National Audit Office

HM REVENUE & CUSTOMS

Management of large business Corporation Tax

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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).