



National Audit Office

HM REVENUE & CUSTOMS 2008-09 ACCOUNTS
Report by the
Comptroller and Auditor General

Issued under Section 2 of the Exchequer and Audit
Departments Act 1921

This Report is published alongside the 2008-09
Accounts of HM Revenue & Customs

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PART ONE

Introduction

Background

1.1 Section 2 of the Exchequer and Audit Departments Act 1921 requires the Comptroller and Auditor General (C&AG) to examine the accounts of HM Revenue & Customs (the Department) 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. The C&AG is 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. The C&AG's audit opinion on the Trust Statement account and this report together satisfy that requirement.

1.2 We have examined the Department's activities and tax streams. The results of that work, our value for money studies under the National Audit Act 1983, and our consideration of the Department's Statement on Internal Control provide the basis for our conclusions about its overall management of the tax systems.

Scope of the audit

1.3 Our examination of the principal tax streams was designed to obtain sufficient evidence on the adequacy and application of the Department's systems, including its management of key risks and its operation and review of regulations and procedure. For the year 2008-09, we selected four areas of our examination for the report:

- Administration of Stamp Duty Land Tax (Part 2).
- Administration of Corporation Tax repayments and postponements (Part 3).
- Progress in tackling fraud on Hydrocarbon Oils Duty (Part 4).
- Administration of Tax Credits (Part 5).

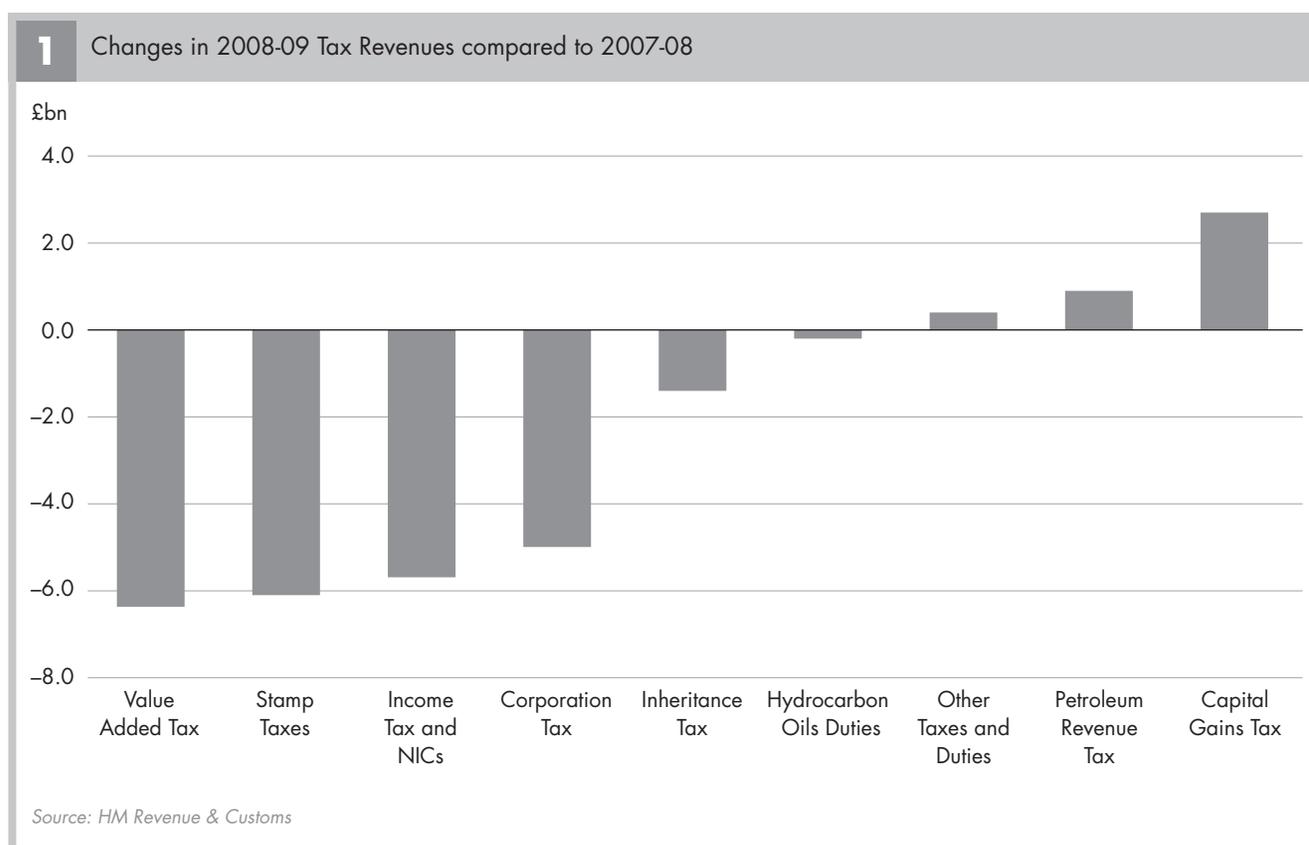
1.4 We also followed up on the key areas covered in our 2007-08 report. Our findings are summarised in paragraphs 1.17 to 1.26. We carried out three value for money studies under the National Audit Act 1983, resulting in the following reports under Section 9 of that Act:

- Control and facilitation of imports (HC 942 of 2007-2008).
- Management of tax debt (HC 1152 of 2007-2008).
- Managing variations in workload (HC 507 of 2008-2009).

Tax Revenues in 2008-09

1.5 In 2008-09 total taxes and duties collected and receivable were £435.7 billion, £21.7 billion lower than in 2007-08. The difference is largely due to falls of £11.4 billion in tax receipts and £15.7 billion in accrued revenues, offset by a £2.7 billion increase in tax debtors and £3.1 billion less creditors (**Figure 1**). The specific reductions in taxes were:

- Stamp Taxes – £6.1 billion, including a £5.1 billion fall due to fewer residential and commercial property transaction volumes and lower prices and a £1 billion due to lower equity prices.
- Corporation Tax – £5.0 billion, reflecting less tax collected from onshore companies (mainly the financial sector), partially offset by more tax from offshore companies as a result of higher oil and gas prices.
- Value Added Tax (VAT) – £6.4 billion, reflecting the effect of the worsening economic conditions in the second half of the year and the reduction in the VAT rate to 15 per cent in December 2008.



- Income Tax and National Insurance Contributions (NICs) -£5.7 billion, mainly due to the effect of changes to income tax rates and allowances, including the £600 increase in the personal allowance to compensate for the abolition of the 10 pence tax rate and the reduction in the basic rate from 22 per cent to 20 per cent, and lower Income Tax collected through Pay-As-You-Earn (PAYE) from a fall in employee bonuses in the financial sector.

1.6 These falls in tax revenues were offset by increases in Capital Gains Tax (£2.7 billion) and Petroleum Revenue Tax (£0.9 billion). A number of factors contributed to the increase in Capital Gains Tax Receipts, including investors taking the opportunity to reorganise their tax affairs ahead of the abolition of taper-relief and the payment of liabilities relating to previous years. The increase in Petroleum Revenue Tax receipts was due to higher oil and gas prices.

1.7 Net revenues were further reduced after allowing for revenue losses of £4.6 billion following the write-off and remission of debts, an increase of £3.3 billion in the provision for doubtful debts, and an increase of £7.2 billion in the provision for liabilities arising from legal claims brought by taxpayers against the Department. After allowing for all expenditure and disbursements, the net revenue for the Consolidated Fund for 2008-09 was £303.9 billion, £32 billion lower than the previous year.

2 Trends in debtors across the main taxes

Debt	31 March 2009 £bn	31 March 2008 £bn	Change £bn
Income Tax & NICs	9.7	8.4	1.3
Value Added Tax	7.6	7.1	0.5
Corporation Tax	3.4	2.2	1.2
Tax Credits	4.3	4.3	0.0
Other	2.7	3.0	(0.3)
	27.7	25.0	2.7
Less Provisions for Bad and Doubtful Debts	(11.2)	(7.9)	(3.3)
Total	16.5	17.1	(0.6)

Source: HM Revenue & Customs

Debtors

1.8 Debtors at 31 March 2009, before provisions for doubtful debts, were £27.7 billion, £2.7 billion (11 per cent) higher than at 31 March 2008. **Figure 2** provides an analysis of the trends in debtors across the main taxes.

1.9 The economic downturn has been a major factor in the increase in debtors. VAT has seen an increase in taxpayers not filing on time or filing on time but not paying. Similar trends have also been seen in other taxes in 2008-09. Income Tax Self Assessment filing rates are lower, down by one per cent to 88 per cent while debtors have increased by 15 per cent over the year. Similarly, Corporation Tax filing rates are down four per cent to 70 per cent while debtors have increased 55 per cent. The Department is currently assessing the evidence of under payment of PAYE and NICs deductions throughout the year.

1.10 Following the 2008 Pre-Budget Report, the Department launched its Business Payment Support Service to help businesses that are having difficulty in paying tax debt due to the economic conditions. The Service allows viable businesses suffering temporary financial difficulties more time-to-pay tax debts. By the end of June 2009, the Department had reached 158,000 agreements with a value of £2.74 billion through the Service. More than half of these arrangements are for periods of three months or less, and the Department's monitoring shows that over 90 per cent of instalments have been paid as agreed. By the end of June, 76,000 agreements (worth £1.7 billion) had been paid in full, leaving 82,000 (worth £1.04 billion) still running.

1.11 The Department estimated the debt that may not be collected mainly based on historical collection rates. Its estimate of debt that may not be collected includes debt discharged due to adjustments in the underlying tax liability as well as debt remitted or written-off. In light of the economic downturn and increasing debtor levels, it has increased provision for doubtful debts to £11.2 billion at 31 March 2009, equivalent to 40 per cent of total debtors; this compares to a provision of £7.9 billion (32 per cent of total debtors) at 31 March 2008. The £3.3 billion increase in the provision includes £1.2 billion that has been added to reflect the current economic downturn, including the effect on collection rates.

1.12 The Department is changing its approach to debt management. In November 2008 we reported¹ that the Department needed to improve its debt management, by strengthening risk profiling; managing debt through a single system; linking and pursuing together debts owed by an individual taxpayer on different taxes; using more innovative methods for communicating with customers; and improving the efficiency of its telephone centre operation. The Department is now moving to a campaign-based approach by analysing debtors and tailoring its interventions according to previous behaviour, risk and likely ability to pay. It also intends to increase the debt management

capacity and capability through its Pacesetter programme, pilot the use of private debt collection agencies, expand the Debt Management Telephone Centre, and bring VAT into the Department's core debt management system.

Accrued Revenues Receivable and Payable

1.13 The Department estimated accrued revenue receivable at £65.1 billion and accrued revenue payable at £22.4 billion. These estimates relate to revenue receivable from taxpayers-whose 2008-09 returns are not filed until after end of the financial year. **Figure 3** provides an analysis by the accrued revenue estimates by tax. The falls in accrued revenue reflect the underlying decline in tax liabilities described in paragraph 1.5 above.

1.14 The Department prepares separate accrued revenue estimates for each tax using statistical models for each tax stream. Note 6 to the Trust Statement describes the estimation techniques and details of the underlying assumptions used in the estimate of accrued revenue receivable for Corporation Tax, self-assessed Income Tax and Class 4 National Insurance Contributions, and Value Added Tax. The Department considers that the levels of variation are acceptable with a maximum likely overall uncertainty expected to be some £4 billion, equivalent to less than one per cent of total revenue.

3 Accrued Revenue Receivable and Accrued Revenue Liabilities

	31 March 2009 £bn	31 March 2008 £bn	Change £bn
Accrued Revenue Receivable			
Income Tax & NICs	31.9	37.9	(6.0)
Value Added Tax	17.8	22.8	(5.0)
Corporation Tax	11.0	14.9	(3.9)
Other	4.4	5.0	(0.6)
	65.1	80.6	(15.5)
Accrued Revenue Liabilities			
Value Added Tax	7.4	9.0	1.6
Corporation Tax	1.9	0.0	(1.9)
National Insurance Funds and NHS	13.1	13.2	0.1
Total	22.4	22.2	(0.2)
Net Accrued Revenues	42.7	58.4	(15.7)

Source: HM Revenue & Customs

¹ Management of tax debt (HC 1152 of 2007-2008).

1.15 We have examined the models used to support the estimates, assessing the appropriateness and validity of the inputs used, and testing the calculations, including the overall uncertainty of the estimates. Some, including those for accrued revenues for PAYE and VAT, draw on records of returns received from traders after 31 March 2009, and so involve very little forecasting.

1.16 For Corporation Tax and self-assessed Income Tax, where the returns relating to 2008-09 liabilities are likely to be submitted several months after the end of the tax year, the Department has to rely on forecasts. We have reviewed the Department's work to confirm that the models are fit for purpose and that the assumptions take appropriate account of the economic downturn. The self assessment forecast is based on the Office for National Statistics' latest estimates of self employment, dividend and savings income growth. Corporation Tax is based on the latest Treasury estimates of profitability in 2009, and the Department has reviewed aspects of its model to assess the effect of repayments on the overall estimate of accrued revenues.

1.17 We are satisfied that the significant uncertainty in the estimates of accrued revenue receivable and accrued revenue liabilities is adequately disclosed in the Trust Statement. The Comptroller and Auditor General's certificate and report includes an emphasis of matter in respect of the significant uncertainty, although his opinion is not qualified in respect of this matter.

Follow up on our 2007-08 Report

1.18 Our 2007-08 Report commented on the Department's collection of income tax through PAYE and Self Assessment. In 2008-2009 we examined its progress in dealing with some of the issues identified.

The collection of income tax through PAYE

1.19 Following the introduction of online filing in 2005, the Department has consistently improved its processing of employer end-of-year returns. By the end of October 2008 the Department had processed 57.1 million (98.5 per cent) of the 58 million 2007-08 returns (P14s) expected, of which only 0.9 per cent of returns failed to meet the Department quality standards. This is an improvement on the previous year where 50.9 million (92.5 per cent) of the 55 million 2006-07 returns expected were processed at the same point, with 1.4 per cent failing to meet quality standards, and significantly ahead of the performance achieved in 2005.

1.20 On 29 June 2009, the Department transferred the processing of PAYE for individuals on to the National Insurance Recording System. The new system will bring all information on individuals' employment and pension income together and has a more complete view of a taxpayer's income. This will improve its ability to match returns with its records and reduce the volume of cases requiring manual checking.

1.21 The deferral of the processing transfer from April 2008, as initially planned, has limited the Department's progress in clearing existing backlogs of PAYE cases that require manual checking. 'Open cases' arise where the Department's systems identify discrepancies in taxpayer records or are unable to match a return to a record. In our 2007-08 report, we recommended that the Department establish appropriate contingency arrangements to clear processing backlogs. At the end of March 2009, there were 20 million open cases compared to 16.2 million at 31 March 2008. This would have been worse if the Department had not used data matching and automated clearance processes to clear over five million open cases that would have been held for manual checking. The Department plans to reach a steady state where open cases for each tax year are cleared within a year and there are no backlogs. It expects the new processing system will greatly reduce the number of cases requiring clerical review each year.

1.22 The delays in clearing open cases can mean that taxpayers are not notified promptly of additional tax payable or refunds due. Based on the Department's last in depth analysis of open cases in 2005, the backlog could affect around 4.5 million individuals who have overpaid in total some £1.6 billion of tax and a further 1.5 million individuals who have underpaid in total some £400 million of tax. Following the contingency actions taken in 2008-09, the Department is undertaking a detailed analysis of the remaining open cases to assess the impact on taxpayers.

1.23 The Department can also experience difficulty in matching information in the employer's end of year return with PAYE and National Insurance deductions paid over in the year. The Department has a project to examine the backlog of unreconciled employer returns, focusing on the more significant cases, and to establish a new process for managing these cases in the future. At the end of 2008-09 there were 500,000 unreconciled employer returns, but the Department considers that there will be no material tax consequences for the vast majority of employers. A sample analysis of 4,000 high value cases identified around 100 cases that involved repayment or recovery.

The collection of income tax through Self Assessment

1.24 The Department introduced a number of important changes to Self Assessment in 2008, including a redesign of the paper and online main tax return and a new deadline of 31 October for filing paper returns. The online deadline remains at 31 January. The Department maintained the good progress made in recent years in the number of returns filed on time and online – by 31 January 2009, 69 per cent of returns (5.8 million) were filed online, significantly exceeding the Department's target of 58 per cent. In addition, it successfully ensured that the unprecedented peak in demand was managed without the service disruptions experienced in 2007-08.

1.25 However, the percentage of returns filed on time continued to fall with some 1.2 million (12.9 per cent) of returns issued not being returned by the filing deadline. The Department considers that advancing the deadline for filing paper return by three months was always likely to adversely affect the number of returns filed by the deadline. The refinement of Self Assessment continues to remove from it established and more compliant taxpayers with simple tax affairs, while taxpayers new to the process are generally less compliant.

1.26 The Department's latest estimates based on the 2003-04 tax year indicate that 32 per cent of filed returns were incorrect, resulting in an under-declaration of liabilities, with an estimated £3.1 billion to £3.8 billion of tax at risk. Last year, we recommended that the Department consider producing its estimates more quickly. It now plans to produce estimates for 2004-05 and 2005-06 later in summer 2009.

1.27 The collection of self assessed liabilities can be postponed where taxpayers appeal against assessments, penalties, surcharges or amendments. In 2007-08 we reported that these items were given little attention and substantial backlogs of uncleared items had built up. During 2008-09 the Department began investigating this backlog, focusing on postponements relating to return years 2005-06 and earlier and has improved the clearance rate. As at January 2009 there were 82,316 postponements, worth £1.2 billion, a small increase on 2007-08.

Conclusion

1.28 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 2008-09 provided assurance that HM Revenue and 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. This assurance is subject to the observations on specific aspects of the administration of taxes in this report.

1.29 In 2008-09 tax revenues were significantly lower than the previous year. The Department's Trust Statement shows that total taxes and duties collected and receivable in 2008-09 were £435.7 billion, £21.7 billion lower than in 2007-08. Debtors increased by £2.7 billion to £27.7 billion, partly due to the effects of the economic recession. The Department has increased its provision for doubtful debts to £11.2 billion, equivalent to 40 per cent of total debtors, including an adjustment for the lower collection rates expected in the downturn. It also significantly reduced its assessments of accrued revenues to a net £42.7 billion at 31 March 2009, £15.7 billion lower than at 31 March 2008. Net revenues were further reduced following the Department's decision to increase by £7.2 billion its provision for liabilities arising from legal claims brought by taxpayers.

1.30 The Department is offering support to businesses in temporary financial difficulty during the recession through its Business Payment Support Service and time-to-pay arrangements. The recession has added to the uncertainty over the realisation of these debts. The Department is changing a number of aspects of its approach to debt management and consolidating the recording of its principal taxes onto its core debt management system. The increased risk of default by tax debtors underlines the need for the Department to actively manage debt.

1.31 Deferring the introduction of the new PAYE service has contributed to the build up in open cases on individual tax records. During 2008-09 the Department successfully introduced new data matching and automated clearance processes to allow it to clear over five million open cases that would have had to be manually checked. At March 2009 there were still some 20 million open cases, of which some six million are likely to entail additional tax payable or a refund. The Department should extend its use of data matching to assist in the clearance of the level of open cases and seek to identify and prioritise the processing of cases that are likely to have a tax effect.

1.32 There are other delays in tax processing. In addition to the 20 million open cases in processing, there are some 500,000 unreconciled employer returns, and in Self Assessment there are over 80,000 postponements, worth £1.2 billion. On Corporation Tax there are some 15,600 postponements, valued at £9.2 billion. While it is inevitable that the tax systems will include cases under examination, backlogs in processing can mean taxpayers are uncertain about their liabilities, the Department's systems do not record up to date data, and in some cases this can lead to delays in accounting for revenues and making repayments. The Department needs to undertake a comprehensive assessment of all processing work on hand and establish a clear action plan for their clearance.

PART TWO

Stamp Duty Land Tax

Introduction

2.1 Stamp duty land tax (SDLT) is a tax on land transactions. It was introduced on 1 December 2003 to replace stamp duty on land and buildings. The Government's objectives for introducing SDLT were to:

- promote fairness by addressing stamp duty avoidance, particularly in commercial property transactions;
- support e-business, through the introduction of e-filing and, in particular, electronic conveyancing; and
- create a modern legal framework for stamp duty in line with other taxes, and a charge that is based more on the substance of transactions.²

2.2 Prior to December 2003, stamp duty charges were based on the documents transferring title and could be avoided if the transaction was documented in a particular way. The Finance Act 2003 attached the tax charge to the transaction rather than the stamping of documents, and made the purchaser responsible for assessing the tax due and reporting and paying this to the Department. The Act also introduced an enforcement and compliance regime for SDLT that was in line with other taxes.

2.3 Our 2003-04 Report³ looked at the introduction of SDLT, including the Department's systems for processing the new tax, and its initial compliance work. In 2008-09, we have examined the Department's progress in implementing SDLT, including processing the tax, the compliance regime, and anti-avoidance measures.

Stamp Duty Land Tax receipts

2.4 The receipts from SDLT exceeded the Department's expectations. **Figure 4 overleaf** shows the total stamp duty and SDLT receipts each year from 2001-02 to 2008-09, and the split between residential and non-residential transactions.

2.5 The Department estimated⁴ that the new tax would raise an additional £330 million in 2004-05, rising to £430 million per annum from 2005-06. The actual increase compared to 2003-04 was £1.3 billion in 2004-05 and £2.5 billion in 2005-06. Much of this increase was due to the rising property market. The number and value of transactions both increased, and as the values increased, more transactions were pushed into bands at which higher rates of SDLT were payable. The rates of SDLT payable range from zero to four per cent, and depend upon the consideration paid and whether the transaction is freehold or leasehold and residential or non-residential. **Figure 5 overleaf** shows that most of the increase in SDLT receipts from 2004-05 until 2007-08 occurred in the higher percentage bands.

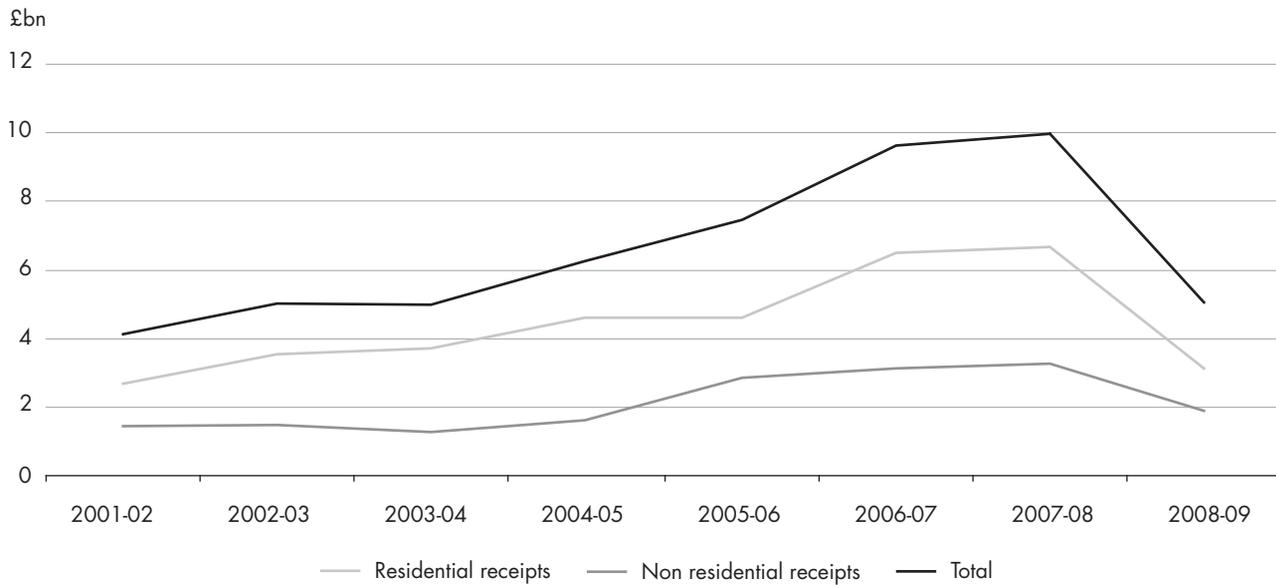
2.6 The effect of the rising property market following the introduction of SDLT makes it difficult to directly compare the new tax with Stamp Duty and assess the contribution made by the introduction of the new tax. The Department did not perform a detailed analysis of the increase in receipts to quantify the contribution of the new tax and of the rising property market.

² Modernising Stamp Duty on land and buildings in the UK, A Consultative Document, April 2002.

³ Comptroller and Auditor General: Inland Revenue: Standard Report 2003-04 – Child and Working Tax Credits and Stamp Duty Land Tax (HC 1602).

⁴ Final Regulatory Impact Assessment Modernising Stamp Duty, 2004.

4 Stamp Duty and Stamp Duty Land Tax receipts

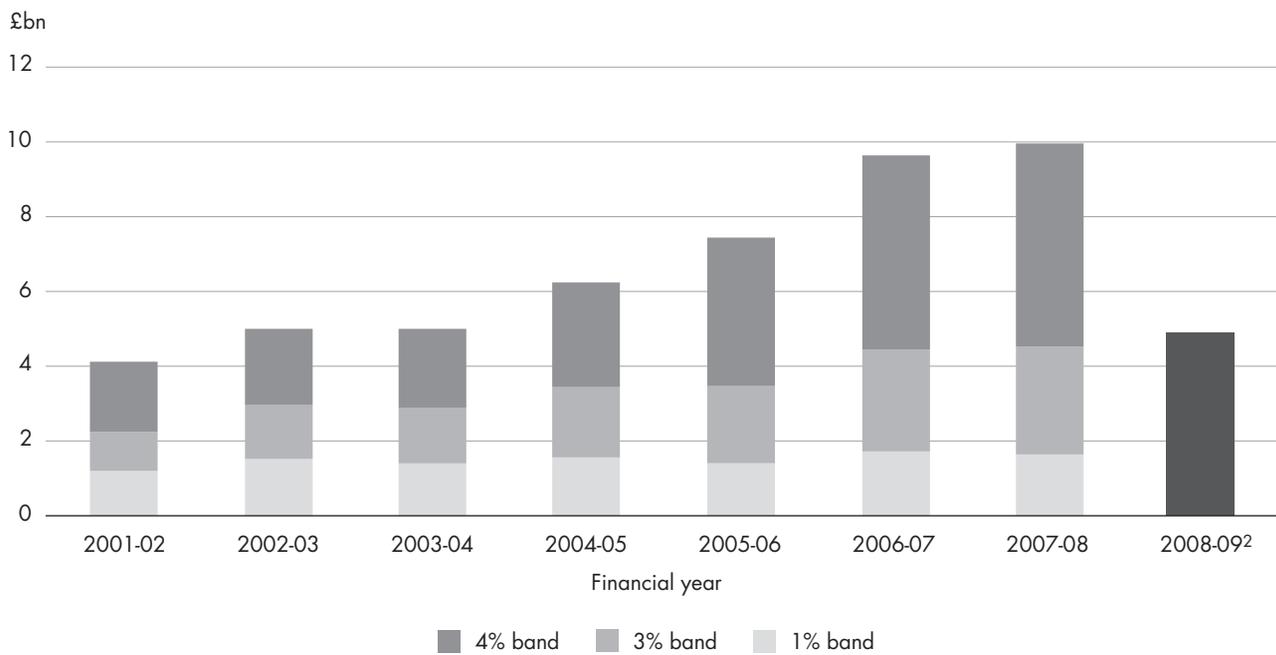


Source: HM Revenue & Customs

NOTES

- 1 The receipts figures are cash-based and exclude accruals adjustments.
- 2 The split between residential and non-residential receipts for 2008-09 is an estimate as actual figures are not yet available.

5 Stamp Duty and Stamp Duty Land Tax receipts by consideration band



Source: HM Revenue & Customs

NOTES

- 1 The receipts figures are cash based and exclude accruals adjustments.
- 2 The analysis by band is not yet available for 2008-09.

2.7 In 2008-09, SDLT receipts decreased by £5.1 billion, or over 50 per cent. This was the second largest decrease in receipts of any single tax, even in absolute terms. The Department estimates that £3.5 billion of the decrease is due to the reduction in transaction numbers, which fell by 45 per cent, and £1.3 billion is due to the decrease in property values. The remaining difference is due to policy changes including the temporary raising of the threshold for the one per cent band from £125,000 to £175,000.

2.8 The Department's analysis of the factors affecting receipts is not a prediction of what total receipts should be, because it does not currently have a robust estimate of the tax gap. Several features of SDLT make it difficult to estimate the tax gap, including lack of information on transactions using avoidance schemes (see paragraphs 2.33 and 2.38), a minimum threshold for reporting transactions (see paragraph 2.9) and limited management information on general non-compliance (see paragraphs 2.27-29). Better understanding the tax gap is the Department's top strategic priority for its SDLT compliance work, and it has begun a project that will contribute to this (see paragraph 2.41).

Filing SDLT Returns

2.9 The purchaser is responsible for notifying the Department of a transaction by completing a SDLT return. Most purchasers use an agent, such as a solicitor or a conveyancer, to file the return on their behalf. Once the Department receives a valid SDLT return, it issues a Land Transaction certificate (SDLT 5), which the purchaser needs for registering the transaction at the Land Registry. In the 2008 Budget, the procedures for notifying the Department of transactions were simplified to reduce the administrative burden on taxpayers. The threshold for notifying transactions was raised⁵ and the requirement to file a return was abolished for transactions below the notifiable threshold.

2.10 The Department predicted that the new tax would require fewer staff to process returns, both because SDLT is self-assessed and because it planned to have a new computer system to automate the processing of returns. However, the computer system was not ready when the tax was introduced in December 2003 and was implemented in stages, between August 2004 and May 2005. In the meantime, the transactions were processed manually, requiring high levels of staff. Even after the computer system was live, significantly more exceptions were generated than the Department had predicted, and staff were needed to process these.

The number of staff processing returns did not reduce in line with the Department's expectations until the middle of 2007, when the use of online filing became more widespread.

2.11 SDLT returns can be filed on paper or online. Until 30 October 2008, agents could also use commercial software or an HMRC CD-Rom to complete the SDLT return, and send the data to the Department in a barcode which was scanned to download the data into the Department's computer system. This method of filing has now been discontinued, with agents encouraged to file online instead. **Figure 6 overleaf** shows the percentage of returns filed using each of the three main filing methods for each quarter since January 2006.

2.12 Online filing has advantages for the Department and for taxpayers:

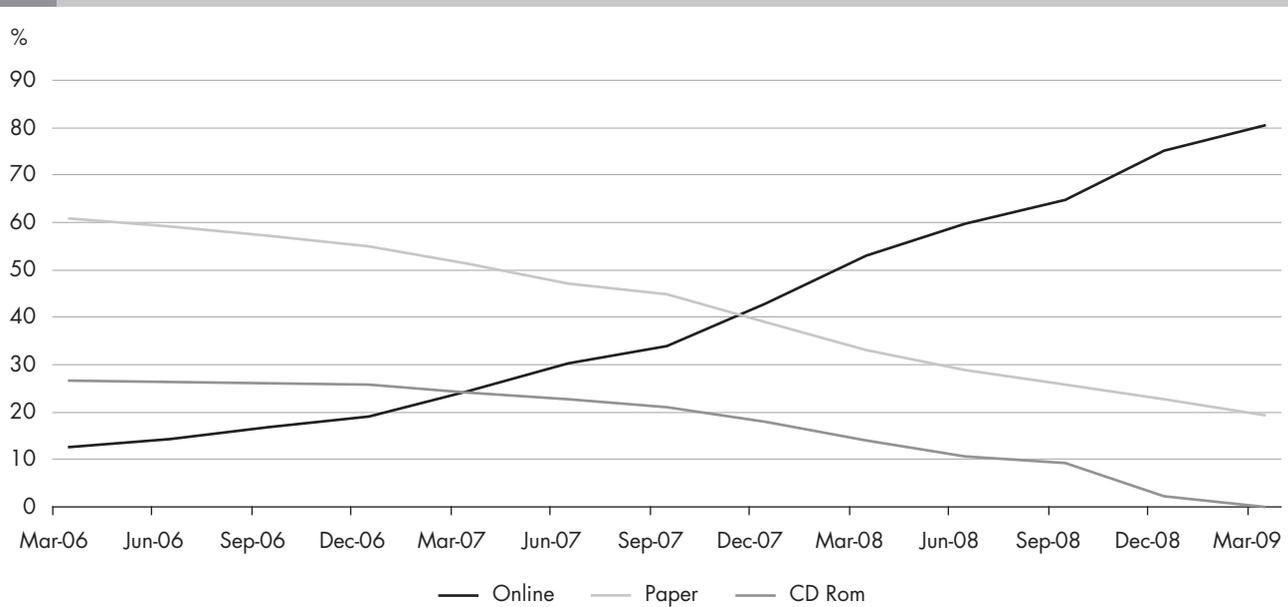
- Information is validated as it is entered, so mistakes can be rectified immediately, saving the taxpayer and the Department time in investigating erroneous or incomplete forms.
- The SDLT liability is calculated automatically, reducing the scope for calculation errors.
- The SDLT 5 is issued electronically on successful submission of an online return, so the taxpayer does not have to wait and the Department does not have the costs of processing and posting the form.

2.13 Despite these advantages, the take-up of online filing was initially lower than expected. To encourage online filing, the Department commissioned research into practitioners' awareness of, and attitude to online filing; provided guidance on its website on the benefits and practicalities; and set up an Outreach team to explain the benefits to solicitors and other conveyancing professionals. As a result, online filing grew from 13 per cent in the quarter ended 31 March 2006 to 81 per cent in the quarter ended 31 March 2009, exceeding the target of 75 per cent even though the Department had set this target to be ambitious.

2.14 The increase in online filing has allowed the Department to issue SDLT 5s more promptly and reduced its use of SDLT 8 forms to correct information that is missing from the paper return, or invalid, inconsistent or illegible. During 2008-09, the Department increased the percentage of SDLT 5s issued within its target time of five days from 80 per cent to 93 per cent. It also exceeded its target of reducing the percentage of returns resulting in the issue of an SDLT 8 to below five per cent.

⁵ The threshold was raised from £1,000 to £40,000 for freehold transactions. For transactions involving leases with a term of seven years or more, notification is only required where the chargeable consideration other than rent exceeds £40,000 or where the annual rent exceeds £1,000.

6 The percentage of SDLT returns received by filing method since 2006



Source: HM Revenue & Customs

2.15 One of the objectives for the introduction of SDLT was supporting e-business, particularly the introduction of electronic conveyancing. E-conveyancing allows the transfer of ownership of property, including registration with the relevant Registry and notification of SDLT, to be processed electronically. In England and Wales, the process is being led by the Land Registry and is not yet fully operational. A similar process, Automated Registration of Title to Land (ARTL), has been introduced in Scotland.

SDLT Compliance Regime

The new compliance regime

2.16 One of the objectives of SDLT was to introduce a modern enforcement and compliance regime, in line with other taxes. SDLT is a self-assessed tax, so it is the taxpayer's responsibility to calculate and pay the correct amount of tax. The Department considers that most returns are completed accurately and that the correct amount of tax is paid, but carries out a compliance review on some returns. It can launch an enquiry within nine months of the filing date if it needs further information to assess whether the correct amount of tax has been calculated and paid. It also has six years in which to make a "discovery assessment" of extra SDLT due if it finds relevant information that the taxpayer has not disclosed.

The Department's compliance yield since the introduction of SDLT

2.17 Our 2003-04 Report looked at the Department's plans for implementing the new compliance regime and found that it initially intended to review a large number of high risk transactions in 2004-05. However, the deferral of the computerised processing system diverted staff resources from compliance work, which was significantly reduced. The Department does not have data on the actual yield from this work in 2004-05, but believes it was negligible. **Figure 7** shows the additional yield, number of enquiries closed, and annual cost of compliance work from 2005-06 onwards.

2.18 The yield to staff cost ratio gives an indication of the productivity of the compliance team, although it is not an exact match of yield to resources applied. The yield is recognised in the year the case is settled and the costs are recognised in the year in which they are incurred. As with other taxes, SDLT enquiries may last for more than one year, especially if they are complex and high yielding, so work on an enquiry may not result in a yield until a future year.

2.19 Following the implementation of the computerised processing system in 2004-05, the Department was able to increase its compliance activity and had compliance staff in its Birmingham, Bristol and Manchester offices. As **Figure 7** shows, it achieved a yield of over £6.3 million in 2005-06, which increased to £10.9 million in 2006-07 as staff gained more experience in working cases.

2.20 As part of its programme of efficiency savings, the Department closed its Manchester office in July 2007, followed by the Bristol office in March 2008. Only three staff from Manchester and Bristol transferred to Birmingham, resulting in a loss of cumulative experience. Despite the office closures, the cost of compliance increased in 2007-08, because the staff in Birmingham had to be trained and build up expertise. The team also experienced a high level of turnover in 2007-08, which had a large impact because the team was so small, and resulted in a further loss of expertise and the need for more training. In addition, staff in Manchester had to prepare enquiries to be handed over and the new staff in Birmingham had to familiarise themselves with the transferred enquiries, adding to the time spent on each enquiry. This disruption resulted in a decrease in the compliance yield for 2007-08 and in the number of cases settled.

2.21 The compliance yield increased in 2008-09, and the costs of compliance work were the lowest recorded. The Department attributes its success to the comparative stability of the compliance team and to its focus on completing high yielding cases. Two large commercial transactions accounted for over £8.6 million of the yield and work carried out prior to 2008-09 contributed to the successful resolution of these cases.

The Department's current compliance activity

2.22 The Department achieved a high yield in 2008-09, although the small number of enquiry staff limited the number of enquiries it opened. Figure 7 shows that the number of completed enquiries declined in 2007-08. **Figure 8** shows that although there was a slight increase in the number of enquiries completed in 2008-09, only 203 enquiries were opened, representing 0.02 per cent of the one million returns filed in the year.

7 Compliance yield and costs

Year	Compliance yield ¹ £'000	Number of enquiries closed	Compliance yield as percentage of total SDLT receipts %	Cost of compliance work ² £'000	Staff cost: yield ratio ³
2005-06	6,318	451	0.08	479	£1:£13.20
2006-07	10,896	728	0.11	566	£1:£19.24
2007-08	3,373	270	0.03	778	£1:£4.34
2008-09	13,253	322	0.28	461	£1:£28.76
Total or average for period	33,840	1,771	0.11	2,284	£1:£14.82

Source: HM Revenue & Customs

NOTES

1 The compliance yield is made up of additional receipts from enquiries, including interventions, and avoidance cases. Interventions are where the Department's action prevents an incorrect refund of tax. Avoidance case yields occur when the taxpayer agrees to settle after the Department challenges the scheme. The compliance yield does not include deferment cases, where the Department has taken action to ensure that deferred consideration is paid. The Department recorded yields from this work from 2007-08, when the yield was £1,201,000 and recorded a yield of £719,000 in 2008-09.

2 The cost comprises staff costs only, and is based on the percentage of staff time spent on compliance work.

3 Based on actual figures.

8 Number of cases opened and completed by quarter

Quarter	Apr-Jun 08	Jul-Sep 08	Oct-Dec 08	Jan-Mar 09	Total 2008-09
Number of enquiries open at start of quarter	491	409	377	397	491
Number of enquiries opened in quarter	2	68	43	90	203
Number of enquiries closed in quarter	84	100	23	115	322
Number of enquiries open at end of quarter	409	377	397	372	372

Source: HM Revenue & Customs

2.23 The Department has three main ways of identifying returns to enquire into:

- Profiling. This involves identifying specific risk factors, and creating a profile to identify cases displaying the risk characteristics. The profile is then run on the database containing details of all SDLT returns, to extract those transactions displaying the risk factors for further investigation.
- Third party information. The main source of information is other parts of the Department, although some information is received from external sources.
- Random sampling. A very small proportion of returns are selected for enquiry on a statistically random basis. As a result, the cases selected are often very straightforward, with minimal risks. The purpose of random enquiries is to act as a deterrent to non-compliance, and to improve the Department's understanding of the nature and extent of non-compliance across the population.

2.24 The Department investigates all cases selected by random sampling and reviews all third party information received. The number of cases it identifies using profiling depends upon the resources it has to effectively work further enquiries once it has dealt with the third party information and random cases. The Department has been reducing its use of profiling since December 2006, and only opened 49 enquiries identified through profiling in 2008-09. It selects the profiling cases it judges likely to be highest yielding. However, the overall number of high risk cases identified through profiling largely depended upon the resources the Department had to work enquiries and a high level judgement that the yield from such cases was likely to be lower than from other work. The number of cases investigated was not determined by a quantitative analysis of the number and type of high risk cases and estimated compliance yield. In 2009-10, the Department intends to increase its profiling and reinstate its Project Board, which is responsible for researching risk factors, targeting work relating to the risk, and ensuring that the outcome of this work informs its selection of cases in the future.

2.25 The Department is satisfied that the 372 enquiries open at the end of 2008-09 were being satisfactorily progressed and not awaiting Departmental action. It has a Quality Assurance programme for its enquiry work to help ensure that enquiries are brought to a timely and appropriate conclusion, and that the correct procedures are followed. In October 2008, the Department introduced a process to review all enquiries that have

been open over twelve months and has begun to examine these cases. **Figure 9** shows the length of time taken to complete the enquiries settled in 2008-09.

2.26 The length of time it takes to complete an enquiry depends on the nature of the risk, the complexity of the case, and the level of cooperation from the taxpayer. Many of the cases that have been open for over six months are purchases of a business, awaiting confirmation of the valuation of goodwill so that the value of the land and buildings can be determined. These have been referred to the Valuation Office Agency, which assists with the valuation of complex goodwill.

The Department's management information for compliance work

2.27 The Department recognised the value of having a computerised case management system for its compliance work in 2002 before SDLT was implemented, but decided that it could not justify the cost. Because it has limited resources for its compliance work, and recording and analysing data without a dedicated computerised package is time consuming, the Department only records basic data on enquiries.

2.28 Although the compliance team are able to assess whether the investigation of a particular risk factor has been worthwhile, the lack of detailed management information makes it difficult for the Department to quantify the total level of non-compliance and thereby evaluate the overall success of its compliance activity; justify the level of resources required to effectively tackle non-compliance; and prove that it is directing its compliance resources to where they will have most impact.

2.29 The Department is planning to implement a computerised case management system for its compliance activity later in 2009-10, which will include a module adapted to the requirements of its SDLT compliance work.

9 Length of time taken to complete enquiries in 2008-09

Length of time to complete enquiry	Number of enquiries	Percentage of enquiries
Under 3 months	51	16
3 to 6 months	16	5
6 to 12 months	38	12
Over 12 months	217	67
Total	322	100

Source: HM Revenue & Customs

The Department's compliance strategy

2.30 In March 2009, the Department drafted a three year strategy for its compliance and avoidance work. The strategy defines the Department's objectives, the challenges it faces in tackling avoidance and evasion, and its strategy for meeting its objectives. The strategy includes:

- developing an understanding of the behaviour of different customer groups;
- developing and communicating guidance to make it easier for customers to comply;
- reviewing and simplifying legislation and procedures;
- improving data management and compiling a comprehensive risk assessment to target resources;
- working with others to share intelligence; and
- ensuring resources are used to maximum effect.

2.31 The Department is already implementing elements of the strategy. The proposed compliance management information system should help the Department with its aim of improving data management and aid the development of a comprehensive risk assessment that it can use to target its resources and ensure that it has appropriate coverage of risk. The Department is working with the Land Registry to improve the identification of transactions that have been self-certified, but where the consideration is actually above the threshold for notification. This work will help to address the risk that purchasers use self-certification to avoid alerting the Department to a transaction that is liable to SDLT. The Department is also working with the Valuation Office Agency to develop guidance on the valuation of goodwill for all taxes, to help taxpayers with valuations that are often complex and make it easier for them to be compliant. The actions that the Department is taking on avoidance are described in paragraphs 2.32 to 2.42.

Anti-avoidance measures

Disclosure requirements

2.32 The Finance Act 2004 introduced the requirement for promoters of certain tax avoidance schemes to provide information about the scheme ("disclose the scheme") to the Department. The disclosure arrangements were extended to cover SDLT in 2005⁶. For SDLT, disclosure is required only for schemes involving commercial property with a market value of at least £5 million. The aim of the disclosure regime for SDLT was to obtain a comprehensive list of the avoidance schemes in operation. This list was to be used to formulate policy on introducing new legislation to close any avoidance loopholes.

2.33 Unlike the disclosure regime for Income Tax, Corporation Tax and Capital Gains Tax, users of SDLT avoidance schemes are not required to notify the Department when a scheme is being used. The Department believed that, because the disclosure requirements were drawn so widely, having to disclose use of a scheme would have imposed an undesirable burden on scheme users.

Schemes disclosed

2.34 By the end of March 2009, the Department had received 764 scheme notifications. The actual number of schemes in use was less than 764 as some schemes were disclosed by more than one promoter and separate notifications are in some cases variations on a theme.

Figure 10 shows the number of scheme notifications made in six monthly intervals from 1 August 2005 when the disclosure regime was introduced. A large number of schemes were notified when the avoidance legislation was introduced because all the schemes already in use were captured. The number of scheme notifications has reduced over time, because most schemes have been disclosed so only new schemes are now being notified. The introduction of anti-avoidance legislation also means that some types of scheme can no longer be used.

10 Number of SDLT avoidance scheme notifications received

	Aug 05 – Sept 05	Oct 05 – March 06	April 06 – Sept 06	Oct 06 – March 07	April 07 – Sept 07	Oct 07 – March 08	April 08 – Sept 08	Oct 08 – March 09
Number of scheme notifications	295	190	75	110	32	34	14	14
Cumulative number of scheme notifications	295	485	560	670	702	736	750	764

Source: HM Revenue & Customs

⁶ The disclosure arrangements were extended to cover SDLT by The Stamp Duty Land Tax Avoidance Schemes (Prescribed Descriptions of Arrangements) Regulations 2005 (SI 2005 No. 1868).

2.35 The Department uses the information disclosed to decide whether to:

- make a case to the Treasury for the law to be changed to block future applications of the scheme;
- investigate whether there are technical grounds for challenging the interpretation of the law in individual cases applying the scheme; or
- take no action on the basis that it judges that the scheme is within the intention of the law, or alternatively has very limited application.

2.36 These decisions often involve complex judgements on whether a particular scheme technically complies with the law, and if so, whether it uses an exemption for a purpose that was not intended and therefore the law should be changed. **Figure 11** summarises the main categories of avoidance scheme which require action (i.e. are not classified as 'inoffensive') and the action taken by the Department in response to the scheme. It also shows the tax potentially avoided in the cases known to the Department.

Investigating cases using avoidance schemes

2.37 The Department did not undertake any work to investigate and challenge cases using avoidance schemes until 2007. This was because it considered it needed to understand how the new legislation worked in practice, and wanted to give taxpayers time to understand how the new tax applied to complex transactions before it began investigations.

2.38 The disclosure scheme rules for SDLT do not oblige users of avoidance schemes to tell the Department when they are using a scheme. If the avoidance scheme brings the chargeable consideration below the threshold requiring a return, the Department may not even know that a transaction has taken place. As well as making it difficult to establish the overall level of avoidance, these factors make it difficult for the Department to identify specific cases to investigate.

2.39 The Department identifies most of the avoidance cases it investigates through voluntary disclosures. The Department identifies a small number of other cases by looking for returns naming a promoter known to have promoted or used a scheme, identifying large property deals for which no return has been received, or through referrals from other parts of the Department.

The Department has not yet tested the legality of any avoidance schemes in a court of law. This is because it did not start investigating any cases until 2007 and because there are no specific legal precedents, which makes investigating cases time consuming and expensive. The Department has now begun to challenge some cases and estimates that there could be test cases by 2010.

Future action on anti-avoidance

2.40 The disclosure regime for SDLT is being extended to cover residential property transactions above £1 million and to identify users of avoidance schemes. These changes were announced in April and November 2008, and draft regulations have been published for consultation with stakeholders.

2.41 In 2008-09, the Department began a project to understand how to assess the scale and scope of avoidance. This work is focusing on commercial transactions and will include understanding the motivations of those using avoidance schemes and defining a compliance spectrum of acceptable and unacceptable behaviour. It will explore the possibility of using databases of property transactions and other information to make a robust estimate of the SDLT tax gap.

2.42 The extension of the disclosure scheme will make it easier for the Department to identify when new avoidance schemes are being used and therefore to evaluate the extent of avoidance. It intends to use this information, and the results of its work on assessing the scale and scope of avoidance, to target its anti-avoidance and compliance work.

Conclusions

2.43 SDLT receipts exceeded the Department's expectations once the new tax was introduced. The Department has not formally quantified how much of the additional yield was due to the new tax and how much due to the rising property market. In 2008-09, SDLT receipts fell by over 50 per cent, due to the decrease in the number of transactions and the decrease in transaction values.

2.44 The expected efficiency savings from SDLT were not fully realised until the use of online filing, introduced in 2005, became significant. The implementation of the new SDLT computer system took longer than planned and even when operational, significant staff resources were still needed to deal with the exceptions raised. Resources had to be diverted to processing from other activities, including compliance work. Uptake was initially slow but the Department made good progress in encouraging online filing and 81 per cent of returns are now filed online.

11 Summary of anti-avoidance schemes, action taken by HMRC, and tax at risk

Description of the scheme	Action taken by HMRC	Tax at risk ¹
<p>Lease with Break Clause</p> <p>These schemes are set up so that there is a long leasehold granted on the property that renders the freehold virtually worthless, and therefore subject to no or minimal SDLT. Instead, payment is made by the purchaser to insert or exercise a break clause in the lease held by the vendor, or for the vendor to not exercise a break clause in the lease held by the purchaser. The payment for inserting or exercising a break clause is not subject to SDLT.</p>	<p>Legislative action Section 75A of the Finance Act 2003 was introduced with effect from 6 December 2006², with the intention of blocking the use of these schemes.</p> <p>Other action The Department is investigating eight cases arising before 6 December 2006.</p>	<p>£14 million from eight cases.</p>
<p>Sub-sale schemes</p> <p>These schemes take advantage of sub-sale relief in section 45 of the Finance Act 2003. They are structured so that the sale of the property for market value between two third parties can claim subsale relief because there also exists a contract for the purchaser to pass the property on, in this case to a connected party. The transaction is structured such that another relief can be claimed, or a low value transfer can be arranged, when the property is passed on.</p>	<p>Legislative action Section 75A of the Finance Act 2003 was introduced with effect from 6 December 2006², with the intention of blocking the use of these schemes.</p> <p>Other action The Department is investigating cases arising both before and after the introduction of section 75A on 6 December 2006. The basis for challenge will be the application of section 45 relief for cases arising before 6 December 2006 and the application of both section 45 relief and section 75A for cases arising after that date.</p>	<p>£175 million from 202 cases.</p>
<p>Partnerships</p> <p>These schemes involve arranging a connection between the purchasing partnership and the vendor. This results in the proportion of the consideration being taken into account as assessable for SDLT being reduced to nothing, or almost nothing.</p>	<p>Legislative action The Department is reviewing all the legislation relating to partnerships and considering whether it is appropriate to revise the legislation. It is also drafting guidance for taxpayers on this complex area.</p> <p>Other action The Department is investigating 18 cases.</p>	<p>£22 million from 18 cases.</p>
<p>Alternative finance</p> <p>These schemes take advantage of a relief intended to allow for alternative financing where a standard interest-based mortgage is not used on religious grounds. Under the avoidance scheme, a subsidiary of a financial institution is set up to eventually own the property without having to pay SDLT.</p>	<p>Legislative action Section 73AB of the Finance Act 2003 was introduced with effect from 12 March 2008³, which disallows the alternative finance exemptions if there are arrangements for a person to acquire control of the relevant financial institution.</p> <p>Other action The Department is investigating a case arising before 12 March 2008.</p>	<p>£6 million from one case.</p>

11 Summary of anti-avoidance schemes, action taken by HMRC and tax at risk *continued*

Description of the scheme	Action taken by HMRC	Tax at risk ¹
<p>Unit Trusts</p> <p>These schemes use an offshore unit trust to transfer ownership of the property, using section 64A of the Finance Act 2003 which states that transfer of a property to a unit trust is not chargeable to SDLT.</p> <p><i>Source: HM Revenue & Customs</i></p>	<p>Legislative action</p> <p>Section 64A of the Finance Act 2003 was removed with effect from 22 March 2006⁴, with the intention of blocking the use of these schemes.</p> <p>Other action</p> <p>Only one case was identified following legislative action and the Department did not pursue this case.</p>	None

NOTES

- The 'tax at risk' figure is the amount of tax potentially payable from the cases under investigation by the Department in May 2009. It does not include an estimate of the amount of tax at risk from all cases that might be using these schemes.
- Section 75A inserted by The Stamp Duty Land Tax (Variation of the Finance Act 2003) Regulations 2006 (SI 2006 No. 3237).
- Section 73AB inserted by para 155 of the Finance Act 2008.
- Section 64A removed by para 166(2) of the Finance Act 2006.

2.45 The diversion of resources meant that the Department built up its compliance activity more slowly than planned, with no additional yield recorded in 2004-05. Over the next four years, the Department's compliance work yielded a total of nearly £34 million. Compliance work was also disrupted by the reorganisations caused by closure of the regional offices, resulting in a drop in the yield and increased cost in 2007-08. The Department achieved a high yield in 2008-09, partly reflecting work in previous years. The impact of staff turnover can be high because the SDLT compliance team is so small and the work is specialist. The Department's SDLT Compliance Strategy recognises the need for succession planning and to improve training and guidance for the compliance team. The Department should ensure it implements the strategy.

2.46 Only 203 enquiries were opened in 2008-09. The Department does not have a quantitative analysis of the tax at risk and the amount of work required to tackle non-compliance effectively. Whilst it aims to use its resources on the highest risk cases, the number of cases that it identifies for investigation depends on its resources, taking into account a high level judgement on the likely yield. The lack of readily accessible management information contributes to the difficulty of making a sound estimate of the total level and nature of non-compliance. The Department should ensure that it implements the proposed case management system as planned and that the system will enable it to produce a comprehensive analysis of all its compliance work. It should then ensure that it matches the size of the compliance team to the overall level of risk, taking into account the need to examine sufficient transactions to provide an effective deterrent effect. The Department has told us that it plans to do this.

2.47 The disclosure regime was extended to SDLT in 2005. For SDLT, unlike other taxes, it is difficult for the Department to identify cases because the disclosure rules for SDLT do not require users to tell the Department when they are using an avoidance scheme. The Department is investigating individual cases to see whether it can challenge the technical application of the law. This did not start until 2007, and therefore it has not brought any cases before the courts, although it has begun to challenge individual cases and estimates that there could be test cases by 2010.

2.48 The lack of a reliable estimate of the SDLT tax gap makes it difficult for the Department to assess whether it is targeting its resources effectively and to justify the use of additional resources. Understanding how to make a better estimate of the tax gap is the Department's top strategic priority for SDLT compliance. The Department has recently prepared a high level compliance strategy that identifies the challenges it faces, and it is undertaking work to allow a sounder estimate of the tax gap. The extension of the disclosure regime will provide further information on the use of avoidance schemes, and the implementation of the computerised case management system will provide more information on the results of compliance enquiries. The Department intends to use this information to produce a detailed analysis of the extent and nature of non-compliance. It should set yield targets based on the estimated level of total non-compliance and avoidance, and use these targets to determine the level and allocation of its compliance resources.

PART THREE

Corporation Tax Postponements and Repayments

Introduction

3.1 Corporation Tax is charged on the worldwide taxable profits of UK based companies.⁷ Companies not based in the UK but having a permanent office or branch are taxed only on their UK activities.⁸ In 2008-09 the Department collected net Corporation Tax revenue of £42.8 billion. This is shown in **Figure 12** together with the breakdown in net Corporation Tax revenue between the main broad industrial sectors over the past four years.

3.2 In our 2004-05 Standard Report we examined various aspects of the Department's management of Corporation Tax. We have continued that process in 2008-09 and focused on:

- postponements: Corporation Tax due is 'postponed' when a company appeals against the Department's judgement of how much tax is due. The Department can also postpone the collection of tax from a company for reasons of administrative efficiency and customer service;
- repayments: the Corporation Tax process can produce repayments, the volume and value of which are increasing in the current trading conditions faced by many companies. We examined the Department's procedures and its response to identified risks.

12 Net Corporation Tax revenue

Year	Net Corporation Tax Revenue (£bn)	Financial Services (including Life Assurance) (£bn)	Oil & Gas (£bn)	Home Industrial & Commercial (£bn)	Estimated Total Number of Taxpayers
2005-06	41.9	11.2	7.3	23.4	875,000
2006-07	44.3	12.2	6.9	25.2	900,000
2007-08	46.4	12.4	6.1	27.9	975,000
2008-09	42.8	7.6	10.4	24.8	-

Source: HM Revenue & Customs

NOTES

1 'Estimated Total Number of Taxpayers' is the number of companies with profits chargeable to Corporation Tax (it does not include companies with losses or which had no taxable profits after allowances). The 2007-08 figure is an estimate and may be revised by the Department before it is published in April 2010. The 2008-09 figure is not yet available.

2 Figures for Number of Taxpayers split by main broad industrial sectors are not available.

3 For 2007-08 and 2008-09, the breakdown of net receipts between industrial sectors is subject to change as tax payments originally made in respect of a group of companies are re-allocated to individual companies within the group.

4 Net Corporation Tax revenue is on a cash basis and therefore does not match the Trust Statement income figure which is prepared on an accruals basis.

7 For the purposes of this report, the term 'company' encompasses all bodies liable to Corporation Tax. This includes: limited companies, clubs, societies, trade associations, housing associations and groups of individuals carrying on businesses other than partnerships.

8 Income and Corporation Taxes Act 1988, Sections 8 and 11.

The Corporation Tax Process

Legal obligations

3.3 Legislation places key obligations on companies, as shown in **Figure 13**.

13 Key obligations	
Requirement	Legislation
Registration	
Companies that are new and begin to carry on business or trade, or those that were dormant or have recommenced trading, must inform the Department that they are liable to tax within three months.	Section 55, Finance Act 2004
Payment	
Companies must pay the right amount of Corporation Tax on time.	Sections 59D(1) & 59E, Taxes Management Act 1970
<i>Payment deadline</i> – the deadline for payment is before the deadline to file a Company Tax Return. Generally, companies must pay by nine months and one day after the end of their Corporation Tax accounting period – this is called the ‘normal due date’.	Statutory Instrument No 3175/1998
<i>Instalments</i> – companies with taxable profits over £1.5 million must pay by instalments at three month intervals starting in the middle of their accounting period and finishing in the fourth month after its end.	
Filing	
Companies must file the tax return by 12 months after the end of their Corporation Tax accounting period – the ‘statutory filing date’.	Schedule 18, paragraph 3, Finance Act 1998
<i>Source: HM Revenue & Customs</i>	

Corporation Tax rates

3.4 There are two rates of Corporation Tax, depending on the company’s taxable profits. These are the ‘lower’ rate (also called the ‘small companies’ rate) and the ‘upper’ rate (also called the ‘full’ or ‘main’ rate).⁹ There is a sliding scale between the lower and upper rates known as ‘marginal rate relief’ so that the effective rate of tax gradually rises as taxable profits increase. The Government updates tax rates through the annual Finance Act. The current rates are 21 per cent and 28 per cent respectively.

Self assessment

3.5 Corporation Tax uses a self assessment process.¹⁰ This process requires each company to work out how much tax it owes for each accounting period. For this purpose it has to calculate the amount of profit on which it must pay tax – the ‘Taxable Profit for Corporation Tax’. The starting point is the pre-tax profit figure in its financial statements which it adjusts to arrive at the final self assessment figure. **Figure 14** provides a simplified illustration of this process.

The Department’s framework for administering Corporation Tax

3.6 **Figure 15 on page R20** shows the key components of the Department’s framework for administering Corporation Tax.

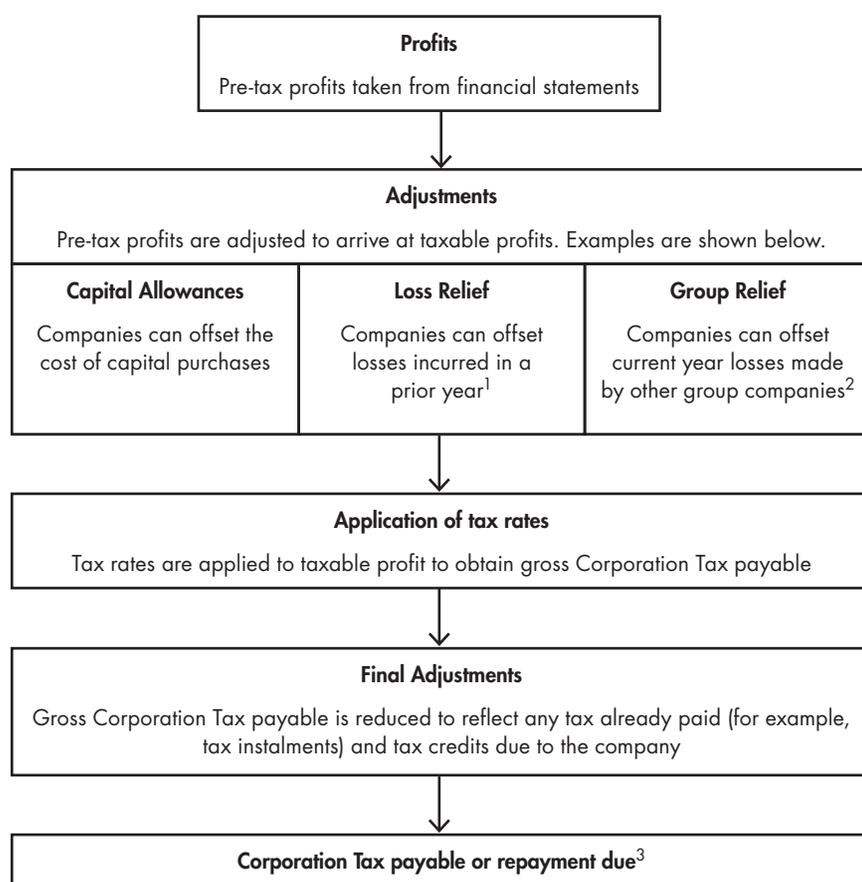
3.7 The Department administers Corporation Tax on the basis of ‘process now, check later’. Essentially this means that the Department processes Company Tax Returns with minimal intervention and then carries out post processing checks including compliance enquiries on selected cases.¹¹

⁹ Income and Corporation Taxes Act 1988, Paragraph 1, Section 13.

¹⁰ Finance Act 1998, Paragraph 7, Schedule 18.

¹¹ The Finance Act 2007, introduced deadlines for when the Department can initiate a compliance enquiry in respect of Company Tax Returns for accounting periods ending after 31 March 2008. The requirements vary depending on the specific circumstances but in general, where a Company Tax Return is delivered by the statutory filing date, the Department has 12 months from the date of delivery in which to initiate a compliance enquiry.

14 The Corporation Tax calculation process



Source: HM Revenue & Customs

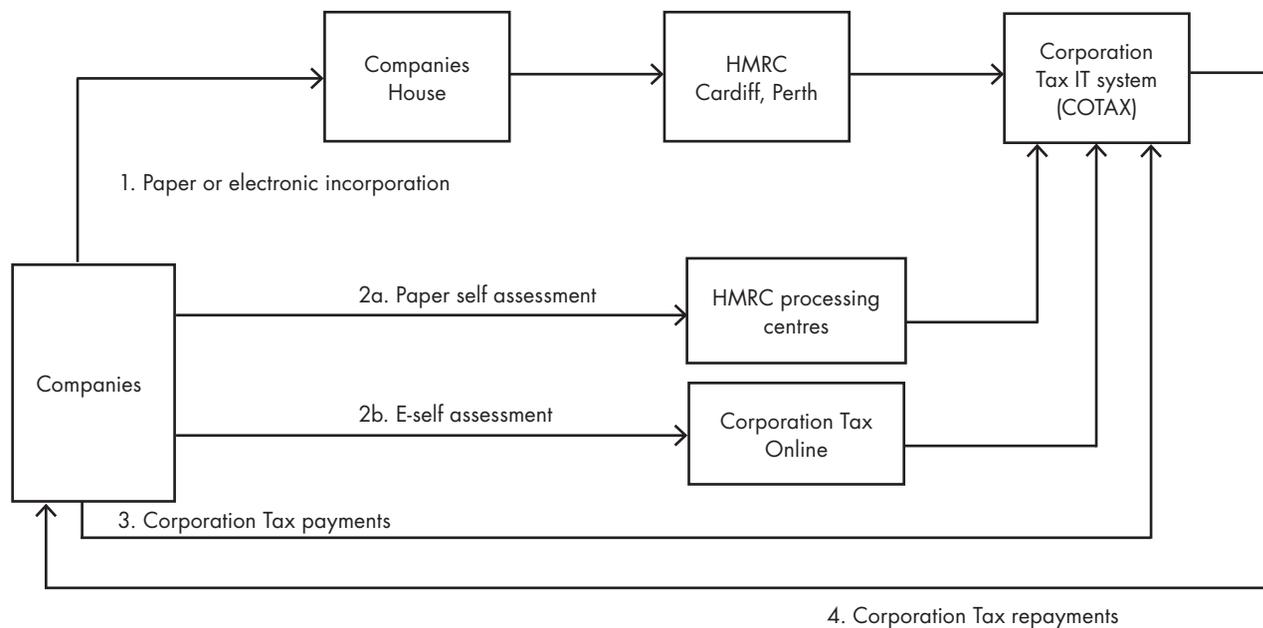
NOTES

1 Trading losses may be offset against the profits of the previous year's Corporation Tax accounting period, or carried forward and offset against profits in any future accounting period. Offsetting losses against prior or future profits allows companies and organisations to reduce their Corporation Tax liability and potentially receive a repayment of Corporation Tax.

2 For Group Relief, companies are members of the same group if one company is a 75 per cent subsidiary of the other or both companies are 75 per cent subsidiaries of a third company.

3 Each company arrives at the above 'Corporation Tax Payable' or 'Repayment Due' by completing the Company Tax Return.

15 The Department's administration of Corporation Tax



Source: HM Revenue & Customs

NOTES

- 1 Companies are incorporated with Companies House who forward the incorporation data to HMRC Cardiff and Perth for input to the Corporation Tax IT system (COTAX) which keeps taxpayer records. COTAX is the Department's main system for supporting the administration of Corporation Tax. It holds self assessment and Corporation Tax payments and repayment details for all companies and organisations eligible for Corporation Tax. Other IT systems, such as CTA/CTC, exist that support the historic (pre-1993) and non-standard Corporation Tax items that COTAX cannot handle.
- 2 Companies file their tax returns (self assessments and supporting documents) by submitting them either to HMRC processing centres for input to COTAX or by e-filing using the 'Corporation Tax Online' system. From April 2011, all companies will be required to file online for accounting periods ending after 31 March 2010 where the company tax return is delivered after 31 March 2011.
- 3 Companies make payments of Corporation Tax which are processed by HMRC and recorded in COTAX.
- 4 Repayments are a common feature of the Corporation Tax self assessment regime as described at paragraph 3.22 onwards.

3.8 The compliance function is carried out by the Large Business Service responsible for around 771 of the largest UK businesses¹² and Local Compliance Offices responsible for other companies. The Department selects cases for compliance enquiries using risk criteria, for example, overseas interests and transactions involving company directors, to identify cases with a relatively higher risk of error or evasion. **Figure 16** provides details on the volume of the Department's Corporation Tax related compliance work in 2008-09.

3.9 Enquiry work can be complex and the Department may have to deal with various agents including tax advisors, legal advisors, accountants and auditors as well as the company itself and its Directors. This work is subject to quality assurance processes within the Large Business Service and Local Compliance. Since October 2008, the

Department has operated new procedures for the Large Business Service that use an issues based approach rather than a review of a sample of enquiries. The new approach focuses on areas where there are signs that improvements may be required, for example, where compliance enquiries are taking a long time to clear or generating low yields. Local Compliance introduced a new quality assurance process in September 2007 covering all aspects of its work including enquiries. Local Compliance Office managers have to prepare a Quality Risk Plan that captures the risks to quality identified within their teams and how they will be addressed. The Department's Risk and Intelligence Service selects cases for Local Compliance intervention nationally based upon risk, with information fed from approved gateways only. The Risk and Intelligence Service conducts quality checks on the risks identified before submission to Local Compliance.

¹² The Department defines a business as 'large' if it has 250+ employees. A 'business' includes all the companies within that business. This is the definition used to demarcate the boundary between 'large and complex' and 'Small and Medium – SME' in Local Compliance.

16 The Department's Corporation Tax compliance work in 2008-09

	Large Business Service	Local Compliance Offices
Number of enquiries in progress at year end	3,970	27,753
Number of new enquiries launched during the year	1,014	19,744

Source: HM Revenue & Customs

NOTE

Unlike Local Compliance, the Large Business Service looks at the number of 'risks' working rather than the number of company enquiries. A risk might cover a number of accounting periods and different companies.

3.10 The aim of a compliance enquiry is to confirm the accuracy of a self assessment set out in the Company Tax Return and results in:

- confirmation of the self assessment – no changes are required; or
- disagreement with the self assessment and provision of an amended figure. The company can appeal against the Department's assessment. An appeal can result in the tax charged being 'postponed'.

Corporation Tax Postponements

Types of postponement

Section 55 postponements

3.11 If a company does not agree with the Department's decision about its Corporation Tax affairs, the Department generally settles the matter through further discussion. Where agreement cannot be reached the company may be able, under Section 55 of the Taxes Management Act 1970, to apply to the Department for a review of the amount of tax and/or penalties due, the payment of which is postponed pending completion of the appeal. Departmental staff not previously involved with the matter under dispute complete these reviews and the Department informs the company of the outcome. If the company does not agree with the result, it has 30 days to refer the appeal to the independent tax tribunal which makes a determination on the amount of Corporation Tax and/or penalties due.¹³

¹³ This 'two tier' approach (i.e. Departmental review and tribunal determination) was introduced from 1 April 2009. The independent tax tribunal is administered by the Tribunals Service (an executive agency of the Ministry of Justice). Prior to 1 April 2009, appeals were made to HMRC's General or Special Commissioners.

Section 1 postponements

3.12 If the Department has reason to believe that an assessment will ultimately be reduced, for example, where the company is part of a group of companies and losses are expected to be set off from elsewhere within the group, it may postpone the tax pending finalisation. The basis for these postponements is the Department's interpretation of the responsibilities of the Commissioners for Her Majesty's Revenue and Customs for the collection and management of Corporation Tax as set out in Section 1 of the Taxes Management Act 1970 and relevant case law.

Management and governance arrangements

3.13 The Department's day to day management of postponements takes place primarily within the Large Business Service and Local Compliance Offices, although cases are also handled by other directorates such as Charities Assets and Residence. **Figure 17 overleaf** provides details of the type, volume and value of postponements managed by the Department over the last two years.

3.14 Postponement cases can be extremely complex. Many are related to accounting periods before the introduction of self assessment in 1999 when companies could appeal against assessments raised by the Department. Currently there is £3.6 billion of postponements recorded on COTAX for pre-self assessment accounting periods (covering the period 1 October 1993 to 30 June 1999) of which £3.2 billion relates to some 60 companies that are part of the largest businesses managed by the Large Business Service. The complex issues involved often mean that it takes many years of litigation before liability can finally be resolved.

3.15 Our examination of postponements in Local Compliance Offices found that many cases for 'small and medium' enterprises were several years old with no evidence of action since the postponement occurred. The Department is taking steps to address this and has recently started to clear-out 'old' postponements below a certain amount without further investigation. The first stage of this process relates to:

- 2,765 postponements of £10,000 or below, with a total value of £3.4 million, where the company concerned is no longer registered with Companies House; and

17 Management of postponements

Type	Number of accounting periods postponed		Value of postponements (£m)	
	As at 28 March 2008	As at 31 March 2009	As at 28 March 2008	As at 31 March 2009
Large Business Service				
S1 TMA	1,251	1,200	4,244	4,096
S55 TMA	888	647	5,656	4,095
Sub-total	2,139	1,847	9,900	8,191
Local Compliance				
S1 TMA	7,208	6,875	385	409
S55 TMA	7,370	6,018	564	588
Sub-total	14,578	12,893	949	997
Other Directorates				
S1 TMA	430	375	28	28
S55 TMA	528	457	406	96
Sub-total	958	832	434	124
Total	17,675	15,572	11,283	9,312

Source: HM Revenue & Customs

NOTES

- 1 S1 TMA = Section 1, Taxes Management Act 1970; S55 TMA = Section 55, Taxes Management Act 1970
- 2 The values of postponements shown in Figure 17 include Corporation Tax charged and any associated penalties. For example, as at 31 March 2009, the total tax postponed was £9,246 million and the total penalties postponed were £66 million, giving the combined total of £9,312 million shown above.
- 3 As at 28 March 2008, the total number of accounting periods postponed was 17,124. However, 551 had both Section 55 and Section 1 postponements, hence the total of 17,675 shown above.
- 4 As at 31 March 2009, the total number of accounting periods postponed was 15,125. However, 447 had both Section 55 and Section 1 postponements, hence the total of 15,572 shown above.
- 5 Information for years prior to 2008 is not available.
- 6 The figures above reflect gross postponements in COTAX. As at 31 March 2009 there was £949 million of postponements in other CT related IT systems such as CTC/CTA. These figures are not included in Figure 17 as breakdowns are not available. Most, if not all, will be S55 TMA postponements.

- 1,603 postponements of £10,000 or below, with a total value of £2.1 million, relating to live companies and accounting periods up to 31 December 2001.

3.16 The Department's Corporation Tax and Value Added Tax (CT&VAT) Directorate, together with operational teams in Local Compliance, are looking at ways in which the Department can manage postponements and prevent the build up of unresolved cases in the future. This includes a review of Local Compliance work lists and the provision of data to help Local Compliance identify and sort postponements to ensure that work is targeted appropriately. The Department regards this exercise as a high priority.

3.17 CT&VAT is accountable for the performance of the Corporation Tax regime, including understanding the underlying trend in postponements and their effect on the tax and its customers. Various reports can be produced that provide CT&VAT with information on the volume and value of postponements at a particular point in time and the approach being taken to manage these amounts. The Department does not produce regular, detailed information on the age profile of all postponements (although we understand that this is possible) believing it to be of minimal qualitative value for management purposes. We consider that such information would add an additional dimension to the Department's oversight of postponements and could be factored in alongside existing considerations of case complexity, tax at risk and available resource to help target cases that should be worked as a priority.

3.18 The management of all aspects of Corporation Tax, including postponements, is monitored by the Department's Business Taxes Board and Corporation Tax Delivery Group¹⁴ and monthly reports produced to Director and Director General level. The Department's position is that CT&VAT would report any risks or problems through normal processes, escalating to Departmental Board level on an exception basis where appropriate. However, what this means is that neither the Executive Committee nor the Departmental Board receives information on postponements on a regular basis. We consider that the provision of such information, for example, on the volume and value of postponements over time with details of expected outcomes, would help senior management to monitor this issue more easily.

Case management processes

3.19 Postponements are recorded on COTAX, which has limited facility to record comments about individual cases, but essentially progress is tracked through the use of paper based files. Our visits to Local Compliance identified the following problems:

- retrieval of records – not all of the corresponding paper based records for those postponements that we sought to examine were available at the time of our initial visit. However, the Department has now provided 100 of the remaining 104 case files for examination.
- Organisation of paper records – the Department has prepared guidance on the key points that staff should follow to ensure that paper files are kept in good order and are easy to navigate. In practice, we found that the quality of paper based files was variable with some easy to follow and others less so. Given the inherent complexity of many cases, it is important that files are organised to a consistently high standard so that they are readily accessible to those who may need to use them, for example, when new staff take up post.

- Alignment of paper records to COTAX – we identified cases shown as postponements on COTAX where there was no reference to the postponement in the paper based case file. We also found examples of postponements shown on the Department's work list that were not recorded as postponements in COTAX. This issue arose in other areas of our audit where COTAX could not be updated to reflect significant events, for example, receipt of an amended self assessment, even though significant periods of time had elapsed (years in some cases).

3.20 The Department's reliance on paper-based records means that it does not back-up key information to facilitate recovery in the event of information loss, for example, through fire. The Department plans to centralise the storage of paper files in large scale repositories which will increase the Department's need to consider effective contingency arrangements.

Financial reporting

3.21 The Department flags postponements within COTAX¹⁵ to stop it from attempting to collect tax during a postponement. Historically, the Department has not recognised any income in respect of postponements flagged in COTAX. However, audit work indicated that the Department was likely to receive tax from some cases and that these amounts could be measured reliably thus meeting the criteria for asset recognition in the Trust Statement. In May 2009, the Department conducted a review of large postponements to assess how much tax it expected to receive as at 31 March 2009. The review encompassed all postponements over £25 million within the Large Business Service and all postponements over £10 million with Local Compliance. In monetary terms this represented £6.1 billion of the £8.2 billion (74 per cent) total value postponed within the Large Business Service and £0.3 billion of the £1.1 billion (27 per cent) total value postponed in Local Compliance and other directorates. The review identified £1,354 million included in postponements which would have been released to revenue on the finalisation of assessments. It also identified £1,819 million where the assessments recorded in COTAX were too high and would need to be reduced. The Department has adjusted the 2008-09 Trust Statement to reflect these items.

14 Business Taxes Board – chaired by the Director General for Business Tax and attended by Business Tax Directors, the Board monitors and discusses key high level risks, issues and performance across the business taxes including Corporation Tax. The Corporation Tax Delivery Group is responsible for overseeing the end to end Corporation Tax process and includes members from relevant business areas.

15 The Department calls this a 'standover'.

Corporation Tax Repayments

The basis for repayments

3.22 Most Corporation Tax repayments arise when a company's finalised assessment reveals an earlier overpayment of tax; for example, through the payment of instalments ahead of the final assessment. Repayments can also arise when companies offset losses against taxable profits. A company can offset losses incurred in their current Corporation Tax accounting period against taxable profits earned in the previous period. This reduces the liability for the previous period, resulting in a repayment of any excess tax paid.¹⁶

3.23 **Figure 18** provides details of the value of repayments in the last four years. Repayments in 2008-09 were higher than in previous years, reflecting the difficult trading conditions experienced by many companies since 2007-08. The Budget 2009 is also likely to give rise to additional repayments in 2009-10 and 2010-11 as it increased the scope for companies to offset losses against the taxable profits of earlier years.

The repayments process

3.24 The Department's assurance over the propriety of repayments is based primarily on a system of pre and post-repayment checks. The COTAX system has a series of programmed inhibits. Some repayments are inhibited on the 'Overpayments Requiring Urgent Review' work list, and if basic checks are not conducted within 14 days, they are processed automatically to prevent delay. Other repayments are inhibited permanently on the 'Overpayments List', and require manual intervention

before they can proceed any further. COTAX also undertakes an automatic risk assessment to identify cases that require pre-repayment security checks. High value repayments, together with a sample of lower value repayments, are checked by the originating Large Business Service or Local Compliance Office to confirm their validity. No repayments are made against these cases until the review process is complete. In addition, repayments over a certain threshold must be authorised individually prior to being made. The vast majority of other repayments are processed automatically and the money is transferred directly to the company's bank account or repaid via payable order.

3.25 The Department's post-repayment regime involves cases being selected by the COTAX system and placed on a weekly action work list for manual post-repayment security checks.¹⁷ If there are concerns, they are escalated accordingly.

3.26 **Figure 19** illustrates the Corporation Tax repayments process and associated key controls.

3.27 In addition to repayments of Corporation Tax, the Department needs to make other types of payments to companies, for example, when paying tax credits on qualifying expenditure (such as research and development or the production of British films). The Department may also need to reimburse a company, for example, for income tax deducted at source on some types of investment income received. These payments are initiated by a manual intervention in COTAX to create a dummy receipt against which a 'repayment' can then be made, if appropriate. The Department refers to receipts created in this way as 'District Set-off' (DSET) postings.

3.28 The Department uses DSET postings to enable repayment processing on COTAX rather than an alternative approach of a manual payable order. DSET postings and repayments are created by individual officers i.e. there is no separation of duties between setting up and approving a DSET posting and the subsequent repayment. However, the Department flags up repayments following a DSET posting as higher risk and they have an increased chance of being picked up by the Department's pre and post repayment security checks. The number of repayments following a DSET posting is shown in **Figure 20**.

18 Repayments

	2005-06	2006-07	2007-08	2008-09
Value (£bn)	4.7	5.4	8.1	9.7

Source: HM Revenue & Customs

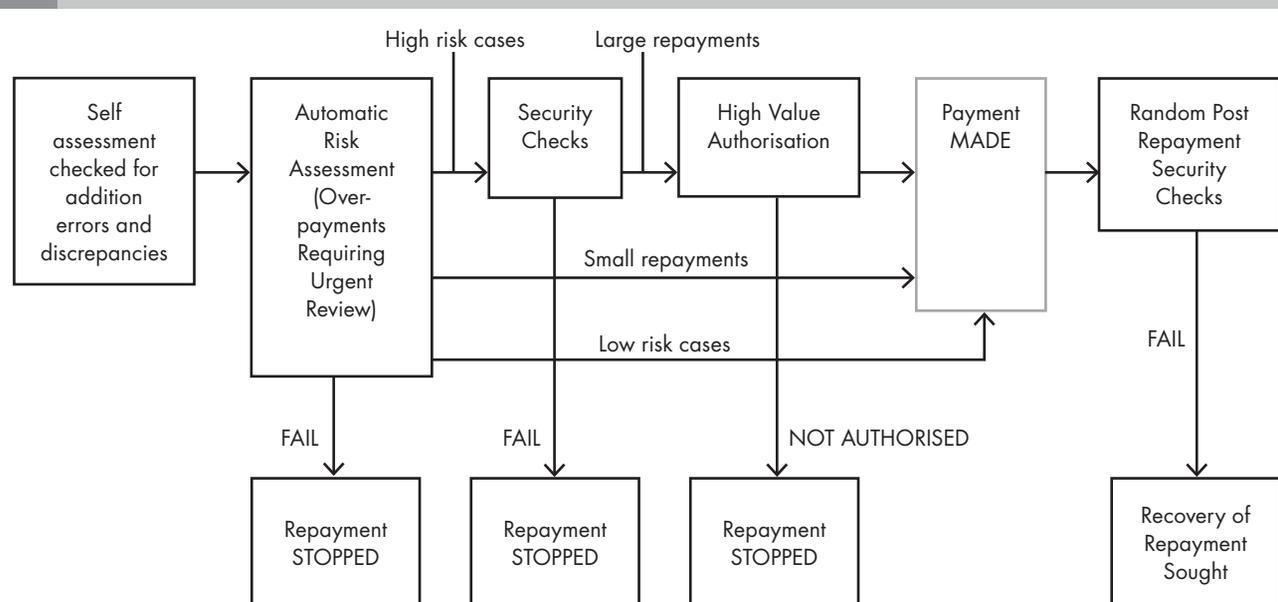
NOTE

The Department does not routinely produce information on the volume of repayments and this could not be produced for the purposes of this report without significant resource cost.

¹⁶ The legal basis for repayments is Section 59D(2) of the Taxes Management Act 1970 – where tax paid exceeds the tax due, "the excess shall be repaid".

¹⁷ This list can include cases that have already had a pre-repayment check, if the circumstances are such that the post-repayment risk criteria are also matched.

19 The Corporation Tax repayments process



Source: HM Revenue & Customs

20 Corporation Tax repayments following DSET posting

Annual totals	2005-06	2006-07	2007-08	2008-09
Volume	8,998	8,300	7,037	7,130

Source: HM Revenue & Customs

NOTES

- The figures above relate to DSET postings of £100 or more.
- The Department does not routinely produce information on the value of repayments following DSET posting and this could not be produced for the purposes of this report without significant resource cost.

The Department's response to repayments risk

3.29 The Department has established a 'Repayments Taskforce' to identify and assess the risks presented by repayments across the different tax streams and to ensure that business areas have addressed identified risks and are following agreed action plans. **Figure 21 overleaf** sets out the Taskforce's conclusions on the most significant risks facing repayments, together with the actions proposed. The Department is undertaking a six-monthly review of this assessment and business area action plans.

21 Corporation Tax repayment assessment results

Risk identified

A dependence on the integrity of Companies House records as part of the Corporation Tax registration process. There is a risk that Corporation Tax registration details are inconsistent with those held by Companies House and/or that information submitted in support of a self assessment is inconsistent with accounts filed at Companies House. In turn, this creates a risk that erroneous/improper Corporation Tax repayments are made or that the Department continues to work on postponements and make determinations in respect of companies that have ceased trading.

Risks around existing pre-repayment checking systems. More specifically: old and limited automatic risk rules, no input from Departmental risk experts (Risk & Intelligence Service and Knowledge Analysis Information Unit), a focus on internal rather than external fraud. The Department also concluded that not all offices had the capability to undertake security checks.

Limitations in escalation routes and intelligence gathering when issues were identified by officers undertaking security checks.

Source: HM Revenue & Customs

Action proposed

The Department is working closely with Companies House, specifically looking at improving the incorporation and initial registration processes, and also on a joint approach to filing of financial information. The plan is to deliver improvements during 2010-11. This will provide greater assurance over the integrity of information feeding into COTAX and the consistency of Corporation Tax self assessments with accounts filed at Companies House.

The Department is reviewing the effectiveness of the pre-repayment checking system and an action plan to address identified issues is scheduled for 2009-10.

The Department is changing the process for pursuing issues identified by security checks and the gathering and utilisation of intelligence.

Conclusion

Postponements

3.30 Figure 17 shows the Department has reduced the volume and value of postponements during 2008-09. However, the total value of postponement cases is still over £9 billion. Historically, the Department has not actively monitored the low value high volume cases in Local Compliance and so it has experienced a gradual build-up of postponements in this area. It is important that the Department has effective case management, oversight and accounting processes to ensure that cases are resolved on a timely basis and companies have certainty about their tax affairs. Since early 2008, the Department has been reviewing its treatment of postponements. The Department has stated that it is developing a long term response. This should identify the actions that it plans to take within a defined timetable and encompass the issues highlighted below.

3.31 In September 2008, the Department started work to clear-out 'old' cases to help reduce the current volume of Local Compliance postponements. This is a one-off initiative to 'write-off' those cases that the Department knows it cannot, or believes it is no longer worth attempting to, pursue to a resolution. The Department recognises that active management of postponements should prevent the build up of unresolved cases and remove the need for such 'clear-out' work in the future.

3.32 Postponement cases are recorded in the Department's Corporation Tax IT system (COTAX). However, the Department has no single electronic case management system for postponements. Consequently, the Department manages cases using a combination of data from COTAX and supporting paper based case files. To ensure accuracy and completeness, as well as the confidentiality of customer information, it is important that the Department has controls in place to align data on COTAX with the paper based records. Otherwise, as we found, mistakes can arise on individual cases which can then lead to the inclusion of incorrect amounts in the Department's accounting records. Our audit identified that the Department needs to improve its performance:

- in more timely processing of key information for example, amended self-assessments. This would help to ensure that significant developments on individual cases are reflected on COTAX within a reasonable timescale;
- in the quality and clarity of information held on paper-based case files;
- in the ability to retrieve case files easily so that records can be updated and cases progressed without undue delay; and
- in the financial reporting of the status of postponements.

3.33 As a priority, the Department should introduce arrangements to obtain periodic assurance, for example, through sample review, that paper records and COTAX remain aligned. Longer term, the Department should consider the merits of encompassing postponements within existing plans for the development of an HMRC electronic compliance case management system.

3.34 As a result of our audit, the Department conducted a review of postponements at the year end that gave rise to a reduction of Corporation Tax revenue in the Trust Statement of £465 million. It also provided up to date information for a significant element of the population based on case by case analysis. The Department should use this experience to develop a regular review to inform the management and oversight of postponements and facilitate the preparation of the figure in the Trust Statement. Summary information on postponements should be monitored by the Executive Committee and the Departmental Board. As a minimum, this information should include details of values and volumes profiled by age and location, together with information on expected outcomes.

Repayments

3.35 The value of repayments has risen steadily in recent years, totalling £9.7 billion in 2008-09. This trend is expected to continue as companies face difficult trading conditions and it is vital that the Department has effective controls in place around such large sums of money flowing out of the Department. The Department is taking action, through its Repayments Taskforce, to identify and address risks presented by repayments and has internal reviews underway and planned, for example, by Internal Audit, to examine the extent to which identified risks are mitigated by the existing control framework.

3.36 While repayments are made primarily through automated processes, a significant volume of repayments (over 7,000 in 2008-09 – Figure 20) arise from manual intervention in the COTAX system and there is no separation of duties within this process. We consider that there is an increased risk of inappropriate repayments being made though this process of manual intervention (known as ‘DSET’ by the Department) that would be addressed through the introduction of separation of duties between the set up and authorisation of these repayments. We understand that the Department’s reviews encompass manually initiated repayments and will provide specific conclusions about its assessment of the adequacy of current procedures.

PART FOUR

Excise Duties – Hydrocarbon Oils Duty

Introduction

4.1 Excise duties are levied on alcohol and tobacco products and mineral oils. Minimum duty rates and a framework for administration of excise duties are set out in various EU Directives. But subject to these, each EU Member State may determine its own rates and administrative requirements.

4.2 Excise duty is liable on hydrocarbon oils at the time it is either produced or imported, at either full or rebated rates specified by the Hydrocarbon Oil Duties Act 1979. Rebates are applied to fuels intended for use in non-road traffic vehicles, such as farm tractors, mowing machines or road construction vehicles, or for heating. These products contain chemical markers and dyes to deter and enable detection and misuse as road fuels. Some oils (known as 'Tied Oils') used for certain industrial purposes, such as the manufacture of tyres and paints, are relieved of duty.

4.3 In 2008-09, the Department collected £24.6 billion from mainly road fuels (unleaded petrol and diesel). Since 2006-07, the yield has increased by £1 billion (four per cent), as shown in **Figure 22**. In 2008-09, the seven largest oil companies operating in the United Kingdom accounted for approximately 90 per cent of the total duty, some £22 billion. The balance came mainly from smaller producers and businesses that trade in imported oil.

4.4 The existence of oils on which no or reduced duty has been paid provides two major risks to revenue through fraud:

- **Laundering process or by mixing:** rebated fuel can either be treated to remove chemical markers and dyes added to allow its identification, or it can be mixed with duty-paid road fuel or lubrication oils and then sold at full or near duty paid.
- **Misuse:** directly diverted for use in vehicles driven on the public highway.

4.5 Misuse of rebated fuel is the simplest fraud, but also the easiest for the Department to detect by looking for the marker dye. Fuel laundering is a more complicated process and is harder to detect. Fraudsters "wash" (by adding a laundering agent) or filter oils to remove the colour dyes and chemical markers.

4.6 Since 2001, the Department has published each year an estimate of hydrocarbon oils revenue lost to the Exchequer, mainly because of fraud. Its estimate of oil losses in 2002-03 was £1.2 billion in Great Britain (GB) with a non-UK duty paid market share of £260 million in Northern Ireland (NI). The Department considers that a significant proportion of the non-UK duty paid market in NI relates to legitimate cross-border shopping of fuel. Also, although it is unable to quantify and differentiate from legitimate cross-border shopping, there is also a large element of fraud resulting from smuggling of fuel from the Republic of Ireland for use in Northern Ireland. The price differential in diesel between the two countries, which is affected by a number of factors, including duty differentials and currency exchange rates, has provided an incentive to smugglers. Also, the border is around 300 miles long with numerous crossing points, making it easy for fraudsters to evade capture. The Department believes that smuggling to the mainland is limited at present. But this risk continues to be monitored.

22 Hydrocarbon Oils Duty – Budget Forecast/ Net Receipts

	2006-07	2007-08	2008-09
Budget Forecast (£bn)	23.7	24.9	25.1
Receipts (£bn)	23.6	24.9	24.6

Source: HM Revenue & Customs and HM Treasury Budget Reports

NOTE

Receipts reflect cash received and therefore does not match the Trust Statement revenue figure which is prepared on an accruals basis.

4.7 In 2002, the Government announced a UK Oils Strategy to tackle the fraud. This report outlines the Department's progress and the Committee of Public Accounts previous recommendations, that it should:¹⁸

- have timely information on the nature and scale of the problem to tackle it effectively;
- consider measures of productivity and effectiveness to assess the quality of intelligence work and compare performance across regions;
- provide incentives for traders to move from manual, paper-based returns to lodging returns electronically and set a target date for the full electronic submission of returns;
- ensure regulatory impact assessments are founded on a sound understanding of the nature of the issues and the likely effect of the proposed regulations; and
- review whether the penalties for oils fraud provide a proportionate deterrent or punishment for the seriousness of the criminal activity, and also consider whether its prosecutions strategy is delivering the results needed to deter potential fraudsters.

Progress against Targets

4.8 The United Kingdom is the only EU Member State that has published estimates of oils fraud. The Department has a target, by 2007-08 to hold the illicit market share for oils in Great Britain at no more than 4.4 per cent, and to continue this up to 2010-11. In 2008 the oils tax gap methodology was subject to a fundamental review; details were published in the Measuring Indirect Tax Gaps Report 2008. The 2006-07 estimate, using the revised methodology, is 4.6 per cent (rounded to five per cent), **Figure 23**. The Department believes, however, on the basis of operational evidence, that this estimate is too high. It carried out a random checking exercise which found illicit fuel in less than 0.5 per cent of vehicles checked, which suggests a lower illicit market share than it had estimated. The assumptions underlying the methodology are currently being re-checked.

4.9 In Northern Ireland, the Department made a public commitment in 2001 to establish and then maintain an upward trend in deliveries of UK duty paid road fuel into Northern Ireland. Its current estimates show some success, with a fall in the non-UK duty paid diesel market share from 53 per cent in 2002-03 to 40 per cent in 2006-07. Likewise, the non-UK duty paid petrol market share fell from 18 per cent to 14 per cent over the same period.

23 Diesel and Petrol: Illicit and non-UK duty paid market share and associated revenue losses

	2002-03	2003-04	2004-05	2005-06	2006-07
Market Share – GB					
Diesel illicit market	10%	9%	7%	6%	5% ¹
Market Share – NI					
Diesel (<i>non UK duty paid</i>)	53%	50%	41%	41%	40%
Petrol (<i>non UK duty paid</i>)	18%	18%	14%	14%	14%
Revenue Losses (£m)					
GB Diesel	1,250	1,250	1,100	850	750
NI Diesel	200	210	180	190	200
NI Petrol	60	60	50	50	50

Source: HM Revenue & Customs

NOTES

1 Figure has been rounded from 4.6 per cent.

2 Estimates include duty and VAT.

3 Due to sampling errors, confidence intervals are provided for tax gap estimates. The figures above are central estimates and are interpreted by HMRC as an indicator of long-term trends in the illicit market and non-UK duty paid share rather than a precise estimate of the level.

4 All estimates for Northern Ireland relate to total non-UK duty paid consumption, rather than the illicit market. This reflects the present difficulty disaggregating total revenue losses between illicit activity and legitimate cross-border shopping.

18 HM Customs and Excise Standard Report-15th Report of Session 2005-06 (HC 695).

4.10 The long time lag in obtaining the relevant data means that the Department does not have estimates of the illicit market until at least 18 months after the financial year to which they relate. Estimates for 2007-08 are therefore not yet available. The Department constantly monitors and assesses operational information to maintain current knowledge of the nature of the fraud and to target its resources accordingly. However, it recognises the need to develop lead indicators, to provide information on in-year changes on the scale of the illicit market.

The Oils Strategy

4.11 The key elements of the Strategy included:

- the Registered Dealers in Controlled Oils scheme to provide a stronger regulatory regime to control the sale and distribution of rebated oils;
- enhancing the existing control of tied oils distribution by requiring all customers, as well as distributors, to be individually approved by the Department and to keep and provide records;
- extra HMRC officers including additional investigators to break up criminal gangs behind oils fraud;
- a new central intelligence unit to support all operational activity with the best information and intelligence available across Government;
- new technological support, particularly in the new intelligence unit and in the specialist testing units;
- greater use of sanctions at the Department's disposal, including vehicle seizures, duty assessments and prosecution in such a mix as is necessary to recover lost revenues and prevent fraud occurring; and
- tackling displacement threats as criminals exploit alternative opportunities for oils fraud.

4.12 The Department recognises the need to continually assess and take action to identify, test and address new risks. For example, extending the Registered Dealers in Controlled Oils scheme to aviation turbine fuel in 2006. However, it is to review the Strategy in 2009-10 to ensure it remains robust and will update it as necessary.

Registered Dealers in Controlled Oils (RDCO) Scheme

4.13 The cornerstone of the Strategy is the Registered Dealers in Controlled Oils scheme (the Scheme) under which the Department authorises distributors to operate. The Department's previous focus was on illicit supply and use and involved detecting illicit fuel and imposing of sanctions. But this provided little control over how illicit suppliers and users were sourcing their illegal fuel.

4.14 Since April 2003, all distributors of controlled oils must register with the Department. Around 4,000 are currently registered under the Scheme, the majority of which are required to submit monthly returns with customer details for all commercial sales of rebated fuels, and domestic sales of more than 3,500 litres per supply or 10,000 litres per annum, **Figure 24**. Distributors have a "duty of care" to take reasonable steps to ensure that the sale of rebated oils is for legitimate use. The Department can impose a range of penalties and sanctions for non-compliance, including withdrawing registration. When distributors apply for admittance to the Scheme, they are subjected to detailed background checks by the Mineral Oils Relief Centre (which maintains a database of registered traders).

4.15 Only around 10 per cent of the RDCO returns are submitted electronically, but this does include all the major oil companies. The Department has notified smaller and medium sized traders of the facility and undertaken educational visits to explain how to use the system. It acknowledges that the software, although robust, is not easy to use and best suited for traders with enhanced computer knowledge. Also, funding required to simplify the system needs to be considered in the wider context of its other IT projects. Against this background, the Department does not consider it would be appropriate to make the on-line use mandatory.

4.16 The effectiveness of the Scheme depends on the Department's analysis of the returns to monitor trends. It is therefore important that the returns are submitted promptly. The number of returns submitted late has decreased from 14,896 in 2003-04 to 5,278 in 2008-09. The Department's approach to increasing compliance has focused on educational visits and warning letters. To discourage a pattern of non-compliance it recently targeted traders who have repeatedly failed to submit returns on time. Penalties are to be issued for persistent failures and, as a last resort, registrations may be revoked.

24 Registered Dealers in Controlled Oils (RDCO) Scheme – performance data

	2003-04 (start of scheme)	2004-05	2005-06	2006-07	2007-08 ¹	2008-09
Registrations:						
Registered Traders	2,795	3,025	3,244	3,549	3,784	4,030
Applications approved with conditions imposed	24	13	4	6	9	3
Number of applications refused	2	3	4	4	3	3
Returns:						
Returns received	36,217	54,174	52,718	52,757	45,547	43,532
Percentage of electronic returns received	9.7%	6.5%	8.7%	8.6%	8.8%	9.5%
Returns received late	14,896	18,244	14,307	11,082	8,657	5,278
Sanctions:						
Warning letters issued	N/A	N/A	N/A	3,263	5,269	4,657
Applications revoked due to poor compliance	2	3	7	9	7	2

Source: HM Revenue & Customs

NOTES

1 In 2007 the Scheme rules were relaxed for some dealers allowing them to submit annual rather than monthly returns.

2 N/A = Data not collected.

4.17 In 2007, the Department reviewed the RDCO scheme to establish the extent to which it was achieving its strategic objectives. It consulted internal and external

stakeholders, such as trade bodies and individual businesses. The key issues raised and the Department's responses were as follows:

Key Issues	Department's Response
Some traders found 'duty of care', record keeping and subsequent return completion, onerous and time consuming.	The Department has introduced an annual return for compliant traders supplying 10,000 litres or less per year. It is also continually reviewing the trader population and assessing the possibility to reduce the burden further.
Department 'heavy handed' regarding the imposition of penalties for failure to obtain customer VAT numbers and/or post codes.	To assist business, the relevant public notice is currently being updated to inform businesses that they should advise their customers that failure to provide VAT numbers and/or post codes is likely to result in visits being made by both Excise and VAT staff.
No facilities to notify the Department anonymously of suspicious activity.	Traders can now notify the Department anonymously via a confidential phone line or directly to the Mineral Oils Relief Centre. The Department has centralised the collation and analysis of oils specific information received from all sources, including human intelligence, to enable more effective analysis and targeting of necessary action.
Some traders commented that nothing seems to be done about their concerns, after informing the Department of suspicious behaviour.	The Department has informed all traders that information will only be shared by either party where it does not compromise any legal restrictions, duty of confidentiality, or operational effectiveness. It also publishes two activity reports each year; one covering Great Britain (GB), the other Northern Ireland (NI), providing examples of how working with the industry has contributed to helping the Department tackle oils fraud. Following discussions with industry representatives only the NI report will still be published. The GB report will be replaced with regular flyers covering national activities for inclusion with returns sent to all RDCOs. These will give brief summaries of cases and information, such as how to contact the Department to report any suspicions about misuse of fuel, any changes to the scheme or any trend information which could be of use to RDCOs in attempting to control the product. After a prosecution the Department now ensures that, where possible, this is reported in either the local or national press. In addition to providing feedback to industry its aim is to deter others.

4.18 The Department considers that the introduction of the RDCO scheme has led some fraudsters to change their behaviour, from purchasing large quantities of controlled oils from a small number of traders to small quantities from a larger number of traders. This and other potential trends are explored through data analysis and supporting activity by compliance officers.

4.19 In 2002, controls were tightened on business dealing in 'Tied' oils used for industrial purposes, e.g. the manufacture of plastics and paint. Around 1,200 traders are on this scheme, and are required to be approved by the Department and submit monthly returns if the throughput of oils is expected to exceed 10,000 litres per annum. In 2008-09, the Department undertook an internal review of the scheme to identify potential risk areas and a programme of high priority assurance visits is to be undertaken in 2009-10.

Operational Measures

4.20 The Department has established an Oils Strategy Delivery Group (OSDG) responsible for commissioning projects to tackle high risk traders and activities and to coordinate interventions across the Department. All the operational teams involved in delivering the strategy are represented on the OSDG. Performance packs are produced on a monthly basis. Our review of the OSDG minutes verified that these packs are monitored, performance is challenged and remedial action initiated when required.

Risk and Intelligence Officers

4.21 Risk and Intelligence officers using a risk scoring system are able to identify high risk RDCO traders to be visited by compliance officers. A small proportion of traders deemed medium and low risk are also visited to ensure the risk process has correctly identified high risk traders. It also has a deterrent effect across the whole spectrum of RDCO traders. Results of the visits are fed back to the risk officers to update the risk process. The Department is exploring how to develop the oils risk matrix, and make it more flexible along the lines of the alcohol risk assessment database, which came into operation in 2005. A more flexible system would allow the risk team to decide the frequency of visits over a defined period using their own judgement in conjunction with the information generated by the risk database.

4.22 As part of its Workforce Change Programme, designed to enable the Department to operate more efficiently, the Risk and Intelligence Service has recently been through a period of significant change to centralise the service. The Change Programme aimed to provide, amongst other things, opportunities to enhance the development of expertise, the sharing of knowledge and best practice and to improve the quantity and quality of intelligence. It is too early to comment on whether these aims have been achieved.

4.23 All the excise risk teams supporting compliance activity have now been centralised and based on one site, the aim being to maximise the potential impact of operational interventions. These teams are multifunctional, supporting a cross-tax approach to risk. There has been significant cross-departmental effort to train staff and work towards achievement of the potential benefits of this change, which is further supported by the use of new risk tools and the different skills and experience brought by the new team members. However, none of the oils risk team volunteered to relocate to the centralised risk team, resulting in a loss of oils expertise. This, together with the upheaval of the move, has contributed to the decrease in the number of compliance referrals from around 1,900 in 2007-08 to 1,500 in 2008-09. However, in part this reduction is also consistent with the Department's drive to a focus on outcomes and quality rather than quantity of referrals.

4.24 The Department acknowledges that it needs to do more to assess the success of its intelligence packages, i.e. better targeting of high risk areas. Key performance indicators are currently being developed for 2009-10, which will be monitored quarterly by the Oils Strategy Delivery Group to ensure that the benefits of centralisation are realised.

Compliance Officers

4.25 Compliance Officers work with the oils traders and distributors to ensure understanding of requirements and compliance with the RDCO and Tied Oils schemes. These officers also undertake audit activity following commercial detections of misuse of rebated fuels or other fraud. Such cases can result in significant assessments, which can recover duty due in the previous three years. As well as tackling specific cases of misuse, these assessments, along with other penalties can have a strong deterrent effect. In addition, Compliance Officers have a key role in exploring new risks. A National Assurance Plan has been developed to ensure co-ordinated risk based activity on all aspects of the oils regime and includes projects to test risks identified by all operational and policy areas, for example, in relation to specific products or types of businesses or transactions.

Inland Detection Officers

4.26 Detection Officers target large scale commercial misuse by traders through the specialist Road Fuel Testing Unit (RFTU). Three types of testing may be carried out: sight, gravity and chemical testing. A sight test is the quickest way of checking for red diesel. It is not conclusive, and so a gravity or chemical test may be undertaken. The nature and scale of the operation will determine which type of test can be applied.

4.27 Information arising from detections is referred to the risk team, who will review, add further information and intelligence and then ask Local Compliance to investigate. The detection might involve a single vehicle, but the RFTU officer will ask if there are any other vehicles involved to establish the potential scope of the misuse. Risk & Intelligence undertake further checks to establish the number of vehicles involved. Local Compliance Officers will then raise an assessment in respect of fuel misused in all vehicles. For the period April 2001 to March 2008, the RFTU has undertaken 580,204 challenges, which resulted in 26,844 detections.¹⁹

4.28 To enhance its ability to detect and deter fraud, the Department continually explores new markers and testing methodologies. It is also increasing its focus on the commercial suppliers of fuel.

Illustrations of detection activity

- A HMRC roadside operation led to the detection of a recycling vehicle using laundered fuel. When officers visited the owners' premises they found a stock tank containing fuel, which was a mixture of transmission oil, waste product and technical oil. In total, 8,000 litres of oil was seized along with 20 vehicles.
- During an operation in the Midlands, officers detected a vehicle running illegally on red diesel. It transpired, following further investigations, that a number of vehicles belonging to the trader had been running on illegal diesel and an assessment for over £10,000 was issued.

Source: HMRC Oils Activity Report – 2005

Criminal Investigators

4.29 Criminal investigators aim to prosecute key offenders and to disrupt and dismantle the criminal gangs behind large-scale supply of illicit fuel using an array of sanctions. From April 2001 to March 2008, the Department achieved the following:

- Total oils seized: 16.99 million litres
(Great Britain 7.61ml; Northern Ireland 9.38ml).
- Laundering plants disrupted: 225
(Great Britain 123; Northern Ireland 102).
- Assessments raised £49.2 million.
- Confiscation orders raised £3.35 million
(Great Britain £3.1 million; Northern Ireland £250,000).
- Vehicles seized in Northern Ireland 6,972.

4.30 The Department focuses its prosecution activity on those areas where it considers such action will be most effective, in particular, when tackling serious crime. Activities to date under the Strategy have led to 113 convictions (Great Britain 80; Northern Ireland 33). The average sentence in Great Britain was 48 months in 2007-08 compared with 16 months in 2001-02. Since 2002-03, the average sentence in Northern Ireland has ranged from six to eight months, **Figure 25 overleaf** Penalties are currently being reviewed as part of the Department's wider review of its powers.

4.31 In 2008, the Department set up a Special Civil Investigation Team to tackle the main oils fraudsters, using the most appropriate sanctions available across all taxes. This new team works closely with other operational teams including Criminal Investigation.

Illustration of a major investigation

HMRC officers arrested 11 people across the UK in a major operation targeting multi-million pound fraud. The arrests were linked to suspected oils fraud estimated to be in the region of £10 million. The organised criminal fraud involved the wholesale trading of hydrocarbon oils and associated money laundering. This nationwide operation involved over 100 HMRC criminal investigators, supported by officers from several police forces.

Source: HMRC Oils Activity Report – May 2007

¹⁹ Year on year details are published in HM Revenue & Customs Autumn Performance Report 2008.

25 Use of Sanctions

	2001-02	2002-03	2003-04	2004-05	2005-06	2006-07	2007-08
Assessments							
Fraud detected and identified following referral by Inland Detection	£8.3m	£13.2m	£11.5m	£7.0m	£3.1m	£2.5m	£3.6m
Penalties¹							
Number	N/A	N/A	N/A	N/A	161	335	182
Total Value ²	N/A	N/A	N/A	N/A	£48,000	£93,000	£47,000
Prosecutions (GB)							
Number of Convictions	9	8	17	12	17	13	4
Average sentence (months)	16	14	14	15	16	28	48
Confiscation Orders ²	£660,000	£374,000	£167,000	£125,000	£272,000	£1.48m	N/A
Prosecutions (NI)							
Number of Convictions	15	3	4	nil	4	4	3
Average sentence (months)	16	8	7	nil	2	6	6
Confiscation Orders	nil	£250,000	nil	nil	nil	nil	nil
Vehicles seized	684	1,576	901	812	856	1,199	844

Source: HM Revenue & Customs Autumn Performance Report 2008

NOTES

- 1 The penalty is £250 for non-submission of returns. Penalties can also be levied at five per cent on the tax due.
- 2 Figures are rounded to nearest £000's.
- 3 N/A = Data not collected.

Working with Others

4.32 An integral part of the Department's approach to tackling oils fraud is an active and cooperative relationship with the Industry. The establishment of the Joint HMRC-Industry Intelligence and Security Forum in May 2003 was a clear statement of their intentions to work together as partners. The central principles of the Forum are to:

- ensure that where the Industry has information on the illegal activity, the pathways exist to pass that information to the Department; and
- provide a forum in which the Department can provide feedback on its activity so that the Industry is reassured that information received is acted upon.

4.33 The Department works closely with legitimate industry and has looked at ways to improve relationships, including collaborative activity to address fraud, as well as to ensure that any policy response is risk based and proportionate. With industry agreement, the GB oils forum has recently been established as a national consultative forum on oils excise duty related issues. The NI forum has been retained to discuss NI specific operational issues. Both groups meet twice a year. In addition, industry representatives are encouraged to contact the Department on a continuing basis to ensure regular dialogue.

4.34 The Department also works closely with other agencies, e.g. the Police, Vehicle Operator and Services Agency, Trading Standards. In Northern Ireland it liaises closely with the other stakeholders in the Organised Crime Task Force (OCTF) and Revenue Commissioners in the Republic of Ireland. The OCTF has recently set up a cross border sub-group on oils which is chaired by the Department.

Illustration of collaborative working

HMRC officers took part in a Lancashire Constabulary-led joint operation with officers from the Vehicle Operator and Services Agency, the Department of Work and Pensions, the Driver Vehicle Licensing Agency and the Environment Agency. The operation identified four commercial vehicles using rebated fuel and around 40 infringements of legislation enforced by other agencies, ranging from vehicle excise duty to benefits fraud, were also detected.

Source: HMRC Oils Activity Report – 2005

Conclusion

4.35 The Department has made good progress in reducing the illicit oils market in Great Britain from 10 per cent in 2002-03 to 4.6 per cent in 2006-07. The estimated cost to the Exchequer has decreased from £1.25 billion to £750 million over the same period. The Department's aim is from 2007-08 to hold the illicit market share at 4.4 per cent and to continue this up to 2010-11.

4.36 The Department believes that the latest estimates of the oils tax gap are too high and is undertaking further work on the methodology and emerging fraud risks. In light of this work and the review of the Strategy, it should consider the scope to bring about a significant and measurable reduction in the illicit market, including a cost/benefit analysis to determine the resources needed to achieve this.

4.37 The non-UK duty paid diesel market share in Northern Ireland has also been reduced from 53 per cent in 2002-03 to 40 per cent in 2006-07. This has been largely achieved by the Department's close liaison with other stakeholders on the Organised Crime Taskforce.

4.38 The Department has made some progress in implementing the Committee's previous recommendations. The Registered Dealers in Controlled Oils (RDICO) scheme has been reviewed and amended to ensure that its aims are achieved, whilst further reducing the administrative burden on traders. To avoid unnecessary assurance visits, the Department is exploring ways which would allow the risk team to decide the frequency of visits over a defined period using their own judgement in conjunction with the information generated by the risk database. The data capture system for RDICO returns however should be updated to make it easier for smaller traders to use. A challenging target date should then be set for the full electronic submission of returns.

4.39 The Department does not have ready access to the underlying data that it uses to measure the illicit market. This data is only available to the Department some 18 months after the financial year: so, for example, estimates for 2007-08 will only become measurable when the relevant data is gathered in October 2009. To mitigate this the Department is currently developing lead indicators to enable it to make a more timely assessment of trends.

4.40 The Department has recently centralised the risk and intelligence team structures to facilitate better quality intelligence packages and therefore improved targeting of high risk areas. But this has proved challenging, particularly as none of the oils risk team relocated. The new centralised risk team therefore had no experience of oils when it was set up. Although the new staff are being trained, it would have been preferable if, at least in the short term, the Department could have retained a few of the ex-staff at the current site until the new staff were sufficiently trained and experienced to take on the new role. Moving forward, however, it is important that the performance is monitored to ensure that the benefits of centralisation are realised.

PART FIVE

Tax Credits

Introduction

5.1 Tax credits form part of the personal tax system. The Department accounts for this expenditure in its Trust Statement for taxes, duties and other revenues and related expenditure. We examine the Department's administration of tax credits as part of the Comptroller and Auditor General's overall responsibilities for the audit of revenue under Section 2 of the Exchequer and Audit Departments Act 1921.

5.2 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 to relieve child and in-work poverty. Child Tax Credit addresses the 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 supports working people by topping-up earnings; the amount depends on factors such as age and/or the number of hours worked – with additional support for eligible childcare costs or where a member of the household is disabled.

5.3 **Figure 26** gives an overview of the tax credits payments and the administrative costs of the scheme for 2007-08 and 2008-09.

5.4 Our examination of the 2008-09 Trust Statement has continued the work we carried out and reported on in previous years, including the review of the Department's progress in dealing with issues raised earlier. This report covers:

- managing overpayments caused by adjustments to awards;
- recovering tax credits debts;
- reducing claimant error and fraud; and
- improving services to claimants.

Managing overpayments caused by adjustments to awards

5.5 The Department initially calculates a provisional annual award of tax credits for eligible claimants based on their income for the previous tax year and their current family circumstances. Awards can be adjusted during the year and claimants are required to tell the Department about changes in their circumstances. After the end of each year, the Department asks claimants to confirm by 31 July their actual circumstances and income so that it can assess the final award and, where appropriate, establish a provisional award for the subsequent year. If the provisional award

26 Tax Credits: Scheme Overview

	2008-09 (provisional)	2007-08 (final)
Families benefiting ¹	5.9m	5.6m
Net cash paid to claimants in year ²	£24.1bn	£20.0bn
Final value of awards ³	Not yet known	£19.9bn
Administrative cost ⁴	£584m	£570m
Staff employed by the Department on tax credits throughout the year ⁵	10,600	9,200

Source: HM Revenue & Customs

NOTES

- 1 Figures represent the average number of families benefiting (excluding IS/JSA out of work cases paid by DWP).
- 2 The Department makes a final assessment of awards after the end of the year when the claimant's actual income and circumstances are known.
- 3 Actual information for 2008-09 will be available in May 2010, after awards have been finalised.
- 4 Administrative costs for 2007-08 have been restated from £581m following a revision to the overhead apportionment methodology.
- 5 Staff numbers for 2008-09 reflect more accurate time recording.

has resulted in an overpayment, the Department seeks to recover the overpayment from future awards or, if there is no ongoing entitlement, directly from the claimant. If the provisional award was lower than the final award, the Department pays the claimant the balance.

5.6 As shown in **Figure 27**, overpayments in 2007-08 caused by adjustments to awards were £1.0 billion, significantly lower than the first three years of the scheme and maintaining the reduction in the levels of overpayment seen in 2006-07. The changes in the 2005 Pre-Budget Report and, in particular, the increase to £25,000 in the threshold for income rises which would be disregarded when awards were finalised, accounted for most of the fall in overpayments. The Department anticipated that these changes would reduce overpayments by one third, although overpayments are some 40 per cent lower than the levels seen in 2005-06 before the measures began to take effect. Administrative improvements in the Department's processing of changes in circumstances which affect entitlement have also contributed to the fall in overpayments. As we reported last year, however, the Department cannot disaggregate the respective contribution of the policy and operational changes.

5.7 Figure 27 also shows that underpayments have increased to £0.8 billion in 2007-08 and now affect some 1.3 million families, some 500,000 more than in 2006-07. This increase reverses the downward trend in underpayments seen in previous years. This is a result of the component in the Pre Budget Report 2005 package which aimed to tackle the problem of families overestimating falls in their income. From April 2007, when an estimate of a reduced current year income is reported, future payments are adjusted but a one-off payment is no longer made for the earlier part of the year. Instead, when the award is finalised at the end of the year any necessary adjustment is made then.

5.8 As household incomes fall as a result of the recession it is likely that more families will become eligible for tax credits and that existing claimants will be able to claim higher amounts. This effect will be partly offset by households ceasing to be eligible due to unemployment or because their working hours fall below the threshold for claiming working tax credit. The Department is currently forecasting additional net spending of up to £500 million annually.

27 Tax Credits Overpayments and Underpayments to 31 March 2008

	2003-04	2004-05	2005-06	2006-07	2007-08
Total Net Payments	£13.5bn	£15.5bn	£17.1bn	£18.6bn	£20.0bn
Families benefiting	4.6m	5.0m	5.3m	5.5m	5.6m
Overpayments	£2.2bn	£1.8bn	£1.7bn	£1.0bn	£1.0bn
As a percentage of total payments	16.3%	11.6%	10.0%	5.4%	5.0%
Families affected by overpayments	1.9m	2.0m	1.9m	1.3m	1.3m
Average overpayment	£1,028	£866	£827	£738	£705
Underpayments	£0.5bn	£0.6bn	£0.5bn	£0.5bn	£0.8bn
As a percentage of total payments	3.4%	3.6%	3.2%	2.8%	4.0%
Families affected by underpayments	0.7m	0.9m	0.9m	0.8m	1.3m
Average underpayment	£651	£614	£620	£626	£618

Source: HM Revenue & Customs

NOTES

- 1 Excludes IS/JSA out of work cases paid by DWP.
- 2 Comprising total overpayments after finalisation.
- 3 In accordance with the Department's normal approach, this figure excludes remissions and recoveries of overpayments made before the end of the year.
- 4 Tax Credit awards for 2008-09 are not all due to be finalised until the end of January 2010. The Department will publish overpayment statistics on these awards in May 2010.
- 5 Average over and underpayments based on actual figures.

5.9 In 2007-08 we reported that the Department found that it had made adjustments to some finalised awards beyond the circumstances provided for in the 2002 Tax Credits Act. It is currently examining some 301,000 awards to regularise its enquiries and make repayments where these are due. It established an initial provision of £20 million to cover an estimated 20,000 awards where it believed that unlawful recoveries from claimants would have to be repaid. By the end of March 2009, out of 187,000 cases examined, the Department had written off £30.1 million in respect of some 31,000 cases that had been incorrectly finalised. Further scans of the tax credits system have identified additional cases which will need to be examined. The Department has increased its provision to reflect a total cost of this exercise over three years to £53 million to take account of the increased number of cases, better information on their make-up and the value of remissions.

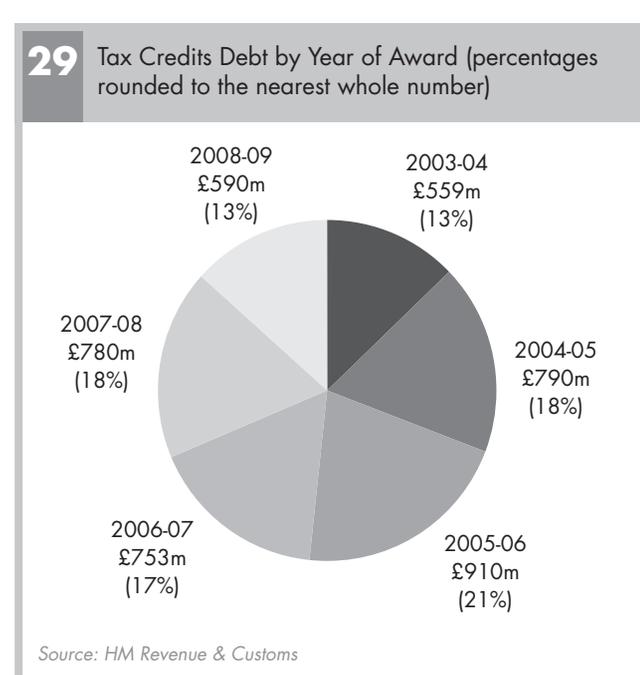
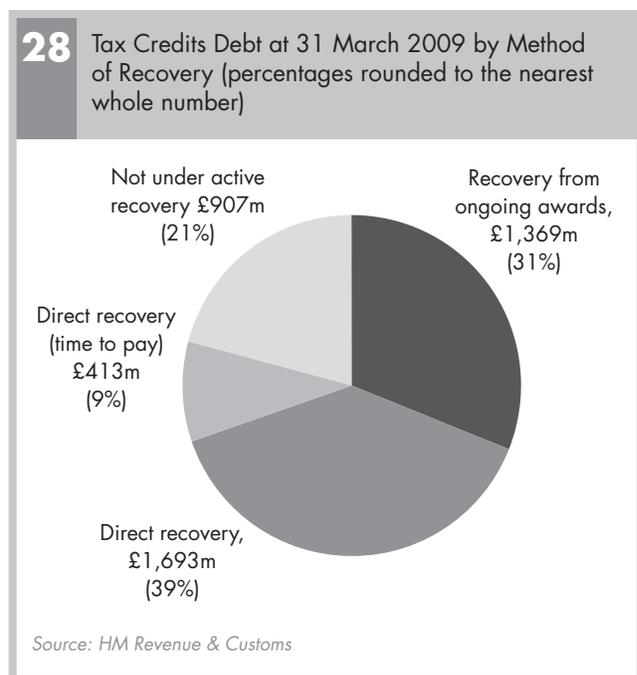
Recovering tax credits debts

5.10 At the end of March 2009, the Department had £4.4 billion²⁰ of overpayments to be recovered. As **Figure 28** shows, £1.4 billion is being recovered from on-going awards. £2.1 billion which cannot be recovered from on-going awards is with the Department's Debt Management and Banking directorate for direct recovery, of which £413 million is being managed under time to pay arrangements. £907 million of the debt was not subject to active recovery as at 31 March 2009, because claimants disputed the overpayments and collection was suspended or the overpayments related to awards that had not been finalised. As **Figure 29** shows a significant proportion of tax credits debt relates back to the early years of the scheme.

5.11 The overall level of tax credits debt was broadly stable throughout 2008-09, with new tax credits debts of £954 million and clearance/recovery of £932 million – a net increase of £22 million. **Figure 30** shows that new debts in 2008-09 were much lower than in earlier years. This decline was mainly due to measures announced in the Pre Budget Report 2005 which have reduced overpayments to less than five per cent of entitlement. The Department has cleared on average £980 million of tax credit debt in each of the last four years. But with new debt identified each year of a similar amount, the balance of uncollected debt has shown little change and the Department will have to increase the clearance rate if it is to begin to reduce the balance.

5.12 In 2008-09, the Department recovered £417 million by offsetting overpayments from previous years against current awards. The Department automatically recovers an overpayment from ongoing entitlement if the claimant is still receiving tax credits payments under the same award. To avoid putting claimants into hardship, the maximum rate at which debt can be recovered from current awards is restricted.

5.13 The Department's Debt Management and Banking directorate is responsible for the direct recovery of overpayments where claimants' circumstances or status has changed and they have ceased entitlement to their awards. The Department allows claimants to make repayment in instalments over a twelve month period and can allow more time to pay or defer collection in cases of financial hardship. At 31 March 2009, of the £2.1 billion of debt with Debt Management and Banking for direct recovery, £413 million was subject to time to



²⁰ This figure is higher than the £4.3 billion reported in the Trust Statement due to £46 million of write-offs recorded in the Department's financial accounts not yet processed in the tax credits system.

30 Tax Credits Debt Identified and Cleared since 2005-06

	2005-06 £m	2006-07 £m	2007-08 £m	2008-09 £m
Debt newly identified in year^{1,2}	1,811	1,552	1,108	954
Debt cleared in year				
Recovery from Ongoing Awards	500	555	439	417
Direct Recoveries	120	228	242	225
Remissions	380	123	390 ³	290
Total clearances	1,000	906	1,071	932
Net movement in debt balance	+810	+646	+37	+22

Source: HM Revenue & Customs

NOTES

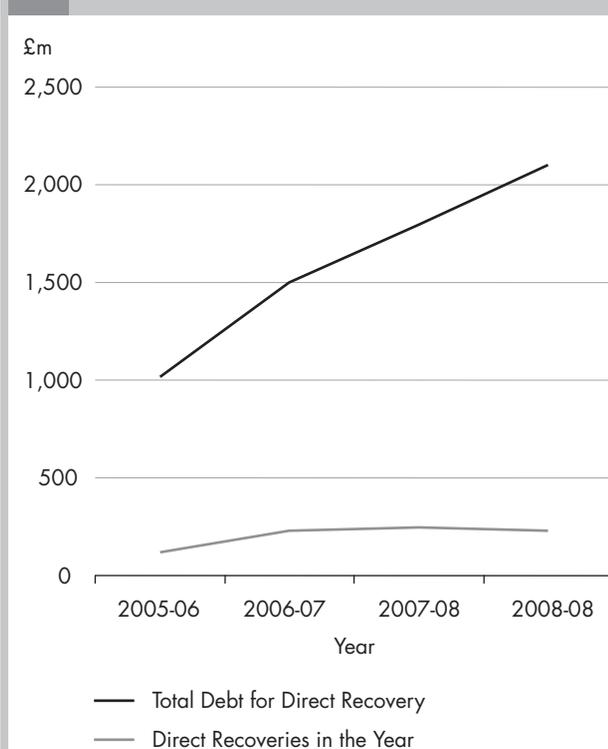
- 1 Debts newly identified in year do not necessarily equate to the year of award.
- 2 This includes debt immediately set-off against previous underpayments.
- 3 The remissions figure for 2007-08 includes £140 million of remissions for debt relating to system errors in the early years of the scheme.
- 4 Totals do not necessarily sum due to roundings.

pay arrangements. As **Figure 31** shows, debts for direct recovery have increased more rapidly than the rate of collection. By March 2009, tax credits debt managed by Debt Management and Banking for direct recovery stood at £2.1 billion, compared with cash recoveries in the year of £225 million.

5.14 The Department currently prioritises much of its debt activity (including tax credits debts) by value – with greater priority being given to higher value debt. Some 94 per cent of tax credits debt is less than £5,000 and six per cent is below £250. The Department is now increasingly prioritising debts by risk rather than by value, using debt campaigns with collection strategies tailored to each segment and designed to use available resource to maximum effect.

5.15 The Department is taking steps to improve its management of tax credits debt. In line with the Transformation Programme and its compliance strategy, it is grouping claimants according to the behaviour that led to the overpayment as well as their circumstances, and applying a more tailored response to recovering the debt. These steps include:

- forming a Debt Recovery Co-ordination Group to bring together all the activity relating to tax credits debt recovery;
- testing a campaign-based approach to the recovery of debt relating to 2008-09 finalisations; and
- trialling on a voluntary basis the use of the PAYE system to recover overpayments through Income Tax coding adjustments as an alternative to direct recovery.

31 The Accumulation of Tax Credits Debt for Direct Recovery

Source: HM Revenue & Customs

5.16 Since April 2003, the Department has written off £1.3 billion of the £8.4 billion overpayments of tax credits (this figure includes subsequent changes to entitlement), including £0.3 billion in 2008-09. It has now made a provision of £2.3 billion in the Trust Statement for overpayments it expects not to be recovered. This provision is equivalent to 53 per cent of total tax credits debt at 31 March 2009, compared to 41 per cent in the previous year. The main reasons for the change are the full provision against classes of tax credits debt which the Department has earmarked for write-off, and the lower rate of cash recoveries on debts transferred to Debt Management and Banking for direct recovery.

5.17 The Department is also looking to write-off certain classes of uncollectible tax credits debt. In addition to those where the cost of collection would be high relative to the value of the debts and therefore would represent poor value for money, these include certain manual payments for awards that could not be administered through the tax credits computer system. In some instances the Department has also not administered the timely annual renewal of these awards in strict accordance with the Tax Credits Act 2002, thereby limiting its ability to recover any overpayments in relation to these awards. It initially proposes to write-off debt in these categories of some £235 million. During 2009-10 it plans to analyse further other classes of debt currently included within the provision with a view to write-off.

Reducing claimant error and fraud

5.18 Tax credits are complex. Claimants make genuine errors in their applications which result in incorrect awards, for example by misunderstanding what should be reported as income or incorrectly calculating childcare costs. Claimants may also provide false information or misrepresent their circumstances to obtain tax credits.

5.19 The Department's Error and Fraud Analysis Programme is designed to provide an estimate of the overall level of error and fraud in tax credits and its composition, based on an annual examination of a stratified random sample of 4,111 finalised awards. The legislation only allows the Department to begin its enquiries after claimants have finalised their award and entitlement has been determined. It requires claimants to return their renewal pack by the end of July although it is possible to do this on the basis of an estimated income which can be updated until the end of the following January. This means that for some 2008-09 awards the Department will not be able to start its investigations until February 2010.

5.20 The Department's latest estimate, based on finalised awards for 2007-08, is that error and fraud resulted in between £1.58 billion and £1.84 billion (7.9 per cent to 9.2 per cent of the final award by value) being paid to claimants to which they were not entitled. In addition, the Department estimates that error led to between £0.17 billion and £0.28 billion (0.8 per cent to 1.4 per cent of the final award by value) not being paid to claimants. This expenditure has not been applied to the purposes intended by Parliament and does not conform with the requirements of the Tax Credits Act 2002.

5.21 Whilst the Department has made changes to its compliance procedures since 2007-08, there is currently no evidence to demonstrate a lower estimate of error and fraud in the tax credit awards for 2008-09. As these levels of error and fraud are material within the context of the £23.7 billion expenditure on the scheme, the Comptroller and Auditor General has again qualified his opinion on the regularity of the expenditure reported in the 2008-09 Trust Statement in respect of tax credits error and fraud.

5.22 Figure 32 gives a summary of the Department's estimated ranges of error and fraud in each of the last three years of the scheme. These estimates which are based on the results of the Department's Error and Fraud Analysis Programme, does not include figures for organised fraud which is measured separately. In 2008-09 losses from organised fraud were £31.9 million.

32 HMRC's estimates of error and fraud on finalised awards

Year	2005-06	2006-07	2007-08
Value of finalised awards²			
£bn	16.0	18.2	19.9
Error and fraud favouring the claimant			
Estimated range (%)	8.5-10.6	7.2-8.4	7.9-9.2
Estimated value (£bn)	1.36-1.69	1.3-1.54	1.58-1.84
Error favouring HMRC			
Estimated range (%)	1.4-2.4	1.3-2.1	0.8-1.4
Estimated value (£bn)	0.23-0.39	0.24-0.39	0.17-0.28

Source: HM Revenue & Customs

NOTES

1 The Department estimates levels of error and fraud based on the examination of a random sample of finalised awards.

2 Excludes IS/JSA out of work cases paid by DWP.

5.23 Since 2006-07, increases in error and fraud have been primarily in the categories of ineligible children, overstated work and hours and ineligible disability claims. The Department estimates that fraud accounted for £150 million (8.8 per cent) of total error and fraud in 2007-08. This is higher than the estimated £40 million (2.8 per cent) of fraud identified in 2006-07, but is partly explained by a change in approach to the classification of fraud cases in its Error and Fraud Analysis Programme.

5.24 As we reported in 2007-08, the Department improved its methodology to provide a more robust estimate of the overall levels of error and fraud in tax credits and to produce this estimate much earlier than in previous years. Its concentration of random enquiries in four compliance offices has helped to improve the consistency and quality of case work. As the estimate is based on finalised awards at the end of the year, it excludes error and fraud identified on awards terminated during the period as a result of its compliance activity.

5.25 In earlier years the Department set a target based on a fixed number of compliance checks. In 2008-09, its compliance teams carried out over 105,000 pre and post payment checks²¹, which identified incorrect payments of £296 million. It also increased the number of compliance checks undertaken before awards were paid, to reduce the risk of incorrect awards entering the system. An analysis of the number of compliance checks performed and their estimated yield in 2008-09 is given in **Figure 33**.

5.26 In 2007-08 the Department used its Error and Fraud Analysis Programme to identify the exposure to losses from particular risks and the breakdown between error and fraud for each risk. It has used this analysis to develop a strategy for tackling key risks. In July 2008, it published the new strategy with a high level plan to reduce the level of customer error. At the same time, it announced a target to limit error and fraud in tax credits to no more than five per cent by March 2011.

5.27 In 2008-09 the Department restructured its approach to compliance to help claimants to understand better their obligations and meet them. The Department's compliance teams are continuing to examine high risk cases, including a specialist team on claims involving organised fraud. But it has also focused on interventions to meet the five per cent target.

5.28 In 2008-09, the Department began a programme of Targeted Education, Enabling and Leverage (TEEL), which uses a campaign based approach to write to and telephone claimants to prevent and correct error across a larger proportion of the population. It is also making more use of other data to corroborate information provided by claimants across a larger proportion of the claimant population, for example by matching tax credits data against child benefit records to identify young people who are no longer in full-time non-advanced education but still included in a tax credits award.

33 HMRC's compliance checks on tax credits awards

	2008-09	2007-08
Number of Checks		
Target/Profile	153,000 ³	150,000
Compliance checks	104,957 ³	157,468
Health checks	37,597 ³	–
Pre payment: post payment ratio for compliance checks	46%:54%	43%:57%
Estimated Yield		
Yield comprising:	£296m	£337m
Incorrect payments prevented ¹	£91m	£150m
Incorrect payments found ²	£205m	£187mn
Checks resulting in change to award:		
Pre award	62%	65%
Post award	78%	78%

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.

3 In 2008-09 the Department carried out 142,554 compliance and health checks against a planned profile of 153,000. The Department no longer sets an annual target for the number of compliance checks to be carried out.

21 All tax credit claims pass through automated verification checks and are risk assessed prior to payment. Where a claim triggers a specified risk rule or a combination of rules it is referred to compliance staff for checking. Risk scores are periodically revised depending on the evaluation of high risk cases such as undeclared income, undeclared partners or incorrect child care costs. HMRC also checks for cases that display features of organised fraud.

5.29 To achieve a reduction in claimant error, the Department needs to influence the behaviour of far greater numbers of claimants than its compliance checks allow. During 2008-09 it undertook further risk profiling to identify those claimant groups who are responsible for a disproportionate share of tax credit losses. It estimates, for example, that some 420,000 of claimants (six per cent) account for some £407 million (29 per cent) of all losses, and that a further 1.36 million (20 per cent) of claimants account for £576 million (40 per cent).

5.30 The Department is overlaying its existing compliance interventions with measures directed at these groups. Over the next two years, it plans to contact a wider group of one million claimants who fall in these disproportionate loss groups. It will write to claimants to seek confirmation of circumstances. Depending on the results of this initial contact, the Department may then move through a hierarchy of measures leading to full compliance enquiry or, in the case of serious non-compliance, to criminal investigation and prosecution.

5.31 The change in the focus of the Department's effort to achieve the planned reduction in error and fraud means that the impact of some activities is less easily measurable, for example communications and marketing campaigns to educate customers. The Department will undertake further work to analyse the expected yield from the range of compliance activities, including proxy measures for its TEEL activities, and develop its performance reporting to obtain timely feedback on the progress of all compliance activities.

5.32 The Department continues to impose a financial penalty when it concludes that there has been a deliberate attempt to over-claim, or the claimant has been negligent and provided the wrong information. In 2008-09 it introduced a new penalty regime which aligns the penalty with the seriousness of the underlying claimant behaviour, distinguishing the errors between genuine mistakes for which there is no penalty, failure to take reasonable care, and deliberate error.

Improving services to claimants

5.33 Claimants have not always understood their obligations to tell HMRC when their circumstances change and to report their actual income and circumstances at the end of each year as part of the renewal process. The Department's research, based on the initial years of the tax credits scheme, showed that some 50 to 60 per cent of overpayments were caused by delays in reporting changes of circumstances.

5.34 In November 2006 the Department established the Tax Credits Transformation Programme to assess and identify the root causes of these problems and define an action plan to address them. The aims of the Transformation Programme are to:

- create a tax credit service which is clearly understood and trusted by claimants and align that delivery with child benefit where it makes sense to do so; and
- ensure the right claimants receive the right money at the right time through a range of services and communications tailored to meet their individual needs and circumstances.

5.35 The first phase of the Transformation Programme involved identifying improvements in service and communication that could be achieved within the constraints of the current computer system. The main limitation of the system is that it does not allow the Department to tell claimants with certainty, when they report a change of circumstance, how it will affect their entitlement.

5.36 The Department undertook a review to identify the key characteristics of the tax credits scheme which have contributed to the main operational difficulties. It found that:

- the 'one size fits all' delivery model adopted on the introduction of tax credits paid little regard to claimants' domestic or financial circumstances or their level of literacy and numeracy. The onus was placed on claimants to ask for assistance in completing claims, with little support for claimants in meeting their obligations;
- communications with claimants did not adequately explain what tax credits are and the role of the claimant in ensuring that awards reflect their circumstances;
- when claimants contacted the Department, its call centre staff were unable to tell them what effect a change of circumstance would have on their awards, leading to uncertainty of outcome for the claimant; and
- claimants with children had to contact different helplines for child benefit and tax credits to submit personal information and to access services.

5.37 In the light of these findings the Department has established a target operating model which sets out the key design principles which underpin the transformation of tax credits. These principles include the delivery of a tailored customer service based on claimants' needs, clearer communications with claimants, greater visibility of outcome, and aligning the delivery of tax credits and child benefit.

5.38 The immediate focus for the Programme has been to improve the service provided to claimants. During 2008-09, the Department piloted a range of service improvements, the majority of which it had implemented by April 2009. **Figure 34** provides a summary of these along with an analysis of the estimated number of claimants expected to benefit.

5.39 The Department has also developed and tested with claimants a set of key messages to improve claimants' understanding of tax credits at each stage in the 'tax credits customer journey'. In the last year it has launched a number of new communication products, including: a new claim pack; new change of circumstances communications, for example P60s and P45s; and new online tools to help claimants understand and find out more about tax credits.

5.40 The Transformation Programme also relies on analysing the different claimant groups and targeting them with tailored services and communications. It is also strengthening its processes for authenticating claimant identities by making better use of its own data and data from third parties. Its aim is to provide on screen advice for advisors which will show the assistance the claimant requires and identify those who need more help.

5.41 In addition to improving the quality of service and communications to the claimant groups targeted by these changes, the Department expects the Transformation Programme to deliver other benefits, including: reductions in the level of underpayments and overpayments equivalent to £23 million and £50 million a year respectively; further reductions in error and fraud totalling some £60 million a year; and efficiency savings in call centres and tax credit operations of some 40 full time equivalent staff years.

34 Service Improvements implemented in 2008

Service Improvement Modules (Implementation date)	Number of claimants benefiting from the service improvement
Claims	
Assisted Claims: to support those customers who need help claiming tax credits (December 2008)	700,000
Change in Circumstances	
Tax Credits/Child Benefit alignment: to allow claimants to report births once and for that information to be shared (December 2008)	350,000
Health Check: to contact customers proactively in order to ensure that the right information is received to keep their awards up to date (November 2008)	20,000
Proactive Questioning: to elicit additional information on changes of circumstances (September 2008)	890,000
Renewal	
Reach Out Renewal (post First Specified Date): to help those who failed to renew on time (August 2008)	125,000

Source: HM Revenue & Customs

Conclusions

5.42 Overpayments following adjustments to awards were £1.0 billion in 2007-08, just over four per cent of total payments and significantly below the levels of overpayment in the early years of the scheme. Underpayments increased to £0.8 billion in 2007-08 and now affect 1.3 million families. Changes to the scheme announced in the 2005 Pre-Budget Report account for the majority of the fall in overpayments, although the Department says it cannot disaggregate the contribution of the policy changes and the improvements in its administration of the scheme. The Department should set clear evaluation strategies for all significant policy and operational changes prior to their implementation.

5.43 At 31 March 2009, £4.4 billion of overpayments remained to be collected, of which £2.1 billion has been passed to the Debt Management and Banking directorate for direct recovery. This debt has accumulated at a faster rate than the Department can collect it. The Department plans to introduce a campaign-based approach to the collection of overpayments arising from 2009 tax credits renewals. It should review its existing policy and procedure for collecting tax credits overpayments. In particular, subject to the limitations within the tax credit systems, the Department should examine the cost effectiveness of extending the offsetting of overpayments against ongoing awards to include any overpayments the claimant may have from a previous award.

5.44 By March 2009, the Department had written off £1.3 billion of overpayments and provided a further £2.3 billion for overpayments it expects not to be recovered. In previous years it has largely restricted write-offs to organised fraud cases and overpayments due to system errors. In 2008-09 it started an exercise to identify and quantify other classes of uncollectible debt which should be written off. It has so far identified £235 million of debt which is attributable to system weaknesses in the initial years of the scheme or which is uneconomic to collect. Further small overpayment debts remain in the system and, in principle, are due to be recovered but for which direct recovery is unlikely to be cost effective. The Department should examine the costs and benefits of recovering small overpayments.

5.45 At 31 March 2009, £907 million of debt was not being recovered, for example, where recovery was temporarily suspended due to a disputed overpayment. Some of this debt dates back to the initial years of the scheme, and the prospect of its recovery will inevitably diminish with age. As part of the review recommended at 5.43 above, the Department should also consider how it can keep debt that is not being actively recovered to an absolute minimum. It should also ensure that appropriate and timely debt recovery action is taken for all debts to minimise the risk of recovery being impaired through its failure to pursue the debt promptly.

5.46 The Department's latest estimate, based on finalised awards for 2007-08, is that error and fraud resulted in overpayments of between £1.58 billion and £1.84 billion (7.9 per cent to 9.2 per cent of the final award by value) being paid to claimants to which they were not entitled. This is an increase on the estimate of error and fraud in 2006-07 awards. In addition, the Department estimates that error led to underpayments of between £0.17 billion and £0.28 billion (0.8 per cent to 1.4 per cent of the final award by value). There is currently no evidence to demonstrate a lower estimate of error and fraud in the tax credit awards for 2008-09. The Comptroller and Auditor General has qualified his opinion on the regularity of the expenditure reported in the Trust Statement in respect of tax credits error and fraud.

5.47 In July 2008, the Department published a new strategy to reduce the level of customer error and at the same time announced a target to limit error and fraud to less than five per cent by March 2011. It has also restructured its approach to compliance to ensure a broader range of interventions and to focus on the outcome of planned interventions. If the Department is to achieve its target, however, it needs to influence the behaviour of a far greater numbers of claimants than its compliance checks allow. It is now overlaying its existing programme of compliance checks to reach one million claimants who account for a disproportionate share of tax credit losses. The Department needs to develop its performance reporting to obtain timely feedback on the progress of all compliance activities.

5.48 During 2008-09, the Department successfully piloted a range of service improvements, the majority of which it had implemented by April 2009. It also launched a number of new communication products to help improve claimants' understanding of tax credits. The Department plans to evaluate the service improvements at end of 2009-10 when it has more data on the outcome of the measures.