



National Audit Office

HM REVENUE & CUSTOMS 2006-07 ACCOUNTS
The Comptroller and Auditor
General's Standard Report

Presented to the House of Commons under Section 2 of the
Exchequer and Audit Departments Act 1921 as amended by
the Government Resources and Accounts Act 2000

This Report is published alongside the 2006-07 Accounts of
HM Revenue & Customs

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SUMMARY

Introduction

1 Section 2 of the Exchequer and Audit Departments Act 1921 requires me to examine the accounts of HM Revenue & Customs on behalf of the House of Commons to ascertain that adequate regulations and procedure have been framed to secure an effective check on the assessment, collection and proper allocation of revenue, and that they are being duly carried out. I am also required by that Act to examine the correctness of the sums brought to account; and to report the results to the House of Commons. My audit certificate and report on the Trust Statement account and this report together satisfy that requirement.

2 Whilst recognising that no tax collection system can ensure that all those who have a tax liability comply with their obligations, the National Audit Office's work in 2006-07 provided assurance that HM Revenue & Customs has framed adequate regulations and procedure to secure an effective check on the assessment, collection and proper allocation of revenue, and that they were being duly carried out. That assurance is subject to reservations about the level of claimant error and fraud in the award of tax credits (see Part Two of this report). The report also includes observations on the collection of income tax through Self Assessment and PAYE and the administration of Value Added Tax.

Corporation tax: film tax relief

3 The Finance Act 2006 introduced new rules for the taxation of film production and in particular, a new tax relief for the production of British cinema films. The Department, in collaboration with the Department for Culture, Media and Sport (DCMS), has designed the new relief to try to avoid the possibilities of it becoming vulnerable to avoidance activity. The Department considers the fact that the relief may only be claimed

by film production companies will help to mitigate this risk. The previous relief was open to companies and individuals whose involvement in film making was confined to providing or arranging finance. These groups are now excluded from the new arrangements.

4 The Department recognises that there are still residual tax avoidance risks, as individual companies may seek to push the boundaries of what may be categorised as qualifying expenditure for film production. As the Department receives claims for film tax relief it will start to construct a risk profile built around experience of dealing with compliance issues, rather than as at present, based on predictive analysis of behaviour. The Department will also assess the operation of the new film tax relief once it has been in place for at least a year. The Department considers that experience with similar policy measures suggests that the overall impact is only clear in the longer term.

5 Against this backdrop, it is important for the Department to ensure that:

- the Memorandum of Understanding between the Department and DCMS sets out clearly the respective roles of the two departments for management of the tax relief. In particular, the responsibilities that DCMS has for the certification process; and
- the processes and procedures that it puts in place to monitor the costs associated with the tax relief are sufficient to meet the commitment to do this under the Regulatory Impact Assessment. The Department should also ensure that its management information systems are able to identify and aggregate the cost of this relief.

Tax Credits

6 During 2006-07 the Department paid a net £18.7 billion in tax credits and an average of 5.5 million families received provisional 2006-07 awards. The Department estimates that year end adjustments to awards meant it overpaid £1.7 billion and underpaid £549 million in 2005-06. In the first three years since the scheme was introduced, the Department calculates that these adjustments, and other small changes to entitlement after the finalisation of awards, have led to a debt of £6.0 billion. It has also identified £600 million from in year adjustments to 2006-07 awards and will identify further overpayments for this year once awards are finalised. By the end of March 2007 the Department had collected £2.0 billion of this debt and written off £0.7 billion. £3.9 billion of overpayments remain to be collected by the Department. It has provided for £1.6 billion in respect of doubtful debts.

7 In the 2005 Pre-Budget Report the Chancellor announced a number of measures which were designed to provide greater certainty to claimants, particularly when families see a rise in income. One important change, for awards for 2006-07 and subsequent years, is the increase from £2,500 to £25,000 of rises in income which are disregarded when finalising awards. The Department estimates that this alone will reduce overpayments by between £400 million – £600 million per annum. The effect of the other changes is harder to establish as they seek to influence claimants' behaviour by encouraging the prompter reporting of changes in circumstances. The Department estimates that the changes together will eventually reduce the value of overpayments by one third. It will publish details on finalised 2006-07 awards in May 2008 which will provide more information on the effect of these measures.

8 The Department terminates an award if the claimant does not report their actual income, fails to return a signed award notice or did not qualify for tax credits. The Department has examined a sample of the 228,000 awards terminated in 2004-05 to improve its understanding of claimant behaviour. The Department estimates that some 180,000 of the awards terminated in 2004-05 were due to the claimant's failure to report their actual 2003-04 incomes, although of these 22,000 new awards were subsequently made to the same claimants before the year end. But there was insufficient evidence to conclude why the remaining claimants had not finalised their awards. In the absence of this information it is not possible to discount the risk that some of these claims were fraudulent. The Department is now undertaking a more comprehensive exercise to examine why claimants fail to finalise their awards.

9 In June 2007, the Department completed its testing of 2004-05 awards, based on 4,500 random enquiries. As a result of this, the Department estimates that claimant error and fraud resulted in between £1.04 billion to £1.30 billion (7.3 to 9.1 per cent of the final value of awards) being paid to claimants to which they were not entitled. The levels in 2003-04 were £1.06 billion to £1.28 billion (8.8 to 10.6 per cent). It also estimates that claimant error resulted in between £200 million to £350 million (1.4 to 2.4 per cent) not being paid to claimants to which they were entitled. The levels in 2003-04 were £190 million to £280 million (1.6 to 2.3 per cent). These levels are unacceptably high, and whilst the Department has made changes to its compliance procedures since 2004-05, there is currently no evidence to demonstrate a lower estimate for 2006-07. Consequently I have qualified my opinion on the Trust Statement.

10 It is important that the Department's work provides an accurate view of levels of error and fraud and it is looking to enhance the quality of this work by using specialist teams to undertake testing. It also needs earlier assessments of the overall level of error and fraud to improve its understanding of the effect of its compliance work.

11 In 2006-07 the Department carried out 137,930 checks on claims it assessed as higher risk. It has identified incorrect payments made of £151 million and prevented incorrect payments of £291 million (£250 million and £447 million in 2005-06). The reduction on 2005-06 is primarily due to fewer attacks by organised fraudsters, following the closure of the tax credit internet site in December 2005. The Department is developing a framework for validating the identity of individuals and will only re-open the tax credit internet system once this work is complete, which is unlikely to be before July 2008.

12 The Department's compliance examinations affect 2.5 per cent of awards, although all claims are subject to a series of checks before they are put into payment. The Department is now considering a broader range of compliance activity to increase its coverage of the tax credits population, aimed at increasing compliance and reducing levels of claimant error and fraud. The Department will always need to perform checks on claims assessed as high risk before payment to safeguard against error and fraud. The Department is now considering whether, in addition to these detailed compliance examinations, more frequent engagement with other groups of tax credit claimants would assist in the deterrence and prevention of error and fraud across the wider claimant population.

13 The Department has taken steps to improve the quality of service provided to claimants. It has a regular programme of enhancements to the tax credits computer system. The initial focus of these was to allow the Department to process new awards, make payments and renew awards. Subsequent software releases focused more on improving the service provided to claimants, for example by improving the information given. Software errors continue to result in some incorrect payments, and the Department has an ongoing programme of work to investigate these. The Department will continue to review the computer system to assess the impact of unresolved errors and it expects to address these through its improvement processes. On 26 May 2005, the Paymaster General announced steps to improve the Tax Credits system. The Department has undertaken a wide programme of work to deliver these commitments.

The collection of income tax through PAYE

14 In 2006-07 the Department collected £125 billion in income tax and £85 billion in National Insurance Contributions through Pay-As-You-Earn (PAYE), the government's largest source of tax revenue. The Department aims to ensure that individuals pay the right amount of tax on their income and to make it as easy as possible for employers and employees to meet their obligations.

15 As I noted in my 2005-06 report, the Department's PAYE computer systems are not well suited to the efficient administration of income tax where people have more than one job or change jobs on a regular basis. This is because the systems structure tax records around jobs rather than individual taxpayers. As a result, the Department can have difficulty identifying all relevant sources of income when calculating tax that should be paid. These difficulties have been compounded by inconsistent working practices within the Department as a consequence of staff not being aware of or failing to follow Departmental procedures, for example when adjusting tax codes for Benefits in Kind. Based on its most recent estimates, each year the Department may not be pursuing some £880 million of tax due, and taxpayers are likely to have overpaid around £340 million, resulting in potentially five million taxpayers not paying the right amount of tax.

16 During 2006-07 the Department introduced a number of measures to improve the quality of PAYE processing. It has mandated use of a spreadsheet tool to improve accuracy in coding. It has also operated a quality improvement process to help managers identify the cause of errors, take action to prevent them recurring and to

help staff learn and improve. This consists of independent monthly checks across all processing offices to provide better information on overall performance against national standards. The Department has embarked on an initiative within local offices known as "Lean", as part of its Processing Pacesetter Programme. This aims to increase efficiency by eliminating duplication or reworking, improving accuracy, increasing productivity and reducing processing times. The Department's data shows that in 2006-07 the accuracy of processing improved in comparison with the previous years, but still fell short of target.

17 The Department has also taken steps to improve the timeliness of processing and ensure it takes into account all the information it holds on a taxpayer. It has dedicated resources to dealing with benefits in kind cases, but weaknesses in management information prevent it from assessing the effect on processing. For 2007-08 the Department has introduced a process to automate the coding of benefits in kind information, which should further improve the timeliness and accuracy of processing by reducing manual intervention. It also introduced a process to reduce the number of open cases automatically generated. These measures should improve the timeliness of processing, but in the absence of management information it is difficult to assess their effect. During 2007-08 the Department should quantify the success of these measures in reducing levels of error.

18 The Department recognises that real improvement in the operation of PAYE can only be achieved through fundamental changes in its computer systems. It therefore plans to move to its National Insurance computer system as the basis for administering the PAYE process. From 2008-09 this will allow all information on individuals to be brought together under their national insurance record and provide the Department with a complete view of a taxpayer's employment income.

19 The Department did not fully implement on time its new computer system to support the online filing of employers' 2004-05 year end returns. The system to validate and process online returns was not ready until June 2005, a number of weeks after the 19 May filing deadline. The Department implemented contingency arrangements to allow it to receive returns, but as a result the Department could not notify employers if their submissions were successful, identify returns that failed to meet quality standards, or accurately identify employers who missed the filing deadline. Because of these delays the Department accepted responsibility for resolving problems with returns, rather than referring them back to employers. But this caused significant pressures within the Department to deal with the resulting backlogs and meant

some of the information needed to support the processing of individual records on the PAYE, National Insurance and student loans system was not available.

20 The Department made improvements for processing 2005-06 employer returns, involving identifying returns which did not meet quality standards; providing employers with better guidance; completing its implementation of all the functions provided by the computer system; and developing a comprehensive plan for processing returns. By the end of October 2006, just over four months after the deadline for submissions, the Department had successfully processed 86 per cent of the 2005-06 P14s, compared with 57 per cent in the equivalent period for 2004-05 returns. The number of returns that failed to meet its quality standards fell from 13 to 5 per cent. Early indications show that the 2006-07 online filing season has been more successful than the two previous years with 1.4 million returns received online, compared to 1.2 million for 2005-06, and 1.4 per cent of returns rejected with errors.

21 The Department has recovered from the problems encountered in 2004-05, but the measures needed in 2005-06 highlight the weaknesses of the original implementation. The Department needs to ensure it applies the lessons learned when extending the system to small employers and in-year filing. In particular it needs to ensure the system is fully developed and tested before it is introduced, external users are educated and supported in use of the system, and processing is supported by clear plans.

22 Since the early 1980's some pension providers have not deducted tax under PAYE from all pensions in payment. This is due to a combination of incorrect central guidance from the Department, inappropriate local agreements and failures by local offices to implement agreed procedures. The precise rationale for this is now unclear, although it is likely that these decisions were taken because staff did not consider the effect to be material against the administration savings for the Department and pension payers. But the Department now estimates this means it is potentially not receiving income tax from 420,000 pensions and its current estimate is that the tax loss is around £135 million per annum. The Department first became aware of this issue in April 2005 and corrected its guidance. But it did not explicitly notify pension providers of the changes and they generally went unnoticed. The Department has now begun a systematic programme of work to put these pensions on a proper footing but it does not intend to recover tax which has not been deducted in years earlier than 2007-08. The Department also needs to consider where else it has made judgements not to collect tax on the grounds of size

and how it can obtain better assurance that its local offices are following central guidance. It also needs to ensure that when it changes guidance, this is accompanied by a wider programme of work to bring this to the attention of those affected and undertake compliance work to ensure these changes are implemented.

The collection of income tax through Self Assessment

23 Self Assessment was introduced in 1996 for taxpayers with a number of sources of income and with less straightforward financial affairs. It now affects 8.7 million self employed and higher rate PAYE taxpayers, 570,000 partnerships and 225,000 trusts. In 2006-07 the Department collected £26.6 billion tax through the system, after repayments. In 2006-07, 88.5 per cent of Self Assessment taxpayers paid the amounts owed on time, against the Department's target of 89.8 per cent. The average monthly debt owed to the Department in 2006-07 was £3.1 billion, an increase of £250 million on the previous year.

24 The Department has changed the Self Assessment process to ease the burden on certain taxpayers. Since 2004-05 the Department has removed 1.6 million taxpayers with very straightforward affairs from the system, although this reduction has been largely offset by increasing numbers of self employed and highly paid employees coming into the system. In April 2005 the Department simplified the Self Assessment process for nearly 1.5 million people with simpler tax affairs by issuing a new Short Tax Return.

25 The administration of Self Assessment involves a number of business areas within the Department, ranging from teams processing returns and undertaking compliance enquiries to collecting debt and providing computer support. In 2006 the Department established a new integrated governance structure to manage Self Assessment, which aims to improve coordination and enhance collaboration across the different parts of the Department involved in administering the process. These arrangements therefore provide a more effective basis for administering Self Assessment. But the structure does not include the Department's compliance activities over Self Assessment. The Department should consider the scope for the closer integration of compliance.

26 Online services offer considerable benefits in the efficient and effective administration of tax and Self Assessment has been at the forefront of the Department's drive to engage with the taxpayer through the internet. The Department has made significant progress in increasing the percentage of returns filed online and is currently meeting its target of 35 per cent of Self Assessment returns to be filed online for 2007-08.

27 In 2006-07 around one million taxpayers did not submit their returns by the 31 January deadline and the Department failed to meet its target that 91.5 per cent of returns were filed on time. The results were lower than those for the previous two years. The Department's early analysis suggests that this was primarily because of reduced media advertising in 2006-07 and problems with its campaign to contact taxpayers new to Self Assessment. In addition to learning from its experience in 2006-07, the Department should examine the effectiveness of the existing penalty regime and consider whether new or greater sanctions are needed to change taxpayer behaviour.

28 The Department operates a penalty system to discourage taxpayers from submitting incorrect returns. The Department often uses abatements depending on the seriousness of the offence, but the penalty charged is effectively open to negotiation which inevitably leads to inconsistency. In recent years the level of abatements has risen and there is little difference between penalties for neglect and more serious cases of fraud. The Department has also found that whilst the arrangements are understood by tax advisers, they are not visible nor understandable to taxpayers. In the 2007 Budget the Government announced a new approach to penalties for incorrect returns. This aims to make a clear distinction between those who make a genuine mistake – who will not incur a penalty – and those who deliberately understate their tax liability. These reforms should help the Department better tailor its approach to address the underlying taxpayer behaviour.

29 The Department assesses the accuracy of filed returns through an annual random enquiry programme. Based on the latest results available for 2001-02, 33 per cent of returns were filed inaccurately. The Department estimates this meant that between £2.5 billion to £3.2 billion tax was at risk in 2001-02 due to inaccurate returns. Some 40 per cent of the tax at risk relates to one per cent of taxpayers. The Department should target groups who are more prone to non-compliance, for example those new to self-employment and subcontractors in the construction industry.

30 The Department has reduced the number of compliance enquiries undertaken in recent years, although the yield generated from this work has increased. The Department has also established specialist teams to tailor its approach to the Self Assessment population, including individuals with complex tax affairs and inward expatriate employees and their employers. The yield from this work has grown consistently over recent years and exceeds the Department's targets. But not having up to date information on total levels of tax at risk reduces the Department's knowledge of overall non-compliance. The Department recognises the need to make earlier and more regular assessments of tax at risk to assess the effectiveness of its compliance activities, inform its risk assessment process and identify new areas for targeting compliance resources. The Department has formed the Risk and Intelligence Service to help take this work forward.

31 Self Assessment repayments are generated automatically following the processing of self assessment returns. A lack of formalised accountabilities has historically made it difficult for the Department to establish central oversight and responsibility over repayments, including the extent to which agreed controls were being operated. Deficiencies in management information have also made it difficult to establish the degree to which these controls could prevent or detect error and irregularities. The Department has evidence of organised criminal activity to obtain fraudulent repayments, sometimes using unsolicited returns. It introduced improved controls in April 2007 to specifically monitor unsolicited returns and is reviewing the effectiveness of its existing automated checks for identifying high risk repayments which require checking before they are made. It needs to closely monitor the success of these measures in deterring organised crime.

Value Added Tax

32 The Department strengthened its operational and legislative measures to tackle missing trader fraud, following an increase in fraudulent activity in 2005-06. The United Kingdom's application for a 'reverse charge' on certain goods was approved by the Council of the European Union in April 2007 and introduced from the 1 June 2007. However, the 'reverse charge' does not extend to the whole range of electronic goods requested in the original application. It has been limited to goods commonly associated with the fraud, i.e. mobile phones and computer chips. In addition, the derogation will only be applicable for the period up until April 2009, at which

time its effectiveness will be reviewed by the European Commission. There is a risk that the organised criminals behind the fraud will divert their attention to other goods not covered by the derogation. The Department, however, recognises that effective monitoring of trading activity will prove crucial in tackling any mutations and preventing an escalation of fraudulent activity in other areas.

33 The extended verification of repayment claims has, according to the Department's operational indicators, reduced the level of fraudulent activity in the UK. However, missing trader fraud is a European Union wide problem as fraudsters exploit EU VAT rules that allow intra-Community goods to be traded VAT-free. The Department should, therefore, continue to work with other Member States in identifying and tackling these criminals, and seek a long term solution to the problem, which may include an overhaul of the current VAT system. However, any changes would need to reduce considerably the possibilities for missing trader fraud, exclude any opportunities for new types of fraud, and not generate a disproportionate administrative burden for traders and authorities.

34 The Department has strengthened its registration controls to prevent fraudsters from obtaining a VAT registration number. Some five per cent of new applications (285,176 in 2006-07) are subject to detailed anti-fraud checking which in 2006-07 delayed processing by up to 12 weeks. The introduction of risk advisors at the registrations units, however, has enhanced the risk assessment process. The number of suspect registration applications refused increased from 3,513 in 2005-06 to 6,073 in 2006-07.

35 The processing of registration applications can be delayed if they are incomplete and/or inaccurate. The Department has a public service agreement target to increase the number of complete and accurate applications received to 50 per cent. Through making the application form user friendly and providing focused guidance for businesses, the Department achieved an outturn of 49 per cent in 2006-07 compared with 27 per cent in 2005-06. The Department also set a new target of processing 95 per cent of all applications within 14 days by March 2008. The interim measure for this target was 30 per cent achievement by March 2007. Of the 285,176 applications received, 27 per cent were processed within the target date. However, progress will need to be significant if the Department is to achieve its 2008 target.

36 The Department has a responsibility for ensuring that correct VAT repayments are paid promptly. Repayment supplements amounting to five per cent of the VAT claim or £50 (whichever is the greater) is paid if repayments are not paid within 30 days of being submitted. It also has to protect VAT revenue, and therefore has controls in place to check VAT repayment claims. In 2006-07 the Department met its target of processing 90 per cent of correct repayment claims within 10 days. The checks, however, identified and prevented over-claims arising from error or fraud totalling £603 million. Repayment supplements in 2006-07 totalled £8.68 million, of which £3.9 million arose as result of the Department's measures in tackling missing trader fraud. It also included £728,216 which was incurred following a systems error that, most importantly, took six calendar days to resolve as the Department did not have in place the IT service level or support arrangements necessary to resolve the issue more quickly. The Department has implemented daily checks to ensure that a similar system problem does not recur, and is currently considering improvements to the wider service level and support arrangements around this process to make sure that action is taken promptly should a similar process problem arise in the future.

PART ONE

Introduction

Background

1.1 Section 2 of the Exchequer and Audit Departments Act 1921 requires me to examine the accounts of HM Revenue & Customs (the Department) on behalf of the House of Commons to ascertain that adequate regulations and procedure have been framed to secure an effective check on the assessment, collection and proper allocation of revenue, and that they are being duly carried out. I am also required by that Act to examine the correctness of the sums brought to account; and to report the results to the House of Commons. My audit certificate and report on the Trust Statement account and this report together satisfy that requirement.

1.2 This part of my report sets out the context for my audit of revenue and is in two sections. The first explains the scope of my audit, the audit approach applied and the audit conclusion from my examination of the revenue accounts. The second section describes the developments in the audit landscape which provide the context for my audit. In particular, the report considers:

- the modernising powers, deterrents and safeguards initiative;
- the review of on-line services by Lord Carter of Coles;
- the Department's Transformation Programme;
- the Accounting Officer's Statement on Internal Control;
- the Department's approach to managed service companies; and
- Corporation tax: film tax relief (the new arrangements announced under the Finance Act 2006).

Scope of the audit and audit conclusion

Audit approach

1.3 In examining the extent to which the Department has framed adequate regulations and procedure to secure an effective check on the assessment, collection and proper allocation of revenue and whether the Department is duly carrying out these regulations and procedure, my staff have developed an audit approach that incorporates a range of audit work across the Department's activities and tax streams. Amongst other things, my staff have:

- conducted specific work on areas of the Department's operations and tax streams, including:
 - the Department's response to the challenges of delivering Tax Credits effectively, which I have covered in Part 2 of this Report;
 - the action the Department is taking to improve the operation of PAYE, which I have examined in Part 3 of this Report;
 - the Department's management of Self Assessment, which I have dealt with in Part 4 of this Report; and
 - the Department's approach to the administration of Value Added Tax, which I have reported on in Part 5 of this document.
- carried out value for money studies under the National Audit Act 1983 that have contributed to my overall view of the Department's management of the tax systems, including reports on:
 - the Department's re-competition of its outsourced IT services, (HC 938, 2005-2006);
 - how the Department helps newly registered business meet their tax obligations (HC 98, 2006-2007);
 - filing of VAT and Company Tax returns (HC 102, 2006-2007);

- how the Department helps individuals understand and complete their tax forms (HC 452, 2006-2007); and
- the Department's accuracy in processing Income Tax (HC 605, session 2006-07).
- considered the Department's Statement on Internal Control (paragraphs 1.11 to 1.14 below) that provides a source of assurance about the quality of the Department's internal control framework;
- followed up on previous developments in areas that I covered in my Standard Report on the 2005-06 Trust Statement and Resource Accounts of HM Revenue & Customs; and
- taken into account the results of my audit of tax revenues, as set out in the separate Report I have appended to my audit certificate on the 2006-07 Trust Statement (pages 79 to 81).

Conclusion

1.4 Whilst recognising that no tax collection system can ensure that all those who have a tax liability comply with their obligations, the National Audit Office's work in 2006-07 provided assurance that HM Revenue & Customs has framed adequate regulations and procedure to secure an effective check on the assessment, collection and proper allocation of revenue, and that they were being duly carried out. That assurance is subject to reservations about the level of claimant error and fraud in the award of tax credits (see Part 2 of this report). The report also includes observations on the collection of income tax through PAYE and Self Assessment and the administration of Value Added Tax.

Developments in the audit landscape

Modernising powers, deterrents and safeguards

1.5 The Government announced a formal review of the Department's powers, deterrents and safeguards following the creation of HM Revenue & Customs under the Commissioners for Revenue & Customs Act (CRCA) 2005. The aim is to design a framework of law and practice for the Department to support the Government's objectives of a tax system that is fair and better adapted to the needs of customers. In June 2005 a Consultative Committee was established, including tax experts, representatives of business and the legal and accountancy professions, to reflect the views of the wider taxpayer community. Following the publication of two general consultation

documents¹ the Department has made progress in the following specific areas, all of which are subject to Parliamentary approval and Royal Assent:

- Criminal Investigation Powers – In August 2006 the Department published a technical consultation document seeking initial views on the statutory powers the Department needs for investigating serious tax crime. Following responses to that document, the Department consulted further over specific proposals for powers and safeguards, including draft legislation and explanatory material. This consultation closed on 13 March 2007. The Government has made proposals based on these consultations in the Finance Bill 2007.
- Surveillance Powers – The Government has included a clause in the Home Office Serious Crime Bill to extend surveillance powers, to apply to matters formerly the responsibility of Inland Revenue. These powers will be subject to the same controls and safeguards that are part of the surveillance powers the Department inherited from the former HM Customs & Excise.
- Civil Penalties - In December 2006 the Department issued a consultation document with draft legislation and explanatory material for civil penalties for incorrect returns. It sought views on proposals for a single structure for penalties for completing incorrect tax returns to apply to Income Tax, Corporation Tax, Capital Gains Tax, VAT and employers' PAYE and National Insurance Contributions. This consultation closed on 13 March 2007. The Government has included proposals based on this consultation in the Finance Bill 2007.

Carter Review of Online Services

1.6 In July 2005 the Paymaster General asked Lord Carter of Coles to advise on measures to increase the use of key online services. His review specifically looked at online services for Self Assessment, PAYE, VAT and Corporation Tax. Lord Carter's report was published on 22 March 2006 as part of Budget 2006, alongside the Government response accepting the recommendations. The recommendations included:

- requiring businesses to file their VAT returns, company tax returns and PAYE in-year forms online in phases from 2008;
- introducing new filing deadlines for Income Tax Self Assessment returns;

- promoting online filing by tax agents and better quality data by withdrawing computer-generated paper 'substitute' Self Assessment returns (for the 2007-08 and subsequent returns); and
- removing perceived barriers to early filing of Self Assessment and company tax returns by linking, for 2007-08 and subsequent years' returns, the period that the Department has to query a return to the date it is filed.

1.7 Following representation from tax agents that the proposed earlier filing dates for both paper and online Self Assessment returns would cause serious disruptions to their businesses, Lord Carter reviewed his findings. He made a revised recommendation that for 2007-08 and subsequent returns, the filing period for paper returns should be reduced to seven months, with a new deadline of 31 October. Lord Carter also recommended that for 2007-08 and subsequent years returns the filing period for online returns should remain at ten months with a deadline of 31 January.

1.8 After consultation with customers, in Budget 2007 the Government announced an extended timetable for implementation of the Carter recommendations. The Department still aims for universal electronic delivery of tax returns from businesses and computer literate individuals as Lord Carter recommended. It expects to deliver all the Carter recommendations for Self Assessment, PAYE, Corporation Tax and Value Added Tax, but this will now be a phased implementation. The extended timetable will give customers more time to prepare and the Department time to ensure that services are robust, and to build customer confidence in those services. The Department will also have the opportunity to further develop understanding of different customer needs, design services to meet those needs, and consider whether any special provisions are needed for particular groups. Parts 3 and 4 of my report examine in more detail the Department's provision of online services for PAYE and Self Assessment.

The Department's Transformation Programme

1.9 In Budget 2006, the Chancellor announced an early settlement of the Comprehensive Spending Review for the Department including access to a £300 million Modernisation Fund to assist the Department in its programme of investment. As part of that settlement the Department agreed to make efficiency savings of five per cent each year to 2011. As part of the Spending Review 2004 the Department is also committed to make £507 million savings by 2007-08, including a net reduction of 12,500 full time equivalent posts and relocating 1,950 posts by 2007-08 and 4,250 by

2009-10. A major challenge for the Department is maintaining "business as usual" whilst delivering these savings.

1.10 One of the conditions of the settlement is for the Department to agree with HM Treasury a plan that sets out spending proposals for the next five years. The Department has developed a five year plan, "the Five Year Ambition", aimed at delivering a more customer focused organisation, ensuring wilful non-compliance is detected and dealt with effectively and running costs reduced. In support of the Five Year Ambition the Department proposes to invest – through its Departmental Transformation Programme – approximately £1.9 billion in the period 2006-07 to 2010-11.

Statement on Internal Control

1.11 To meet his reporting responsibilities to Parliament, the Principal Accounting Officer has provided in pages 1 to 8 of the 2006-07 Accounts a Statement on Internal Control. The Statement serves two reporting purposes:

- to provide Parliament with assurance that the Accounting Officer has put in place the necessary control framework to manage risk. This is set out in paragraphs 2.1 to 5.7 of the Statement; and
- to give the Accounting Officer the opportunity to highlight to Parliament the areas of concern highlighted by his review of the effectiveness of internal control. These matters are described in paragraphs 6.1 to 6.23 of the Statement.

1.12 Principally as part of my audit of the Trust Statement and the Resource Accounts, my role with regard to the Statement on Internal Control is to consider whether the Accounting Officer's statement reflects the Department's compliance with HM Treasury's disclosure guidance. I report in my audit certificate if it does not. I also consider the Accounting Officer's Statement on Internal Control in reaching a conclusion about the adequacy of the systems for the assessment, collection and proper allocation of revenues brought to account by the Department. In doing so I consider whether the Statement properly reflects all material control weaknesses that have come to attention in my audit.

1.13 The Department has introduced an effective process for preparing its annual Statement on Internal Control. This involves a reporting process that ensures that each of its Executive Committee members prepares an individual internal control statement. The statements are underpinned by evidence reported from Directors. The Executive Committee then considers which control matters should be included in the Departmental Statement

having weighed the relative importance and materiality of the control matters reported by individual members. The Department's Internal Audit also scrutinises the Statement on Internal Control, including analysis of the underlying material that is independent of the Executive Committee's own review procedures. The Department's Audit Committee also examines and challenges the Statement on Internal Control, drawing on both the Executive Committee's review process as well as Internal Audit's work.

1.14 The Statement on Internal Control for 2006-07 acknowledges that the Department faces a number of significant control weaknesses. My report considers some of these issues, namely tax credits (Part two), Pay as You Earn (Part three), Self Assessment (Part four) and VAT (Part five).

Managed service companies

1.15 Managed service companies are intermediary companies through which the services of a worker are provided to an end client. The tax treatment of the services provided is governed by the intermediaries legislation (also known as "IR35"). This looks at the relationship between the worker and the client to establish whether the contract means the worker is actually an employee of the client. Where this is the case, the intermediary company is required to pay employed levels of tax and National Insurance contributions on the income. Where this is not the case the intermediaries legislation does not apply and offers the opportunity for payment to be received in the form of dividends rather than salary. Routing income through an intermediary company to disguise employment enables the worker and end client to avoid paying employed levels of tax and National Insurance contributions.

1.16 The Department has evidence of a significant growth in managed service company schemes being used to avoid paying employed levels of tax and National Insurance contributions. The Department estimates that the number of individuals providing services through such schemes has increased from 65,000 in 2002-03 to 240,000 in 2005-06 and that there are now over 150 scheme providers. The Department has encountered difficulties in enforcing the IR35 legislation because of the large and growing number of workers involved. Furthermore, when a debt has been established as a result of an investigation, it has found that some managed service companies escape payment as they have few assets and can generally be wound up or cease to trade, with workers moving to new managed service companies.

1.17 The Government recently announced changes which are intended to address these problems. In Budget 2007, the Government announced it would remove Managed Service Companies from the scope of the Intermediaries legislation and individuals working in Managed Service Companies will pay tax and National Insurance contributions at the same level as other employees. The Government estimates that the changes will increase tax yield by £1.05 billion in the three tax years starting from 2007-08.

Corporation tax: film tax relief

Introduction

1.18 The Finance Act 2006 introduced new rules for the taxation of film production and in particular, a new tax relief for the production of British cinema films. The principal features of the new film tax relief are that:

- it is a relief that is available solely against Corporation Tax;
- it is only available to the company that actually produces the film;
- the film is made to be shown commercially in cinemas;
- the film must be certified as British, based on qualifying criteria that are predominantly cultural;
- at least 25 per cent of the eligible production expenditure should relate to film making that has taken place in the United Kingdom;
- a production company can claim film tax relief on a provisional basis, before a film is complete, provided that it has an interim certificate indicating that the film is culturally of a British nature; and
- the film tax relief includes a payable tax credit.

These new rules began on 1 January 2007 for films whose production companies began principal photography on or after that date; and for films where the production companies had started principal photography before 1 January 2007 but had not completed filming at that date.

1.19 Under these arrangements, the responsibility for administering the film tax relief is shared between HM Revenue & Customs, the Department for Culture, Media and Sport (DCMS) and the UK Film Council (UKFC), a non-departmental public body that is sponsored by the DCMS. The DCMS is responsible for issuing the certificates (both interim and final) that certify that a film is culturally British; and therefore potentially eligible for the tax relief. The DCMS administers the new "cultural test" through and on the advice of the UKFC. A film production

company that receives a certificate from the DCMS may then apply to HM Revenue & Customs for film tax relief as part of its annual corporation tax return.

Historical context

1.20 Before the Finance Act 2006, tax relief was available for production and acquisition of British films under various sections of the Finance (No. 2) Act 1992, the Finance (No. 2) Act 1997 and the Income Tax (Trading and Other Income) Act 2005. In July 2005, HM Treasury published for consultation the results of a review that it had conducted on the film tax relief that was available under these legislative arrangements.² The review concluded that the tax reliefs were subject to a number of weaknesses, both operationally and in their fit with the Government's objective of encouraging stable and sustained investment in the production of culturally British films.

1.21 Operationally, HM Treasury was concerned at the extent to which the tax reliefs were subject to tax avoidance. The review highlighted that between 2000 and 2005, the Government had enacted in legislation no less than 13 anti-avoidance measures to protect the Exchequer against abuse of film tax incentives. The Treasury concluded that because of the high levels of avoidance, the existing reliefs were no longer an effective means of delivering the Government's objectives for the United Kingdom film industry. HM Treasury also identified other factors that contributed to this view:

- the tax reliefs were available for all eligible expenditure, irrespective of the country in which the costs were incurred, provided that the production met the certification criteria. In some instances, this meant that the extent of activity in the United Kingdom was low;
- tax avoidance had created a degree of undesirable market distortion. In particular, HM Treasury cited the production of poor quality products that had been made solely for the purpose of claiming accelerated tax relief;
- the extent of tax avoidance had also created uncertainty in the film industry, because it had resulted in higher levels of support than had been intended; and that in turn had generated uncertainty about the Government's commitment to provide continuing support; and
- the availability of the tax relief to film financiers (rather than solely to film producers) had proved an inefficient way of supporting the industry.

The Government enacted the new film tax relief rules in the Finance Act 2006. These rules are supported by statutory instruments and by specific guidance that is available to film production companies to help them apply the new provisions of the relief.

1.22 Companies and others involved in the production or financing of films that were completed before 1 January 2007 can claim tax relief under the rules in the Finance (No 2) Act 1992, the Finance (No 2) Act 1997 and Income Tax (Trading and Other Income) Act 2005 on eligible production expenditure, but only on acquisition expenditure incurred by 30 September 2007. There is a small category of productions that began filming before 1 January 2007, were not completed at that date and which do not satisfy the new cultural definition of a British film. These films can also qualify for relief under the old rules but with 31 March 2008 as the final date for acquisitions.

Costs to the Exchequer of the new film tax relief

1.23 The Regulatory Impact Assessment for the new tax relief, published alongside Budget 2006, indicates that the new relief was estimated to cost £20 million in 2006-07 and will cost £120 million a year thereafter.³ The Department is not yet able to confirm an estimated cost for 2006-07 for the new relief, principally because it has only received a relatively small number of claims under the new relief. This is not unexpected, given that the regulatory framework to allow such claims to be made for films commencing principal photography before January 2007 under the new relief was not in place until March 2007. In addition, because of the retrospective way in which Corporation Tax works, where businesses are able to submit their annual tax returns up to twelve months after the end of their accounting period, the Department does not expect to have a reliable estimate for the 2006-07 cost of the relief until early in 2008-09.

1.24 The Department will capture the expenditure taken into account, and amounts claimed as payable, for film tax relief from the annual Company Tax return. The Department's principal IT System for managing Corporation Tax (the COTAX system) is currently not configured either to calculate or to identify the value of film tax relief claimed by film production companies as a deduction from tax, rather than as a payable credit. For monitoring purposes, the Department therefore plans to supplement the information on claims that is available on individual tax returns with data supplied by the offices that process the claims. The Department will collate this data centrally to provide an overall picture of the cost of this new tax incentive.

Operational characteristics of the new film tax relief

The relationship between HM Revenue & Customs and the Department for Culture, Media and Sport

1.25 Both the Department and DCMS recognise that the relationship between them will have to change to reflect the new rules that apply to film tax relief; and to reflect the roles that UKFC will play in supporting DCMS. The two Departments are currently developing a Memorandum of Understanding that will set out their respective roles for the various aspects of administering the film tax relief and in particular, the certification process. The Memorandum should provide a sufficient framework to ensure (amongst other things) that DCMS puts in place appropriate validation and quality assurance procedures around the certification process. The Memorandum will, where appropriate, also formalise the practices that have evolved under the old tax relief regime; as well as to clarify responsibilities where new rules apply.

1.26 The Memorandum of Understanding will also acknowledge that it is the Department that has overall responsibility for managing risk, simply because the ultimate risk to the Exchequer lies within the yield of Corporation Tax. However, both the Department and DCMS intend to maintain a joint risk register that they will review at regular monthly liaison meetings. Within this framework, each Department will be able to alert the other to new specific or generic risks. The Finance Act 2006 provides the Department with new powers to supply DCMS with information if its normal enquiry programme highlights a particular risk attached to an individual film.⁴ For example, if the Department's enquiries suggest that a film does not meet the criteria for being a British film, then the Department can share this information with DCMS.

Claiming film tax relief

1.27 An important feature of the new film tax relief is that it is only available to film production companies, which are defined in the Finance Act 2006. Under this legislation there can be only one such company for any film. This should reduce the number of claims that the Department has to consider: for each film made, there will be a single production company and one claim for tax relief, based on a single certificate indicating that the film is culturally British. However, the new rules do allow a production company to claim for film tax relief on a provisional basis, before a film is complete, on the basis of an interim certificate issued by DCMS indicating that the film is culturally British. Where a company has asked for an interim certificate, it must also obtain a final certificate (on completion of the film) which will replace any interim certificates that it has received.

1.28 DCMS is responsible for issuing all certificates and will do so having taken advice from UKFC, where UKFC has considered whether a film qualifies as British. A film may be British where:

- it satisfies the "cultural test" provided for in Films Act 1985 (as amended);⁵
- it meets the terms of one of the United Kingdom's bilateral co-production treaties; or
- it meets the terms of the European Convention on Cinematographic Co-production.

DCMS will normally issue any interim certificates with a validity period of three years, although they may, at the request of the production company, be for longer periods. This may be necessary where a company undertakes a lengthy production such as an animation or a live action film, with a large amount of computer generated imagery. Under the former film tax relief arrangements, the certificates issued by DCMS had no expiry date. The introduction of expiry dates for the new certificates provides an element of control that was missing from the previous arrangements, though any certificates in circulation for the former relief will be useless for acquisitions made after 31 March 2008 (see paragraph 1.22).

1.29 The Department is putting in place processes and procedures with DCMS to monitor the issue of certificates so that it will be able to track applications for the tax relief. These arrangements include:

- receiving early notice of the production companies that have applied to DCMS and UKFC for certificates;
- receiving monthly information of films certified either on an interim or on a final basis as British. This information will allow the Department to:
 - allocate each case to the appropriate office for considering claims, since the monthly information will include the name of the production company as well as the name of the film; and
 - confirm, once the claim is received from the company, that DCMS did in fact issue any certificate that is supplied.

The Department is required to accept any certificate that is issued by DCMS. However, if the Department does have grounds from its enquiry work to suspect that a certificate was wrongly issued, then it can, under the Finance Act 2006, inform DCMS of this.⁶ DCMS can then investigate these suspicions and where justified, revoke the certificate.⁷ The Department is then able to treat any revoked certificate as never having been issued; and any tax relief obtained on the basis of it is withdrawn.⁸

Conclusion

1.30 The Finance Act 2006 introduced new rules for the taxation of film production and in particular, a new tax relief for the production of British cinema films. The Department, in collaboration with DCMS, has designed the new relief to try to avoid the possibilities of it becoming vulnerable to avoidance activity. The Department considers the fact that the relief may only be claimed by film production companies will help to mitigate this risk. The previous relief was open to companies and individuals whose involvement in film making was confined to providing or arranging finance. These groups are now excluded from the new arrangements.

1.31 The Department recognises that there are still residual tax avoidance risks, as individual companies may seek to push the boundaries of what may be categorised as qualifying expenditure for film production. As the Department receives claims for film tax relief it will start to construct a risk profile built around experience of dealing with compliance issues, rather than as at present, based on predictive analysis of behaviour. The Department will also assess the operation of the new film tax relief once it has been in place for at least a year. The Department considers that experience with similar policy measures suggests that the overall impact is only clear in the longer term.

1.32 Against this backdrop, it is important for the Department to ensure that:

- the Memorandum of Understanding between the Department and DCMS sets out clearly the respective roles of the two departments for management of the tax relief. In particular, the responsibilities that DCMS has for the certification process; and
- the processes and procedures that it puts in place to monitor the costs associated with the tax relief are sufficient to meet the commitment to do this under the Regulatory Impact Assessment.⁹ The Department should also ensure that its management information systems are able to identify and aggregate the cost of this relief.

PART TWO

Tax Credits

Introduction

2.1 Child and Working Tax Credits (tax credits) were introduced in April 2003 as part of the Government's reforms of the tax and benefits system aimed at relieving child and in-work poverty. They provide additional financial support to families with children and working people on low incomes in accordance with their circumstances. They replaced the Working Families and the Disabled Person's Tax Credits which were introduced in 1999, and the Children's Tax Credit, introduced in 2001.

2.2 During 2006-07, the Department paid a net £18.7 billion in tax credits and an average of 5.5 million families received awards. The cost of administering the scheme was £587 million. **Figure 1** gives an overview of the tax credits scheme since its introduction in April 2003.

2.3 Child Tax Credit is designed to address the specific needs of families with children, and provides financial support based on the number of children and any disabilities they may have. It is available to those aged 16 or over, whether working or not, who are responsible for at least one child. Working Tax Credit is intended to support working people, both employed and self employed, by topping-up earnings; the amount depends on factors such as age and/or the number of hours worked. Additional support is available for eligible childcare costs or where a member of the household suffers from disability.

1 Tax Credits: Scheme Overview

	2003-04	2004-05	2005-06	2006-07 provisional ²
Families benefiting ¹	4.6m	5.0m	5.3m	5.5m
Of which: Child Tax Credit	4.4m	4.8m	5.0m	5.2m
Working Tax Credit	1.6m	1.7m	1.8m	1.9m
Net cash paid to claimants in year	£13.5bn	£15.8bn	£17.3bn	£18.7bn
Final value of awards ³	£12.0bn	£14.3bn	£16.0bn	Not yet known
Administrative cost ⁴	£406m	£475m	£467m	£587m
Staff employed by the Department	7,300	8,200	8,750	10,120

Source: HM Revenue & Customs

NOTES

- Figures represent the average number of families benefiting in the year for 2003-04, 2004-05 and 2005-06 in finalised awards and for 2006-07 in provisional awards. Some families benefit from both Child and Working Tax Credits.
- Actual information for 2006-07 will be available in May 2008, after awards have been finalised.
- The Department makes a final assessment of awards after the end of the year when the claimant's actual circumstances are known.
- Administrative costs have increased from 2005-06 to 2006-07 because of an increase in staff costs, and a change in the Department's approach to overhead apportionment following the introduction of new financial systems.

2.4 My recent Standard Reports have covered a number of important issues in the administration of tax credits, including overpayments and their recovery, high levels of error and fraud and attacks on the system by organised criminals. As part of my work in 2006-07 I have examined the progress the Department has made in dealing with these issues and my report covers:

- overpayments and underpayments caused by adjustments to awards;
- recovery of overpayments;
- claimant error and fraud; and
- the service provided to tax credit claimants.

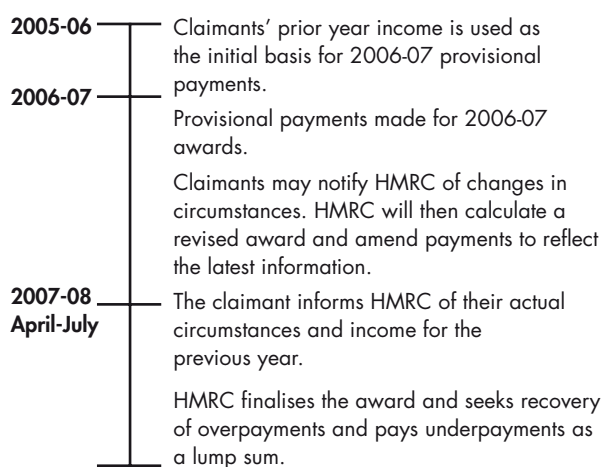
Overpayments and underpayments caused by adjustments to awards

2.5 The amount of tax credits paid is based on an annual entitlement. The Department calculates a provisional award and makes payment using the latest information it holds about the claimant. For 2005-06 awards, claimants had until 31 August 2006 to confirm their actual circumstances and income. The Department used this information to make an assessment of the final award and, where it was renewed, establish a provisional award for 2006-07. In some cases the final award differed from the provisional award, for example where the final income was different from the figure used to calculate provisional awards. The Department paid the claimant a lump sum where it calculated that the provisional award resulted in an underpayment. Where the provisional award resulted in an overpayment, the Department is seeking to recover it from future awards or, if there is no ongoing entitlement, directly from the claimant. An overview of the timetable for the calculation and payment of awards is given in **Figure 2**.

2.6 In 2005-06 overpayments were £1.7 billion, as shown in **Figure 3**. In accordance with the Department's normal approach, this figure is net of remissions and recoveries of overpayments made before the end of the year. Tax Credit awards for 2006-07 are not all due to be finalised until the end of January 2008. The Department will publish overpayment statistics on these awards in May 2008.

2.7 Overpayments in 2005-06 included £378 million relating to some 254,000 terminated awards for 2004-05. The Department terminated awards if claimants failed to report their actual incomes and circumstances for 2004-05 in order to finalise and renew their award by 30 September 2005, failed to return a signed award notice

2 Timetable for the calculation and payment of 2006-2007 awards



Source: National Audit Office

3 Tax Credits Overpayments and Underpayments to 31 March 2006

	2003-04	2004-05	2005-06
Net cash paid to claimants in year	£13.5bn	£15.8bn	£17.3m
Families benefiting	4.6m	5.0m	5.3m
Overpayments	£2.2bn	£1.8bn	£1.7bn
Subsequent changes to entitlement ¹	£0.1bn	£0.1bn	–
Total to be recovered	£2.3bn	£2.0bn	£1.7bn
Families affected by overpayments	1.9m	2.0m	1.9m
Underpayments	£464m	£556m	£549m
Families affected by underpayments	0.7m	0.9m	0.9m

Source: HM Revenue & Customs

NOTES

¹ This is mainly individual error and fraud subsequently identified in finalised awards through the Department's compliance activity.

² Figures may not sum due to rounding.

for 2005-06, or were found not to qualify for tax credits. Terminated awards can be reinstated where claimants have had a reasonable explanation for failing to confirm their income and circumstances in the renewal window.

2.8 The Department has examined a sample of the 228,000 awards terminated in 2004-05 to improve its understanding of claimant behaviour. The Department estimates that some 180,000 of the awards terminated were due to the claimant's failure to report their actual 2003-04 incomes, although of these 22,000 new awards were subsequently made to the same claimants before the year end. But there was insufficient evidence to conclude why the remaining claimants had not finalised their awards. The Department is now undertaking a more comprehensive exercise to examine why claimants fail to finalise their awards.

2.9 To limit the need for adjustments to provisional awards, the Department disregards certain rises in the claimant's income during the previous year when it finalises awards. This level was initially set at £2,500 and the Department estimates that final entitlements to tax credits in 2005-06 would have been around £700 million lower without this disregard.

2.10 The 2005 Pre-Budget Report announced changes which were designed to provide greater certainty to claimants, particularly when claimants see a rise in income. The principal measures are:

- for awards for 2006-07 and subsequent years, the level at which increases in income are disregarded when finalising awards has been raised from £2,500 to £25,000. The Department estimates that the impact of this measure alone would reduce overpayments by £400-£600 million. The cost to the Exchequer of this change is the foregone recovery of these overpayments;
- from April 2006, place additional responsibilities on claimants to notify the Department promptly of changes in circumstances in-year that affect their awards;
- for awards from 2005-06, bring forward the date by which claimants have to finalise their awards;
- introduce automatic limits on the recovery of overpayments where awards are adjusted in-year following a reported change in circumstance, with the aim of encouraging more families to report in-year changes of circumstances; and
- increase payments only for the remainder of the year when claimants report a fall in income during the year; with a further payment if appropriate when the award is finalised after the end of the year.

2.11 The Department will publish details on finalised 2006-07 awards in May 2008 which will provide more information on the effect of these measures. When fully implemented the Department anticipates that the package

as a whole will reduce the value of overpayments by a third. The Department's latest information – based on its in-year monitoring of payments and entitlement arising from changes of circumstances – indicates that the measures should deliver this reduction.

Recovery of overpayments

2.12 The Department's approach to recovering overpayments is set out in its guidance to claimants.¹⁰ Where there is on-going entitlement, it recovers overpayments from future tax credit payments. But the Department restricts recoveries made against the payment of future awards to prevent hardship. It seeks direct recovery of overpayments where the claim is no longer in payment and considers requests to pay by instalments. The Department expects complete recovery of overpayments to take several years.

2.13 At the end of March 2007, £3.9 billion was owed to the Department in respect of overpayments.¹¹ Of this debt, £1.7 billion was being recovered from ongoing awards and £1.5 billion directly from claimants. In addition, some £700 million of debt was not yet subject to active recovery action, for example because the Department had not or had only recently issued a notice to pay, ceased awards where the award had not been finalised, or the claimants' appeal periods had not yet expired.

Recovery of overpayments from ongoing awards

2.14 Over the first four years of the scheme the Department has recovered £1.6 billion of overpayments from ongoing tax credit awards. It is seeking to collect a further £1.7 billion against future payments. Some of these overpayments may later be subject to direct recovery if the award ceases, for example because of family break-up or if the youngest child leaves full time education.

2.15 The Department restricts recoveries made against the payment of future awards where it considers this would cause hardship and the maximum it recovers each year is:

- 10 per cent from claimants entitled to the maximum award;
- 25 per cent for those entitled to more than the family element of Child Tax Credit, or less than the maximum Working Tax Credit; and
- 100 per cent for those entitled to only the family element of Child Tax Credit.

2.16 Since the introduction of tax credits, the Government has made changes to how overpayments are recovered. Originally, where claimants notified the Department of changes in circumstances within the year which gave rise to an overpayment, it aimed to recover the overpayment in full before the end of that year. This contrasted with the treatment of changes in circumstances notified after the year end, where claimants were given longer to repay.

2.17 The 2005 Pre Budget Report announced the introduction of automatic limits on the recovery of overpayments where awards are adjusted in-year following a reported change in circumstance. The Department originally intended to introduce this change in November 2006. Automating this process involves significant changes to the tax credits computer system. After testing, the Department concluded that making the changes as initially intended would have raised an unacceptable level of risk of incorrect payments. The Department introduced interim manual arrangements to limit rates of recovery when contacted by claimants and some 5,000 claimants had their claims adjusted under these arrangements. In January 2007, the Department introduced an enhanced process to identify cases where recovery limits should apply, which meant the claimant did not have to request this and in the period January to March 2007 52,000 awards were automatically adjusted by this process. The Department expects an automated process to be in place in the summer of 2007.

Direct recovery of overpayments

2.18 Since the introduction of tax credits, the Department's debt management teams have been passed £1.9 billion of debt to recover. By the end of 2006-07, they had collected £0.4 billion and £1.5 billion was outstanding. The Department accepts payments by instalments over 12 months and considers requests to pay over a longer period. It has agreed 535,000 arrangements for overpayments to be repaid this way.

2.19 Tax Credit awards for 2003-04 were not all finalised until the end of January 2005. It was only once this process had been completed that direct recovery of debt could fully commence. But the Department experienced difficulties transferring information on debt from the tax credits computer system to the system used for debt management. The direct recovery of debt has been affected by the backlog of work that was created.

Write-offs and provisions for bad debt

2.20 The Department has to form a view on the tax credit debt that may not be recovered and may eventually be written off. In the first three years of the scheme, it has written off £0.7 billion of the £6.0 billion debt to be recovered shown in **Figure 4**. It has also written off £0.2 billion in respect of amounts paid and written off in the same year, before awards were finalised, for example where it has identified organised fraud. In addition, a total provision of £1.6 billion has been made in the Trust Statement account for doubtful debt. An analysis of amounts written-off and amounts to be recovered is given in Figure 4.

4 Recovery and write-offs of overpayments from 2003-04 – 2005-06

	2003-04	2004-05	2005-06	Total
Overpayments¹	£2.2bn	£1.8bn	£1.7bn	£5.8bn
Subsequent adjustments to entitlement ²	£0.1bn	£0.1bn	–	£0.2bn
Total to be recovered	£2.3bn	£2.0bn	£1.7bn	£6.0bn
Amounts written off by 5 April 2007	(£0.4bn)	(£0.3bn)	(£0.1bn)	(£0.7bn)
Amounts recovered by 5 April 2007	(£1.1bn)	(£0.6bn)	(£0.3bn)	(£2.0bn)
Debt to be recovered at 5 April 2007	£0.9bn	£1.1bn	£1.3bn	£3.3bn

Source: HM Revenue & Customs

NOTES

1 This table excludes amounts for 2006-07 awards. The overall level of overpayments for these awards will not be known until they have been finalised. Figures may not sum due to rounding.

2 This is mainly individual error and fraud subsequently identified in finalised awards through the Department's compliance activity.

2.21 In 2006-07 the Department has written off £369 million. Around half of the total amount written off relates to £300 million overpayments made to claimants in the first four years of the scheme who failed to notify the Department they had stopped work, but continued to receive Working tax credits. Some of these individuals should have instead claimed Income Support or Jobseekers Allowance. The Department has reviewed the extent to which these overpayments can be recovered and concluded that it would not be cost effective to recover £186 million, and this has been written off in 2006-07. The Department is seeking to recover the remaining overpayments.

2.22 In 2006-07 the Department also wrote off £61 million in respect of official error, £40 million in respect of Organised Fraud and £37 million in respect of duplicate payments made in 2003-04. The remaining write offs include small overpayments the Department considered were not cost effective to pursue, overpayments where recovery would cause hardship to claimants, and debt that the Department considers is irrecoverable for various other reasons.

Claimant error and fraud

Compliance checks performed on tax credit awards

2.23 The Department tries to maintain a balance between ensuring the accessibility of the scheme to claimants and maintaining safeguards against the risk of error and fraud. It aims to achieve this by investigating claims which it judges present the highest risk and checks these before or, in certain cases after, claims are paid. In July 2006, it published "Tackling Error and Fraud in the Child and Working Tax Credits" which set out its plans for tackling claimant error and fraud. This included strategies to reduce customer error by improving communications to make them easier to understand, and improving the quality of advice and processing work undertaken by contact centres. Strategies to tackle fraud included further developing risk assessment procedures, embedding compliance specialists in contact centres and working with other Government Departments and the private sector to combat identify fraud.

The Department's compliance checks

2.24 Figure 5 provides details of the volume and effectiveness of the Department's direct compliance checks. In 2006-07, its compliance teams carried out 137,930 pre and post payment checks on the highest risk claims, which identified incorrect payments of £148 million and prevented incorrect payments of £138 million.

2.25 Since April 2005, the Department has increased the number of checks undertaken before awards are paid, which is the most cost effective way to avoid financial loss. During 2006-07 it performed 41 per cent of its compliance checks on claims before they were paid. These checks are important in correcting errors before claims start to be paid, providing customer education and demonstrating visible compliance activity. The Department also performs compliance checks on claims that are being paid. This aims to target high risk claims in payment and counter paper based attacks on the system, the method which the Department found fraudsters resorted to following the closure of the tax credits internet site.

5 HMRC's direct compliance checks

	2004-05	2005-06	2006-07
Volume of Checks			
Target	101,500	110,000	130,000
Actual checks	107,789	146,376	137,930
Pre payment: post payment ratio	16%:84%	45%:55%	41%:59%
Effectiveness of checks			
Actual Yield ¹ , comprising:	£130m ²	£528m	£286m
Incorrect payments prevented ³		£307m	£138m
Incorrect payments found ⁴		£221m	£148m
Checks resulting in change to award:			
Pre award	93%	93%	68%
Post award	65%	85%	81%

Source: HM Revenue & Customs

NOTES

1 The Department does not generally set a target for yield.

2 The Department did not record information on the composition of yield in 2004-05.

3 The estimate of incorrect payments prevented is the additional amounts that would have been paid during the year had payment not been stopped.

4 The estimate of incorrect payments found is the value of payments made before HMRC took action.

2.26 In addition to direct checks by tax credit compliance teams, the Department may act in other ways to identify fraud and withhold tax credits payments. This can be either as a result of the work of its criminal investigation teams or through other procedures, such as inspecting claim forms prior to processing for evidence of organised fraud. **Figure 6** provides an analysis of the outcomes arising from all of its actions in 2006-07 to stop erroneous and fraudulent tax credit claims. The Department estimates that in 2006-07 it prevented incorrect payments of £291 million; this comprises £233 million from checks on claims before they were paid and £58 million from checks on awards in payment. The Department's checks of awards in payment also found it had made incorrect payments of £151 million, including £40 million of suspected organised fraud. The fall in levels of suspected organised fraud from 2005-06 is primarily due to fewer attacks following the closure of the tax credit internet site in December 2005. The Department is developing a framework for validating the identity of individuals and will only re-open the internet system once this work is complete, which is unlikely to be before July 2008.

6 Outcome of all HMRC compliance and other actions on tax credits fraud and error cases in 2006-07 (2005-06 figure in brackets)

	Individual error and fraud £m	Suspected Organised Fraud £m	Total £m
Checks before claims entered into payment			
Incorrect payments prevented ¹	61 (19)	172 (313)	233 (332)
Checks on awards in payment			
Incorrect payments presented ¹	18 (19)	40 (96)	58 (115)
Incorrect payments found ²	111 (119)	40 (131)	151 (250)
Total	190 (157)	252 (540)	442 (697)

Source: HM Revenue & Customs

NOTES

1 The estimate of incorrect payments prevented is the additional amounts that would have been paid during the year had payment not been stopped.

2 The estimate of incorrect payments found is the value of payments made before HMRC took action.

2.27 The Department is looking to broaden the range of its compliance work to encourage tax credits claimants to comply with their obligations. It is considering how it can apply a broader range of compliance actions to improve compliance across the wider tax credit population, in addition to focusing its actions on those it assesses as high risk. This builds on its experience of compliance elsewhere in the Department. If successful, this will allow it to offer support and advice to a much larger number of claimants, improving customer service and potentially reducing levels of claimant error and fraud.

2.28 If an enquiry uncovers evidence of non-compliance, the Department's next step is to determine appropriate sanctions and recover the amounts owed (including any charges and penalties imposed). As shown in **Figure 7**, a relatively small number of cases are selected for criminal prosecution. The Department limits its use of criminal prosecution to the more serious cases of tax credits fraud and those involving organised attacks on the system.

Overall levels of claimant error and fraud

2.29 The Department measures the overall level of error and fraud by investigating a random sample of finalised awards, although the design of the tax credits scheme affects the speed with which it can complete this work. Some claimants, such as those taxpayers included within Self Assessment, may not finalise their awards for the preceding year until 31 January. The Department may therefore not have been able to start its investigation of some 2004-05 awards until February 2006.

2.30 In June 2007, the Department completed its testing of 2004-05 awards, based on 4,500 random enquiries. As a result of this, the Department estimates that claimant error and fraud resulted in between £1.04 billion to £1.30 billion (7.3 to 9.1 per cent of the final value of awards) being paid to claimants to which they were not entitled.¹² The levels in 2003-04 were £1.06 billion to £1.28 billion (8.8 to 10.6 per cent). It also estimates

7 Tax Credits Sanctions

	2004-05	2005-06	2006-07
Cases where a penalty was charged	1,114	2,241	1,365
Total value of penalties charged	£445,645	£887,585	£610,000
Cases selected for Criminal prosecutions	211	289	183

Source: HM Revenue & Customs

that claimant error resulted in between £200 million to £350 million (1.4 to 2.4 per cent) not being paid to claimants to which they were entitled. The levels in 2003-04 were £190 million to £280 million (1.6 to 2.3 per cent). As separately noted in my report on the 2006-07 Trust Statement, I concluded that this level was unacceptably high and, whilst the Department has made changes to its compliance procedures since 2004-05, there is currently no evidence to demonstrate a lower estimate for 2006-07. I have therefore qualified my opinion on the regularity of the expenditure reported in the Trust Statement in respect of tax credits claimant error and fraud.

2.31 In my 2006 Report, I noted that the Department was taking steps to improve the quality of its work in conducting these enquiries. These included providing additional guidance to compliance staff, performing greater management checks, closer working with teams undertaking Self Assessment enquiries and coaching individual staff to improve the quality of work on specific cases. My staff examined a sample of 2004-05 random enquires and found that these changes had not led to the anticipated improvement in the quality of enquiry work. The Department is now considering what further action it can take to enhance this work, including using specialist teams.

2.32 The Department is also working on plans to prepare more timely estimates of error and fraud, in addition to its work on finalised awards. It is examining how it can obtain early indicators of attempted error and fraud, for example by deriving an estimate from its compliance work on new claims. It is also considering how it can speed up its work on the random examination of awards.

2.33 Towards the end of 2006, the Department commenced a reorganisation of its compliance teams, by transferring more work to large centralised teams, supported by a reduced number of local teams based around the UK. The Department considers that increased centralisation of this work will increase its effectiveness at identifying claimant fraud and error. The reorganisation was nearing completion at the time of my report.

Ensuring that claimants meet the residency criteria for tax credits

2.34 To be eligible for tax credits, claimants need to be present and ordinarily resident in the United Kingdom (UK). Individuals are responsible for notifying the Department if they leave the UK for more than eight weeks. There are no means by which the Department can monitor whether claimants have in fact left the country. The Department has the power to charge penalties where claimants do not notify of such changes in circumstances, although it has not yet charged any such penalties.

2.35 Some concerns have been expressed that migrant workers are incorrectly claiming awards because they do not meet the residency criteria for tax credits. On 1 May 2004, 10 new countries joined the European Union (EU) and many people from those countries entered the UK to work. Migrant workers have to fulfil the same criteria as UK nationals to qualify for tax credits, which are set out in **Figure 8**. The Department performs pre and post payment checks to look for possible fraud and error, but these are made on all claimant applications, irrespective of nationality. The Department does not request information on nationality because it is not a condition for entitlement to tax credits. The Department's legal advice is that it is unlawful

8 Eligibility criteria for tax credits

A claimant must be both present and ordinarily resident in the UK throughout the period of the award. A person is considered ordinarily resident if they normally live in the UK (apart from temporary or occasional absences¹) and have chosen to live and settle in the UK for the time being. A person can be ordinarily resident in more than one country and the fact that a person might be said to have a home in another country does not mean that they cannot also be ordinarily resident in the UK.

For new claims on or after 1 May 2004 for Child Tax Credit a person must also have a 'right to reside' in the UK. The Department considers that the following groups are among those with a right to reside in the UK.

- All European Economic Area (EEA) Nationals legally working in the UK, including A8 nationals who are required to register their employment with the Workers Registration Scheme and have done so.
- Nationals of the A8 countries who are seeking work in the UK and have sufficient resources above the level of Income Support.
- EEA nationals, including nationals of the A8 countries, who are economically inactive and have sufficient resources above the level of Income Support.

Source: HM Revenue & Customs

NOTE

- ¹ Absences of up to eight, or in certain cases 12, weeks may be discounted.

to target members of particular national groups unless it has identified a significant risk to the Exchequer from those nationalities which is not shared by other nationalities. The Department has told me that it continues to evaluate the extent of the risk.

2.36 In the light of these concerns, in 2006-07 the Department carried out a pilot exercise in conjunction with its Employer Compliance teams looking at an agency employing skilled labourers, to help it understand whether there are any particular risks with claims from agency workers. This exercise identified risks of non-compliance such as failure to notify the Department of reductions in hours worked. But the Department considers this is a risk with all claimants and not just in relation to agency workers. At the time of my report the Department was undertaking another pilot exercise to assess the level of specific risks which it expects to complete in August 2007.

The service provided to tax credit claimants

2.37 The Department has experienced problems with the service provided to claimants following the introduction of tax credits and has taken steps in the first four years of the scheme to improve the quality of service provided. These have included developing the tax credits computer system to improve the accuracy of processing and the quality of award notices, a series of measures announced by the Paymaster General in May 2005 to improve customer service and the development of revised procedures for handling complaints.

Developing the tax credits computer system

2.38 There were difficulties with the tax credits computer system following its implementation in 2003 and unforeseen overpayments due to software errors. The Department has recovered significantly from these problems. Since the initial implementation of the system, it has had a regular programme of enhancements (software releases) to the tax credits computer system, set out in **Figure 9**. The initial focus of the software releases was to allow the Department to process new awards, make payments and renew awards. Subsequent software releases focused more on improving the service provided to claimants, for example by improving the information provided to claimants.

2.39 The Department has an ongoing programme of prioritising and correcting software errors. In October 2005, it undertook an analysis of the tax credits computer system and identified 199 software errors which potentially cause underpayments and overpayments. The Department found that 63 of these had a high impact in that large numbers of households were affected by each problem and/or the resultant underpayments or overpayments were of high value. Of the 63 errors, 35 caused overpayments of £102 million and underpayments of £106 million, affecting 215,000 claimants. The Department could not quantify the effect of the remaining 28 in terms of the number of claimants and amounts involved prior to correcting the software errors and recalculating entitlement. The Department made enhancements to the computer system in October 2006, which included changes to increase its ability to detect and correct incidents before they affect claimants. At the time of my report, the Department was updating its quantification of the effect of software errors, although it has identified certain errors that continued to affect payments in 2006-07.

- i** In May 2006, a software error resulted in overpayments of £24.6 million. This was an unintended effect of changes made to the tax credits system in that month. The Department corrected the computer system and wrote to the claimants informing them that the overpayment would either be recovered from future payments or that they could repay it directly to the Department.
- ii** The Department has encountered difficulties in finalising awards for some claimants. In 2005-06, the computer system was unable to finalise approximately 70,000 awards and the Department manually issued renewal notices where appropriate. The Department is examining what computer changes are needed and is making daily updates to the computer system in the meantime.
- iii** There continued to be some software problems that prevented the Department from making automated payment for a minority of claimants. At 31 March 2007 around 45,000 claimants were not receiving automated payments. A number of these were affected by a specific problem which the Department corrected in April 2007. At the end of April 2007 around 18,000 claimants were not receiving automated payment.

9 Timetable and content of Tax Credit system releases

Release	Content	Delivery Date
One	Provision of the basic process for claims and awards to be processed.	October 2002
Two	This allowed payments to be made to claimants and to process changes in circumstances and income: it also provided facilities for accounting and payment reconciliations.	April 2003
Three	Preparation for the renewals process	November 2003
	Support for the Department's compliance activity	November 2003
	Provision of Management Information	Part delivered
Four	Main system to support the process for the finalisation and renewal of awards. Further support for compliance activity. Initial support for debt management.	April 2004
Five	Remaining elements of the system to complete the October 2004 renewals process. Additional support for debt management.	September 2004
Six	Support for an amended renewals process.	April 2005
	Amendments to the claim form, the award notice and the renewal notice.	
	Restriction in the rate of recovery of overpayments where full recovery would cause hardship.	
	Recovery of current year overpayments from the provisional payments for the following year.	June 2005
Seven	Support for improved internal accounting.	
	Improved matching of data between the Tax Credits and Child Benefit system to improve the accuracy of payment.	November 2005
Eight	Provision of automated daily check of payments made against payments authorised.	
	A redesigned award notice providing a detailed breakdown of how awards are calculated	April 2006
	Increase in the level of in-year income disregard to £25,000	
Nine	Reduction in the period for renewing awards from six to five months	
	Production of new award and renewal notices	October 2006
	Improvements to IT processes to improve system resilience	
	Improved information to support the bank reconciliation process.	
	Provision of full playback of all changes that have affected the award on the renewals notice.	

Source: HM Revenue & Customs

Processing accuracy

2.40 The Department has a target to decide accurately 95 per cent of new claims, renewed awards and changes of circumstances. As shown in **Figure 10**, the Department has made significant improvements against its target since the introduction of tax credits. This target reflects whether the information has been correctly entered on the tax credits system, but does not measure if the actual payment made was correct. The Department is now designing a new check which aims to establish if it is paying the right money to the right people at the right time. The Department will be collecting this information as part of its 2007-08 checks.

10 Accuracy of processing tax credit awards

	2003-04	2004-05	2005-06	2006-07
	%	%	%	%
Target	90.0	90.0	95.0	95.0
Actual	78.6	96.5	97.9	96.8 (provisional)

Source: HM Revenue & Customs

2.41 The results do not attempt to capture the extent to which official error causes incorrect payments. In 2007, the Department undertook an exercise to measure the level of official error, involving an examination of a small sample of cases where a claimant had raised a dispute with the Department regarding an overpayment of tax credits. This indicated that official error occurred in about five per cent of disputed overpayment cases. The Department has been collecting this information on a routine basis since April 2007. It is also considering other ways of improving the information it makes available on official error.

The Paymaster General's Improvements

2.42 On 26 May 2005, the Paymaster General (PMG) announced steps to improve the Tax Credits system. The Department considers that it has now delivered these commitments and **Figure 11** sets out the action taken.

2.43 The Department is working on an improved business design to deliver tax credits in the future. This now forms part of the Department's Transformation Programme. It aims to deliver a tax credit service which is clearly understood and trusted by customers, so that they can rely on it to support them in raising their children and returning to work. It is also aligning that delivery with Child Benefit where appropriate. The Department also aims to ensure the right customers receive the right money at the right time, through a range of services and communications that is tailored to meet their individual needs and circumstances.

2.44 The Department has started to tailor the service it offers to claimants to suit different circumstances and is piloting new arrangements over the next few months. It has already piloted a Service Improvement Module focusing on the needs of those who need to make a new claim following the breakdown of the household which ended an earlier joint award. A second pilot involved proactive questioning to gather details of changes in circumstance to ensure the Department is advised of all the relevant facts.

11

Status of PMG's May 2005 improvements

Commitment

Review the effectiveness of information provided to claimants, and to reduce the number of cases where people receive unnecessary duplication of award notices.

Test new methods of reminding claimants of the importance of providing up to date in year information on changes in income and circumstances.

Develop options to improve the quality of the helpline service.

Identify IT system problems and processing errors more quickly.

Developing innovative ways of working with the voluntary sector to target more active support on vulnerable families.

Review the operation of the Code of Practice on overpayments, so that recovery can be suspended in cases of genuine hardship, while a disputed overpayment is resolved.

Action taken

Improved award notices introduced from April 2006 with shorter, clearer guidance. The Department has reduced the unnecessary issue of award notices, for example award notices are no longer issued following notification of a change of address.

The Department has improved the information contained in renewal notices to allow claimants to check the changes made in the period of the award.

Messages added to queuing mechanism, reminding claimants which Changes of Circumstances should be reported. The Department has sent targeted mail shots to claimants' most likely to have had a change in their circumstances.

From early 2006-07 improved helpline scripts and improved training of helpline staff. The Department has empowered staff to take more action on cases and piloted a number of improvements in this area.

Review in October 2005 of all known outstanding software problems impacting payments.

Release 9 (October 2006) included changes to increase the ability to detect and correct incidents before they impact customers.

The Department established about a dozen task forces involving members of the voluntary sector. These addressed a range of issues, such as appeals, award notices, backdating of awards, its Code of Practice on recovering overpayments (CoP 26), the tax credits website, complaints and redress etc. In addition, the Department began work with Citizens Advice Bureau on a pilot exercise involving a trial of taking new tax credit claims by phone. A workshop was also held in February 2007 to identify areas of difficulty caused by the tax credit system for intermediary organizations, and to begin the process of addressing those problems.

A Revised Code of Practice was published in April 2006, which included clarification of what is meant by 'reasonable belief'.

The Department now suspends the recovery of overpayments while the dispute is resolved.

Source: HM Revenue & Customs

Handling complaints and disputed overpayments

2.45 The Department has established procedures for handling complaints, which are set out in its fact sheet: 'Complaints and putting things right'. It distinguishes between complaints and disputed overpayments.

Complaints

2.46 Claimants can make complaints to the Department about the service provided. If claimants are unhappy with the Department's initial decisions they can ask it to review their case again. If claimants are unhappy with the way the Department has handled their complaint, they can ask the Adjudicator to review their case. Claimants can also refer their case to the Parliamentary and Health Service Ombudsman (the Ombudsman). **Figure 12** shows the number of complaints made to the Tax Credits Office since 2004-05.

2.47 The Department's Tax Credit Office received complaints in 54,483 cases in 2006-07. Although this represents 55 per cent of all the complaints received in the Department, it is less than one per cent of all tax credit claimants. The Department estimates that 75 per cent of tax credit complaints in 2006-07 relate to its decision on disputed overpayments. The second largest category of complaints received related to delays.

Disputed Overpayments

2.48 The Department has separate procedures to deal with disputed overpayments. The Department's policy is that the claimant should not have to pay back all or part of an overpayment due to a mistake by the Department if it was reasonable for the claimant to think the award was right. **Figure 13** provides details of disputed overpayments received since the Department began to recover overpayments in 2004-05. The Department introduced streamlined procedures during part of 2005-06 to deal with disputes against the recovery of overpayments on the grounds of official error. These led to the increase in overpayments written off in that year.

2.49 The Department aims to deal with disputed overpayments within four weeks. At the end of 2006-07 it had 46,000 disputed overpayment cases on hand.

12 Complaints made to the Tax Credit Office

	2004-05	2005-06	2006-07
Complaints made	47,921	62,686	54,483

Source: HM Revenue & Customs

The Adjudicator and the Ombudsman

2.50 The Adjudicator is an independent person who considers routinely whether or not the Department has applied its discretion appropriately when investigating cases of complaints and redress. In 2006-07 the Adjudicator found wholly or partly in the claimants' favour in 56 per cent of the tax credit investigations completed (74 per cent in 2005-06), as shown in **Figure 14**.

2.51 The Ombudsman continued to receive a large number of complaints about the administration of the tax credit system in 2006-07, and complaints relating to tax credits constituted a large proportion of her work. At the beginning of the 2006-07 year the Ombudsman decided that the Department's complaint handling processing had improved sufficiently to allow her to set up new arrangements for handling tax credit complaints. From April 2006, therefore, she decided to investigate only those complaints that had exhausted the Department's complaints procedure (including a referral to the Adjudicator's Office), those which raised new issues that needed exploring, or cases where other issues made it inappropriate to refer them back to the Department. As a result, she accepted fewer cases for investigation in 2006-07 than in the previous year (120 compared with 404). During the year she reported on 393 cases, some of which had been accepted in previous years, and referred 330 complaints back to the Department under the new arrangements. The proportion of tax credits cases fully or partly upheld reduced slightly from the previous year (74 per cent compared to 90 per cent) although this still remained higher than for other Parliamentary complaints investigated by the Ombudsman (58 per cent fully or partly upheld).

13 Disputed Overpayments

	2004-05	2005-06	2006-07
Disputes received	216,679	364,380	371,282
Number of overpayments written off following the dispute	10,300	160,702	9,912

Source: HM Revenue & Customs

14 Outcome of complaints made to the Adjudicator on tax credits

	2003-04	2004-05	2005-06	2006-07
Complaints made	24	195	569	1,774
Percentage upheld	75%	86%	74%	56%

Source: Annual Reports of the Adjudicator 2004, 2005, 2006 and 2007

Conclusions

2.52 During 2006-07 the Department paid a net £18.7 billion in tax credits and an average of 5.5 million families received provisional 2006-07 awards. The Department estimates that year end adjustments to awards meant it overpaid £1.7 billion and underpaid £549 million in 2005-06. In the first three years since the scheme was introduced, the Department calculates that these adjustments, and other small changes to entitlement after the finalisation of awards, have led to a debt of £6.0 billion. It has also identified £600 million from in year adjustments to 2006-07 awards and will identify further overpayments for this year once awards are finalised. By the end of March 2007 the Department had collected £2.0 billion of this debt and written off £0.7 billion. £3.9 billion of overpayments remain to be collected by the Department. It has provided for £1.6 billion in respect of doubtful debts.

2.53 In the 2005 Pre-Budget Report the Chancellor announced a number of measures which were designed to provide greater certainty to claimants, particularly when families see a rise in income. One important change, for awards for 2006-07 and subsequent years, is the increase from £2,500 to £25,000 of rises in income which are disregarded when finalising awards. The Department estimates that this alone will reduce overpayments by between £400 million – £600 million per annum. The effect of the other changes is harder to establish as they seek to influence claimants' behaviour by encouraging the prompter reporting of changes in circumstances. The Department estimates that the changes together will eventually reduce the value of overpayments by one third. It will publish details on finalised 2006-07 awards in May 2008 which will provide more information on the effect of these measures.

2.54 The Department terminates an award if the claimant does not report their actual income, fails to return a signed award notice or did not qualify for tax credits. The Department has examined a sample of the 228,000 awards terminated in 2004-05 to improve its understanding of claimant behaviour. The Department estimates that some 180,000 of the awards terminated in 2004-05 were due to the claimant's failure to report their actual 2003-04 incomes, although of these 22,000 new awards were subsequently made to the same claimants before the year end. But there was insufficient evidence to conclude why the remaining claimants had not finalised their awards. In the absence of this information it is not possible to discount the risk that some of these claims were fraudulent. The Department is now undertaking a more comprehensive exercise to examine why claimants fail to finalise their awards.

2.55 In June 2007, the Department completed its testing of 2004-05 awards, based on 4,500 random enquiries. As a result of this, the Department estimates that claimant error and fraud resulted in between £1.04 billion to £1.30 billion (7.3 to 9.1 per cent of the final value of awards) being paid to claimants to which they were not entitled. The levels in 2003-04 were £1.06 billion to £1.28 billion (8.8 to 10.6 per cent). It also estimates that claimant error resulted in between £200 million to £350 million (1.4 to 2.4 per cent) not being paid to claimants to which they were entitled. The levels in 2003-04 were £190 million to £280 million (1.6 to 2.3 per cent). These levels are unacceptably high, and whilst the Department has made changes to its compliance procedures since 2004-05, there is currently no evidence to demonstrate a lower estimate for 2006-07. Consequently I have qualified my opinion on the Trust Statement.

2.56 It is important that the Department's work provides an accurate view of levels of error and fraud and it is looking to enhance the quality of this work by using specialist teams to undertake testing. It also needs earlier assessments of the overall level of error and fraud to improve its understanding of the effect of its compliance work.

2.57 In 2006-07 the Department carried out 137,930 checks on claims it assessed as higher risk. It has identified incorrect payments made of £151 million and prevented incorrect payments of £291 million (£250 million and £447 million in 2005-06). The reduction on 2005-06 is primarily due to fewer attacks by organised fraudsters, following the closure of the tax credit internet site in December 2005. The Department is developing a framework for validating the identity of individuals and will only re-open the tax credit internet system once this work is complete, which is unlikely to be before July 2008.

2.58 The Department's compliance examinations affect 2.5 per cent of awards, although all claims are subject to a series of checks before they are put into payment. The Department is now considering a broader range of compliance activity to increase its coverage of the tax credits population, aimed at increasing compliance and reducing levels of claimant error and fraud. The Department will always need to perform checks on claims assessed as high risk before payment to safeguard against error and fraud. The Department is now considering whether, in addition to these detailed compliance examinations, more frequent engagement with other groups of tax credit claimants would assist in the deterrence and prevention of error and fraud across the wider claimant population.

2.59 The Department has taken steps to improve the quality of service provided to claimants. It has a regular programme of enhancements to the tax credits computer system. The initial focus of these was to allow the Department to process new awards, make payments and renew awards. Subsequent software releases focused more on improving the service provided to claimants, for example by improving the information given. Software errors continue to result in some incorrect payments, and the Department has an ongoing programme of work to investigate these. The Department will continue to review the computer system to assess the impact of unresolved errors and it expects to address these through its improvement processes. On 26 May 2005, the Paymaster General announced steps to improve the Tax Credits system. The Department has undertaken a wide programme of work to deliver these commitments.

PART THREE

The collection of Income Tax through Pay As You Earn

Introduction

3.1 Pay As You Earn (PAYE) collects income tax at source from employment and pensions. In 2006-07 the Department collected £125 billion in income tax and £85 billion in National Insurance Contributions through two million PAYE schemes operated by employers and pension providers, in respect of over 50 millions jobs and pensions.¹³

3.2 PAYE is designed to collect the right amount of tax from people during the year, without the need for adjustments after the end of the tax year. During the year the employer calculates the tax due on earnings to date for the year. The Department issues a tax code, where appropriate, for each employee which indicates the amount of tax-free pay allowed. The Department bases tax codes on individual circumstances and revises these where it is notified of changes. The amounts deducted by employers are paid over to the Department each month or quarter. When an employee changes jobs the information about earnings, tax deducted and tax code should be transferred from the old to the new employer. At the end of the tax year, the employer provides a return of the amounts deducted from individual employees' earnings. The Department matches this information to its records and checks whether the right amount of tax has been collected.

3.3 In my Standard Report last year I noted the main challenges for PAYE included:

- The increasing complexity of the employment market. PAYE originated at a time when it was much more common for employees to have a single stable, full-time employment. But there has been a rise in the numbers of people in groups for whom PAYE is more difficult to operate, such as working students, short-term contract agency workers and pensioners. With employees changing jobs more frequently, or holding more than one job at a time, it becomes more difficult to ensure that the right amount of tax

is collected during the year and to ensure that all the necessary information is brought together at the end of the year to check the accuracy of deductions.

- In this complex environment, the Department's computer systems are less well suited to the Department's task of effectively administering PAYE. The main PAYE system, COP (Computerisation of PAYE), was introduced in the 1980s and structures records around jobs, rather than individual taxpayers. The Department can therefore have difficulty in ensuring that taxpayers with more than one source of employment income during the year pay the correct amount of tax.
- At the end of the tax year, employers report to the Department the amounts deducted during the year for each employee and the information is checked against the Department's records. The majority of PAYE cases are cleared automatically, but about 30 per cent of cases cannot, for example, where the information received fails to match to a record or the amount deducted appears incorrect. These 'open cases' need clerical intervention and numbers of open cases have been rising in recent years, partly because the Department uses temporary reference numbers where an employee does not have a National Insurance number or has failed to provide it to his employer.
- In recent years there has been an increasing tendency for employees and employers not to provide the Department with accurate and timely information on income and changes in employment. When an employee changes jobs, they receive a form P45 from their old employer showing details of pay and tax to date and the current PAYE code. The new employer uses these details to make the right tax deductions from pay. However, in 70 per cent of job changes, the new employee does not present a P45 and the employee instead completes a form P46 showing basic information,

such as whether they hold more than one job. The employer therefore applies one of a limited range of codes until the Department has checked the P46 against previous records and issued an updated code.

- The difficulties in operating PAYE have been compounded by inconsistent working practices within the Department. Staff have not always worked cases accurately or followed Departmental guidance, particularly in cases with multiple sources of income and those with benefits in kind.

3.4 Based on sampling exercises, including the quality of its work in dealing with taxpayers with multiple sources of income and those receiving benefits in kind, the Department's Internal Audit has estimated that each year the Department may not be pursuing some £880 million of tax due, and taxpayers are likely to have overpaid around £340 million, resulting in potentially five million taxpayers not paying the right amount of tax. These reviews were undertaken in the period between 2004 and 2006 and provide estimates of the potential impact of weaknesses in the current PAYE schemes. They are not aligned to the Department's current clerical procedures.¹⁴

3.5 In response to these challenges, the Department has:

- introduced more rigorous, standardised working practices including more frequent quality checks;
- prioritised the working of benefits in kind information;
- introduced new computer support tools to improve the accuracy of work on calculating tax codes; and
- put in hand a major change programme to improve computer support for PAYE. In 2008, the Department plans to move PAYE processing onto the National Insurance computer system. It will then be able to structure information around a more complete view of each employee. In the mean time, staff working on PAYE have been given 'view access' to the information held on the National Insurance computer system to enable them to take account of all the information available when working cases. The process of updating records with benefits in kind information has also been automated.

3.6 As part of my work in 2006-07 I have examined the progress the Department has made in dealing with these issues and my report:

- provides an update on the issues identified last year and the actions the Department is taking;
- describes the Department's new governance arrangements for PAYE;

- considers the Department's handling of end of year information provided by employers and the continuing moves to filing online;
- examines the Department's approach to monitoring the quality of PAYE work and the current position on managing open cases;
- comments on the Department's compliance activity in relation to employers' obligations; and
- comments on a newly identified issue relating to the incorrect taxation of small occupational pensions and the action the Department has in hand to rectify the problems.

Action to improve and modernise PAYE

Enhancing PAYE governance

3.7 The administration of PAYE involves a number of business areas within the Department ranging from processing offices through to information technology and debt management. Towards the end of 2006 the Department established a new integrated governance structure to manage the end-to-end PAYE process to improve coordination and enhance collaboration across the different parts of the Department involved in its administration. The new structure includes a PAYE Management Board to ensure the Departments' directorates involved in operating PAYE work together, at a strategic level, to plan, manage and improve the performance of the process. The Management Board prepares an annual delivery plan, sets key performance indicators, and maintains a strategic risks and issues register and monitors and reports progress and addresses any major performance issues arising within PAYE. In addition, the Department has brought together the management of PAYE, Self Assessment and National Insurance into a single directorate.

End of year filing

3.8 Employers pay over to the Department all income tax and National Insurance deducted from employee earnings periodically (normally monthly) throughout the year. The Department receives a lump sum payment for these deductions, without information about the employees to whom they relate, so cannot allocate payments to individual employees. The Department does not demand detailed in year information from employers. PAYE was designed in this way so as to avoid placing an excessive burden on business. The Department can relate tax payments received in the year to employees only when it has received and processed employers' annual PAYE returns. These returns show total earnings, tax deducted and National Insurance Contributions and

statutory payments under each PAYE scheme (form P35) and information on individual employees (form P14). Following the end of the tax year, submissions of P14s and P35s to the Department peak in April and May in the run up to the filing deadline of 19 May.

3.9 The Department reconciles amounts actually received from employers to this information and records income received and tax and national insurance paid by individual taxpayers. Where there is a difference between the tax due and the tax paid or the system fails to match other information on the taxpayer's record, the case is left open to be checked manually.¹⁵ As shown in **Figure 1**, it can take over a year before the Department knows how much tax an individual has paid, and even longer to establish whether that amount is correct.

3.10 Employers also inform the Department of expenses and benefits in kind, such as a company car or private health care, provided to employees in the year. The process for handling this information is partly automated and partly manual. The computer checks the tax paid against what should have been paid. Where there are differences, clerical action is required to make repayments or collect underpayments and to change the tax code for the future so that the taxpayer pays the correct amount.¹⁶

1 Payment and Accounting for PAYE deductions

This diagram shows the time lag between an employee paying tax and the Department establishing from whom the tax has been received. The Department aims to process returns as quickly as possible, but its ability to process returns depends on the quality of information received.

Illustration 6 April: start of new tax year

April 2005 – March 2006: Employer uses the tax code as provided by HMRC to deduct income tax from an employee's salary and pays it over to HMRC, along with National Insurance contributions, by the 19th of the following month. No information about from whom the tax is deducted is provided.

By 19th May 2006: Employer sends HMRC a return (P14 form) showing total income tax and National Insurance paid for the employee for the year.

After May 2006: HMRC processes the return and compares it to expected payment as per taxpayer's record on the PAYE system. Discrepancies will be investigated by local office staff. A small number of cases can take up to a year to resolve.

Source: National Audit Office

Improving the process for filing year-end employers' returns

3.11 In April 2002, the Chancellor of the Exchequer announced that the Government would implement the recommendations of Lord Carter of Coles' Review of Payroll Services to mandate online filing of employers' end of year returns. Employers with 250 or more employees have been required to file end of year returns online from the 2004-05 tax year and employers with 50 or more employees to file online from the 2005-06 tax year. Under Government proposals, employers with fewer than 50 employees do not have to file online until 2009-2010. But in accordance with Lord Carter's recommendations, the Department implemented a scheme of tax free incentive payments to encourage small employers to file online before this time.¹⁷ In 2005-06 over 70 per cent (1.2 million) of the end of year returns received by the Department were sent online. And over 60 per cent (1.1 million) of employers with fewer than 50 employees sent their returns online.

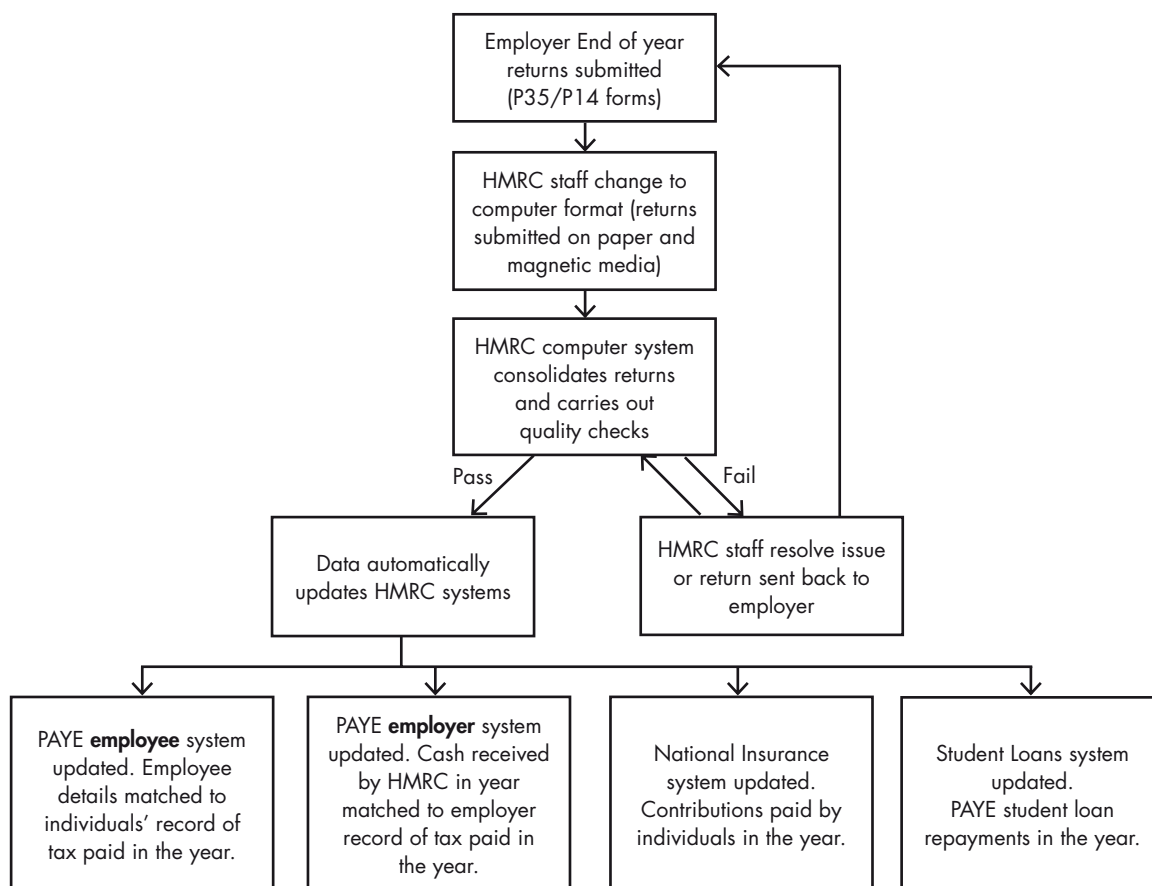
3.12 An overview of the process for submitting end of year returns and how these update the Department's computer systems is shown in **Figure 2**. A key feature of the system is the quality checking applied to employer submissions to ensure P35 and P14 forms are complete and accurate before updating the Department's main PAYE and National Insurance systems. The Department normally refers any forms that fail these checks back to the employer.

The introduction of online filing by employers

3.13 As I have previously reported, the Department encountered difficulties in 2005 with the initial implementation of the computer system to support the online processing of employers end of year returns. Delays in implementing computer changes meant that the system for quality checking and automatically processing returns was not ready until June 2005. The Department had to introduce contingency arrangements to store returns until it could begin processing in June. Because of the delays in the delivery of the full system, the Department decided that it would only contact an employer or send a return back for correction if it could not correct the errors itself. It set up an in-house team to correct those returns that failed the validations because of employer error.

3.14 As this was the first year of online filing, some employers were unfamiliar with the acceptance messages issued under the contingency system for returns received, and sent duplicate returns. The Department also experienced problems where some software used by employers was incompatible with its own system.

2 The end of year process



Source: National Audit Office

3.15 As a consequence of the additional work to clear the processing backlogs the Department's target to process by 31 March 2006 98 per cent of 2004-05 employee details submitted was met one month late. These backlogs also affected wider aspects of the Department's work:

- the PAYE system was delayed in carrying out its check to ensure employees had paid the right amount of tax in the year, increasing the number of open cases (this is discussed in more detail in paragraphs 3.35 – 3.41);
- some records on the National Insurance system were delayed in being updated which meant the Department issued deficiency notices to a number of individuals where their employers scheme had not been processed; and

- the delay in providing up to date information to the Student Loan Company meant that an estimated 50,000 student loan statements for 2004-05 were issued by the Company in September 2006 that incorrectly showed that no repayments had been made.

Improvements for processing 2005-06 returns

3.16 The Department made a number of improvements for the processing of 2005-06 employer returns, involving:

- a programme to educate those employers who had made errors when submitting their 2004-05 returns and the operation of validation rules throughout the process to reject automatically returns which did not meet the Department's quality standards. This helped reduce to five per cent the proportion of returns sent back to employers for correction. The Department estimates that 13 per cent of 2004-05 returns failed to meet its quality standards;

- the production of a revised processing plan, detailing key milestones and targets in the processing of employer year-end returns. The Department operates an End of Year forum, involving representatives from its PAYE, Self Assessment and National Insurance Directorate and other relevant parts of the business, to monitor and oversee performance against the plan; and
- completing its implementation of all the functions provided by the computer system.

3.17 The processing of 2005-06 end of year returns ran more smoothly than 2004-05, as shown by **Figure 3**. By the end of October 2006, just over four months after the deadline for submissions, the Department had successfully processed 86 per cent of the 2005-06 P14 forms, compared with 57 per cent in the equivalent period for 2004-05 returns. At March 2007 there were 1.17 million PAYE taxpayer records which required updating for information on 2005-06 returns – this level is much lower than the position at same time in the previous year (19.2 million).

Progress in processing 2006-07 returns

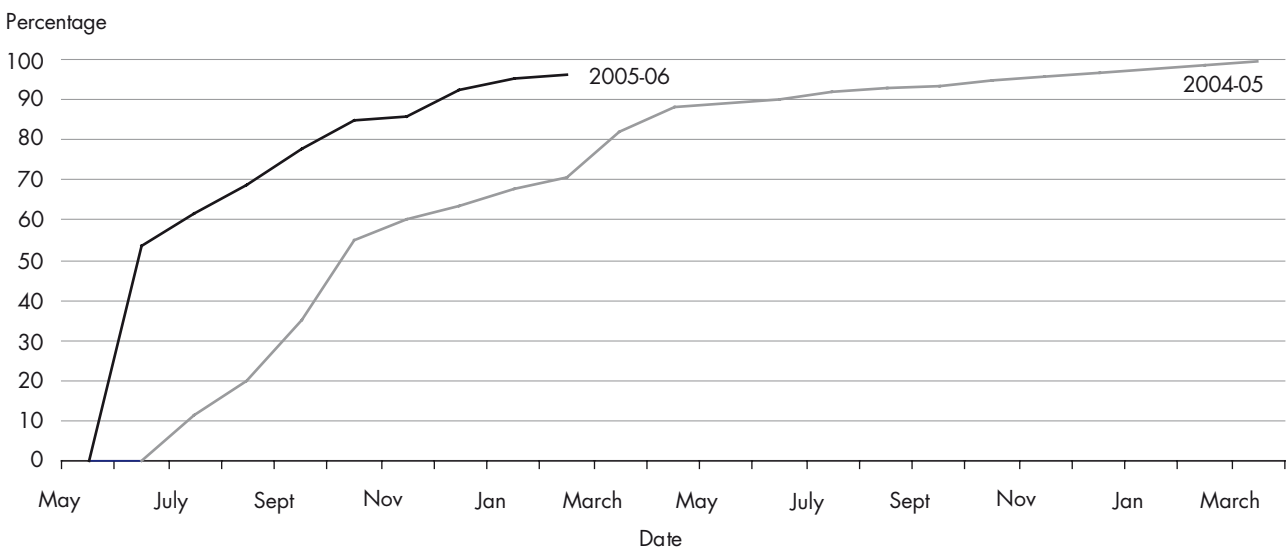
3.18 The Department’s feedback through its contact with employers and software developers is that 2006-07 has been a much more successful online filing year in comparison with the previous two years. More online

returns have been received and the proportion of rejected claims has continued to fall. By 28 May 2007, the Department had received 1.8 million returns for 2006-07 of which 1.4 million were received online. The figure of online returns received at the same time last year for 2005-06 was 1.2 million. 1.4 per cent of returns were rejected with errors for 2006-07 compared with five per cent for 2005-06.

3.19 The Department experienced some problems with the online filing system in 2007, including some agents not being able to access their client’s information on the system for nine days in early May. While the Department resolved these issues reasonably quickly, the impending filing deadline meant this inevitably caused difficulties. Some representative bodies sought an extension to the filing deadline because of these problems. The Department felt this was not necessary because the problem was resolved quickly and because it would not charge employers a penalty if they submitted their return by 28 May under an existing published concession that takes effect every year. The Department believes that no employers were forced to file after 28 May because of these problems.

3 Processing year end returns to the National Insurance system: comparison of 2004-05 and 2005-06

This figure shows the time taken to fully process employers’ end of year returns for 2004-05 and 2005-06. The filing deadline is the 19 May following the end of the tax year.



Source: HM Revenue & Customs

3.20 Although the Department believes that the filing experience for the vast majority of customers was good, it accepts that there are a number of lessons to be learnt around planning, communications and response times and is taking this forward as part of reviewing 2006-07.

3.21 The Department believes that the computer systems introduced in 2005 are now working as designed and are beginning to deliver the improvements in processing that these were intended to bring. The Department began to process information on individuals on 9 April and up to the end of May has processed 70 per cent of returns to the National Insurance computer system. That compares to 20 per cent for 2003-04. The Department has a target to process 98 per cent of P14s received by 31 December 2007, but it currently anticipates it will reach this target by 30 September 2007. This means that individual tax and National Insurance records will be up to date and that individual information is sent to other Departments, such as the Department for Work and Pensions and the Student Loan Company much sooner than in previous years.

Extension of online filing

3.22 A further review of the Department's online services by Lord Carter, published in March 2006, recommended that businesses should be required to file in year returns (forms P45 and P46) electronically, starting with large and medium sized employers from April 2008. Following the consultation process, mandatory online filing was deferred until April 2009 to provide employers with additional time to prepare for the change. Although employers who wish to file online before this time can do so.

3.23 The Department is taking action to ensure the lessons from the introduction of the system for year end returns are taken into account in developing systems for in year filing. The team responsible for implementing Lord Carter's second review has worked closely with – and includes some members of – the team involved in delivering online filing for year end returns. Furthermore, at an early stage in implementing Lord Carter's new recommendations, the Department held discussions around the lessons learned to ensure its plans were informed by earlier experience. Specific examples of lessons learned include:

- making test services available to software vendors six months before any major changes to online services. This follows concerns by vendors that they did not have sufficient time to develop their products for end of year filing; and
- the importance of developing and building a collaborative relationship with software developers, employers and their agents. By building on the

relationships already established, the Department considers it has been better able to understand customer needs and work with its stakeholders to develop ideas for improving the in year process.

Measures to improve the quality of processing

3.24 The Department needs to process taxpayers' information at various stages in the operation of PAYE, for example to adjust a tax code to reflect benefits-in-kind or where an employee changes job. In my 2006 report, I noted that staff had not always been aware of or followed Departmental policies which had resulted in inconsistent practices being followed or inaccurate processing. The Department has introduced a number of measures to improve the quality of its processing.

3.25 In 2004 the Department introduced a spreadsheet based tool, Coding Assistant, to reduce the need for manual calculation of tax codes, which has improved accuracy in coding decisions. While the Department made use of Coding Assistant mandatory in July 2005, there were delays in achieving widespread implementation and it only began to have a major impact in early 2006-07. The Department also operates a quality improvement process within individual processing offices to help managers identify the cause of errors, take action to prevent them recurring and to help staff learn and improve.

3.26 The Department also undertakes a Quality Monitoring Exercise (QME), an independent monthly check on a sample of work across all processing offices, to ensure they meet national standards¹⁹. The results provide managers with timely information on performance, highlighting areas of weakness, and on the effectiveness of the quality improvement arrangements within offices. From November 2005 the Department has performed its monitoring of PAYE processing through QME on a monthly basis, rather than the previous annual basis.

3.27 The majority of PAYE cases are processed automatically, but around 30 per cent require manual processing which is more prone to error. The Department's QME data show that the accuracy rate for all cases (manually and automatically processed) gradually improved from 2002-03, but fell during 2005-06 to 94.7 per cent against a target of 97.5 per cent. 2006-07 results displayed a slight improvement, but still fell short of the target.

3.28 For manually processed cases only, the accuracy rate has declined since 2002-03 to 79.9 per cent in 2005-06, well below the target of 89 per cent. The performance improved during 2006-07 to 82.1 per cent but was still well short of the 91 per cent target. At present almost one in five manually processed cases therefore contains errors with a financial impact on taxpayers. The Department aims to increase the accuracy rate to 93 per cent for 2007-08.

3.29 The fall in accuracy rates stems in part from changes in the caseload. Since 2004-05 certain taxpayers with simpler financial affairs are no longer required to file a Self Assessment tax return. This brings wider benefits but it has increased the volume of more complex PAYE processing as their cases are now processed entirely through this system. 1.15 million cases were transferred in 2004-05 and a further 0.3 million cases in 2005-06.

3.30 The Department has embarked on an initiative within local offices known as "Lean", as part of its Processing Pacesetter Programme. This aims to increase efficiency by eliminating duplication or reworking, improving accuracy, increasing productivity and reducing processing times. One significant aspect of this initiative is the introduction of quality checks by managers to identify errors before they impact on the taxpayer. In 2006 and 2007, following a successful pilot involving three large processing offices, the Department has been rolling out "Lean" to other offices. My report on HMRC: Accuracy in Processing Income Tax [HC 605, session 2006-07] examines in greater detail the Department's levels of accuracy in processing Income Tax, the causes of errors and their impact, and changes underway in the Department to improve the accuracy of processing.

Measures to address processing delays and incomplete information

3.31 In addition to the Department's work to improve the accuracy of its processing work on PAYE information, the Department is taking steps to improve the timeliness of its processing and to provide staff with a better view of individual taxpayers' affairs, taking account of all the information it holds.

Processing benefits in kind information

3.32 The process for handling benefits in kind information is partly automated and partly manual. The computer checks the tax paid against what should have been paid, before clerical action makes repayments or collects underpayments. My 2005-06 report showed that the necessary clerical action was not always being undertaken and computer printouts were not being worked accurately and/or in a timely manner because of competing work priorities. The failure to process benefits in kind information

has contributed significantly to the overall errors in PAYE. Through a sampling exercise, the Department estimates that these failures potentially account for £181 million tax being overpaid and £519 million tax being underpaid, affecting 1.9 million taxpayers.

3.33 The Department has examined how it can improve its performance in response to these findings. It has reminded staff of the need to process this work on a timely basis and has targeted resources at higher risk cases. The NAO visited a number of processing offices and found that the Department had dedicated specific resources to this task. But due to deficiencies in management information systems the Department cannot monitor whether its instructions have increased the number of benefits in kind work items being processed.

3.34 In May 2007 the Department introduced an automated process for managing changes to tax codes for benefits in kind. This should reduce the risk of processing error and of necessary changes not being processed by staff and help ensure that the correct amount of tax is paid sooner. But the actual effect of these changes will not be known until 2008 after it has completed its processing of benefits in kind received in 2007-08.

Managing 'Open Cases'

3.35 'Open cases' are a normal part of the PAYE process but changing employment demographics have increased the numbers generated in recent years. In 2006-07 one million people started work for the first time, there were 13 million job movements and 20 per cent of all jobs lasted less than one year. There were also nearly four million employees with more than one source of income.

3.36 At the year end, the Department's computer system checks whether the tax an employee should have paid in the year is consistent with year-end pay and tax information received from employers. The computer identifies discrepancies or fails to match information to a taxpayer's record in approximately 30 per cent of cases and these open cases must be checked manually. The Department may have to wait some time before it has sufficient information to complete these checks, for example, when it does not have complete employment details. Reasons for open cases arising include:

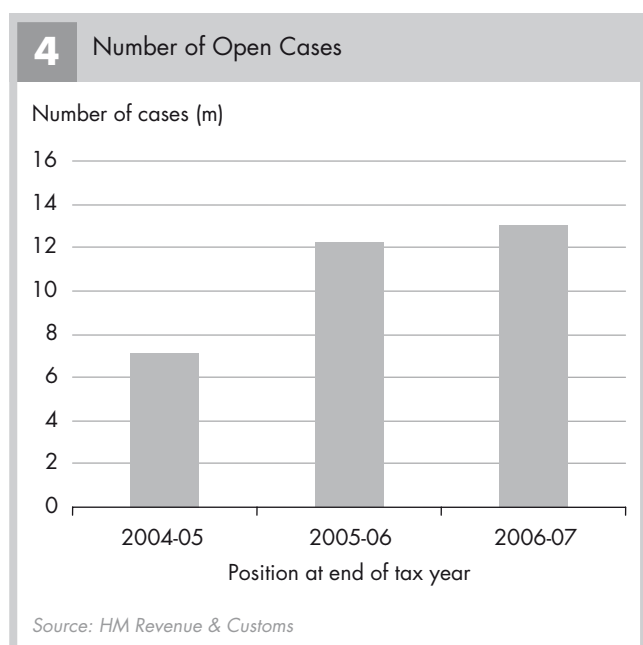
- the Department holding incorrect information on employees because employers provided inaccurate details such as the wrong National Insurance number;
- the employer operated a different code from that on the taxpayer's record; and

- the Department holding incomplete information due to employers and employees not providing the Department with timely and accurate information on changes in employment. This can make it difficult for the Department to obtain a full picture of an individual's employments, particularly where employees leave jobs near the end of year.

3.37 Delays in clearing these records can mean that taxpayers are not notified on a timely basis of additional tax payable or refunds due. The Department's initial business plans for 2006-07 predicted that there would be six million open cases at 31 March 2007. It increased this projection to 10.6 million for a variety of reasons including low take up of overtime. But there were actually 13 million open cases at March 2007 as shown in **Figure 4**.¹⁹ These high levels partly arose because of delays in the system for processing employers' year end returns discussed in paragraph 3.13. In addition the Department was unable to allocate all of its planned staff resources to open case work.

3.38 The Department has taken measures to reduce the number of open cases including:

- redeploying some staff to work on open cases and using staff in other areas to help with the easier cases. It has also offered more overtime for its more experienced staff to help it deal with the more difficult cases; and
- introducing an automated process to bring together information on all the employments of a taxpayer prior to the year-end checks. The Department estimates that this will reduce the level of open cases by 10 per cent.



It expects these measures – along with a greater management focus on clearance of open cases – to reduce the number of open cases to 10.5 million by March 2008.

3.39 The Department's staff need to examine manually each open case to resolve the discrepancy. In 2006, its Internal Audit Office carried out a sampling exercise and found that errors in processing open cases resulted in the wrong tax being paid in 16 per cent of cases. While these errors are high, they have reduced from 26 per cent in 2000-01. The Department estimates some 80 per cent of the errors occur because:

- it failed to bring together all the information it needed to examine the case properly;
- it had not updated the taxpayer's record with information held for their temporary reference number – the Department creates a temporary reference number for each employment where an individual's National Insurance number is not known. Some taxpayers incorrectly have more than one temporary reference number or a temporary reference number in addition to a National Insurance number; and
- it had not adequately maintained taxpayer records, despite its efforts to improve data quality.

3.40 In September 2006 the Department gave around 17,000 staff access to taxpayer information held on the National Insurance system. This aimed to provide PAYE staff with full details of a person's employment history and make it easier to check if the right amount of tax had been paid. It should also assist staff in processing open cases. My staff found this to have been well received by teams in the sample of offices visited.

3.41 The Department believes however that the changes to create a single view of an employees' tax affairs discussed below will help them manage open cases more effectively by reducing the number arising in the first place and giving staff better quality information to process them accurately.

Creating a single view of employees' tax affairs

3.42 The PAYE computer system structures records around jobs rather than individual taxpayers. Currently employment records are held in 12 regional databases. As a result, the Department can have difficulty in ensuring that taxpayers with more than one job or pension pay the correct amount of tax until records are consolidated after the end of the tax year. Based on its most recent analysis of sample data on taxpayers with multiple sources of income, the Department estimates that each year potentially £140 million tax was overpaid and £280 million tax underpaid, affecting some 1.2 million taxpayers.

3.43 The Department recognises that fundamental changes are necessary to address these problems. In April 2007 it introduced automatic consolidation of end of year employee details. This is intended to ensure that more employees with multiple sources of income or who have changed employments during the tax year will pay the correct amount of tax sooner, because manual intervention to check whether tax has been overpaid or underpaid will be needed in fewer cases. In May 2007, the Department also introduced automatic coding of employee benefits in kind to further ensure that employees will be paying the right amount of tax sooner.

3.44 In 2008 the Department plans to move from its Computerisation of PAYE (COP) database to its National Insurance computer system as the basis for administering the PAYE process. This will bring together an individual's PAYE details by reference to their national insurance number irrespective of the number of sources of income, provide a complete view of an employee's income and enable that single view to be maintained more effectively, further enhancing the Department's ability to ensure that the correct tax is paid when there are multiple sources of employment income. The staff view will also have a contact history facility that will record contact with the customer or their employer whether received electronically, by phone or post. In some cases the system will provide an automatic update to the contact history; in other cases staff will update the record themselves. This should mean that the Department provides an improved customer service as staff dealing with taxpayers cases will have a more complete picture of the taxpayers details and be better able to resolve the enquiry in one go.

3.45 On top of all these improvements, in April 2008 the Department plans to introduce new automatic checks on employee starter and leaver information submitted either online or on paper so that the quality of information that goes onto the National Insurance computer system will improve, and result in fewer enquiries to employers and employees.

3.46 Successful implementation should reduce significantly the major source of errors. The Department plans to make the computer changes in 2008-09, the earliest date it considers possible given the scale of migration to a different system and its technical challenges. The Department is taking action to ensure successful implementation by planning the movement of data from the old systems to the new, and planning how to resolve cases that will not transfer. The Department also plans to test the computer system thoroughly before it is introduced.

Taxation of small personal and occupational pensions

3.47 Consultations between the Department and pension providers around the newly implemented arrangements to tax retirement annuity contracts under PAYE have highlighted errors in the taxation of some small personal and occupational pensions which mean that many pensioners have not been paying tax on otherwise taxable pension income and others have been under-taxed. The Department estimates, through a sampling exercise, that of an estimated 8.9 million pensions in payment it has not collected income tax from around 420,000 of these with a potential tax loss of some £135 million per annum as a consequence.²⁰

3.48 The Department believes this problem dates back to 1983 when its PAYE computer system was introduced. At this time it published guidance to pension providers which was not strictly in line with the PAYE regulations and processes. This guidance advised pension providers not to operate PAYE for new pensions when no form P45 was produced by the pensioner and the pension payment was below the basic personal tax allowance. This meant that no form P14s were to be submitted to the Department. Instead, the pension provider was advised to merely retain for three years a list of payments made. The precise rationale for these instructions are now unclear but the Department believes they were introduced as a short term measure to reduce the volume of data needing to be processed at the time PAYE was computerised; but the practice has only recently been withdrawn.

3.49 In addition to this incorrect guidance a number of inappropriate local agreements were made between local tax offices and pension providers to exclude some pensions from tax on a 'de minimis' basis. These agreements varied but, typically were for tax not to be deducted from pensions of £500 or less; this included agreements where NT (i.e. "no tax") codes were operated and P14s were submitted as well as cases where PAYE was not operated at all. In some cases it now appears that the 'de minimis' amounts have been increased over the years, in some cases with the authority of the local tax office and in some cases without. This means that some larger pensions might now be going untaxed.

3.50 In cases where pension providers submit form P14s for individual pensions, the Department should consider if the individual has a tax liability when the pension is aggregated with the pensioner's other income. But as noted in paragraph 3.3, the nature of the PAYE computer system sometimes makes it difficult for the Department to bring together different sources of income for an individual. Many of these P14s were deposited in

a “residual file” to support any subsequent examination of the individuals’ tax affairs. But the Department did not routinely take action to examine these forms.

3.51 The Department first became aware of this issue in April 2005 and it changed its incorrect guidance. But it did not explicitly notify pension providers of the changes and they generally went unnoticed and were not implemented. Furthermore, the Department believes that some of its local offices agreed with pension providers to continue their previous local agreements when they queried the changed instructions. The Department is now engaged on a programme of work to withdraw systematically the incorrect local agreements.

3.52 The Department is now taking the following steps to correct the tax treatment of these pensions which involve:

- determining the number of pensions and pensioners not being fully taxed;
- consulting with the pension providers to fully assess the scale of the problem and establish complete records of all pensions classified as small or de minimis and not being properly taxed;
- developing an action plan to correct the tax treatment at the earliest opportunity. The Department’s decisions on the timescale are influenced by its desire to manage the impact on pensioners who have previously not been taxed or have been under-taxed on their pensions. Furthermore, it needs to provide pension providers with sufficient time to make the necessary changes to their systems. The Department also needs to ensure that its own systems are ready to handle the changes; and
- ensuring that no action is taken to recover tax for years before 2006-07 where, as in the majority of cases, there has been no failure on the part of individual pensioners.

3.53 At the time of my report the Department had not finally yet set its timetable for corrective action but it envisages obtaining P14s from pension providers for all pensions in payment for 2007-08 by May 2008. The changes in the PAYE computer system described in paragraph 3.44 will then consolidate pension records with any other details held in relation to individual pensioners. This would result, for most cases, in correct 2008-09 tax codes (including NT codes where no tax is properly due) being issued to pension providers. It would also allow any 2007-08 tax underpayments to be established and collected in 2008-09 or later years. P14’s which could not

be matched with a taxpayer record would be dealt with as open cases requiring manual intervention (described in paragraphs 3.35–3.41). The Department is developing in parallel a communication strategy to cover this corrective action.

The Department’s compliance activity over employers

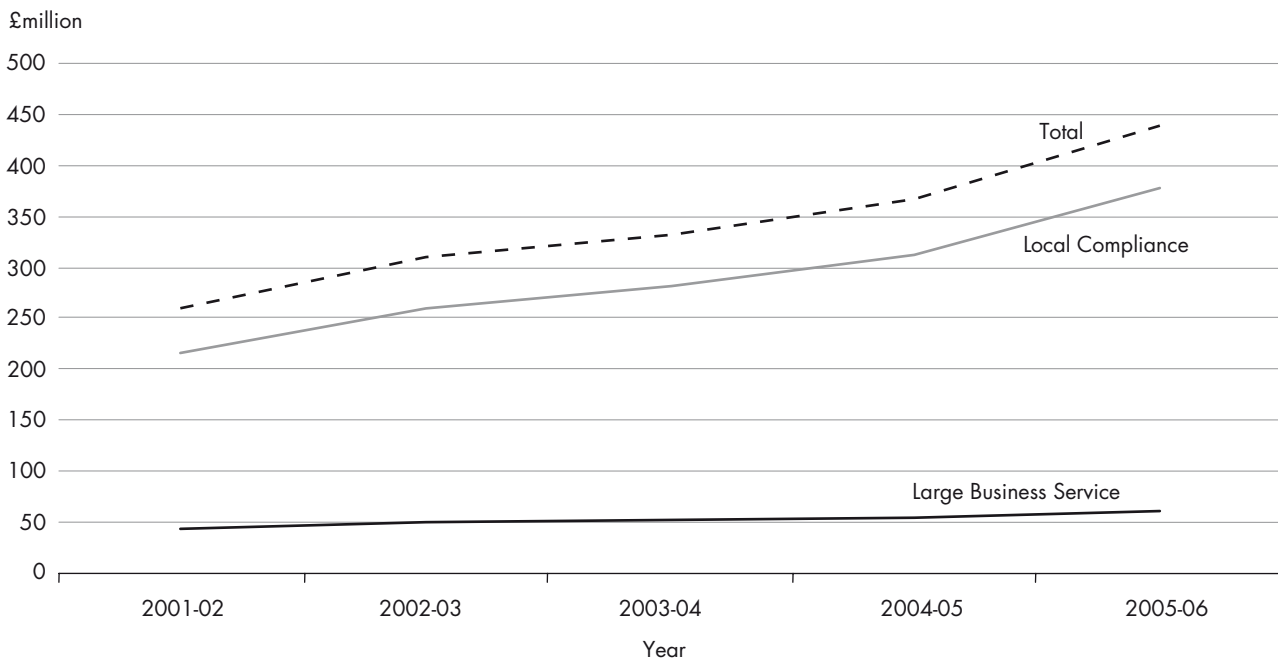
3.54 The Department carries out compliance work to provide assurance that employers are meeting their statutory obligations in operating and collecting PAYE and National Insurance Contributions. The Department’s compliance teams visit selected employers to assess their PAYE processes and, where necessary, sample test underlying records.

3.55 The Department’s Large Business Service (LBS) is responsible for enforcing compliance within the UK’s largest employers. It carries out around 250 reviews each year. The Department’s Local Compliance function is responsible for the inspection of “smaller” employers, and carries out roughly 18,000 reviews each year. Compliance reviews generate additional tax yield where employers made errors in operating PAYE. Another important aspect of PAYE compliance work is the enabling activities performed by review teams, which are designed to help improve employers’ systems and avoid future errors.

3.56 The Department’s statistics show that tax yields from PAYE compliance reviews are increasing year on year, particularly in relation to Local Compliance reviews. As shown in **Figure 5 overleaf**, in 2005-06 the Department generated additional tax of £439 million (£366 million in 2004-05). The Department does not set yield targets for compliance work.

3.57 The Department’s methods of selecting employers for review are regularly evaluated to ensure that employers most at risk of non-compliance are targeted wherever possible. During 2006-07 LBS reviewed its risk assessment processes to make better use of intelligence gathered by Local Compliance teams in identifying employers for review.

5 PAYE Compliance Yield



Source: HM Revenue & Customs

Conclusions

3.58 In 2006-07 the Department collected £125 billion in income tax and £85 billion in National Insurance Contributions through Pay-As-You-Earn (PAYE), the Government's largest source of tax revenue. The Department aims to ensure that individuals pay the right amount of tax on their income and to make it as easy as possible for employers and employees to meet their obligations.

3.59 As I noted in my 2005-06 report, the Department's PAYE computer systems are not well suited to the efficient administration of income tax where people have more than one job or change jobs on a regular basis. This is because the systems structure tax records around jobs rather than individual taxpayers. As a result, the Department can have difficulty identifying all relevant sources of income when calculating tax that should be paid. These difficulties have been compounded by inconsistent working practices within the Department as a consequence of staff not being aware of or failing to follow Departmental procedures, for example when adjusting tax codes for Benefits in Kind. Based on its most recent estimates, each year the Department may not be pursuing some £880 million of tax due, and taxpayers are likely to have overpaid around £340 million, resulting in potentially five million taxpayers not paying the right amount of tax.

3.60 During 2006-07 the Department introduced a number of measures to improve the quality of PAYE processing. It has mandated use of a spreadsheet tool to improve accuracy in coding. It has also operated a quality improvement process to help managers identify the cause of errors, take action to prevent them recurring and to help staff learn and improve. This consists of independent monthly checks across all processing offices to provide better information on overall performance against national standards. The Department has embarked on an initiative within local offices known as "Lean", as part of its Processing Pacesetter Programme. This aims to increase efficiency by eliminating duplication or reworking, improving accuracy, increasing productivity and reducing processing times. The Department's data shows that in 2006-07 the accuracy of processing improved in comparison with the previous years, but still fell short of target.

3.61 The Department has also taken steps to improve the timeliness of processing and ensure it takes into account all the information it holds on a taxpayer. It has dedicated resources to dealing with benefits in kind cases, but weaknesses in management information prevent it from assessing the effect on processing. For 2007-08 the Department has introduced a process to automate the coding of benefits in kind information which should further improve the timeliness and accuracy of processing by reducing manual intervention. It also introduced a process to reduce the number of open cases automatically generated. These measures should improve the timeliness of

processing, but in the absence of management information it is difficult to assess their effect. During 2007-08 the Department should quantify the success of these measures in reducing levels of error.

3.62 The Department recognises that real improvement in the operation of PAYE can only be achieved through fundamental changes in its computer systems. It therefore plans to move to its National Insurance computer system as the basis for administering the PAYE process. From 2008-09 this will allow all information on individuals to be brought together under their national insurance record and provide the Department with a complete view of a taxpayer's employment income.

3.63 The Department did not fully implement on time its new computer system to support the online filing of employers' 2004-05 year end returns. The system to validate and process online returns was not ready until June 2005, a number of weeks after the 19 May filing deadline. The Department implemented contingency arrangements to allow it to receive returns, but as a result the Department could not notify employers if their submissions were successful, identify returns that failed to meet quality standards, or accurately identify employers who missed the filing deadline. Because of these delays the Department accepted responsibility for resolving problems with returns, rather than referring them back to employers. But this caused significant pressures within the Department to deal with the resulting backlogs and meant some of the information needed to support the processing of individual records on the PAYE, National Insurance and student loans system was not available.

3.64 The Department made improvements for processing 2005-06 employer returns, involving identifying returns which did not meet quality standards; providing employers with better guidance; completing its implementation of all the functions provided by the computer system; and developing a comprehensive plan for processing returns. By the end of October 2006, just over four months after the deadline for submissions, the Department had successfully processed 86 per cent of the 2005-06 P14s, compared with 57 per cent in the equivalent period for 2004-05 returns. The number of returns that failed to meet its quality standards fell from 13 to 5 per cent. Early indications show that the 2006-07 online filing season has been more successful than the two previous years with 1.4 million returns received online, compared to 1.2 million for 2005-06, and 1.4 per cent of returns rejected with errors.

3.65 The Department has recovered from the problems encountered in 2004-05, but the measures needed in 2005-06 highlight the weaknesses of the original implementation. The Department needs to ensure it applies the lessons learned when extending the system to small employers and in-year filing. In particular it needs to ensure the system is fully developed and tested before it is introduced, external users are educated and supported in use of the system, and processing is supported by clear plans.

3.66 Since the early 1980's some pension providers have not deducted tax under PAYE from all pensions in payment. This is due to a combination of incorrect central guidance from the Department, inappropriate local agreements and failures by local offices to implement agreed procedures. The precise rationale for this is now unclear, although it is likely that these decisions were taken because staff did not consider the effect to be material against the administration savings for the Department and pension payers. But the Department now estimates this means it is potentially not receiving income tax from 420,000 pensions and its current estimate is that the tax loss is around £135 million per annum. The Department first became aware of this issue in April 2005 and corrected its guidance. But it did not explicitly notify pension providers of the changes and they generally went unnoticed. The Department has now begun a systematic programme of work to put these pensions on a proper footing but it does not intend to recover tax which has not been deducted in previous years. The Department also needs to consider where else it has made judgements not to collect tax on the grounds of size and how it can obtain better assurance that its local offices are following central guidance. It also needs to ensure that when it changes guidance, this is accompanied by a wider programme of work to bring this to the attention of those affected and undertake compliance work to ensure these changes are implemented.

PART FOUR

The collection of Income Tax, National Insurance and Capital Gains Tax through Self Assessment

Introduction

4.1 Taxpayers with a number of sources of income and with less straightforward financial affairs are required to complete Self Assessment returns to establish how much Income Tax they should pay. These include the self employed, business partners, company directors, landlords, those with foreign income and any others with 'complex tax affairs'. In 2006-07 the Department issued Self Assessment returns to 8.7 million self employed and higher rate PAYE taxpayers, 570,000 partnerships and 225,000 trusts and the Department collected £26.6 billion (after repayments) income tax, class 4 National Insurance Contributions and Capital Gains Tax through the system.²¹

4.2 The Department's objective is to provide a good service to customers and to the Exchequer by making the obligation to self assess as easy as possible for taxpayers to understand and comply with. It operates an online Self Assessment service and taxpayers are encouraged to file their tax returns electronically. The Department has two main Public Service Agreement targets for Self Assessment relating to the timely receipt of returns and online filing. In 2006-07, the Department did not meet its target for the percentage of self assessment returns filed on time, but exceeded its target for the percentage of returns filed online as shown in **Figure 1**.

4.3 This part of my report considers how the Department administers Self Assessment. It examines how it manages the receipt and processing of returns, the enquiries it undertakes, how it ensures taxpayers comply with their obligations and its procedures for handling repayments and collection of debt.

The Self Assessment process

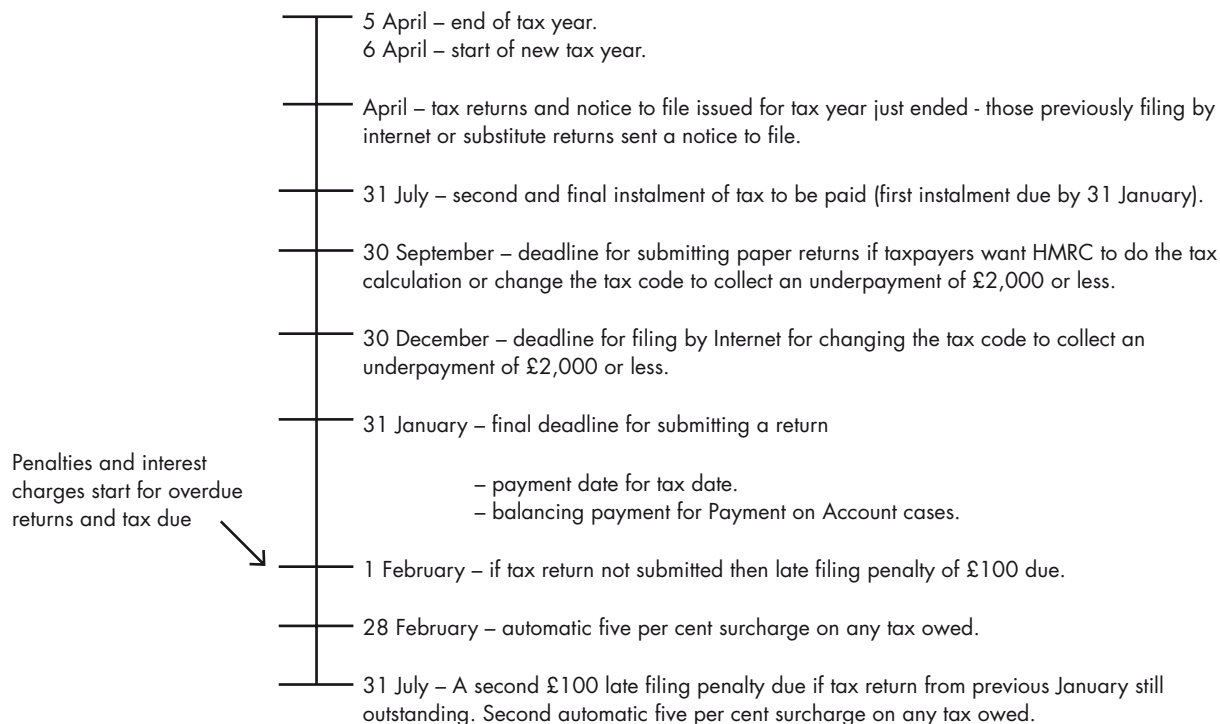
4.4 The introduction of Self Assessment represented a major change in the administration of tax for those who receive tax returns. Under this system, the primary responsibility for calculating the tax liability shifted from the Department to taxpayers. Taxpayers are required to complete returns to establish how much income tax they should pay and to provide the Department with the information it needs to validate this calculation. The Department estimates that approximately half of Self Assessment taxpayers use an agent to complete their return (ranging from tax professionals to relatives). Taxpayers have a statutory obligation to submit their returns for the preceding tax year by 31 January. The Department operates a statutory penalty regime for taxpayers who fail to meet this deadline. The timetable for filing returns is set out in **Figure 2**.

1 HMRC's targets for the filing of Self Assessment returns

Target	2004-05		2005-06		2006-07	
	Target	Result	Target	Result	Target	Result
By 2007-08 increase the percentage of Self Assessment returns filed on time to at least 93 per cent	90.6	90.6	90.6	90.3	91.5	89.2
By 2007-08 increase the percentage of Self Assessment returns filed online to 35 per cent	Not set	16.8	25	24.3	29	35.1

Source: HM Revenue & Customs

2 Self assessment timeline



Source: HM Revenue & Customs

4.5 The Department processes the information included in returns to record the taxpayer's self assessment and to calculate the tax payable or repayable, and provide PAYE taxpayers with an accurate tax code. This process is generally automated where returns are received online. But the Department has to manually enter information into its computer systems where it receives paper returns.

Recent improvements to the Self Assessment Process

4.6 The number of taxpayers having to file Self Assessment returns increased from 8.5 million in 1996-97 to 9.5 million in 2003-04. In 2004-05, the Department revised the criteria for including people within Self Assessment and removed over one million from the system, mainly employees and pensioners with very straightforward financial affairs. The Department's efforts to reduce the Self Assessment population have been largely offset by increasing numbers of self employed taxpayers and highly paid employees. In 2006-07 9.5 million individuals, partnerships and trusts were required to submit returns.

4.7 In 2005 the Department further simplified the Self Assessment process by introducing a short tax return and simpler guidance for people with simple tax affairs.

The Department issued this four page return to around 1.5 million Self Assessment taxpayers for the 2006-07 tax year.

4.8 The Department has a project to introduce a re-designed main tax return from 2007-08 (which will be first issued in April 2008). It aims to reduce the burden on taxpayers by introducing a simplified return that is easier to complete and to provide guidance that is easier to understand. This will also reduce the number of pages that some taxpayers are required to complete.

Self Assessment governance

4.9 The administration of Self Assessment involves a number of business areas within the Department, ranging from teams processing returns and undertaking compliance enquiries to collecting debt and providing computer support. In 2006, the Department established a new integrated governance structure to manage the end-to-end Self Assessment process to improve co-ordination and enhance collaboration across the different parts of the Department involved in administering the process. The new structure includes a Self Assessment Management Board to ensure the Department's directorates involved in operating Self Assessment work together, at a strategic level, to plan, manage and improve the performance of the process. The Board prepares an annual delivery plan, sets

3 Self assessment requirements by taxpayer

Taxpayer category		Type of return to be filed	Number of people 2006-2007
<i>Complexity of financial affairs</i>			
Very simple	Employees and pensioners with very straightforward affairs who largely pay most of their Income Tax due through Pay As You Earn.	Not required	29 million
Simple	Some employees who receive other income, the self employed with turnover of less than £15,000, some pensioners, people with property income in the United Kingdom below £15,000 and people receiving saving and investment income.	Short Return* (four pages)	1.1 million
More complex	Some higher rate employees who may also receive other income, the self employed with turnover of greater than £15,000, pensioners, people with property income in the United Kingdom above £15,000 and people receiving saving and investment income from overseas.	Full Return* (10 pages, plus supplementary pages for certain taxpayers)	7.6 million

* But taxpayers may instead choose to file online returns.

This table does not include partnerships and trusts.

Source: HM Revenue & Customs

key performance indicators and maintains a strategic risks and issues register. It then monitors and reports progress against the plan and the indicators and addresses any major performance issues arising within self assessment. Whilst there is close liaison between the Department's compliance function and the Self Assessment Management Board, compliance is not part of the formal governance structure.

4.10 In addition, the Department has brought together the management of PAYE, Self Assessment and National Insurance into a single directorate.

Getting Self Assessment returns in

4.11 Taxpayers are legally required to submit a Self Assessment return when the Department issues a tax return (which includes a notice to file) or a notice to file. The Department issue a paper return only to those who are expected to submit a paper return. It issues notices to file to people who have previously filed online or used a computer generated substitute. Taxpayers are also legally required to notify the Department if they have untaxed income or capital gains and the Department has not issued a Self Assessment return.

Filing on time

4.12 Each year around 10 per cent of taxpayers fail to meet the 31 January statutory deadline for filing. The Department has introduced a number of measures to encourage taxpayers to file returns on time, it:

- performs the tax calculation for taxpayers who submit returns by the end of September;
- runs advertising campaigns reminding taxpayers of the key filing deadlines; and
- contacts by letter or telephone a number of taxpayers within groups who had either previously filed late or are new to self assessment

4.13 In 2006-07 around one million taxpayers did not submit returns by the 31 January deadline and the Department failed to achieve its target of 91.5 per cent of returns filed on time, as shown in **Figure 4**. The results were also lower than those for the previous two years. The Department is undertaking research to identify if there is any particular group or factors that explain the performance, but its preliminary analysis suggests that the shortfall was due to:

- reduced media advertising in 2006-07, compared with previous years; and
- a temporary, and now resolved, problem in the process that loads individuals' details into the Department's automated dialling system restricted the Department's telephone campaign to remind some individuals new to Self Assessment of their obligations to submit a return. The problem meant that instead of the intended target audience of 312,565, the Department was able to make contact with only 80,000 people. But the Department was able to select and attempt contact with a further 773,000 taxpayers in other groups (for example, those who had filed returns late in an earlier year).

4 Self Assessment returns processed for the preceding tax years

Processing Year	2003-04		2004-05		2005-06		2006-07	
	Millions	%	Millions	%	Millions	%	Millions	%
Issued by HMRC	9.47		9.84		9.08		9.28	
Filed by 30 September	4.3	43.6	4.4	44.0	3.72	39.7	3.54	37.3
Filed by 31 January	8.58	90.6	8.91	90.6	8.20	90.3	8.28	89.2
Filing Target* (93% by 2007-08)	–	90.6	–	90.6	–	90.6	–	91.5
Outstanding at 1 February	0.89	9.4	0.93	9.4	0.88	9.7	1.00	10.8

* The filing targets are for 31 January, as specified in PSA1,4 (Spending Review 2004). The 2003-04 filing target was set in Spending Review 2002.

Source: HM Revenue & Customs

It has also been recognised that achievement of the Department's filing target of 93 per cent by 2008 would be a challenge for the Department, principally because filing performance relies heavily on taxpayer behaviour and also because of the changes in criteria in April 2004 which have removed over 1.6 million taxpayers from self assessment. These taxpayers had relatively simple tax affairs and a better record for filing and paying on time.²²

4.14 As shown in **Figure 5 overleaf**, there is significant increase in filing around the 31 January deadline, which puts pressure on the Department to process these returns. It is probably inevitable that there will always be a last minute rush whenever the deadline.

4.15 In 2008 the Department will be introducing a series of measures recommended in Lord Carter's review in 2006 of HMRC's Online Services to increase the number of taxpayers who file electronically and help to manage the peak pressures:

- the deadline for filing paper returns is being brought forward to 31 October without changing the 31 January deadline for filing electronic returns, to provide an incentive for online filing;
- the Department will withdraw approval for computer generated paper 'substitute' returns. Currently around 1.6 million 'substitute' returns for individuals are filed, almost exclusively by agents; and
- the window for the Department to enquire into returns will change from 12 months from the 31 January filing deadline to 12 months from the date the return is filed. Lord Carter considers this might remove a perceived disincentive to file returns early.

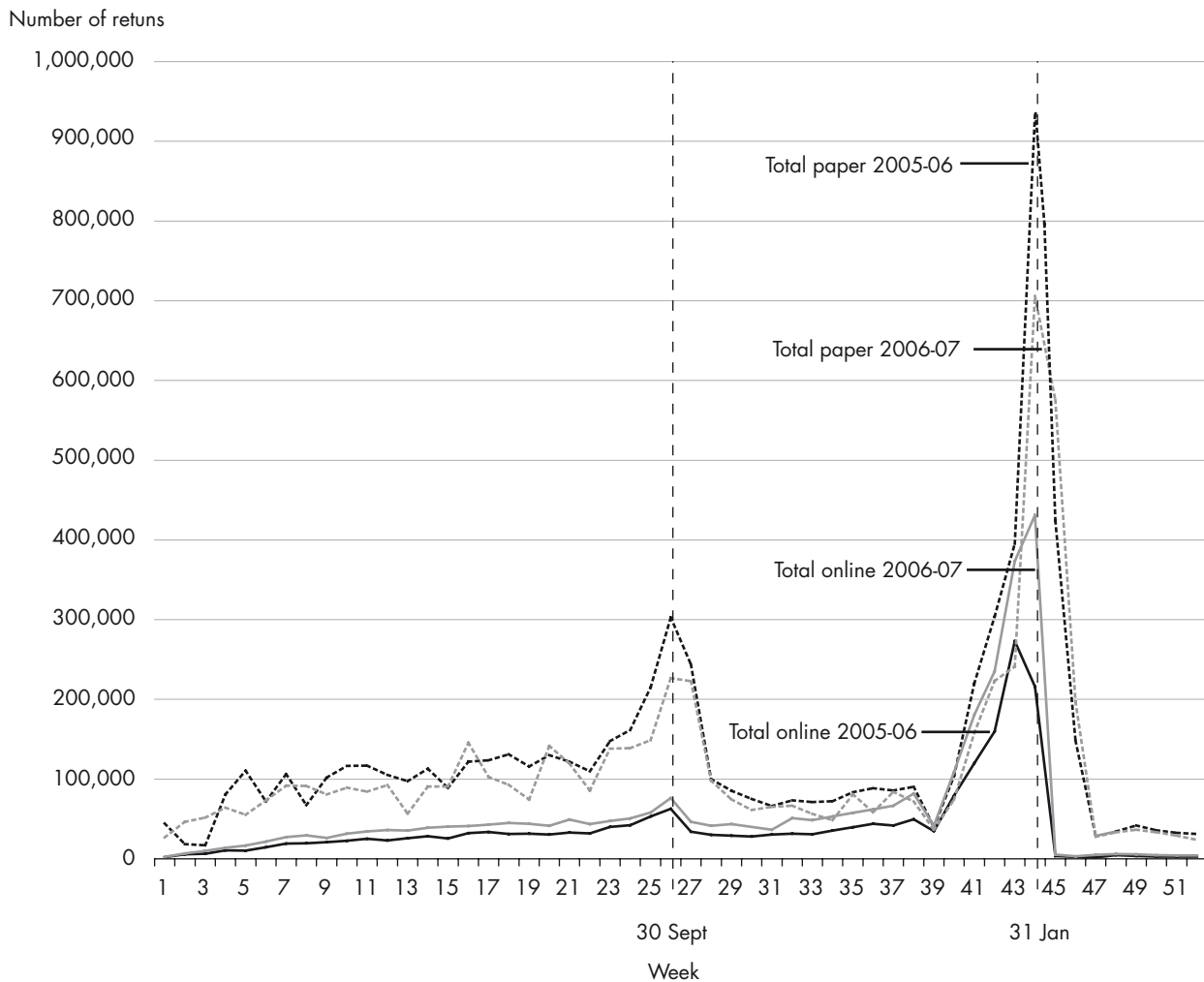
Filing returns online

4.16 In 2000 the Department introduced an internet based system for filing of Self Assessment returns. This aimed to increase the efficiency with which the Department processes returns, and free up resources from time spent on processing and error correction, to focus on more complex activities such as compliance and customer support. It also aimed to help taxpayers fulfil their obligations accurately and more quickly.

4.17 The vast majority of taxpayers have the opportunity to file their returns online for free using the Department's online product. But this only currently supports the main tax return and the most common supplementary pages. Taxpayers who are required to complete less common supplementary pages, for example those with capital gains or foreign income, do not have access to free online filing. These taxpayers have to file returns on paper or purchase third party software which supports online filing of the large majority of supplementary pages. The Department is planning to extend its online product to include the Capital Gains and Foreign income supplementary pages from April 2008. There is no online version of the short tax return but the online system does provide a tailored version of the return and taxpayers may use it as an alternative to the paper short return.

4.18 There has been a continuing increase in levels of online filing since the system was introduced and in 2006-07 2.9 million taxpayers filed their return this way. As shown in Figure 1, although the Department slightly missed its target in 2005-06, it exceeded its target in 2006-07, with 35.1 per cent of returns filed online. The Department believes this upsurge in online filing is due to:

5 Self Assessment returns filed during 2005-06 and 2006-07 by week



Source: HM Revenue & Customs

- the increased importance given to online services within the Department's marketing campaigns, both specifically for Self Assessment and the service as a whole;
- increasing reliability and resilience of the online service;
- increasing acceptance of this channel by agents; and
- the general trend for more complicated transactions being undertaken on the Internet as broadband penetration and confidence with the internet increases throughout the UK population.

Penalties for late filing of returns

4.19 In accordance with legislation, the Department has a penalty regime to deter late filing of returns. It issues £100 automatic fixed penalties to taxpayers who submit their returns after the filing deadline. If the return is filed late, the Department will cap this penalty to nil if it is established there is no tax liability or if a repayment is due. The penalty will also be capped to the amount of liability due if this is less than £100. A second automatic £100 penalty is charged if a return is more than six months late. If the return is more than a year late, the taxpayer may be charged a penalty of up to 100 per cent of the tax due on the return, in addition to having to pay the tax itself. **Figure 6** shows the number of penalties issued and the amount paid since 2003-04.

4.20 An additional measure to encourage late filers to submit outstanding returns is the use of daily penalties. These penalties can be up to £60 per day for each return outstanding and are charged when the return has been outstanding for more than 12 months and the Department believes that fixed penalties alone will not result in someone filing their return. The Department can also impose a determination (estimate) for an outstanding return and daily penalties can be raised where the determination is paid but the return remains outstanding. The Department seeks approval to apply daily penalties from the General Commissioners on a case by case basis. Since October 2003 the Department has pursued almost one million returns through the daily penalty process, as shown in **Figure 7**. In the period from October 2003 to March 2007 the number of daily penalties raised was 153,105 which has generated additional Tax of £329 million.

4.21 After gaining approval from the Commissioners, the Department warns taxpayers that daily penalties will be imposed if they do not file returns within 14 days. In 306,444 cases the threat of imposing daily penalties by the issue of a letter was sufficient to bring in outstanding returns without having to resort to actually imposing penalties.²³

Processing Self Assessment returns

4.22 The Department processes all self assessment returns to establish if taxpayers have paid the right amount of tax and to recover additional amounts due or to repay any overpayment. It also updates taxpayers' records and, in PAYE cases, individuals' tax codes to ensure that the right tax is deducted from employees' future earnings. This process is largely automatic where returns are

6 £100 automatic late filing penalty notices

	2003-04	2004-05	2005-06	2006-07
Number of penalties issued*	1,640,267	1,715,775	1,658,883	1,735,241
Penalties capped (£0 - £99.99)	932,168	980,913	1,056,212	916,565
Penalties cancelled on appeal	215,851	233,731	190,407	152,795
Penalties after capping and cancellation on appeal	492,248	501,131	412,264	665,881
Amounts received at October Balance Date**	£37.7m	£37.3m	£39.4m	Not yet known

* These figures include second automatic penalties.

** Amounts received cover penalties issued for all years and all penalty types.

Source: HM Revenue & Customs

7 Self Assessment – daily penalties

	Returns pursued through daily penalty process	Returns received following notification of intention to impose daily penalty	Returns where daily penalties were imposed	Additional Tax generated £ million
2003-04 (October to March) ¹	183,236	82,263	10,416	50
2004-05	304,792	198,597	37,451	111
2005-06	261,066	195,691	59,154	96
2006-07	220,561	149,636	46,084	71.6*
Total	969,655	626,187	153,105	328.8

* Part year to January 2007 due to the yield reporting process.

Source: HM Revenue & Customs

NOTE

¹ HMRC did not hold data linking returns received and tax assessed to daily penalties raised prior to October 2003 and the extent to which daily penalties were paid prior to this.

received through the internet, but the majority of returns are still submitted on paper and staff need to manually enter the information from these into the Department's computer systems. If the Department spot an obvious mistake, such as arithmetical errors or carry forward of the wrong figure from one box to another when processing the return they will repair it.

4.23 The Department operates a Quality Assurance/Quality Control improvement process to help managers in processing offices to identify the causes of errors, take action to prevent them recurring and help staff learn and improve.

4.24 In addition, the Department has also stepped up its monitoring of processing accuracy. Its Quality Monitoring Exercise (QME) is an independent monthly check on a sample of work across all processing offices to ensure they meet national standards. The results provide managers with timely information on performance, highlighting areas of weakness. It also provides an indication of the effectiveness of the QA/QC arrangements. From November 2005 the Department has performed its monitoring of Self Assessment processing through QME on a monthly basis, rather than on an annual basis as in previous years. The Department has taken a number of steps to improve the accuracy of its processing of Self Assessment returns. In 2005 it introduced a coding tool to reduce the need for manual calculation of tax codes and improve accuracy in coding.

4.25 The Department's QME data show that since 2001-02 the accuracy rate for processing Self Assessment returns has ranged between 72 and 75 per cent, including tax and non-tax errors. From 2004-05 processing accuracy has improved and in 2006-07 the Department achieved processing accuracy of 78.1 per cent; this was however short of its target of 84 per cent.

4.26 Processing accuracy rates have been much higher when assessed against their tax effects. In 2006-07 the Department accurately processed 96.5 per cent of Self Assessment returns, compared to its target of 97 per cent. Extrapolated across all Self Assessment returns filed, this indicates that around 300,000 returns were processed with some level of error by the Department in the tax due. The Department estimates that the gross value of errors in tax assessments resulting from internal inaccuracies in processing filed returns was £198 million (£54 million undercharges and £144 million overcharges). These amounts are reduced to £79 million (£33 million undercharges and £46 million overcharges) following the correction of errors and likely corrections for cases which are subject to ongoing correspondence or further review.

4.27 The Department has also embarked on an initiative within local offices known as 'Lean', as part of its Processing Pacesetter Programme. This aims to increase efficiency by eliminating duplication or reworking, improving accuracy, increasing productivity and reducing processing times. One significant aspect of this initiative is the introduction of quality checks by managers to identify errors before they impact on the taxpayer. In 2006 and 2007, following a successful pilot involving three large processing offices, the Department has been rolling out "Lean" to other offices.

4.28 My report on HMRC: Accuracy in Processing Income Tax [HC 605, session 2006-07] examines in greater detail the Department's levels of accuracy in processing Income Tax, the causes of errors and their impact, and changes underway in the Department to improve the accuracy of processing.

Enquiring into Self Assessment returns

4.29 Those taxpayers who are required to file a return are responsible for providing the Department with complete and correct information about their tax affairs in their annual return. The Department has a statutory right to enquire into any return and it can open an enquiry into a return at any time within one year from the filing deadline of 31 January. From April 2008 the window for opening an enquiry will change to one year from the date the return is filed. For returns filed late, it has up to 15 months to open an enquiry. After this, the Department cannot amend the taxpayer's self assessment, unless new facts come to light, undisclosed in the tax return, which show that insufficient tax has been paid.

4.30 The Department performs "full enquiries" or partial enquiries on aspects of certain Self Assessment returns. Full enquiries cover all parts of a return. Most of these are selected following a risk assessment, but the Department also randomly selects around 6,000 returns each year for a full enquiry. "Aspect enquiries" focus on specific elements of a return. There are mandatory reviews for returns with certain features, although the vast majority are chosen following a risk assessment. If a return appears fundamentally incorrect after an aspect enquiry has been opened, this may be converted to a full enquiry.

4.31 **Figure 8** shows the results of the Department's compliance enquiries. The Department has reduced the number of enquiries undertaken in recent years, as part of the development of its wider risk strategy and risk assessment processes. The Department aims to focus on the non compliant and reduce administrative burdens on compliant taxpayers and has increased total and average yields from its work. The increased

yield from aspect enquiries in 2006-07 relates in part to the settlement of enquiries into a number of Employee Benefit Trust cases. Full enquiries generate higher yield than aspect enquiries, but are more resource intensive to undertake. The Department can learn about trends in non-compliance from analysis of enquiry results but for a fuller understanding it needs the results of the random enquiry programme.

Tax at risk from inaccurate returns

4.32 The Department assesses the accuracy of filed returns through an annual random enquiry programme. Based on the latest results available from the programme for 2001-02, 67 per cent of returns were filed accurately by registered Self Assessment taxpayers, slightly under the Department's target of 70 per cent. The Department estimates this meant that between £2.5 billion and

£3.2 billion tax was at risk in 2001-02 due to inaccurate returns. As shown in **Figure 9**, levels of non-compliance have been stable over recent years, with approximately one third of taxpayers not fully complying with their obligations each year.

4.33 The results of the random enquiry programme suggest that each year around 15 per cent of taxpayers are non compliant by less than £500, as shown in Figure 9. But the extent of non compliance greater than £1,000 has been gradually increasing and 13 per cent of taxpayers were non compliant by more than £1,000 in 2001-02, although some of the increase is due to increases in incomes. Further analysis of the results indicates that around five per cent of Self Assessment taxpayers account for three quarters of the tax at risk. Furthermore, some 40 per cent of the tax at risk is due to one per cent of Self Assessment taxpayers.

8 Self Assessment compliance enquiries

Enquiry type	2003-04	2004-05	2005-06	2006-07#
<i>Full enquiries</i>				
Actual	42,000	38,000	34,000	29,000
Yield*	£194m	£200m	£221m	£278m
Average yield per case	£4,619	£5,263	£6,500	£9,586
<i>Aspect enquiries</i>				
Actual	176,000	159,000	139,000	132,000
Yield*	£274m	£320m	£355m	£788m
Average yield per case	£1,557	£2,013	£2,554	£5,970

Figures for 2006-07 not yet finalised.

* Yield is shown in HM Revenue & Customs Annual Report.

Source: HM Revenue & Customs

9 The Self Assessment Random Enquiry Programme

Measure	1998-99 %	1999-2000 %	2000-01 %	2001-02 %
Compliant	67	69	68	67
Non compliant, of which non-compliance by value:	33	31	32	33
£1 to £500	18	15	15	15
£501 to £1,000	5	5	5	5
over £1,000	10	11	12	13
Total tax at risk per annum	£3.1 bn	£2.4 bn	£2.7 bn	£2.8 bn

Source: HM Revenue & Customs

4.34 My staff examined a sample of enquiries conducted by the Department and found that these involved a detailed examination of the risk of non-compliance. But the random enquiry programme covers only registered taxpayers, and is not intended to provide an estimate of under-declared income from people working in the informal economy or taxpayers who are engaged in other employment for which they are not declaring their income. My staff noted that the Department's teams also identify taxpayers who made errors in their returns which result in them paying too much tax, but the Department does not provide an analysis of the number of taxpayers affected in this way or quantify the amounts involved.

4.35 The usefulness of the information from the random enquiry programme is limited by the time required to complete the work and produce results. This lead time is because the Department can only open an enquiry when a return has been filed and even a straightforward case can take several months to conclude as individuals need sufficient time to provide information. Some of the more complex cases can take several years to complete, but are more likely to be non compliant and are therefore needed to establish overall levels of error.

4.36 In the absence of up to date information on the overall levels of non compliance, it is more difficult for the Department to assess the overall effectiveness of its enquiry programme or its more recent initiatives to combat risks on certain taxpayer groups. The Department is currently reviewing the work it carries out on random enquiries with the aim of ensuring that the resource involved in examining these cases is being used as effectively as possible.

Helping Self Assessment taxpayers pay the right tax

4.37 The Department provides help and advice for taxpayers in completing and filing their Self Assessment return. Taxpayers can use the Department's website to obtain information and ask questions using structured enquiry forms, or contact telephone call centres and help lines for assistance with queries and to seek advice. They may write to their own tax office or make an appointment to visit an enquiry centre to discuss their Self Assessment return and seek advice. The Department has published guidance to accompany the tax return and further material such as "Self Assessment – your guide" to answer likely questions, which is also available on the website.

Complex Personal Tax teams

4.38 The Department has established specialist teams to provide a tailored approach to certain sectors of the Self Assessment population. It has established Complex Personal Tax teams which deal with individuals with complex tax affairs and also inward expatriate employees and their employers.

4.39 In 2003, the Department created Complex Personal Return (CPR) Teams to deal with the tax affairs of individuals with both a high level of income (over £200,000 per annum) and some element of complexity about their Self Assessment tax returns. Examples of complexity include high levels of income from land and property, high levels of foreign income, and large capital gains. The teams deal with all aspects of the customer's personal tax affairs including processing, correspondence and enquiries. Each customer is allocated a personal caseworker who will deal with their tax affairs and act as the first point of contact between the Department and the customer or the customer's adviser. In 2003-04, Complex Personal Return taxpayers represented less than 0.5 per cent of all Self Assessment taxpayers, but provided over 10 per cent of the tax collected through Self Assessment.

4.40 These teams undertake a more rigorous examination of Self Assessment returns received, which is designed to reflect their complexity. Before April 2007, every CPR tax return received an annual compliance and risk review, which was used to decide whether an enquiry or other intervention is required. This process forms part of the Department's risk assessment and is unique to CPR teams. From April 2007 following a restructuring exercise, the Department has created a central risk team within its Complex Personal Tax teams which is responsible for running projects to identify high risk returns that require a full manual risk assessment. But each return will still be risk assessed (as part of an annual risk review) at the capture stage. The NAO found that the yield generated from this work demonstrated the impact of dedicating more resource to undertaking rigorous risk assessments at an early stage and carrying out more detailed and effective enquiries on individuals with complex tax affairs

4.41 In 2003, the Department also created specialised teams to deal with the tax affairs of inward expatriate employees and their employers. The Department considers these individuals need specialist attention because they may have complex and substantial remuneration packages and the tax at stake is relatively large. Decisions on taxation can also depend on foreign legislation and on interpretations of treaties between countries.

4.42 The Department generates yield as a result of undertaking detailed enquiries on returns. As shown in **Figure 10**, yield has increased significantly since these teams were created and they have exceeded their targets. This has arisen from better targeting of work and increased staff resources, which allows more thorough and larger numbers of enquiries.

Other initiatives to improve compliance

4.43 In 2004, the Department introduced a new initiative (Minor Queries) whereby it proactively contacted certain taxpayers or their agents by telephone with queries on returns submitted. In addition to correcting obvious errors where the right answer is clear, it makes calls to clarify entries on the return – for example illegible entries or transposed figures, or a misunderstanding of the purpose of boxes in the return – in order to correct minor mistakes. These early interventions are intended to correct errors without the need for a formal enquiry and the resolution of these queries can result in adjustments in favour of either the taxpayer or the Department. The Department estimates that this initiative generated £36 million in the three years up to March 2007, against its target of £78 million. A number of factors contributed to the shortfall. Initially there were delays in getting staff in place and training them and a new information system was needed to manage their work. More significantly, responsibility for doing the work transferred to processing staff who were not responsible for meeting the yield target. In May 2007 the Department streamlined the process for correcting obvious or minor errors to allow compliance teams to examine cases in a more structured way.

4.44 The Department is increasingly using leverage letters to encourage taxpayers to comply with their obligations. These involve writing in advance to selected groups of taxpayers to highlight common errors or reacting to more specific issues that may emerge from their returns. By subsequently monitoring these individuals the Department can measure the effectiveness of each

campaign and target its action towards those individuals who remain non compliant. In 2005-06 the Department issued 171,859 leverage letters (117,280 letters in 2004-05) which generated yield of £17 million (£7 million in 2004-05). The Department also considers that such letters generate a ‘correction’ effect in the following years as taxpayers are more likely to comply in the future.

4.45 The Department operates a statutory penalty system to discourage taxpayers from submitting incorrect returns. It can charge the full amount of the error as a penalty, although the Department often uses abatements depending on the seriousness of the offence. But the penalty charged is effectively open to negotiation which inevitably leads to inconsistency. In recent years the level of abatements has risen and there is little difference between penalties for neglect and more serious cases of fraud. The Department has also found that whilst the arrangements are understood by tax advisers, they are not visible or easily understood by taxpayers. In the 2007 Budget the Government announced a new approach to penalties for incorrect returns.²⁴ This aims to make a clear distinction between those who make a genuine mistake – who will not incur a penalty – and those who deliberately understate their tax liability.

4.46 The Department has received information about certain offshore bank account holders with UK addresses and has evidence to suggest that a number of these people have not declared the source of the income or the interest as taxable income. In April 2007, the Department introduced a disclosure facility which encourages voluntary disclosure of such offshore bank accounts. Where taxpayers meet the terms of this facility, tax penalties are limited to 10 per cent of the tax due. The Department has also indicated that it will continue to make enquiries based on this information in cases where a voluntary disclosure is not made. The Department is unlikely to seek penalties of less than 30 per cent where irregularities are established.

10 Specialist Teams Enquiry Performance

	2003-04	2004-05	2005-06	2006-07
CPR Teams				
Target Yield	Not set	£54 million	£77 million	£134 million
Actual Yield	£36 million	£56 million	£78 million	£197 million
Expats Teams				
Target Yield	N/A	£24 million	£47 million	£80 million
Actual Yield	N/A	£25 million	£57 million	£102 million

Source: HM Revenue & Customs

Reform of the Construction Industry Scheme

4.47 In 1972, the Government established a special tax deduction scheme to deal with the practice, endemic in the construction industry, of engaging workers on a “cash in hand” basis. A revised Construction Industry Scheme was introduced in 1999, but this suffered from problems and businesses were concerned about the costs to them of operating it.

4.48 The Department introduced changes to the Construction Industry Scheme (CIS) in April 2007, which mean that:

- Subcontractors will no longer be required to present cards or certificates to a contractor in order to be paid. On engaging a subcontractor who has not been paid by them in the current or previous two tax years the contractor must contact the Department to ascertain whether the subcontractor should be paid gross or net (and at what deduction rate).
- The contractor will make payment to the subcontractor in accordance with the net or gross instructions given by the Department.
- Contractors will submit monthly returns to the Department listing all payments, whether gross or net, made to subcontractors and including a declaration that the subcontractors listed are not engaged under contracts of employment.
- Where the subcontractor has been paid under deduction, the contractor must provide him with a statement confirming the amounts paid and deducted.
- Contractors can now use electronic channels for meeting their CIS obligations.

4.49 The Department’s intention is that the new scheme will reduce the burden of operating the scheme on the construction business, improve the industry’s compliance with its tax obligations and help the industry get the employment status of its workers right.

Making tax repayments

4.50 Repayments arise when the tax paid - on account or by deduction at source (for example through PAYE) – exceeds the individual’s tax liability. In 2005-06 £4.2 billion repayments were made to some 2.7 million Self Assessment taxpayers.

4.51 Self Assessment repayments are generated automatically following the processing of the Self Assessment return. They are subject to routine automated

checks and in certain cases or areas of particular risk the Department may specifically verify the repayment before it is made.

4.52 A lack of formalised accountabilities historically made it difficult for the Department to establish central oversight and responsibility over repayments. As I noted in my 2004-05 report on the accounts of the Inland Revenue, no individual in the Department had overall responsibility for repayments and no individual was specifically responsible for repayments under each tax stream. Deficiencies in management information also made it difficult to establish the degree to which controls could prevent or detect error and irregularities. As a result, in 2005 the Department established a Departmental Steering Group, chaired by the Director of Finance. Progress in making improvements has been slower than anticipated and the Department is now reviewing the existing governance arrangements for repayments and has initiated work to develop options for improvement. But the new integrated governance arrangements for Self Assessment have clarified accountability for repayments.

4.53 In the spring of 2006 Internal Audit reported that there were continuing weaknesses in the Department’s operation of self assessment repayment processes. They found that in 2004-05 the Department’s calculations of amounts to be repaid were incorrect in 11 per cent of cases. Extrapolating the results of their sample, Internal Audit estimated that taxpayers had been overpaid £176 million and underpaid £34 million. In response to these problems, the Department has established new arrangements to provide assurance that Departmental instructions are being followed by staff.

Unsolicited Self Assessment returns

4.54 Some taxpayers submit Self Assessment returns to the Department even though none has been requested. This is usually because they have a new source of income or a chargeable gain during the year. The Department receives over 200,000 “unsolicited returns” each year.

4.55 The Department has evidence of organised criminal activity to obtain fraudulent repayments, some of which have involved “unsolicited returns”. Since the Department first became aware of these systematic attacks it has disrupted one particularly virulent example which involved 50 purported tax agents, 14,000 false Self Assessment returns and potentially £34 million in false repayments.

4.56 The Department is seeking to counter the known attacks. It has created an Income Tax Self Assessment Repayments Delivery Group to design and implement

process and other changes to reduce risks to the repayments process and develop specific interventions to counter remaining risks. In April 2007, the Department introduced changes to enable processing staff to identify unsolicited returns more easily so that in appropriate cases they can be closely checked before any repayment is made. The Department is also reviewing the effectiveness of its existing automated checks on repayments to better identify high risk repayments for further checking, and is considering using enhanced risk profiling for repayment fraud using data from different Departmental systems. The Department has informed me that it recognises the need to be vigilant given the constant changes in the methods used to perpetrate organised fraud and that it is committed to fully engaging with HM Treasury to ensure a joint understanding of the potential Exchequer risks.

Collecting Self Assessment Debt

4.57 Taxpayers are usually required to make two payments on account based on their tax liability for the previous year. The first is payable by 31 January before the end of the current tax year and the second by 31 July after the end of the tax year. Any outstanding balance of tax is payable by the following 31 January. Some taxpayers, such as employees who pay most of their income tax through PAYE, are not required to make payments on account and have only to pay any outstanding balance of tax by the following 31 January.

4.58 If a taxpayer fails to file a return, the Department can issue a determination estimating the amount of tax to be paid.

4.59 In 2006-07, 88.5 per cent of Self Assessment taxpayers paid the amounts owed on time, against the Department's target of 89.8 per cent. The Department considers that it did not achieve its target because some of the individuals removed from Self Assessment had a better record for paying on time, as noted in paragraph 4.13. Furthermore increasing number of self employed taxpayers have been brought into Self Assessment and the Department's experience is that those new to the system tend to be less compliant. In 2007-08, the Department plans to further develop its operational targets for reducing debt.

4.60 The Department charges interest and surcharges where tax is paid late. Interest is charged on any tax not paid at the 31 January payment date. A five per cent surcharge is also payable on any tax which remains unpaid at 28 February. The Department imposes a further five per cent surcharge on any remaining tax outstanding after 31 July.

4.61 Figure 11 provides an analysis of the age of self assessment debt at 31 March 2007. The vast majority of debt has been outstanding for more than two months. The Department is satisfied that the proportion of debt outstanding for more than one year is being actively managed through legal proceedings, agreed arrangements to pay debt over time and through its efforts to trace individuals.

4.62 As shown in Figure 12, average monthly Self Assessment debt increased from £2.7 billion in 2004-05 to £3.1 billion in 2006-07. The Department considers that this increase is due to:

- economic growth, which has resulted in higher levels of underlying Self Assessment receipts; Self Assessment receipts have risen from £23.4 billion in 2005-06 to £26.6 billion in 2006-07;
- increased use of determinations (estimated tax demands) in an attempt to secure returns and payment from non-payers and non-filers; and
- the recent transfer of Self Assessment debt into the Department's automated debt management systems means that it issues determinations much earlier than it had been able to do so in the past and some amounts are reflected in the debt balance much sooner.

11 Self Assessment Debt Age Profile at 31 March 2007

Age of Debt	Debt £bn	Proportion %
Less than 2 months old	0.18	5
Between 2 & 12 months old	1.99	56
Greater than 12 months old	1.41	39
Total	3.58	100

Source: HM Revenue & Customs

12 Self Assessment Debt

Year	Self Assessment Receipts £ bn	Average Monthly Debt £ bn
2004-05	21.84	2.68
2005-06	23.43	2.89
2006-07	26.59	3.13

Source: HM Revenue & Customs

4.63 If a taxpayer disputes an amount due under Self Assessment then the Department suspends this debt from collection. If the taxpayer has a legal right on appeal to apply for postponement of the amount due, then the Department records this as a formal standover. The Department also can informally standover debt, where circumstances require a temporary suspension of enforcement action. As shown in **Figure 13**, the value of stoodover debt has also steadily increased over recent years. This growth has arisen for the same reasons that have driven the overall growth in self assessment debt levels. At the end of October 2006, over £1 billion was in dispute and was not legally collectible. Of this, £502 million has been stoodover for more than two years and £216 million over one year.

4.64 A recent analysis of amounts stoodover has shown there were some 85,000 cases of stoodover tax totalling £1.113 billion at May 2007. 114 of these items relate to some £500 million of tax, almost half of the total amount stoodover. The Department is taking action on these and a high percentage are with its Special Civil Investigations Office.

4.65 In 2006, Internal Audit examined the Department's arrangements for reviewing stoodover debt to see if they were being examined regularly by the Department and concluded there was a high risk that the Department's work in this area was not being progressed in a timely and appropriate manner. In addition to the risk of poor service to the taxpayer, delays in processing stoodover debt can make it harder for the Department to subsequently collect debt and potentially lead to a loss of revenue. Internal Audit plan further work in 2007 to quantify the full financial risk.

4.66 The Department has sought to improve Governance in these areas. It has set up a cross Departmental working group tasked with specifically reviewing stoodover debt. This aims to improve the measurement of stoodover debt, develop targets and plans to reduce it and confirm it is being correctly treated and subject to regular management review.

Conclusions

4.67 Self Assessment was introduced in 1996 for taxpayers with a number of sources of income and with less straightforward financial affairs. It now affects 8.7 million self employed and higher rate PAYE taxpayers, 570,000 partnerships and 225,000 trusts. In 2006-07 the Department collected £26.6 billion tax through the system, after repayments. In 2006-07, 88.5 per cent of Self Assessment taxpayers paid the amounts owed on time, against the Department's target of 89.8 per cent. The average monthly debt owed to the Department in 2006-07 was £3.1 billion, an increase of £250 million on the previous year.

4.68 The Department has changed the Self Assessment process to ease the burden on certain taxpayers. Since 2004-05 the Department has removed 1.6 million taxpayers with very straightforward affairs from the system, although this reduction has been largely offset by increasing numbers of self employed and highly paid employees coming into the system. In April 2005 the Department simplified the Self Assessment process for nearly 1.5 million people with simpler tax affairs by issuing a new Short Tax Return.

13 Self Assessment Tax Stoodover

Date	Self Assessment Tax due for collection £ billion	Self Assessment Tax Stoodover £ million	As a percentage of Self Assessment Tax due for collection %
October 2001	24.8	611	2.5
October 2002	26.3	595	2.3
October 2003	25.8	628	2.4
October 2004	26.7	790	3.0
October 2005	29.2	873	3.0
October 2006	30.7	1,031	3.4

Source: HM Revenue & Customs

4.69 The administration of Self Assessment involves a number of business areas within the Department, ranging from teams processing returns and undertaking compliance enquiries to collecting debt and providing computer support. In 2006 the Department established a new integrated governance structure to manage Self Assessment, which aims to improve coordination and enhance collaboration across the different parts of the Department involved in administering the process. These arrangements therefore provide a more effective basis for administering Self Assessment. But the structure does not include the Department's compliance activities over Self Assessment. The Department should consider the scope for the closer integration of compliance.

4.70 Online services offer considerable benefits in the efficient and effective administration of tax and Self Assessment has been at the forefront of the Department's drive to engage with the taxpayer through the internet. The Department has made significant progress in increasing the percentage of returns filed online and is currently meeting its target of 35 per cent of Self Assessment returns to be filed online for 2007-08.

4.71 In 2006-07 around one million taxpayers did not submit their returns by the 31 January deadline and the Department failed to meet its target that 91.5 per cent of returns were filed on time. The results were lower than those for the previous two years. The Department's early analysis suggests that this was primarily because of reduced media advertising in 2006-07 and problems with its campaign to contact taxpayers new to Self Assessment. In addition to learning from its experience in 2006-07, the Department should examine the effectiveness of the existing penalty regime and consider whether new or greater sanctions are needed to change taxpayer behaviour.

4.72 The Department operates a penalty system to discourage taxpayers from submitting incorrect returns. The Department often uses abatements depending on the seriousness of the offence, but the penalty charged is effectively open to negotiation which inevitably leads to inconsistency. In recent years the level of abatements has risen and there is little difference between penalties for neglect and more serious cases of fraud. The Department has also found that whilst the arrangements are understood by tax advisers, they are not visible or easily understood by taxpayers. In the 2007 Budget the Government announced a new approach to penalties for incorrect returns. This aims to make a clear distinction between those who make a genuine mistake – who will not incur a penalty – and those who deliberately

understate their tax liability. These reforms should help the Department better tailor its approach to address the underlying taxpayer behaviour.

4.73 The Department assesses the accuracy of filed returns through an annual random enquiry programme. Based on the latest results available for 2001-02, 33 per cent of returns were filed inaccurately. The Department estimates this meant that between £2.5 billion to £3.2 billion tax was at risk in 2001-02 due to inaccurate returns. Some 40 per cent of the tax at risk relates to one per cent of taxpayers. The Department should target groups who are more prone to non-compliance, for example partnerships and sole traders.

4.74 The Department has reduced the number of compliance enquiries undertaken in recent years, although the yield generated from this work has increased. The Department has also established specialist teams to tailor its approach to the Self Assessment population, including individuals with complex tax affairs and inward expatriate employees and their employers. The yield from this work has grown consistently over recent years and exceeds the Department's targets. But not having up to date information on total levels of tax at risk reduces the Department's knowledge of overall non-compliance. The Department recognises the need to make earlier and more regular assessments of tax at risk to assess the effectiveness of its compliance activities, inform its risk assessment process and identify new areas for targeting compliance resources. The Department has formed the Risk and Intelligence Service to help take this work forward.

4.75 Self Assessment repayments are generated automatically following the processing of self assessment returns. A lack of formalised accountabilities has historically made it difficult for the Department to establish central oversight and responsibility over repayments, including the extent to which agreed controls were being operated. Deficiencies in management information have also made it difficult to establish the degree to which these controls could prevent or detect error and irregularities. The Department has evidence of organised criminal activity to obtain fraudulent repayments, sometimes using unsolicited returns. It introduced improved controls in April 2007 to specifically monitor unsolicited returns and is reviewing the effectiveness of its existing automated checks for identifying high risk repayments which require checking before they are made. It needs to closely monitor the success of these measures in deterring organised crime.

PART FIVE

Value Added Tax

Introduction

5.1 This part of the report examines the management of Value Added Tax (VAT) by HM Revenue & Customs. VAT is levied on the supply of goods and services within the United Kingdom and Isle of Man. Registered businesses incur VAT on the goods and services they purchase (input VAT) and, subject to partial exemption restrictions, can recover the cost against the VAT charged on the sale of their own goods and services (output VAT), or if there is an excess by reclaiming a repayment from the Department. VAT is, therefore, ultimately paid by the consumer. In 2006-07 net VAT revenue totalled £85.5 billion, an increase of £11.8 billion on the previous year (**Figure 1**).²⁵ This was primarily due to the success of the Department's operational strategy in tackling missing trader fraud and spending growth. Of the £85.5 billion, approximately £19.0 billion came from VAT on imports.

Statutory Framework for VAT

5.2 The EU Principal VAT Directive provides the general legislative framework for European Member States to administer.²⁶ Member States are required to enshrine the provisions of the Directive in national law so as to ensure a harmonised approach to operating VAT systems across

the European Union. In the United Kingdom these basic rules are implemented by the Value Added Tax Act 1994 (as amended).

5.3 Under the VAT Act 1994, traders are required to register for VAT if their taxable business turnover has exceeded a defined threshold in the previous twelve months, or is expected to exceed the threshold in the next 30 days. From 1 April 2007, the taxable turnover threshold for compulsory registration was increased from £61,000 to £64,000. The threshold for allowing businesses to deregister their VAT obligation also increased from £59,000 to £62,000.²⁷ Traders operating below the threshold can apply for voluntary registration, providing the business trades in goods and services that are 'taxable supplies' for VAT purposes (or would be taxable supplies if they were carried out in the UK). Similarly, those intending to carry on a business trading in goods and services that would be 'taxable supplies' for VAT purposes (or would be taxable supplies if they were carried out in the UK), can also apply for registration.

5.4 Member States may set the level of their standard rate of VAT, subject to a minimum of 15 per cent. They may also apply either one or two reduced rates of VAT on a range of specified goods and services, subject to a minimum of five per cent. In addition, the UK is able to maintain a zero rate of VAT provided for under special transitional provisions dating from the introduction of VAT in the UK. There are currently three rates of VAT applicable in the UK:

- a standard rate of 17.5 per cent charged on the supply of all goods and services unless specifically relieved;
- a reduced rate of five per cent which applies, for example, to supplies of domestic fuel and power, certain renovation and alteration of dwellings, residential conversions and the installation of energy-saving materials; and

1 Annual VAT Yield Figures

Year	Net VAT Yield (£ billion)
2003-04	71.1
2004-05	74.2
2005-06	73.8
2006-07	85.5

Source: HMRC Annual Accounts

- a zero rate which applies, for example, on the supply of items such as food, passenger transport, books and printed matter, and children's clothes.

The Directive also provides for certain exemptions from VAT. Examples of VAT exemptions in the UK are: finance; insurance; education; and health and welfare.

Developments on Missing Trader Fraud

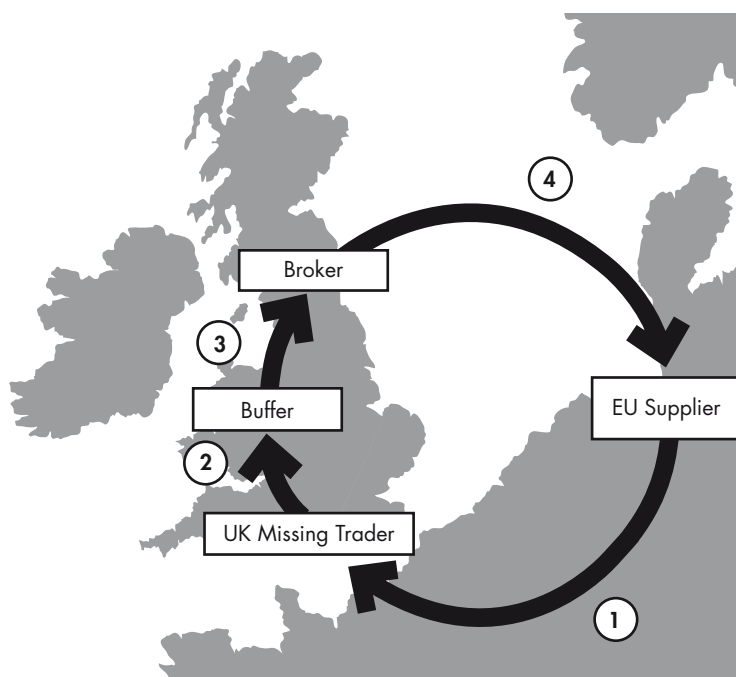
5.5 This section provides an update on how the Department is tackling missing trader fraud.²⁸ In its simplest form the fraud involves a business obtaining a VAT registration number in the UK for the purpose of purchasing goods, VAT free, from other EU Member States. The business then sells the goods at a VAT inclusive price in the UK and disappears without paying the VAT to the Department. In its most abusive form, commonly referred to as carousel fraud, traders sell the same goods repeatedly through contrived supply chains involving other traders in both the UK and other Member States of the European Union (**Figure 2**).

5.6. The Department has been tackling missing trader fraud since 2000. Its early strategy focussed, among other things, on registration checks, targeted compliance visits, criminal investigations targeted at the organisations that are persistently attacking the VAT system, and working with the European Union and other international partners

to raise awareness of the fraud and to improve information exchange and cooperation. Despite these measures, the level of attempted fraud reached a new peak in 2005-06 when the Department estimated it at between £3.5 billion and £4.75 billion. However, as a significant proportion of these attempted frauds were stopped, the actual cash loss was estimated at between £2 billion and £3 billion.²⁹ The Department, in response to the increase in fraudulent activity, introduced further operational and legislative interventions to strengthen the strategy.

5.7 During 2006-07 the Department re-deployed 700 staff to verify a greater proportion of VAT repayment claims received from traders suspected of participating in missing trader fraud. Using a risk based approach, the Department's aim is to only repay those amounts due to be paid, and to deny repayments where there is no entitlement or that entitlement is disallowed due to knowledge of fraud in supply chains. The Department's position was strengthened by the European Court's judgement in the 'Kittel' case, where the Court ruled that VAT repayments could be denied where there was evidence that the trader knew or should have known that the transactions formed part of the overall scheme to defraud.³⁰ The Department's operational indicators show that this, together with other measures, has significantly reduced attempted fraud in 2006-07.³¹

2 An example of a simple VAT missing trader fraud chain



Source: National Audit Office

1. An EU supplier from another Member State sells goods for £1,000,000 to a trader based in the UK free of VAT. Sales of goods between VAT registered companies in the EU are zero-rated for VAT.

2. The trader sells the goods to another trader commonly known as the buffer at a reduced price of £900,000 plus £157,500 VAT. In order to avoid the price of the goods spiralling upwards each time the carousel turns, one business in the chain must sell at a loss. Following an intensive period of trading the initial UK trader goes missing without paying the VAT due to HMRC.

3. The buffer accounts for VAT correctly and sells the goods to a trader at the end of the UK chain, termed the broker, for £950,000 plus £166,250 VAT.

4. The broker makes a zero-rated VAT sale back to the original EU supplier for £970,000 and is entitled to reclaim the input VAT of £166,250 on the goods purchased from the buffer. HMRC pays the claim and incurs a cash loss because the missing trader did not pay the VAT due on the sale to the buffer.

5.8 Around 95 per cent of traders whose returns have been selected under the current verification programme, have been found to be either participating in or profiting from trading linked to missing trader fraud. Repayment claims have either been identified as not properly being due, or because of sufficient suspicion are continuing to be investigated. Moreover, so far only one per cent, by value, of the VAT withheld under this programme has been found to be correctly claimed and properly payable. The Department can, whilst the verifications are being undertaken, make repayments if security or a bank guarantee is provided. Additionally, repayments can be made on transactions which are clearly not linked to fraudulent activity, e.g. business overheads.

5.9 In December 2005 the Government submitted a request to the European Commission to derogate from the Sixth VAT Directive and introduce a 'reverse charge' on goods commonly used in missing trader fraud, such as mobile phones and computer parts together with other electronic goods, for example MP3 players and digital cameras. Under this measure VAT would not be charged on the sale of these goods between businesses. Instead VAT would only be collected on retail sales to final consumers, therefore removing the opportunity for criminals to engage in missing trader fraud. The European Commission supported the application and agreed that the reverse charge should be applicable until 31 December 2009.

5.10 In April 2007 the Council of the European Union authorised the Government's request to introduce the 'reverse charge'. However, it is only applicable until 30 April 2009 at which point its continued use will be reviewed by the Commission.³² In addition, the scope of the derogation is limited to sales, over £5,000, of mobile phones and computer chips.³³ Prior to its introduction on 1 June, the Department provided advice and worked closely with traders to facilitate the transition. It is now estimated that the measure will lead to an increase in VAT receipts of £135 million in 2007-08, compared with the original estimate of £500 million.³⁴ This is because the:

- Department's current operational strategy has succeeded in dampening down the level of attempted fraudulent activity since the derogation was originally applied for;
- scope of goods covered by the derogation is not as wide as originally envisaged; and
- financial effect of the reverse charge was originally calculated on the basis that the reverse charge would commence from 1 January 2007.

5.11 As the 'reverse charge' will apply only to specific products, fraudsters may switch to other goods not covered by the measure and therefore limit its effectiveness.

An extension of the reverse charge could be sought, should these mutations arise. The Department, however, recognises that effective monitoring of trading activity will prove crucial in tackling any mutations and preventing an escalation of fraudulent activity in other areas.

5.12 The Government announced, in Budget 2007, its intention to extend the list of goods covered by Joint and Several liability actions under section 77A of the VAT Act 1994, which was enacted in May 2007. The measure which applied previously to telephones, computers and their parts, now includes a variety of electronic equipment and accessories. Under this measure a VAT registered business can become liable for VAT due from another trader in the supply chain if the business knew or had reasonable grounds to suspect that VAT amounts were going unpaid elsewhere in the chain. The Department aims to use this measure more extensively, should the fraud mutate to other goods not covered by the derogation.

5.13 In addition to preventing future losses, the Department's heightened compliance activity in tackling the fraud has identified a significant amount of VAT debt owed by fraudsters. The deployment of additional staff in 2006-07 to tackle (disrupt) missing trader fraud has resulted in an increase in the number and value of VAT assessments issued, and hence debts being reported. As a consequence, the level of debt related to missing trader fraud has risen from £687 million in 2005-06 to £2.3 billion in 2006-07.

5.14 The Department does not, however, pursue this debt until the outcome of any criminal action is known, which because of the complexity of the investigations, may take several years to conclude. Where these actions are successful, the criminal assets are seized and the sums assessed are written off. In non-criminal cases involving missing trader fraud, the Department will either deregister the defaulting business or use the insolvency rules to transfer control of the business from a potential fraudster to a licensed insolvency practitioner. This approach prevents more significant losses and, in some cases, provides a means of securing the personal assets of individuals behind the fraud. In cases where there is an immediate risk of significant asset dissipation, the Department may apply to the High Court to appoint a provisional liquidator to close down the company immediately.

5.15 In 2006-07, 210 traders involved in missing trader fraud were made insolvent as a result of Department action. The Department also initiated provisional liquidation action against 11 businesses and approximately £0.7 million has been recovered and a further £2.9 million in assets have been secured. Furthermore, there are 115 missing trader cases, with debts totalling £557 million, where insolvency action is currently ongoing. Debts may be written off in other cases which are not subject to insolvency or the criminal asset recovery process and where there is no prospect of recovering the tax owed.

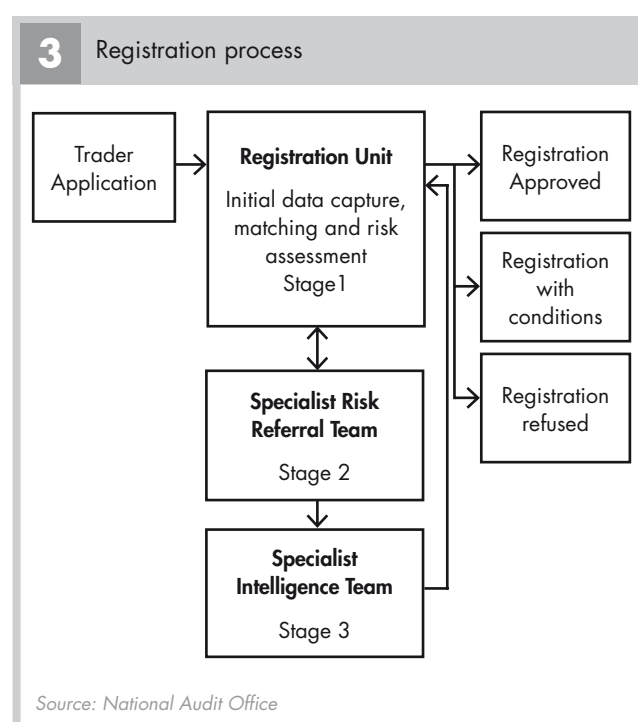
5.16 Organised criminals currently exploit EU VAT rules, which allow intra-Community goods to be traded VAT-free. The Department's current operational measures have successfully reduced the level of attempted fraudulent activity. However, missing trader fraud is a European Union wide problem, estimated at £40 billion (€60 billion), which can only be successfully tackled with the co-operation of other European Union Member States.³⁵ The Department should, therefore, continue to work with other Member States in identifying and tackling these criminals, and seek a long term solution to the problem, which may include an overhaul of the current VAT system. However, any changes would need to reduce considerably the possibilities for missing trader fraud, exclude any opportunities for new types of fraud, and not generate a disproportionate administrative burden for traders and the authorities.

VAT Registration Checks

5.17 VAT registration is the entry point for businesses to the VAT system. The National Registration Service is responsible for ensuring that registration applications, de-registrations and amendments are processed promptly and accurately. In line with the Department's commitment to help taxable persons to meet their obligations, the Service aims to support the needs of customers, provide advice and guidance, and ensure that processes are effective to meet demand. This customer-focused approach is also balanced against the requirement to reduce VAT fraud levels. Legally, the Department cannot refuse to register a business if its taxable turnover exceeds (or will exceed) the registration threshold (as per paragraph 5.3). However, it has the right to refuse a VAT application from an intending trader or one seeking voluntary registration, if it has reasonable grounds to suspect that the applicant is or is likely to be involved in fraudulent activities.

5.18 The Department continues to face attacks against the VAT system from criminal networks orchestrating missing trader (and other forms of) fraud. Preventing criminals from entering the VAT system is critical in tackling both missing trader and labour provider (gang-master) fraud, as

outside the VAT system they cannot perpetrate the fraud.³⁶ All applications are subject to an initial, semi-automated risk assessment process to identify potential fraudulent applications; the first of potentially three levels of checking, determined by the risk they represent, as shown in **Figure 3**. As a result of this initial (stage 1) risk assessment, the Registration Units will, where necessary, contact traders to ask for further information before continuing the application process. This occurs, for example, where the application is incomplete or unclear; or evidence of intent to trade or of economic activity is needed to make the risk assessment decision. Most applications, approximately 95 per cent, require no further risk assessment and are processed accordingly. Around five per cent of all applications are referred to specialist risk advisors (stage 2), and just one per cent are further referred to a specialist intelligence team (stage 3). Where the registration unit does not have sufficient evidence to refuse an application but still has suspicions about a trader, it can impose conditions on the registration, such as requiring a financial guarantee or shortening the first VAT period to enable the Department to make an early assessment of compliance.



NOTE

For 2006-07, Registration Units were based in Carmarthen, Grimsby, Newry and Wolverhampton. By April 2008 it is anticipated that two units will remain: Grimsby and Wolverhampton.³⁷ All applications are subject to validation checks to identify potential fraudulent applications. High risk applications (representing around five per cent of all applications) may be referred to the Risk and Intelligence Teams for further examination.

5.19 Prior to 2005-06, registration applications identified as high risk were sent direct to the specialist intelligence team for further detailed checking of trading activity and individuals involved in the business. However, in order to enhance the timeliness of the processing procedures, experienced missing trader officers were re-deployed, on a part-time basis, to each of the Registration Units to act as missing trader risk advisors. As well as speeding up the risk decision process the risk advisors acted as a filter for applications referred to the Intelligence Team. In September 2006, following a review of procedures, the Department decided to restructure the risk advisory function and established a centralised pre-registration risk referral team under the control of the Risk and Intelligence Unit. The Department saw the move as an opportunity to create a dedicated team that will be able to develop expertise in high-risk VAT registration applications.

5.20 The use of the risk advisors has enhanced the quality of the risk assessment process and led to a significant increase in the number of suspect applications either being refused or registered with specific conditions. In 2006-07 the total number of missing trader applications refused or registered subject to conditions was 4,382 and 2,320 respectively. In addition, 1,691 labour provider (gang master) applications were refused (**Figure 4**). This reflects the Department's efforts to prevent abuse of the VAT system by traders who are intent on registering only to commit fraud.

5.21 The Department has noticed following the introduction of tighter pre-registration controls that fraudulent traders are attempting to circumvent checks by acquiring VAT registered businesses, which are then used to trade in goods normally associated with missing trader fraud. In response, the National Registration Service has developed additional risk checks and issued fresh guidance to help registration teams identify such activity and protect the VAT system. In 2006-07 the Department refused 177 suspect amendment requests.

Registration Performance Targets

5.22 In 2006-07 the National Registration Service processed 285,176 new applications. Some 20 per cent of these applications were received electronically, compared with 13 per cent in 2005-06, the first full year in which the Department made e-registration available (**Figure 5**).³⁸ Increased awareness of e-VAT services among the trader population has led to improved take-up levels.

5.23 The National Registration Service has an internal performance target for the time taken to process VAT applications. Up until 2005-06 the service had performed well against a target of processing 95 per cent of complete and accurate applications within 15 days of receipt; with 94 and 97 per cent reported in 2004-05 and 2005-06 respectively. However, for those applications that were not complete and accurate, processing times could have

4 Registration checks and outcomes

	2004-05	2005-06	2006-07
New registration applications received	269,515	284,804	285,176
Missing Trader Applications			
New applications subject to detailed checking by specialist risk and intelligence teams	4,573	8,672	10,635
New applications refused on suspect grounds ¹	1,866	2,271	4,382
Businesses registered with specific conditions	151	1,230	2,320
Labour Provider Applications			
New applications subject to detailed checking by specialist risk and intelligence teams	N/A ²	1,189	809
New applications refused on suspect grounds ¹	N/A ²	1,242	1,691
Businesses registered with specific conditions	N/A ²	446	247

Source: HM Revenue & Customs

NOTES

1 Includes suspect fraudulent applications refused by the Registrations Units without referral to risk and intelligence teams, and those refused following further checks.

2 Data collection commenced in 2005-06.

5 VAT registration

	2004-05	2005-06	2006-07
Number of new registration applications received	269,515	284,804	285,176
Percentage of applications received electronically	0.1%	13.0%	20.0% ¹
Percentage of complete and accurate registrations processed within 15 days [Target 95%]	94%	97%	N/A ²
Percentage of registrations processed within target – 14 days [Target 30%]	N/A ²	N/A ²	27%
Percentage of applications received that were complete and accurate [Target 50%]	27%	27%	49%

Source: HM Revenue & Customs

NOTES

1 My Report on “Helping new businesses meet their tax obligations” published on 6 December 2006 indicated a take up of 16 per cent for the period April to July 2006. The take-up for the full year had increased to 20 per cent.

2 For 2004-05 and 2005-06 the Department operated to a performance target reflecting the percentage of complete and accurate registration applications processed within a target of 15 days. In 2006-07 the Department set a new target of processing 95 per cent of all applications within 14 days by the year 2008. The interim measure for this target was 30 per cent by year-end March 2007.

been considerably longer where additional information was required. The average time taken to process 95 per cent of applications was 29 days. Some five per cent of applications are subject to detailed anti-fraud checking, which in 2006-07 frequently delayed processing by up to 12 weeks. To ensure that processing is more customer-focused, the Department set a new target of processing 95 per cent of all applications within 14 days by the year-end March 2008. The interim measure for this target was 30 per cent achievement by the year-end March 2007. Of the 285,176 applications received, 27 per cent were processed within the target date (Figure 5).

5.24 The Department aims to ensure that 50 per cent of applications for registration are complete and accurate.³⁹ Around 49 per cent were complete and accurate in 2006-07 compared with 27 per cent in 2005-06 (Figure 5). My report on “Helping new businesses meet their tax obligations” explained that the low accuracy rates were mainly due to the relatively complex VAT registration form compared to the registration forms businesses must submit for other taxes.⁴⁰ This is because the business completing the VAT registration form needs to understand both technical terms and complex concepts.

5.25 Some of the information that the Department asks for on the form is to help the registration units identify applications that come from fraudsters trying to enter the VAT system. The Department recognised that for the majority of businesses the registration form should be simplified, and undertook to redesign it as well as provide clearer and more focussed guidance to help businesses complete it. The Department issued a new paper-based

VAT registration form in December 2006 and has used its website to notify prospective applicants of common mistakes in filling out the forms. The new VAT registration form is simpler and more user friendly. To achieve this, some questions have been deleted and new questions added, and the order rearranged to make more logical sense sequentially.

5.26 A ‘Registration Working Group’ was set up in September 2006 to coordinate efforts for improving customer service. The Group has helped promulgate revised guidance for businesses, as well as remove the requirement to provide, as standard, intending trading evidence. It also initiated a comprehensive review of the registration risk referral process in March 2007. The Department expects that implementing the review recommendations will help to improve processing timescales. In addition, it is developing a new computerised risk engine which will automate and enhance the current manual registration risk assessment process undertaken by the Registration Units.

Validation and Credibility Checks on VAT Returns

5.27 The 1.9m VAT registered businesses submit almost eight million VAT returns each year, of which 8.6 per cent were filed electronically in 2006-07 (Figure 6 overleaf). The majority of registered traders file returns quarterly, usually one month after the end of the quarter. However, some returns are also submitted on a monthly or annual basis.

6 VAT tax returns filed

Year	Returns received (millions)	Returns completed electronically	Percentage of returns filed electronically
2003-04	7.4	14,000	0.2
2004-05	7.8	86,000	1.1
2005-06	7.8	380,000	4.9
2006-07	7.9	677,000	8.6

Source: HM Customs & Excise

NOTE

The VAT returns received figure is based on businesses who file monthly, quarterly and annually. It also includes changes through new registrations and de-registrations.

5.28 The majority of processing for VAT returns is completed at a single site (Southend), where, following post opening and validation (where basic manual checks are carried out on all returns), the returns are microfilmed. Whilst being microfilmed, the cameras pick up information from the bar code on the return and transmit an early message to the VAT Mainframe to note that a return has been received (to stop erroneous enforcement). The VAT return is then passed to the VAT Data Capture Unit where the data is entered onto the VAT Mainframe, the core computer system the Department uses for managing VAT. The returns are subsequently subjected to automated completeness and accuracy checks. Errors and omissions are identified and referred to the Accounting & Adjustment Team (Liverpool) for further checking and correction. All repayment returns are subject to credibility checks before they are authorised for payment. Outstanding debts are pursued by the Department's Debt Management Units (**Figure 7**).

5.29 To provide assurance that VAT repayment claims from traders are legitimate and accurate, the Department uses computerised credibility checks to assess the claims against a set of variable parameters. These checks are intended to direct early attention to inconsistencies in traders' returns. They also complement the risk-based programme of assurance visits to traders' premises. Claims which fail the credibility tests are classified into those that must be checked before any repayment is made (pre-repayment credibility queries) and those where the repayment can be made prior to further checks (post-repayment credibility queries).

5.30 The Department's VAT Credibility Operations Unit, based in Liverpool, scrutinises the pre-repayment queries. Those queries that it cannot resolve, together with queries down-graded to post-repayment status, are referred to local offices for further examination. In 2006-07 the credibility checks selected 218,860 returns for further checking, representing 10 per cent of all repayment returns received. Of these, 177,241 (£25 billion) were selected for pre-repayment verification and 41,619 (£1.74 billion) for post-repayment verification. As a result of these checks it was found that some repayment claims had been overstated by a combined total value of £603 million (£497 million in 2005-06), either through error or fraud.

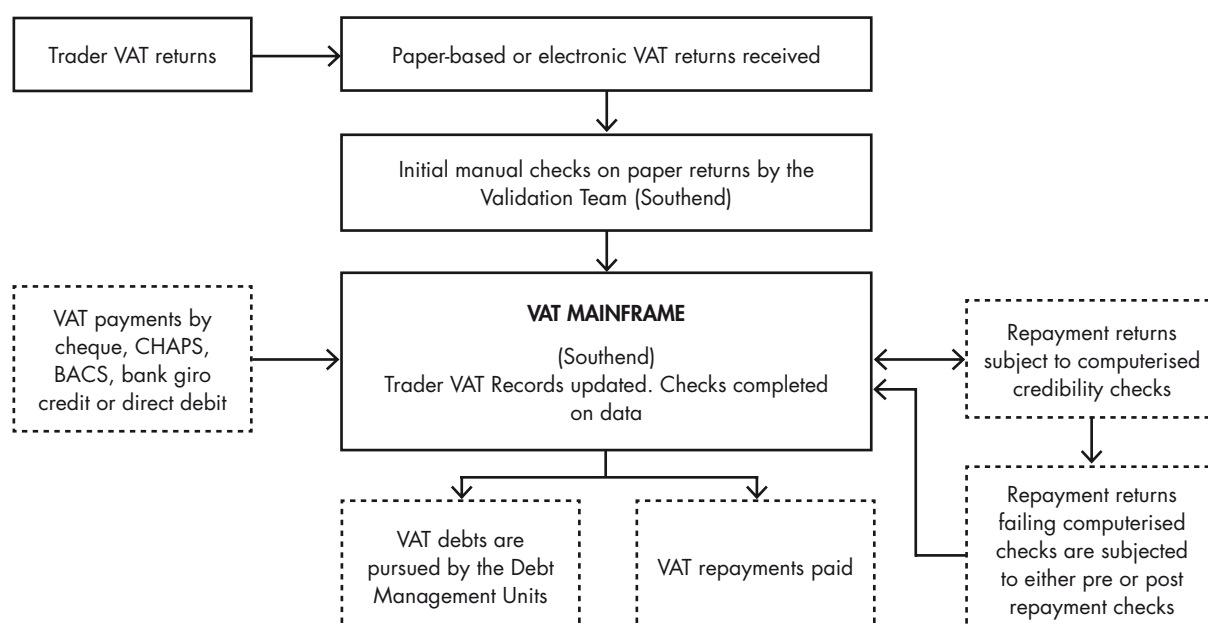
5.31 The Department will pay a repayment supplement of five per cent of the value of the claim or £50, whichever is the greater, if authorisation of the repayment is unreasonably delayed beyond 30 days. In 2006-07 it achieved its published target to authorise at least 90 per cent of correct repayment returns within 10 working days.⁴¹ At the same time, the Department makes it clear to businesses that it will carry out checks and apply safeguards to ensure that claims are legitimate and accurate.

5.32 In 2006-07 the Department paid £8.68 million in repayment supplement (**Figure 8**), of which a significant proportion, i.e. £3.9 million, comprised:

- £1.8 million (£1.6 million in 2005-06) which the Department had to pay following the judgement by the European Court of Justice (ECJ) in the Bond-House case, where the ECJ concluded it should not have withheld VAT repayments, and⁴²
- £2.1 million (£1.4 million in 2005-06) paid to traders following the verification of VAT repayments undertaken as part of the Department's strategy in tackling missing trader fraud.

5.33 The supplement also includes £728,216 which was incurred following a systems error.⁴³ In August 2006, the system responsible for capturing electronic data from local VAT offices failed to transfer information to the VAT mainframe and, in turn, update a number of IT suites essential to performing the majority of VAT business activities. Whilst a number of business areas were affected during this time, particular disruption was caused to completing pre-repayment credibility operations. The problem led to a total downtime of six calendar days. The Department has now implemented rigorous daily checks to ensure that a similar system problem does not recur, and has acknowledged the weaknesses in its wider IT service level and support arrangements around this process. The Department is currently reviewing these arrangements and aims to take any necessary steps to make sure that action is taken promptly should a similar process problem arise in the future.

7 Overview of the VAT filing process

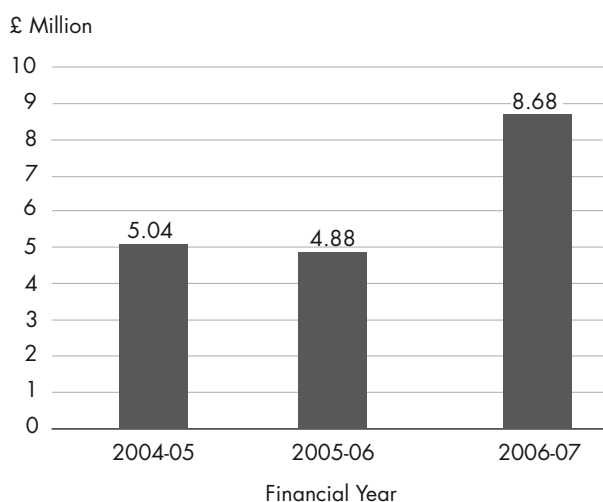


Source: National Audit Office

NOTE

The VAT Mainframe holds all the trader information needed for day to day processing. VAT returns are subject to completeness and accuracy checks both before and when entered into the Mainframe. Traders owing VAT can either pay by cheque, CHAPS, BACS, bank giro credit or direct debit. Outstanding VAT debts are monitored and collected by the Debt Management Units. Repayment returns are subject to credibility checks before payments are made.

8 VAT repayment supplements



Source: HM Revenue & Customs

NOTE

The Department pays a repayment supplement of five per cent of the value of the claim or £50, whichever is the greater, if authorisation of the repayment is unreasonably delayed beyond 30 days. In 2006-07 and 2005-06 repayment supplements totalling £1.8 million and £1.6 million respectively were paid, following the decision by the European Court of Justice in the Bond House case, that the Department should not have withheld VAT repayments.

Conclusion

5.34 The Department strengthened its operational and legislative measures to tackle missing trader fraud, following an increase in fraudulent activity in 2005-06. The United Kingdom's application for a 'reverse charge' on certain goods was approved by the Council of the European Union in April 2007 and introduced from the 1 June 2007. However, the 'reverse charge' does not extend to the whole range of electronic goods requested in the original application. It has been limited to goods commonly associated with the fraud, i.e. mobile phones and computer chips. In addition, the derogation will only be applicable for the period up until April 2009, at which time its effectiveness will be reviewed by the European Commission. There is a risk that the organised criminals behind the fraud will divert their attention to other goods not covered by the derogation. The Department, however, recognises that effective monitoring of trading activity will prove crucial in tackling any mutations and preventing an escalation of fraudulent activity in other areas.

5.35 The extended verification of repayment claims has, according to the Department's operational indicators, reduced the level of fraudulent activity in the UK. However, missing trader fraud is a European Union wide problem as fraudsters exploit EU VAT rules that allow intra-Community goods to be traded VAT-free. The Department should, therefore, continue to work with other Member States in identifying and tackling these criminals, and seek a long term solution to the problem, which may include an overhaul of the current VAT system. However, any changes would need to reduce considerably the possibilities for missing trader fraud, exclude any opportunities for new types of fraud, and not generate a disproportionate administrative burden for traders and authorities

5.36 The Department has strengthened its registration controls to prevent fraudsters from obtaining a VAT registration number. Some five per cent of new applications (285,176 in 2006-07) are subject to detailed anti-fraud checking which in 2006-07 delayed processing by up to 12 weeks. The introduction of risk advisors at the registrations units, however, has enhanced the risk assessment process. The number of suspect registration applications refused increased from 3,513 in 2005-06 to 6,073 in 2006-07.

5.37 The processing of registration applications can be delayed if they are incomplete and/ or inaccurate. The Department has a public service agreement target to increase the number of complete and accurate applications received to 50 per cent. Through making the application form user friendly and providing focused guidance for businesses, the Department achieved an outturn of 49 per cent in 2006-07 compared with 27 per cent in 2005-06. The Department also set a new target of processing 95 per cent of all applications within 14 days by March 2008. The interim measure for this target was 30 per cent achievement by March 2007. Of the 285,176 applications received, 27 per cent were processed within the target date. However, progress will need to be significant if the Department is to achieve its 2008 target.

5.38 The Department has a responsibility for ensuring that correct VAT repayments are paid promptly. Repayment supplements amounting to five per cent of the VAT claim or £50 (whichever is the greater) is paid if repayments are not paid within 30 days of being submitted. It also has to protect VAT revenue, and therefore has controls in place to check VAT repayment claims. In 2006-07 the Department met its target of processing 90 per cent of correct repayment claims within 10 days. The checks, however, identified and prevented over-claims arising from error or fraud totalling £603 million. Repayment supplements in 2006-07 totalled £8.68 million, of which £3.9 million arose as result of the Department's measures in tackling missing trader fraud. It also included £728,216 which was incurred following a systems error that, most importantly, took six calendar days to resolve as the Department did not have in place the IT service level or support arrangements necessary to resolve the issue more quickly. The Department has implemented daily checks to ensure that a similar system problem does not recur, and is currently considering improvements to the wider service level and support arrangements around this process to make sure that action is taken promptly should a similar process problem arise in the future.

ENDNOTES

- 1** *"HMRC and the Taxpayer: Modernising Powers, Deterrents & Safeguards: initial consultation document"* published March 2005. *"Modernising Powers, Deterrents & Safeguards: A Consultation on the Developing Programme of Work"*, published March 2006.
- 2** Reform of film tax incentives: Promoting the sustainable production of culturally British films, HM Treasury, July 2005.
- 3** Budget 2006: Regulatory Impact Assessments, Chapter 3 (paragraph 3.45) published March 2006 by HM Treasury and HM Revenue & Customs.
- 4** Finance Act 2006 Schedule 5, paragraph 24.
- 5** The Films (Definition of a British Film) (No 2) Order 2006 (SI 2006 No 3430) amended the definition of a culturally British film under the Film Act 1985.
- 6** Finance Act 2006 Schedule 5, paragraph 24.
- 7** Finance Act 2006, Schedule 5, paragraph 31.
- 8** Finance Act 2006 Schedule 5, paragraph 19 (amending the Films Act 1985, Schedule 1).
- 9** Budget 2006 : Regulatory Impact Assessment : Chapter 3 (paragraph 3.55) Published March 2006 by HM Treasury and HM Revenue & Customs.
- 10** Code of Practice 26, What happens if we have paid you too much Tax Credits.
- 11** This results from overpayments for 2003-04 to 2005-06, plus £600 million overpayments identified in 2006-07 resulting from claimants reporting in year changes of circumstances. The Department will identify further overpayments for 2006-07 when these awards are finalised.
- 12** These estimates do not include incorrect payments found through HMRC's compliance checks as shown in Figures 5 and 6, Part 2.
- 13** In 2006-07 HMRC received over 50 million form P14s, including those for employments and pensions that ceased during the year. At the end of 2006-07 there were 38 million employment and pension sources.
- 14** In the light of further analysis of its work on multiple income sources, the Department has revised its previous estimate of overall tax at risk reported in 2005-06. HMRC's estimate of tax at risk has been revised downwards from some £1 billion of tax due not being pursued, overpayments of around £500 million, resulting in potentially 5.7 million taxpayers not paying the right amount of tax
- 15** The computer system automatically clears cases where the underpayment is not more than £50 or the overpayment in £10 or less.
- 16** The Department ignores any differences that are below £1.
- 17** The relevant legislation is in the Income Tax (Incentive Payments for Voluntary Electronic Communication of PAYE Returns) Regulations 2003 (SI 2003/2495)
- 18** The results from the QME exercise measure levels of error with HMRC's current clerical procedures. The errors identified by Internal Audit, discussed in paragraph 3.4, look at wider weaknesses in PAYE, for example the failure to process information promptly or to bring together all the relevant information on a taxpayer when calculating tax payable
- 19** The Department has increased its estimate of the number of open cases at the end of 2005-06 from 8.7 million to 12.2 million. The increase relates to 3.5 million unprocessed cases that arose because of computer difficulties, which the Department expected to clear promptly. But these were not cleared as quickly as the Department anticipated and Figure 4, Part 3 therefore reflects the revised estimate.

- 20** The Department has estimated the tax loss by examining a sample of its records. The results of the sampling provide 95 per cent confidence that the tax loss is £135 million (+ / - £85 million) and 80 per cent confidence that the tax loss is between £80 million and £190 million.
- 21** All partnerships are required to complete a partnership tax return. Trustees or personal representatives of a deceased person's estate where income arises on assets in the estate are required to complete Trust returns.
- 22** NAO Report –Filing of Income Tax Self Assessment Returns [HC 74 Session 2005-2006] 22 June 2005.
- 23** On average there are two returns outstanding per case. Therefore the number of returns received following notification to impose Daily Penalties shown in Figure 7, Part 4 is higher than the number of letters issued.
- 24** This issue is also discussed in paragraph 1.5 of my report.
- 25** Gross VAT Receipts £144.5 billion (£134.4 billion, 2005-06); Repayments £59 billion (£60.6 billion, 2005-06). These amounts include 4.2 billion, mainly relating to missing trader fraud, which have either been written off or recognised as doubtful debts.
- 26** Council Directive 2006/112/EC replaced, in a single consolidated text, the first and sixth VAT directives and subsequent amendments on 1 January 2007.
- 27** HM Treasury, Budget 2007 Building Britain's long-term future: Prosperity and fairness for families, Chapter A Budget Policy decisions, March 2007, HC342.
- 28** Report on VAT Missing Trader Fraud – HM Revenue & Customs 2005-06 Accounts, HC 1159 (R38).
- 29** HM Revenue & Customs, Measuring Indirect Tax losses 2006, December 2006.
- 30** European Court of Justice Axcel Kittel v Belgian State, Case C-439/04, July 2006.
- 31** Estimates of VAT losses arising from missing trader fraud are published alongside the Chancellor's Pre-Budget Report. Estimates for 2006-07 are therefore expected to be published in December 2007.
- 32** Council Decision of 16 April 2007 authorising the United Kingdom to introduce a special measure derogating from Article 193 of Directive 2006/112/EC on the common system of value added tax.
- 33** Mobile phones include other communication devices, such as Blackberrys, but phones supplied under an airtime contract (but not 'pay-as-you-go' phones) will be excluded from the reverse charge.
- 34** Figures obtained from HM Treasury's Financial Statement and Budget Report Appendix A, Table A1.1 and HM Revenue & Customs' 2005-06 Accounts, HC 1159, R48.
- 35** HM Revenue & Customs 2005-06 Accounts (HC 1159) – *Report on VAT Missing Trader Fraud* (R49).
- 36** In a similar way that Missing Trader Fraud is committed, fraudsters operating as gang-masters charge VAT on the supply of labour, but do not declare it on their VAT return to the Department. They then disappear once significant VAT profits have been made during an intense period of trading.
- 37** There is a separate team, the Non-Established Taxable Persons Unit (in Aberdeen), which deals with VAT applications from businesses that are located outside the UK but which make taxable supplies within the UK and are, therefore, required to account for UK VAT.
- 38** Businesses have been able to register for VAT on-line since December 2004.
- 39** HM Revenue & Customs PSA objective III 'Improve customer experience, support business and reduce the compliance burden'; Key Indicator 4: Demonstrate a measurable improvement in (b) improving the proportion of applications for VAT registration that are complete and accurate to 50 per cent.
- 40** HM Revenue & Customs: Helping newly registered businesses meet their tax obligations. HC 98 Session 2006-07, 6 December 2006.
- 41** Notice 700/58 Treatment of VAT repayment returns and VAT repayment supplement, paragraph 5.1.
- 42** Judgement made on 12 January 2006 in case of Optigen Ltd, Fulcrum Electronics and Bond House Systems Ltd v Commissioners of Customs and Excise. As part of its strategy in tackling missing trader fraud, the Department withheld VAT repayments to companies on the grounds that they were part of an overall chain to defraud and that the circular sale of goods in the chain had no economic substance.
- 43** The total repayment supplement paid was £1.262 million, of which £534,000 was recovered.