staff as mentors to less experienced staff, to help them gain the necessary skills and knowledge. The Department's staff considered the Large Business Service had opportunities to improve staff continuity planning through hand over periods to reduce pressures on the remaining staff and to minimise delays in progressing work. The Large Business Service has proposed a new mentoring scheme, the previous scheme having lapsed in 2005. It considers that the benefits will include support for new entrants as they take on complex and demanding work and tapping into the experience and knowledge of longer serving staff.

Career progression

4.16 In the main, staff in the Department are responsible for managing their own career progression. They told us they considered they needed experience across the range of the Department's activities and management experience to progress up the career ladder. This has deterred those staff seeking the highest positions from remaining within one technical section, such as the Large Business Service. It can also inhibit developing a complement of staff with the deep industry knowledge, experience and skills to which large businesses attach great value. This contrasts with the private sector, where building and maintaining a specialism is often rewarded through pay and career progression. It also contributes to the mismatch of in-depth skills and knowledge between the Department and businesses.

4.17 The Department aims to counter this problem through a recently launched career path for technical tax staff, providing a clearer understanding of the career options open to them and how these recognise and reward tax knowledge and skills. The Department has also developed a 'technical gateway' programme, which seeks to encourage technical tax staff to apply directly for more senior posts, with tests of their technical expertise. It also operates talent programmes for technical tax staff in which the 'gateway' for career progression is set by a tax specialist training board. The Department recognises that the opportunities for career development in technical roles are not well understood by its staff and there is some confusion among staff over how best to manage their careers. Improved publicity of this programme among Department staff will help to raise awareness that technical specialisms can also provide routes to promotion.

APPENDIX ONE

National Audit Office methodology

Scope and parameters of this examination

1 This report examines the approach of HM Revenue & Customs to managing large business Corporation Tax. The National Audit Office has previously examined how the Department manages the Corporation Tax of small and medium sized businesses through its local offices.[11] The Department manages large business Corporation Tax through its Large Business Service and specialist functions within the Department. These include the anti avoidance group, litigation services and knowledge analysis and intelligence. This report defines large businesses as those whose Corporation Tax matters are administered by the Large Business Service of the Department. It examines:

- trends in large business Corporation Tax (Part 1);
- managing risks to tax revenues (Part 2);
- measuring and managing performance (Part 3); and
- Department staff skills and resources (Part 4).

2 Our methodology included:

- analysis of the Department's financial and management data to evaluate its performance;
- consultation and focus groups with Departmental staff from the Large Business Service and across the specialist functions involved in managing large business Corporation Tax;
- consultation and focus groups with representatives from the tax departments of large businesses across the Large Business Service sectors and from the accountancy profession, transfer pricing experts and legal experts; and
- international liaison to identify opportunities to improve measures of performance and manage risk.

Financial and data analysis

3 We analysed Departmental financial and management Corporation Tax data to evaluate the Department's performance. This included analysis of:

- Corporation Tax revenues over five years, including large business contributions;
- the additional Corporation Tax collected as result of the Large Business Service's enquiry work over four years;
- research to estimate the Corporation Tax gap;
- the Large Business Service 'resourcing to risk' management information system, focusing on the number of enquiries, the estimated maximum value of the tax under consideration and resources used for enquiry work and the age of enquiries;
- avoidance schemes disclosed to the Department since disclosure rules came into force in 2004; and
- Large Business Service employees' retirements and training.

We also observed a case review between a client relationship manager and tax specialists to develop an estimate of a business's risk profile and observed a meeting between the Large Business Service staff and the staff of the business's tax department to discuss the risk review and its outcomes.

4 We reviewed the methodology, data sets and reports from the Large Business Service's own surveys of its staff and drew upon these within our report. These were:

- an interview based survey of 36 senior staff, including Director, national business directors, unit heads, client relationship managers, tax specialist managers and resource managers on resourcing to risk (November 2006); and

11 "Corporation Tax: companies managed by HM Revenue & Customs' Area Offices", (HC 678, 2005-06).

- a telephone structured survey of 35 client relationship managers, nine tax specialists and seven tax specialist managers. The survey gained their views and experiences of the operating model, relationships with large businesses, joint working with other parts of the Department and factors such as their training and development and accountability and authority. The research team stratified the client relationship managers by a number of variables. These included people on different staff grades, a distribution across industry sectors, a geographical distribution and whether their large businesses were fully or partially administered by the Large Business Service. The Department's research team also attended meetings of five industry sectors.

Focus group with HM Revenue & Customs' staff

5 We held two focus groups in London in December 2006, with staff of:

- Anti avoidance group;
- Business customer unit;
- Enforcement and compliance;
- Central compliance;
- Corporation Tax and VAT processes;
- Large Business Service (Banking, Insurance and Telecommunications sectors, Strategic response unit, Interfaces and Practices unit); and
- a representative of local offices.

6 We structured each focus group into teams to discuss the main risks to effective management of large business Corporation Tax, their causes and strategies to mitigate these risks, with wider discussion of the presentations from each sub group. We would like to thank each participant for their contributions. We have drawn on the outcomes from each focus group throughout the report in our overall evaluation of the risks to effective management of large business Corporation Tax.

Focus group with large businesses, experts and professional bodies

7 We held a focus group in London in February 2007 with tax representatives from a range of large companies across the sectors of the Large Business Service, from the accountancy profession, transfer pricing experts and legal experts. We structured the focus group into four teams to consider:

- the effectiveness of the Large Business Service in managing large businesses' Corporation Tax, including the strengths and constraints of its current management tools and strategy; and
- ideas for what would be an ideal approach to managing large business Corporation Tax, including the opportunities to transform the Government's approach.

8 We have drawn on the focus group findings throughout the report in our overall evaluation of the views of businesses, experts and their representatives. We would like to thank each participant for their contributions.

Name	Organisation
Simon Baines	Deloitte and Touche
Brian Chapman	Unilever
John Fairley	Baker & McKenzie
David Fletcher	HSBC
Ashley Greenbank	Law Society
Iain Greenwood	Grosvenor Estates
Graham Halstead	Royal Bank of Scotland
Steve Hoy	Lloyds TSB
Adam Little	BP
Mike Karp	PricewaterhouseCoopers
Patrick Mears	Allen & Overy
Gabrielle McParlin	Deloitte and Touche
Tim Murrills	ExxonMobil
Abdul Nabi	Marks and Spencer
Lynne Patmore	Robson Rhodes
Charlotte Redcliffe	Centrica
Susan Reid	BT Group plc
Bill Sandiford	Zurich Financial Services
Paul Tipping	British Bankers' Association (Retired March 2007)

9 We also met Richard Murphy, founder of the Tax Justice Network and director of Tax Research LLP, which undertakes work on taxation policy and accounting, in the United Kingdom and abroad.

Revenue Departments overseas

10 We visited the Canadian Revenue Agency (www.cra-arc.gc.ca), the Office of the Auditor General of Canada (www.oag-bvg.gc.ca), the United States of America Internal Revenue Service (www.irs.gov) and Government Accountability Office (www.gao.gov), in February 2007. The visits focused on obtaining information about the risks other revenue departments face in managing large business Corporation Tax, how they manage these risks and measure their performance. We selected these countries as they raise a significant share of total Corporation Tax receipts from large businesses. We also consulted the Australian Taxation Office to obtain information on its use of effective tax rates as part of assessing business risks. We would like to thank each Department for their time and help in our examination:

Australian Taxation Office

Peter Coakley
Assistant Commissioner
Risk & Intelligence Practice
Large Business and International

Adam McKissack
Risk & Intelligence Practice
Large Business and International

Julia Neville
Assistant Commissioner
Issues Management and Government Relations

Neil Olesen
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Policy Management Division

Andrew Reed
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Canada Revenue Agency

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Steve Johnson
Director
Large Business and Program Integration Division

United States Internal Revenue Service

Kelly Cables
Director, Performance, Quality & Audit Assistance
Large and Mid-Size Business Division

Douglas W O'Donnell
Director, International Compliance, Strategy and Policy
Large and Mid-Size Business Division

Seconding an external Corporation Tax expert to the study team

11 The study team included Damian De Backer, a secondee with Corporation Tax expertise and experience of the large business sector, from PWC. Mr De Backer's role was to provide external insight on the risks to effective management of large business Corporation Tax, gather views of the effectiveness of the Department's approach and its structured assessment of risk against risk factors and provide insights on opportunities to improve the management of large business Corporation Tax. We have drawn on the outcomes throughout the report, in particular, in gaining the views and experiences of large businesses.

External mentor

12 We appointed Nicholas Dee, an expert in corporate taxation, as the external mentor to our study. Mr Dee is a Barrister and Chartered Accountant. His current positions include Non-Executive Chairman of the Executive Committee of the Institute for Fiscal Studies and Of Counsel to Burt, Staples & Maner, LLP. He has worked in industry and major accounting firms and is a former Chairman of the Confederation of British Industry Tax Committee. We would like to thank Mr Dee for his help throughout our examination.

13 Mr Dee's role included:

- providing expert advice on Corporation Tax matters throughout our examination, including commentary on our developing analysis;
- providing advice on the structure and themes for focus groups with staff of the Large Business Service and with businesses, experts and professional bodies;
- assistance with identifying a range of potential participants for the focus group with businesses, experts and professional bodies, across the range of Large Business Service sectors;
- facilitating the focus groups; and
- providing assistance on the consultation with the advisory panel.

Advisory panel

14 We established an Advisory Panel to provide expert advice on the emerging findings, conclusions and recommendations from our fieldwork. We selected the membership of the panel to provide a spectrum of external perspectives and expertise. We would like to thank each member for their contributions.

Panel member	Organisation
Ken Ashcroft	Risk & Resourcing Unit, HM Revenue & Customs
Richard Baron	Head of Taxation, Institute of Directors
Colin Davis	Technical Officer, Chartered Institute of Taxation
Judith Freedman	KPMG Professor of Business Taxation, Oxford University Law Faculty
John Hasseldine	Professor of Accounting and Taxation, Tax Research Institute, University of Nottingham
Judith Knott	Business Customer Unit, HM Revenue & Customs
Sally Littlejohns	Interfaces and Practices Unit, Large Business Service, HM Revenue & Customs
Ian McCafferty	Chief Economic Adviser, Confederation of British Industry
John Page	Head of Risk, Large Business Service, HM Revenue & Customs
Priyen Patel	HM Treasury Revenue Policy/Corporate Tax Operational Consultative Committee
Chas Roy-Chowdhury	Head of Taxation, Association of Chartered Certified Accountants
Mervyn Woods	Head of Taxation Policy, Confederation of British Industry
Ian Young	Technical Manager, Tax Faculty, The Institute of Chartered Accountants in England & Wales

APPENDIX TWO

"Corporation Tax: Companies managed by HM Revenue & Customs' Area Offices"

Comptroller and Auditor General's Report

1 The Comptroller and Auditor General reported on "Corporation Tax: Companies managed by HM Revenue & Customs' Area Offices", in January 2006.[12] Key findings in this report included:

- HM Revenue & Customs had improved the management of Corporation Tax in area offices in recent years. However, variations in performance across the offices offered scope for further savings.
- Between 1999 and 2004-05, area offices secured a 42 per cent increase in the extra revenue from their enquiries on Company Tax returns, giving a total of £602 million for 2004-05.
- Focusing on higher risk cases meant the increase in revenue came from fewer enquiries. The Department had made greater use of databases and risk profiles to select enquiry cases and had plans to develop these techniques further.
- Around 40 per cent of enquiries resulted in no change to the tax or assessment of profit and around 40 per cent of Company Tax returns contained errors.
- Yields varied between offices. Companies had different chances of selection for enquiry depending on their location and average enquiry costs in some offices were twice as high as in others. Much of the variation stemmed from imbalances in the number and experience of tax specialists and other staff compared to the size and complexity of workload in each Area.
- There was scope for efficiency savings, higher yields and shorter enquiries across the 68 Areas.
- The Department was planning to restructure work into fewer but larger offices to match staffing levels and experience more closely to workloads and compliance risks and share best practice and experience of new techniques.

Committee of Public Accounts' report

2 The Committee of Public Accounts produced their report on "Corporation Tax: companies managed by HM Revenue & Customs' Area Offices" in June 2006.[13] Conclusions in the Committee's report of relevance to this examination, along with the Department's response in October 2006[14], are shown in the table opposite.

12 Report by the Comptroller and Auditor General, 13 January 2006, HC 678, 2005-06 http://www.nao.org.uk/publications/nao_reports/05-06/0506678.pdf.

13 *Corporation Tax: Companies managed by HM Revenue & Customs' Area Offices*, Committee of Public Accounts: Forty-ninth Report, HC 967, 2005-06 http://www.publications.parliament.uk/pa/cm200506/cmselect/cmpubacc/967/967.pdf.

14 Treasury minutes on HM Revenue & Customs' response to the Committee of Public Accounts, *Corporation Tax: Companies managed by HM Revenue & Customs' Area Offices*, 49th Report, October 2006, command 6908. http://www.official-documents.gov.uk/document/cm69/6908/6908.pdf.

Committee of Public Accounts' conclusion	HM Revenue & Customs' response
Conclusion (i): …only 60 per cent of enquiries succeeded in increasing the tax or profit assessment. The Department needs to improve the targeting of enquiries, and thereby increase the tax yield. It should strengthen the use of risk assessment techniques, particularly in those Areas, which do not make full use of available databases and those with the lowest enquiry success rate.	The Department is currently re-organising its risk processes. This includes: ■ constructing a coordinated view of risk on a national basis for all taxes and duties; ■ compilation of risk registers for each tax and duty; ■ moving towards targeting enquiry work from the emerging national picture of risk; and ■ establishing compliance strategies for customer segments. This will enable the Department to develop a more nationally focused risk assessment process, concentrating on cases with the highest risk to the Exchequer.
Conclusion (iv): The Department … is developing a risk strategy for its compliance work, looking across business taxes. It should establish the marginal payback of the different elements of that work to focus on areas of greatest potential return that also cover other taxes.	The Department adopts a risk-based approach to the cases it takes up. One of the aims is to take up those cases, which present the largest potential risk to the Exchequer. The risk strategy the Department is developing will be used to establish the appropriate resources needed to be employed in the areas of largest potential risk across all heads of duty and ensure coverage.
Conclusion (ix): Varying results and efficiency of enquiry work … reflect this mismatch of resources to risk, and differences in risk assessment skills …. The Department should redesign its compliance work to match the risks posed by different business sectors.	The Department recognises that … it has not been able to fully match resources to riskier cases. Deploying resources to risk is a difficult process because risk patterns can change quickly while redeploying resource necessarily requires greater lead-in times. The Department…is also using its Pacesetter programme to improve the quality of its enquiry process by focussing on improved outputs, skills and consistency across the country.

APPENDIX THREE

Risk estimates and enquiries

Developing a structured assessment of a business's Corporation Tax risks

1 The Department carries out a risk review of each large business. It uses reviews to estimate the level of confidence it can have in the business's Corporation Tax compliance. The review involves examining the business's systems, processes, transactions and behaviour to assess its Corporation Tax risks **(Figure 11)**.

2 Following its structured estimate of Corporation Tax risks, the Department develops a Business Risk Score for each business. It shares its risk estimate with the business, via the client relationship manager, for review and comment.

Planning and carrying out enquiries on a business

3 The client relationship manager plans any enquiries into a business's Corporation Tax position based on the structured assessment of the business's Corporation Tax risk factors and the outcome of sharing this with the business, and estimates of individual amounts of Corporation Tax under consideration. The Department aims to target enquiries on businesses that present the greatest risks to Corporation Tax. **Figure 12** outlines the key stages.

11 Shows the main risk factors involved in the Department's estimate of a business's Corporation Tax risks

Size, structure and complexity of the business	■ level of United Kingdom profits and losses ■ scale of Corporation Tax at risk ■ evidence of acquisitions, disposals and restructuring ■ range of international activities, global exposure and transfer pricing
Tax governance	■ systems and integrity in the business's management of tax risk ■ adequacy of skilled resources in the business's tax department
Financial arrangements	■ whether the business has straightforward financial arrangements or the arrangements require significant resources to understand
Avoidance schemes	■ whether the business does not use or is unlikely to use avoidance schemes, or the business makes regular and frequent use of avoidance schemes or creates such schemes
Strength of underlying systems	■ whether the business's Company Tax returns are accurate with no reason to question the accounting systems, or they have widespread errors and there are known problems with accounting systems
Legal complexity and challenges	■ whether the business's legal arrangements are straightforward, or the business makes frequent and complex legal challenges
Co-operation with the Department	■ whether the business is prompt and co-operative or obstructive or litigious in its relations with the Department

Source: National Audit Office analysis

4 Simple enquiries may be settled relatively quickly, for example where few checks are needed, the business cooperates promptly with requests for information, the Department is able to reach a conclusion readily on the outcome and the Department and business can agree a settlement, or where no additional Corporation Tax is assessed as due. Some enquiries may continue over months or years, due to the large scale or complexity of the enquiry, the relations between the Department and business, or the Department's ability to resource and manage the enquiry. Since 2007, the Department's senior management take responsibility for the active management and resolution of enquiries that remain unsettled 18 months after being opened. The Department works with businesses to develop a framework for action plans and timescales to resolve outstanding issues.

12 Outlines key stages of an enquiry and where delays occur

Step 1

The Department carries out a comprehensive programme of checks on the Company Tax return and supporting information and compares this with information it already holds about the business. The Department also reviews a company's Corporation Tax position and transactions in real time, to avoid having to wait until the business files a Company Tax return before it can begin an enquiry.

If the Department then thinks there is a risk that the Company Tax return may be incorrect, or other activities put a business's Corporation Tax at risk, it may open an enquiry.

Step 2

The Department notifies the business that it intends to open an enquiry. This states what the enquiry will cover and whether the Department wishes to look at all aspects of the business's Company Tax return, or specific issues. The Department tells the business what its rights and responsibilities are and the information it requires from the business.

The business can choose to appoint a professional adviser to deal with the Department.

The degree to which a business cooperates with the enquiry and provides the Department with information requested can affect the speed with which the enquiry progresses. Some enquiries may be protracted where the Department has to wait significant periods to receive information from the business.

Step 3

The Department's enquiry may cover:

- requests for clarification of information provided
- detailed consideration of whether the business has treated activities correctly for tax purposes
- examining business records and documents.
- *An enquiry may take longer to complete where the Department asks for a greater extent of information and records and subjects these to greater scrutiny or follow up questions. The ability of the Department to put staff resources onto the enquiry to request and review the business's records also affects its rate of progress.*
- *The Department's internal management of the enquiry will also affect the speed of progress. This may be influenced by the ability of different functions of the Department to coordinate activities in reviewing the material received and to reach a view on these.*

Step 4

The Department may carry out an in-depth review of the business's records on which its Company Tax return was based or which put its Corporation Tax at risk. This may take place at the business's premises and involve meetings with the business's tax staff or its professional advisers.

The Department's and the business's ability to schedule visits and meetings of key personnel will affect the progress of the enquiry.

The Department provides a written record of meetings on which the business may comment. The Department may also ask for information relating to third parties, such as Directors.

The Department may use its statutory powers to obtain information and business records if the business does not provide these voluntarily. The business may be subject to penalties if it still does not comply.

The business may appeal to the Tax Appeal Commissioners against any penalties. It may also appeal to the Commissioners if it considers the enquiry should be closed. It may do this if it believes that it has provided the Department with the information requested and that Department is unnecessarily prolonging the enquiry.

An appeal to the Tax Appeal Commissioners may extend the enquiry while the business waits to hear if its appeal is successful.

Step 5

When its enquiry is completed, if the Department finds nothing wrong, it writes to the business and stops its enquiry.

If the Department finds something wrong, it asks the business for a meeting to discuss what it has found, the amount of Corporation Tax it thinks the business owes and whether and how far it considers the underpayment of tax is due to negligent conduct or fraud. It asks the business to make a payment on account towards any additional Corporation Tax it thinks is due. However, the business does not have to pay anything if it does not think it should.

If the enquiry reveals the business has made an innocent mistake it will not be liable to a penalty, but will be charged interest on any additional Corporation Tax due.

If the enquiry reveals the business paid too little Corporation Tax as a result of negligent or fraudulent conduct, it may be liable to a penalty.

The Department will try to agree with the business any amendments it wishes to make. These are based upon what the Department considers reasonable given the information it has received. It explains to the business how it has arrived at the amendments.

12 Outlines key stages of an enquiry and where delays occur - *continued*

Step 6

Where an enquiry results in additional Corporation Tax liabilities for more than one year and/or where penalties are incurred, the Department may aim to settle the enquiry through a contract with the business. This involves negotiating a settlement with the business. Negotiations may cover the amount of penalty payable and any reductions will be affected by the business's degree of cooperation during the enquiry and the degree to which the business voluntarily disclosed information.

The business may make an offer to settle the enquiry through an agreed sum for additional Corporation Tax, interest and penalty. If the Department accepts the offer, it will not use formal proceedings to recover these amounts. The Department may accept payment by instalments, over as short a period as possible.

Negotiations between the Department and the business may take an extended period to conclude before they agree on a settlement amount.

Step 7

If the business does not make an offer to settle the enquiry, the Department issues a notice of closure for the enquiry stating the tax due. Interest is chargeable on this amount. There may also be surcharges and penalties. The business has the right to appeal against the Department's conclusions.

Settlement of the enquiry may be prolonged when the business appeals against the Department's conclusions.

Step 8

The Department may decide to proceed to litigation to conclude an enquiry.

Enquiries subject to litigation may be extended while the Department and the business prepare their cases for the courts and await the court case. The length of time in court will also affect the period to settlement of the enquiry.

Source: National Audit Office analysis

APPENDIX FOUR

"Review of links with large business"

1 In 2006, the Government appointed Sir David Varney to undertake a review of the relationship between large business and HM Revenue & Customs. Prior to the review, businesses perceived that 'the Department was inconsistent in the approach adopted.'

2 The review involved consultation with over 140 businesses to prioritise the concerns of business and to develop, alongside business, outcomes and proposals to address these. The report identified that business want a relationship based on mutual trust with an appreciation of commercial drivers, resourced by trained and supported staff. The Department wants a relationship based on trust and transparency and a shared commitment to efficient and effective compliance.

3 The Department and business both wished to see:

- greater certainty;
- an efficient risk-based approach to dealing with tax matters;
- speedy resolution of issues; and
- clarity through effective consultation and dialogue.

4 The review identified eight key proposals to achieve these aims:

- Introduce a system of advance rulings to give United Kingdom and international business certainty regarding tax consequences of investment decisions and corporate reconstructions.
- Extend existing clearances to provide a view on tax consequences of commercial issues as normal practice.
- By 31 December 2007, implement a risk-based approach to enquiries.
- A comprehensive approach to the settlement of transfer pricing enquiries including resolution of all but particularly complex cases within 18 months.
- Improve the mechanisms for dispute resolution and communication of these effectively to business. The norm to be for disputes to be resolved by client relationship managers.
- Senior Department management to take responsibility for active management and resolution of enquiries that remain outstanding for more than 18 months.
- The Department to be accountable for taking the business perspective into consideration throughout their work by using a consistent approach to informal and formal consultation.
- An update of guidance relevant to large business through a programme agreed with business representatives.

5 In March 2007, the Department issued its 'Approach to compliance risk management'[15] in response to the proposals in the 'Review of links with large business'. The approach addresses:

- what the Department means by tax risk and the criteria and information it uses to assess it;
- the process by which the Department conducts and agrees risk assessments for large business customers; and
- how, in future, the Department would vary its activities more clearly in response to risk, to reduce significantly the number of checks and enquiries for low risk businesses and to increase the intensity and effectiveness of its interventions on high risk businesses.

6 The Department has based its strategy on the premise that the majority of businesses want to pay the right amount of tax at the right time. It will rely on businesses' systems and work with them in line with the Hampton report[16] on reducing administrative burdens.

15 http://www.hmrc.gov.uk/budget2007/large-business-riskman.pdf.
16 http://www.hm-treasury.gov.uk/budget/budget_05/other_documents/bud_bud05_hampton.cfm.

APPENDIX FIVE

Disclosure of direct tax avoidance schemes

1 In August 2004, the Government introduced legislation to require the disclosure of direct tax avoidance schemes.[17] This was limited to tax arrangements concerning employment or certain financial products. In August 2006, it widened legislation to the whole of Income Tax, Corporation Tax and Capital Gains Tax. The legislation requires disclosure of a tax arrangement when:

- it will, or might be expected to, enable any person to obtain a tax advantage;
- that tax advantage is, or might be expected to be, the main benefit or one of the main benefits of the arrangement; and
- it is a tax arrangement that falls within any description ('hallmarks') prescribed in the relevant regulations.

2 In most situations where a disclosure is required it must be made by the scheme 'promoter' within five days of it being made available. However, the scheme user may need to make the disclosure where:

- the promoter is based outside the United Kingdom;
- the promoter is a lawyer and legal privilege applies; and
- there is no promoter.

3 The hallmarks are:

- wishing to keep the arrangements confidential from a competitor;
- wishing to keep the arrangements confidential from the Department;
- arrangements for which a premium fee could reasonably be obtained;
- arrangements that include off-market terms;
- arrangements that are standardised tax products;
- arrangements that are loss schemes; and
- arrangements that are certain leasing arrangements.

4 Upon disclosure, the Department issues the promoter with an eight digit scheme reference number for the disclosed scheme. By law, the promoter must provide this number to each client that uses the scheme, who in turn must include the number on the tax return. A person who designs and implements their own scheme must disclose it within 30 days of it being implemented.

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17 http://www.hmrc.gov.uk/aiu/index.htm.

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Management of large business Corporation Tax

A report by the Comptroller and Auditor General

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