HM Revenue & Customs 2010-11 Accounts

Report by the Comptroller and Auditor General

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Summary

Scope of the audit

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.

2 We have examined the Department’s activities and principal tax streams, and obtained evidence on the adequacy and operation of its regulations and procedures. This report sets out our overall conclusions from this examination, and our findings and recommendations in three areas which were a priority for the Department in 2010-11:

- The resolution of tax disputes (Part Two);
- Stabilising the PAYE Service (Part Three); and
- Tax Credits (Part Four).

3 This report is part of a wider programme of audit we conduct on the Department. The programme includes our annual financial audit of the Department’s accounts and examination of its systems for the assessment and collection of taxes, and value for money studies and other work either across government or focusing specifically on the Department. In devising our programme, we have regard to the NAO’s three strategic themes of cost-effective service delivery, financial management and informed government. Recognising the Department’s challenge of balancing objectives on revenue, cost and customer experience, we seek to provide objective insight on how the Department is:

- transforming its performance and improving compliance among taxpayers and benefit and tax credits claimants using its customer-centric approach; and
- achieving value for money by delivering a sustainable cost base while maintaining revenues.
Our conclusions on the Department’s overall management of the tax systems are based on our examination under Section 2 of the Exchequer and Audit Departments Act 1921, our value for money studies under the National Audit Act 1983, and consideration of the Department’s Statement on Internal Control. Since our previous report on the Department’s Accounts, we have completed two value for money studies, resulting in the following reports:

- HMRC: Engaging with Tax Agents (Session 2010-11, HC 486, 13 October 2010); and
- Managing civil tax investigations (Session 2010-11, HC 677, 17 December 2010).

We have begun work on five further value for money studies, to be published later in 2011-12, on: Improving the efficiency of HMRC processes (Pacesetter); Reducing costs in HMRC; Online filing of tax returns; HMRC’s professional (tax) skills; and The delivery of the Compliance & Enforcement Programme.

Conclusion

Whilst recognising that no tax collection system can ensure that all those who have a tax liability comply with their obligations, we conclude that in 2010-11, HM Revenue & Customs has framed adequate regulations and procedure to secure an effective check on the assessment, collection and proper allocation of revenue, and that they were being duly carried out. This assurance is subject to the observations on specific aspects of the administration of taxes and tax credits in this report.

The resolution of tax disputes

Tax disputes between the Department and major businesses are an inevitable consequence of the complexity and international nature of modern business transactions. At 31 March 2011, the Department was investigating over 2,700 issues with the largest companies, with potential tax at stake of £25.5 billion.

In 2007, the Department published its Litigation and Settlement Strategy, setting out its framework for concluding tax disputes across all taxes, duties and tax credits streams. The Strategy seeks to ensure consistency in the way in which tax disputes are resolved and requires each tax issue to be considered on its own merits, rather than as part of a package. It provides a sound framework for resolving disputes, but the Department’s review of the Strategy in December 2009 identified differences in understanding amongst its staff of the flexibility permitted by the Strategy in settling disputes.

The Department launched its High Risk Corporates Programme (the Programme) in 2006 with the intention of resolving long-outstanding tax disputes with large companies; improving its relationship with these businesses; and discouraging aggressive tax avoidance behaviour. The Department has concluded settlements with companies in the Programme totalling over £9 billion since 2006. The Programme has helped to reduce the backlog of outstanding tax issues and has contributed to reduced avoidance activity by major companies. Companies have welcomed the Department’s commitment to resolving tax disputes within the Programme to an accelerated timescale, although this brings the risk that issues will be traded as settlement deadlines are approached. We have seen examples where the Programme Board has agreed not to pursue issues involving finely balanced arguments. Whilst this is consistent with the Litigation and Settlement Strategy, the Department accepts that it could be more explicit in describing the criteria used to make marginal decisions.

The High Risk Corporates Programme Board (the Programme Board) includes relevant senior stakeholders from across the Department and provides a strong governance framework. In general, the largest and most contentious proposed settlements with companies both in and outside of the Programme must be approved by the Programme Board. The Board is a useful forum for challenging proposed settlements, reinforced by the requirement for consensus before settlements are agreed.

In four of the largest settlements we examined, the Department used specific governance arrangements, which involved reducing the size of the team dealing with the case and the settlement being signed off by Commissioners without a prior reference to the Programme Board. In three of these cases, one or both of the Commissioners signing off the settlement also participated in the settlement negotiations. These arrangements meant that in these three cases, there was no, or limited, separation between the negotiation and the approval of major tax settlements (though in one case there was support from independent legal counsel for the settlement). In the case where both Commissioners were involved in the negotiations, there was no independent scrutiny of the proposed settlement. The Department believes that there will always be cases where Commissioners have to be involved and a clear separation will not be possible. However, in our view, this reduces the demonstrable assurance that the settlement reached is appropriate, for both external stakeholders, including other taxpayers and Parliament, and the Department’s own staff.

A substantial majority of the settlements that we examined complied with the Litigation and Settlement Strategy and the Department’s processes for involving relevant technical experts and for approving settlements. We found two significant exceptions to this. In one case, a settlement was reached without those negotiating the settlement realising that it should have been referred to the Programme Board before being agreed with the company. When the Programme Board reviewed the settlement, they established that a financial error had been made. In another case, the settlement was put to the Programme Board by email, and agreed even though not all members of the Board formally responded.
13 Parliament has provided the Commissioners with some discretion with regard to their duty for the collection and management of taxes, but a 2005 House of Lords judgement ("the Wilkinson case") limits the extent of this discretion. We found some differences of view within the Department on the implications of this judgment for settling tax disputes, and we found one instance where Commissioners were invited to exercise these powers on the basis of oral legal advice. In our view, in the particular circumstances of this case, it would have been helpful to have secured confirmation of that advice in writing.

Recommendations

14 The High Risk Corporates Programme sets out strong governance arrangements for overseeing the settlement of a number of major tax disputes which should achieve clear separation between the analysis and negotiation, and the approval of large tax settlements. In order to provide confidence to internal and external stakeholders on the appropriateness of all such settlements, the Department should ensure that this separation is fully in place in the resolution of every major tax dispute.

15 We found two cases where it was unclear to the staff working on the settlement that the proposal would need to be approved by the Programme Board. In both cases, the Board subsequently raised substantive issues about the proposal. The Department should issue guidance as soon as possible to clarify the criteria for referral of cases to the Programme Board.

16 Referrals to the Programme Board are based on the overall settlement value of the case, but referrals to Commissioners are based on the value of individual issues. The criteria for referring proposed settlements to Commissioners should take account of the overall settlement value as well as the value of individual issues.

17 The Commissioners are able to use discretion in exercising the collection and management powers granted to them by Parliament, but this has been limited by a House of Lords judgement. The Department should ensure that there is clarity on when to apply these powers to resolving tax disputes, and each proposal to use the powers in settling major tax disputes should be supported by appropriate legal advice.

18 The Department has decided that it needs to re-launch its Litigation and Settlement Strategy. This is a sensible approach and should be done as soon as possible, taking our comments in this report into account, to ensure that there is a common understanding within the Department of how to apply the strategy in determining whether to settle or litigate on individual tax issues.
Stabilising the PAYE Service

19 Historically the Department faced a number of challenges in its administration of income tax through the Pay As You Earn system. The increasing complexity of employments and pensions made it more difficult for it to administer individuals’ tax affairs without some degree of manual working. In recent years, the number of cases requiring manual intervention exceeded its capacity to clear them, leading to backlogs in processing and uncertainty for those individuals with unresolved tax liabilities.

20 In June 2009, the Department implemented the new National Insurance and PAYE Service (NPS). Unlike the predecessor PAYE system, NPS combines all the information the Department holds on an individual’s employment and pension income into a single record. The increased automation under NPS offers the Department the opportunity to process PAYE accurately and on time and reduce the volume of over and underpayments, which will help to restore taxpayers’ confidence in the system. Over and underpayments of tax are nevertheless a normal part of the PAYE process, and will continue to occur, for example, where people move in and out of work or receive changes to taxable benefits.

21 The Department encountered a number of operational challenges in 2009-10 following the introduction of NPS. The phased release of the automated reconciliation functionality led it to defer its reconciliation of approximately 39 million taxpayer records for 2008-09, delaying the identification of over and underpayments of tax by over a year. It also limited its ability to deal with the backlog of some 17.9 million cases pre-dating NPS, contributing to the Department having to forego the recovery of underpayments of tax relating to 2006-07 and earlier years assessed as uneconomic to collect or out of time. The failure to keep so many PAYE taxpayers’ affairs up to date resulted in significant reputational damage for the Department. It also led the Committee of Public Accounts to conclude that the Department had failed in its duty to process PAYE accurately and on time, and deliver an acceptable standard of service to PAYE taxpayers.

22 Against this background, the Department has made significant progress in stabilising its administration of PAYE during 2010-11. By the end of March 2011, it had successfully reconciled the vast majority of the records available for automated reconciliation for 2008-09 and 2009-10, and processed the associated over or underpayments of tax. It had also ensured that over 99 per cent of all annual codes for 2011-12 for issue to taxpayers were dispatched on time. At the same time, it introduced new test procedures to safeguard against inaccurate tax calculations and codes being issued to taxpayers.

23 The poor quality of PAYE data and initial issues with the NPS specification following its implementation resulted in more processing exceptions (or work items) than originally anticipated. The Department had to divert its operational resources to review and, where necessary, correct NPS data before it could undertake its processing of end of year reconciliations and annual coding. This recovery work was extensive, covering over 11 million records, over 25 per cent of the NPS database. A consequence of diverting operational resources to recovery is that some in-year changes to individuals’ records have not been processed, increasing the risk of some taxpayers facing higher under or overpayment of tax at the year end. In response to this risk, the Department has established priorities for manual processing and clearing in-year work items.
The Department’s decision to reconcile the 2008-09 and 2009-10 tax years together also contributed to increased workloads. To keep workloads to a manageable level, it temporarily raised the threshold for not reclaiming underpaid tax identified through reconciliation to £300. After subsequently extending the increase in threshold to 2007-08, the Department estimates that this had excluded £266 million from recovery by March 2011.

The Department began to implement a two-year plan to clear the backlog of cases relating to its legacy PAYE system by the end of 2012, by prioritising the reconciliation of 416,000 underpayment cases relating to 2007-08 and identifying £228 million for recovery. While the Department has lost the opportunity to recover underpayments for the 2006-07 tax year, it plans to complete the reconciliation and process the repayment of an estimated £2.8 billion of tax overpaid in the 2003-04 to 2007-08 tax years by the end of 2012.

The Department plans to complete the stabilisation of PAYE by 2013. This includes completing by March 2012, the identification and manual clearance of a forecast 6.7 million records relating to the 2008-09 and 2009-10 tax years where it has not yet received all the information it needs to reconcile automatically. It then plans to accelerate the identification and manual clearance of similar records for the 2010-11 and 2011-12 tax years, and complete this by March 2013. Under NPS, the Department expects it will need to manually review 3 to 4 million of these records to complete the annual end of year reconciliation, compared with 16 to 17 million records immediately before its implementation. It has allocated an additional £34 million in 2011-12 to begin its clearance of all PAYE processing arrears.

The Department recognises that it must address the issue of PAYE data quality if it is to realise the full benefits of NPS. The need to maintain PAYE data quality will become even more important with the planned introduction of Real Time Information (RTI) for PAYE in 2013 and the Department for Work and Pensions’ reliance on this information to deliver the new Universal Credit. It has launched a PAYE data improvement project to identify and address the impact of poor data quality on the implementation of RTI.

Under RTI, employers and pension schemes will be required to report income tax and national insurance deductions at the same time as they pay them. RTI data will initially be passed to NPS on the same timescales as it comes from employers today and over time, NPS will be updated more frequently. The potential increase in the volume of in-year changes to taxpayer records could, if not accurately matched to NPS records, adversely affect the accuracy of codes issued from NPS at a time when the Department’s capacity to deal with them will be diminishing. As part of its cost reduction programme, the Department plans to reduce the headcount in its Personal Tax business area from some 24,900 currently to around 16,400 by April 2015.

Recommendations

The Department has established plans to complete the stabilisation of PAYE by bringing its reconciliation of all outstanding tax years up to date by March 2013 and introducing further efficiencies to NPS in April 2012, but its plans for dealing with in-year processing, including manual clearance of work items, are not yet finalised. It should develop a fuller understanding of the impact of work items to develop a comprehensive plan which embraces in-year work management.
The Department has significant work to complete in stabilising PAYE on the new NPS platform by 2013, which is an essential foundation for the introduction of RTI and the headcount reductions in its Personal Tax business area by April 2015. It should define its operating model for PAYE and how it plans to transform that model as it moves to the RTI environment.

The Department has had to divert significant resources to PAYE recovery to deal with the higher volumes of work following NPS implementation. The change in the frequency of information passed to NPS from RTI has the potential to increase the number of in-year changes in PAYE records and introduce further challenges to data quality. In the light of its experience with NPS, the Department needs to thoroughly test the adequacy of its plans for implementing RTI, and in particular its capacity to manage the risks presented by poor data quality and their impact on processing.

**Tax credits error and fraud**

Based on the latest information available, the Department estimates that in 2009-10 it overpaid between £1.75 billion and £2.14 billion to tax credits claimants due to error and fraud and underpaid between £0.25 billion and £0.55 billion to claimants due to error. The levels of error and fraud are material within the context of the £28.1 billion spent on tax credits. As 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, the Comptroller and Auditor General has qualified his opinion on the regularity of the tax credits expenditure reported in the 2010-11 Trust Statement.

The Department’s target is to reduce tax credits error and fraud to no more than 5 per cent of the value of finalised entitlement by the end of March 2011; this cannot be measured until 2012. In April 2009, it launched a revised strategy for reducing error and fraud. As part of an increased focus on preventing error and fraud, the Department aimed to target high-risk claims and correct the awards before they enter the tax credits system (‘Check First, Then Pay’). There is evidence that this new approach is working. In the first year of the strategy, 2009-10, the Department estimates that error and fraud fell from between 8.3 and 9.6 per cent to between 6.6 and 8.1 per cent.

During 2010-11, the Department has significantly increased the number of interventions to 1.8 million and prevented an estimated £792 million in error and fraud losses, a threefold increase in the losses prevented before the strategy was introduced. A key feature of its approach were 450,000 new checks against high risk cases completed before new claims, changes of circumstance and renewals were processed, preventing an estimated loss of £200 million. The Department has worked to improve its targeting of high risk awards, but accepts that there is scope to refine its methodology, to increase the proportion of error or fraud identified above the 13 to 16 per cent currently achieved.
To provide a measure of its progress, the Department has set itself a series of proxy targets based on the error and fraud prevented as a result of its interventions. It estimates that in 2010-11 it prevented £1,054 million of error and fraud, marginally in excess of its £1 billion target. We found that while the Department continues to develop its measurement of interventions which form the basis of this estimate, there is scope to improve the consistency and accuracy of measurement processes and the related assurance activities.

In October 2010, the Department launched a joint fraud and error strategy with the Department for Work and Pensions. In the context of that strategy, the Department has a target to prevent £8.0 billion of tax credits error and fraud over the period of the 2010 Spending Review.

Tax credits debt

At the end of March 2011, the overall level of tax credits debt stood at £4.7 billion, compared with its target of £4.3 billion. The Department estimates that without any further intervention tax credits debts could increase to £7.4 billion by 2014-15.

The Department’s plan to develop a more active approach for managing tax credits debt has so far met with limited success. By the end of April 2011, some £380 million of the £550 million of recent debt included in the current tax credits debt campaign remained to be collected or otherwise cleared. It has assessed the value for money of collecting £1.7 billion of tax credits debt not under active recovery, and expects to decide what debt should be remitted by the end of July 2011.

Recommendations

The success of the Department’s strategy to reduce error and fraud depends on its ability to target those cases that are most likely to yield the highest levels of error and fraud. This is in turn informed by the quality of the management information on the outcome of its interventions. The Department needs to ensure that results of interventions are accurately measured and recorded in its systems.

The Department is now expected to prevent losses of £8.0 billion through error and fraud interventions over the period of the 2010 Spending Review. The measurement of losses prevented will be central to the assessment of its performance. To inform this assessment, it should develop its existing assurance activities on the measurement of its interventions to support a statistical evaluation of the level of uncertainty in the estimate of error and fraud identified against the proxy target.

The Department faces a significant increase in tax credits debt without further intervention. It should reassess its plan for reducing tax credits debt to determine whether the campaign strategy and the level of resources dedicated to its delivery are sufficient to actively manage all new tax credits debt and clear uncollected debts from previous years.
Part One

Introduction

Tax revenues in 2010-11

1.1 In 2010-11, total revenues accruing to the Department were £468.9 billion, £33.1 billion (7.6 per cent) greater than in 2009-10. Figure 1 shows the tax revenues reported in the Department’s Trust Statement in the last five years.

1.2 Figure 2 shows the changes in tax revenues between 2009-10 and 2010-11. Revenues from the largest taxes – Income Tax and National Insurance contributions, Value Added Tax (VAT) and Corporation Tax – account for the majority of the increase in revenues from the previous year. Other taxes contributing to the increase in revenues include Capital Gains Tax, Hydrocarbon Oils Duties, and the new Bank Levy. Bank Payroll Tax accrued revenue of £2.5 billion was initially recognised in 2009-10; the actual receipts were higher than this estimate. This difference has been accounted for in the current year.

Figure 1
Total revenue 2006-07 to 2010-11

£ billion

2006-07: 441.3
2007-08: 461.6
2008-09: 441.0
2009-10: 435.8
2010-11: 468.9

NOTES
1 Total Revenue figures for the years 2006-07 to 2008-09 vary from those published in the respective Trust Statement Accounts, which include Tax Credits as negative taxation within Revenue for those years.
2 Total revenue in 2006-07, 2007-08 and 2008-09 excludes revenue from fines and penalties.

Source: HM Revenue & Customs
The increase from the prior year reflects the improving economic situation, as well as the impact of rate and duty rate changes. The increase in VAT revenue is also affected by the temporary reduction of the VAT rate to 15 per cent that decreased receipts in the prior year, and the increases due to the return to the 17.5 per cent VAT rate in March 2010 and increase to 20 per cent in January 2011.

Assets and liabilities

Receivables

Receivables represent all taxpayer liabilities which have been established for which payments have not been received at the year end; this has increased by £1.4 billion (5.0 per cent) to £29.5 billion, after taking account of changes to accounting policies. A provision for doubtful debts has been estimated as £10.0 billion, based on the Department’s expectation of the value that is likely to be collected.

In our 2009-10 report on the accounts, we reported on the Department’s efforts to improve debt collection through new approaches such as the use of debt collection agencies and the introduction of tailored debt campaigns that targeted debt by its characteristics.
1.6 In 2010-11, £11.7 billion of debt was assigned to campaigns, leading to the collection of approximately £7 billion. The Department is developing and refining its approach to campaigns, including their evaluation, and it is too early to conclude on the effectiveness of this approach.

Bank Levy

1.7 Legislation in the Finance Bill 2011 introduces a new bank levy based on the balance sheets of UK banking groups and building societies, effective from 1 January 2011. The first payments are due through Corporation Tax instalment payments following commencement of the legislation. The Trust Statement includes revenue of £0.7 billion, which is the Department’s estimate of the amounts due in the period.
Part Two

The resolution of tax disputes

Introduction

2.1 A tax dispute is a disagreement between the Department and the taxpayer that is not readily resolved. There are broadly two types of disputes. Disputes can be about the facts in a particular case or about the interpretation and application of tax law.

2.2 At 31 March 2011, the Department was investigating over 2,700 issues with the largest companies, including enquiries where facts had still to be established or verified, and cases involving disputes. The estimated tax under consideration in these open issues was £25.5 billion.

2.3 Tax disputes are a long-established feature of the United Kingdom’s and other countries’ tax systems. Many businesses, especially the largest, now trade and operate in multiple countries. Corporate structures and the nature of transactions have both become more complex, and new technologies and other developments mean that most businesses operate in a climate of rapid change. These complexities mean that establishing tax liabilities is often far from straightforward, leaving scope for differences of opinion which can develop into tax disputes.

2.4 In November 2010, the Committee of Public Accounts examined the Department on its arrangements for settling tax disputes with large companies. In the light of this, the Comptroller and Auditor General decided to undertake a review of these arrangements.

2.5 Our review considered two questions:

- Are the Department’s processes for resolving tax disputes adequate to secure an effective check on the assessment and collection of tax revenue?

- Has the Department complied with its processes for resolving tax disputes?

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2.6 Our review focused on the Department’s processes for resolving tax disputes with the largest companies. The 770 largest companies are dealt with by the Department’s Large Business Service, and in aggregate accounted for over a third of all revenues from Corporation Tax, VAT, PAYE Income Tax and National Insurance contributions in 2010-11. We examined a sample of 27 disputes, to assess whether the Department had complied with statutory requirements and its own processes for resolving disputes. Our review considered whether the Department’s processes were adequate to establish a sound position on the amount of tax due; it did not involve coming to an independent judgement on the tax liability in individual cases. The disputed issues we examined mainly involved Corporation Tax, with a smaller number about Value Added Tax, or the payment or administration of employee taxes. We examined disputes that were resolved in or after 2006, as this was when the Department adopted a revised approach to resolving high value tax disputes with large companies. Figure 3 shows the number of open issues over the last five years, for the companies dealt with by the Large Business Service. Figure 4 shows the value of open issues over the last five years, stratified by issue value.

**Figure 3**

Number of open issues for Large Business Service companies over the last five years

<table>
<thead>
<tr>
<th>Number of issues</th>
</tr>
</thead>
<tbody>
<tr>
<td>7,624</td>
</tr>
<tr>
<td>3,852</td>
</tr>
<tr>
<td>2,477</td>
</tr>
<tr>
<td>3,230</td>
</tr>
<tr>
<td>2,721</td>
</tr>
</tbody>
</table>

**NOTES**

1. An issue is a ‘risk’ recorded on the Large Business Service’s CORE System. These cover a wide range of matters across all the taxes that companies pay and include enquiries where facts have still to be established and details verified. They are therefore not all ‘disputes’.

2. The number of issues is a snapshot showing the number of open issues as at 31 March of each year. This includes issues that were opened in previous tax years and have not been resolved, rather than the number of issues opened in the year.

3. An issue may include consideration of the tax liability for more than one year.

*Source: National Audit Office analysis of HM Revenue & Customs data*
The processes for resolving tax disputes

The process for identifying and resolving issues

2.7 The Department uses risk assessment techniques to examine returns from taxpayers to identify issues where the taxpayer’s self-assessment may be incorrect or incomplete. The risk assessment of larger companies also considers the likelihood of the company providing information that is inaccurate or incomplete, or not fully disclosing all relevant information and judgements. The Department can open enquiries and carry out compliance checks on any tax returns. Not all enquiries develop into disputes, and the issue can be resolved by agreement at any point. Figure 5 overleaf shows the process for resolving enquiries and disputes.
Figure 5
General disputes resolution process map

Taxpayer submits return

Risk factor(s) identified

Department risk assesses return

Department raises issues with taxpayer, by formal enquiry where needed, to establish facts and analyse legal issues

Assessment issued following enquiry

Taxpayer does not agree with the assessment

No significant risk factors identified

Enquiry finds no amendment is required

Taxpayer accepts the assessment

Tax liability established

NOTE
1 Disputes can arise at any stage after an enquiry is opened, but many enquiries are resolved without disputes developing.

Source: National Audit Office
Disputes can arise at any stage after an enquiry is opened, but many enquiries are resolved without disputes developing.

- **European Court of Justice**
  - Risk factor(s) identified
  - Taxpayer does not agree with the assessment
  - No significant risk factors identified
  - Enquiry finds no amendment is required
  - Taxpayer accepts the assessment

- **Taxpayer requests review**
  - Department risk assesses return
  - Assessment issued following enquiry where needed, to establish facts and analyse legal issues
  - Tax liability established

- **Taxpayer submits return**
  - Department raises issues with taxpayer
  - Taxpayer submits return
  - Review varies or upholds assessment and taxpayer appeals

- **Taxpayer appeals to Tribunal**
  - First-tier Tribunal (Tax Chamber)
  - Either side appeals
  - Upper Tribunal (Tax and Chancery Chamber)
  - Either side appeals

- **Any Tribunal or Court may need to make a reference to the European Court for a preliminary ruling**
  - Court of Appeal
  - Either side appeals

- **Supreme Court**
  - Either side appeals

- **Department and taxpayer accept decision of Tribunal or Court**
  - Review cancels assessment or varies or upholds it and taxpayer accepts this

- **Figure 5**
  - General disputes resolution process map

Source: National Audit Office
2.8 If there is still a difference of opinion following the enquiry, the Department will usually issue an assessment of the amount of tax it thinks is due. Since 1 April 2009, taxpayers have been entitled to ask the Department to review its decisions, including assessments. This review is carried out by someone in the Department who was not involved in the original decision. The review may result in the Department’s assessment being either cancelled (effectively reinstating the taxpayer’s self assessment), varied or upheld. If the assessment is not cancelled, or the taxpayer does not ask for a review, the taxpayer can refer the matter to the First-tier Tribunal (Tax Chamber). The Tribunal is part of HM Courts and Tribunals Service, an executive agency of the Ministry of Justice, and independent of the Department.

2.9 Either side can withdraw at any stage before the Tribunal hears the case and agree to settle. Following the First-tier Tribunal’s decision, either side can appeal to the upper Tribunal (Tax and Chancery Chamber), then to the Court of Appeal and Supreme Court. Any tribunal or court may refer the case to the Court of Justice of the European Union.

Litigation and Settlement Strategy

2.10 The Department’s Litigation and Settlement Strategy sets out its framework for concluding tax disputes, whether by agreement with the taxpayer or by litigation (which includes referral to the Tribunals as well as referral to the courts). The Litigation and Settlement Strategy applies to all disputes involving tax, duties, or tax credits. It was introduced in May 2007 with the aim of bringing consistency to the way that the Department resolves disputes, and ending the practice of agreeing settlements for a proportion of the tax under dispute (‘compromise deals’) or settling several issues for a single sum (‘package deals’).

2.11 The Litigation and Settlement Strategy encourages settlement of disputes by agreement, and sets out the terms under which settlement may be reached. It requires each issue to be considered on its own merits and resolved in accordance with the law. Where the nature of the issue is such that there is a range of plausible outcomes, settlement must be for not less than the Department would reasonably expect to get from litigation. The Strategy states that, in general, cases should be dropped where the Department does not have a strong case, or the evidence is weak.

3 The right to a review is under Sections 49A to 49H of the Taxes Management Act 1970, introduced by The Transfer of Tribunal Functions and Revenue and Customs Appeals Order 2009, SI 2009 No. 56.

4 The law provides a statutory basis for tax appeals to the Tribunal to be determined by agreement between the Department and the taxpayer, notably Section 54 of the Taxes Management Act 1970 for direct taxes and Section 85 of the Value Added Tax Act 1994 for indirect taxes.

5 Litigation and Settlement Strategy, HM Revenue & Customs, 2007 (http://www.hmrc.gov.uk/practitioners/lss.pdf)
Processes applying to the largest disputes

2.12 The Department has five Commissioners, who have ultimate responsibility for collecting and managing tax revenues. In practice, Commissioners are normally only directly involved in signing off the settlement of the largest tax disputes. Figure 6 overleaf shows an extract from the Department’s organisational structure for Business Tax. The resolution of most large and complex tax disputes will involve several Directorates, for example, experts in Corporation Tax and accountancy specialists, and also legal and policy advisers where relevant. Each company in the Large Business Service has a Customer Relationship Manager, who is responsible for managing the Department’s ongoing relationship with the company across all taxes and duties, and for coordinating all the Department’s technical specialists relevant to the company’s tax affairs.

2.13 The Department established a High Risk Corporates Programme (the Programme) in 2006, and settlements totalling over £9 billion have been reached with the companies participating in the Programme since it began. At the time, many large companies had multiple, long-unresolved tax disputes, and in some cases were involved in extensive avoidance activity. The Programme was set up to address this situation, with the aims of:

- reducing avoidance and improving the compliance of the largest businesses;
- improving the relationship between the Department and the businesses; and
- establishing and collecting the right amount of tax.

2.14 The High Risk Corporates Programme involves an intensive process for resolving the participating company’s issues. The approach includes Board-to-Board, or other high level, engagement between the Department and the company with a commitment from both sides to apply high levels of resource to providing information and resolving issues within an accelerated timeframe. In addition, the Department seeks agreement from the Board of a company within the Programme that it will in future work more constructively with the Department.

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6 Commissioners for Revenue and Customs Act 2005, Section 5 (1).

7 The need for a more professional relationship and speedier resolution of tax issues were also identified in Sir David Varney’s 2006 Review of Links with Large Business report (http://www.hmrc.gov.uk/large-business/ review-report.pdf) which built on the Hartnett Review ‘Inland Revenue’s Review of Links with Business 2001’.
The Director General for Business Tax has overall accountability for the Programme and the Director, Large Business Service is the Programme’s owner. There is a Programme Board, responsible for agreeing which companies will be admitted to the Programme (based on factors such as the size, age and wider application of the issues under consideration), endorsing proposed settlements, and for the priorities, development and governance of the Programme. The Programme Board is chaired by the Director, Large Business Service and its membership includes the Directors of VAT; Corporation Tax, International and Anti-Avoidance; and Special Investigations and representatives from the Solicitor’s Office. Each case has an Enquiry Coordinator, whose responsibilities include bringing together the work of the Customer Relationship Manager and all the Department’s technical specialists, policy advisers, caseworkers, consultants and solicitors that have an interest in the case. Figure 7 on page R24 shows the governance structure for the Programme.
2.16 For disputes dealt with outside the Programme, the Customer Relationship Manager is initially responsible for bringing together the relevant specialists in resolving tax issues. The Department encourages these parties to reach consensus on how the issue should be resolved but, if they cannot agree, then the issue is escalated to the relevant Directors for a decision.

2.17 There are defined procedures for signing off settlements for cases within and outside of the Programme. For cases outside the Programme where the tax under consideration is less than £100 million, agreement must be reached between the relevant stakeholders. Since November 2009, cases must be referred to the Programme Board before settlement where the tax under consideration exceeds £100 million, and there is a proposal for the Department to concede one issue or more, or to accept less than 100 per cent of the total tax under consideration, or where the case and issues are particularly sensitive.
Figure 7
High Risk Corporates Programme governance structure

Programme governance

Commissioners
Sign off issues over £250 million

Director General Business Tax

High Risk Corporates Programme Senior Responsible Officer
Director, Large Business Service

High Risk Corporates Programme Board
Chaired by Director, Large Business Service
Sign off settlements over £100 million if case outside Programme, or over £50 million if case in Programme

High Risk Corporates Programme Leader

Project team

Enquiry Coordinator
Responsible for leading case

Customer Relationship Manager
Responsible for long-term customer relationship

Issue owners
Liaise with specialists to progress individual issues

Tax specialists
Policy specialists
Transfer pricing specialists
Solicitor’s Office High Risk Corporates Programme Advisory Team
Process specialists
Anti-avoidance advisers

Source: HM Revenue & Customs
2.18 For companies within the Programme, the decision is taken by the Programme Board if the tax under consideration exceeds £20 million for one issue or £50 million for a combination of issues in a settlement, or where there are issues of particular sensitivity, difficulty or with wider significance. Issues of lower value are also referred to the Programme Board where the Department’s stakeholders cannot reach consensus. The Programme Board must reach a consensus on the matters referred to it; it does not take decisions by majority. Any issues where the Programme Board cannot reach a consensus are referred to Commissioners for sign off.

2.19 All individual issues where the tax under consideration is more than £250 million, or where there is potential for adverse national publicity or for questions to be raised in Parliament, or which represent a significant departure from previous policy, must be signed off by Commissioners. In practice, two Commissioners are required to sign off settlements, usually the Permanent Secretary for Tax, as the Department’s senior tax specialist, and the Director General for Business Tax.

Are the Department’s processes adequate?

Strengths of current processes

2.20 There are elements of the Department’s current processes that contribute strongly to ensuring that the correct tax liabilities are established and the associated tax is collected in a timely way. In complex tax disputes, establishing the amount of tax due is not straightforward. The Department has established teams of specialists for taxes, aspects of taxes and policy and legal matters and has processes for involving relevant specialists in considering each tax dispute. The requirement for consensus among these specialists, and defined procedures for escalating issues where agreement cannot be reached, help to ensure that the relevant knowledge and expertise are deployed.

2.21 The Litigation and Settlement Strategy sets out a clear framework for resolving disputes. When settlements are authorised, whether by Commissioners, the Programme Board or at lower levels, there is a requirement to confirm that the settlement complies with the Litigation and Settlement Strategy.

2.22 The Litigation and Settlement Strategy encourages settling disputes by agreement where possible. This reduces costs for both the Department and the taxpayer, and means issues can be settled more quickly, which is again in the interests of both parties. The Department is also moving towards more real time working, discussing issues with taxpayers before returns are submitted so that issues are resolved before they become disputes. Where there are differences of opinion and litigation looks likely, the Department has sought to share technical arguments with the taxpayer, ensuring that each side fully understands the other’s perspective. This allows the area of disagreement to be identified before the case goes to litigation and, in some cases, removes the disagreement entirely.
2.23 The Programme Board is a forum that brings together relevant expertise and subjects arguments to challenge, especially as a consensus rather than a majority is required for a decision.⁸ The requirements for settlements above a certain value, or otherwise of significance, to be signed off by the Programme Board and in some cases also by Commissioners should ensure that the most important decisions are taken at an appropriately senior level.

2.24 There has been a significant reduction in the number of open issues with companies dealt with by the Large Business Service since 2006. This is in line with the recommendations made by the Committee of Public Accounts in 2008 for the Department to shift towards focusing on high risk businesses, close down long-running enquiries and deal more quickly with new tax risks.⁹ The Programme has contributed to the reduction of high value open issues and brought in a yield of £9.2 billion to March 2011.

2.25 As part of our review, we interviewed major accountancy firms and six of the UK’s largest businesses to get their views on the Department’s performance in resolving tax disputes. In general, both groups welcomed the impact of the Programme in allowing them to resolve long outstanding disputes within an accelerated timescale. This has provided large businesses with certainty on major tax issues and helped to improve their relationship with the Department.

2.26 In September 2010, the Department reviewed the impact of the High Risk Corporates Programme on company behaviours, focusing on the earliest cases where sufficient time had elapsed to make an assessment. This indicated that the Programme had helped to improve the levels of openness, cooperation and disclosure in these companies. The review also suggested that the companies concerned had reduced the scale of their aggressive and artificial tax avoidance activity. However, the review was unable to establish the degree to which these changes were due to the direct impact of the Programme, as opposed to other factors, such as changes in the economic environment and in share ownership and control, the outcome of other litigation cases involving other companies, and changes to the tax avoidance disclosure regime.¹⁰

2.27 Some of the accountancy firms and companies we interviewed held the view that the Litigation and Settlement Strategy and the Department’s willingness to resolve issues more quickly had reduced the incentives for creating avoidance schemes. Whereas previously there might have been an incentive for companies to create multiple avoidance schemes (to enable trade-offs during the settlement process), the Strategy’s focus on individual issues, together with the Department’s readiness to litigate where issues cannot be settled, has helped to reduce the advantages of this approach.

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⁸ Our review identified one case where the Board could not reach a consensus, so the case was escalated to the Commissioners for a decision.


¹⁰ The ‘Disclosure of Tax Avoidance Schemes’ (DOTAS) regime requires promoters of avoidance schemes to notify the Department of the details of the scheme, and users of avoidance schemes to notify the Department when they are using an avoidance scheme. The regime was introduced in 2004, was widened in 2008 to include Corporation Tax, among others, and now covers most of the largest taxes.
Shortcomings in current processes

2.28 In four of the largest settlements we examined, the Department operated specific governance arrangements. The Department considered each of these cases to involve a single issue, with a range of possible outcomes for the tax due, rather than being the ‘all or nothing’ cases normally dealt with by the Programme Board. The arrangements involved reducing the size of the team dealing with the case, and sign off by Commissioners without a prior reference to the Programme Board. In each case, the team included the relevant Director, supported by Deputy Directors, and Commissioners were involved. These arrangements meant that decisions were taken at the most senior level, and relevant technical and legal expertise remained available. The Department’s view is that the Programme Board would not have added value to the decision-making process in these particular cases given the involvement of senior staff, including the Commissioners and members of the Programme Board, and relevant internal and external experts.

2.29 In two of the four cases, one of the Commissioners approving the settlements had participated in the negotiations and, in another case, both Commissioners had done so. Where Commissioners are directly involved in negotiating settlements, particularly where the Programme Board is not used, there is less independent oversight of settlements to provide assurance, internally and externally, that these have been reached on an appropriate basis. The Department has attracted criticism from Parliament and its own staff because of the absence of adequate separation between the analysis, negotiation and approval processes for major tax settlements. The complexities of the issues in these cases make it more difficult to demonstrate that an appropriate tax liability has been assessed and legal restraints over taxpayer confidentiality mean that the details of these cases cannot be released subsequently.

2.30 We found cases where large companies wanted early engagement with a Commissioner to secure an authoritative view of the Department’s position. The Department’s strategy for board level engagement with large business means that contact between Commissioners and business leaders on specific and general issues will continue to be a feature of its approach. The Department believes that a degree of Commissioner involvement in resolving some tax disputes is inevitable. However, the Department recognises that it needs to build its capacity to negotiate settlements on major cases in staff below Commissioner level. This should help to reduce the frequency of taxpayers requesting the involvement of Commissioners on specific issues as settlement discussions are continuing.

11 Examples of cases where there is a range of possible outcomes for the tax due are those with transfer pricing issues, which require a determination of the share of taxable profits.
12 Commissioners for Revenue and Customs Act 2005, Section 18.
2.31 There is currently a difference between the criteria for referral of decisions to the Programme Board and those for referral to Commissioners. The threshold for referral to the Programme Board is based on the total value of a settlement with a taxpayer, which usually covers more than one issue. The threshold for a referral to Commissioners is, however, based on the value of individual issues. We found a settlement worth more than £400 million, with issues totalling over £400 million conceded by the Department because it considered its position was weak, which was not referred to Commissioners because no single issue exceeded £250 million.

2.32 The Department has a clearly defined approach to settling disputes, as set out in the Litigation and Settlement Strategy. An internal review of the Litigation and Settlement Strategy in December 2009 found that, when it was launched in May 2007, the extent to which it was understood by the Department’s staff varied. Some staff did not appreciate the flexibility it offered, or thought it emphasised litigation. This initially led to delays in some cases, and inconsistent application, creating an adversarial relationship with some taxpayers. The Department does not currently intend to revise the substance of its Litigation and Settlement Strategy as its core message does not need to change, but is planning to relaunch the Strategy to make the messages clearer. This should assist in developing a common understanding within the Department on how to apply the Strategy in the resolution of tax disputes.

Has the Department complied with its processes for resolving tax disputes?

2.33 We examined 27 settlements, involving 21 companies and assessed the extent to which the processes applied by the Department were consistent with:

- statutory requirements, for example, the provisions for the exercise by the Commissioners of their discretion under their statutory ‘collection and management’ powers;

- the Litigation and Settlement Strategy; and

- internal guidelines on the arrangements for approving settlements.

2.34 Fifteen of the settlements we examined were in the High Risk Corporates Programme, and a further three were presented to the Programme Board for a decision. The settlements involved between one and 236 issues, with values (which totalled £8.8 billion) ranging from some £70 million to more than £1 billion. In selecting settlements to examine, we aimed to select the largest issues by value, irrespective of the type of tax involved. We selected our sample to include issues where a large amount of tax was under consideration, even if the final settlement value was small. We selected a sample of cases settled since April 2006 meeting one or more of the following criteria:

13 The Commissioners have a limited discretion with regard to their duty for the collection and management of taxes under Section 5 of the Commissioners for Revenue and Customs Act 2005. In certain limited circumstances, they can forego the collection of tax, for example if there is a higher net return from not collecting the tax. The judgement in Wilkinson v Commissioners of Inland Revenue in the House of Lords 2005 set out the limits of the circumstances in which the collection of tax could be foregone.

14 Four of the cases not referred to the Programme Board for a decision were those subject to the special governance arrangements noted in paragraph 2.28.
Settlements reached by companies in the Programme.

Other settlements considered by the Programme Board.

Settlements where the issues involved the tax under consideration of more than £250 million, whether the company was in the Programme or not.

Any settlements where we were made aware of specific concerns about the governance of the dispute resolution.

Collection and management powers

2.35 Our review identified a number of cases where the Commissioners had been asked to exercise powers available to them under Section 5 of the Commissioners for Revenue and Customs Act 2005 to forego the collection of tax. We did not identify any instances where these powers were exercised inappropriately. We noted, however, some differences of view within the Department on the implications of the Wilkinson judgement on the Commissioners’ ability to exercise these powers to resolve tax disputes. If the Commissioners apply powers inappropriately, they may face a Judicial Review of their decision.

2.36 In one case, we identified that Commissioners had been asked to exercise their collection and management powers on the basis of oral advice from the Department’s Solicitor’s Office. In our view, in the particular circumstances of this case, it would have been helpful to have secured confirmation of that advice in writing to provide a clearer audit trail.

Adherence to the Litigation and Settlement Strategy and guidelines for approving settlements

2.37 We found that the Department had complied with the requirements of the Strategy and with internal guidelines for managing cases in a substantial majority of the cases we examined. Technical and legal expertise was sought and received as appropriate and the available documentation indicated that individual issues had been considered on their merits. We did, however, note exceptions in the following cases which were referred to the Programme Board as the tax under consideration exceeded £100 million:

- A case was settled before the Department recognised that it should have been referred to the Programme Board. The Board identified a financial error, demonstrating its value as a check on settlement proposals.

- A case where the Department came under pressure from a company to agree a settlement on a single issue very quickly. The Department judged that it should not wait until the next monthly Programme Board meeting, so the proposed settlement was put to the Programme Board by email and Board members were given a week to respond. The settlement proposal was agreed even though not all Board members responded by the deadline.
2.38 The High Risk Corporates Programme approach assists in resolving long outstanding issues within an accelerated timeframe. However, there is a risk that the pressure to reach resolution quickly will be at the expense of considering issues properly. There is also a risk that, in settling a range of issues in a short timeframe, weaker issues will be dropped in the wider interest of obtaining a settlement, where they might have been pursued if considered in isolation. We have seen examples where the Programme Board has agreed not to pursue issues involving finely balanced arguments. Whilst this is consistent with the Litigation and Settlement Strategy, the Department accepts that it could be more explicit in describing the criteria used to make marginal decisions.

Future developments

2.39 The Department is currently piloting ‘Alternative Dispute Resolution’ procedures, to try to resolve disputes earlier in the process. The aim is to save both the Department and the taxpayer time and money by resolving disputes sooner through the early use of mediation. The Department is also piloting a dispute resolution process that involves an internal facilitator for smaller cases. These pilots have so far been well received by taxpayers and the accountancy firms.

2.40 The Department is also keen to build on the successes of the High Risk Corporates Programme. It is looking to extend its principles and disciplines to dealing with tax disputes with the next tier of businesses who are overseen by the ‘Large and Complex’ teams within the Department’s Local Compliance Offices.
Part Three

Stabilising the PAYE Service

Introduction

3.1 Pay As You Earn (PAYE) is the Department’s largest tax collection process. In 2010-11, it collected £157.2 billion in Income Tax and £96.9 billion in National Insurance contributions, of which nearly 90 per cent was collected through PAYE. There are approximately 39 million individuals with an active PAYE employment record, including 10 million receiving pension income, administered through 2.1 million PAYE schemes. Each year the Department processes around 57 million returns for separate employments and pensions.

3.2 The PAYE process embraces the Department, employers and pension scheme administrators (collectively referred to as employers), and individuals. Employers administer PAYE by ensuring that the correct amounts of tax and National Insurance contributions are deducted from employees’ earnings and paid over to the Department each month. After the Department has received information on earnings and tax deductions from employers at the end of each year, it reconciles each individual’s record to confirm that the correct amount of tax has been paid though PAYE. Whilst most people pay the right amount in-year, over and underpayments are nevertheless a normal part of the PAYE process and can occur, for example, for people moving in and out of work or receiving changes to taxable benefits. Figure 8 overleaf outlines the main stages in the PAYE process.

3.3 Up to 2009, the Department’s information on individual employments was structured around employers and held on 12 separate regional databases, making it difficult for it to obtain a complete view of an individual’s income. The limitations of the system and changing employment patterns led to an increasing number of cases where it was not possible to reconcile an individual’s tax without manual intervention. This led to the numbers of unreconciled (or ‘open’) cases in the PAYE system to outstrip the Department’s capacity to work them. At its peak this backlog reached 32 million in 2008. After the Department’s efforts to reduce this number in advance of system changes, the backlog of open cases relating to 2007-08 and previous tax years stood at 17.9 million.
3.4 This Part of the report examines the Department’s administration of PAYE by considering:

- the improvements in PAYE processing that are intended under the new National Insurance and PAYE Service (NPS);
- the difficulties encountered in the operation of PAYE following the introduction of NPS;
- the short-term progress made in stabilising the delivery of PAYE in 2010-11, including the progress in clearing the backlog of cases pre-dating NPS; and
- the plans for stabilising the delivery of the PAYE service by 2013.
The National Insurance and PAYE Service

3.5 In June 2009, the Department implemented the new National Insurance and PAYE Service (NPS) to replace its former PAYE computer system. NPS introduced a number of important system changes which offer the opportunity to process PAYE accurately and on time, and reduce the volume of over and underpayments of income tax.

3.6 Under NPS, PAYE records are structured around the individual rather than the employer or pension scheme. The creation of a single taxpayer record brings all of an individual’s sources of income together for the first time, increasing the Department’s ability to confirm that individuals start the tax year on the correct code. This will help ensure that the correct amount of tax is deducted in-year, reducing the number of over and underpayments identified at the end of the tax year.

3.7 NPS increases the opportunity for the Department to complete its end of year reconciliation of taxpayers’ records automatically. This allows it to confirm that the right amount of tax has been collected and, where necessary, process over or underpayments of tax earlier than in the past. The increased automation of PAYE processes under NPS also allows the Department to focus its manual processing on clearing exceptions caused by unexpected data or missing information, or where processing is overly complicated or not cost-effective to automate.

Operational difficulties following NPS implementation

3.8 As we reported in July 2010, problems in the quality of the PAYE data transferred from the predecessor system and the NPS system specifications led to difficulties in the timeliness and accuracy of PAYE processing. The Department only fully appreciated the extent of the data inaccuracies when it started processing annual codes for 2010-11, in January 2010, leading it to suspend the production and issue of codes. As part of its recovery programme, it isolated and cleansed in excess of nine million NPS records which it had assessed as having a high risk of error, before processing through NPS. Although it corrected the majority of codes by the start of the 2010-11 tax year, the recovery was not completed until the end of September 2010.

3.9 The phased release of NPS also meant that the functionality to support the automated reconciliation of individuals’ PAYE records was not available to the Department between July 2009 and April 2010. This led the Department to defer its reconciliation of approximately 39 million taxpayer records for 2008-09 to September 2010, delaying the clearance of these records and the identification of over and underpayments of tax by over a year. It also meant that it was not able to process the bulk of the backlog of 17.9 million unreconciled cases from 2007-08 and earlier tax years.
3.10 The delay in clearing the processing backlog and the effect of legislative changes mean that the Department will now not recover underpayments of tax relating to the 2006-07 and earlier tax years. The Finance Act 2008 reduced the time limit for collecting tax from six years to four years, so a notional £150 million of tax underpaid in the 2004-05 and 2005-06 tax years could no longer be pursued.\textsuperscript{15}

3.11 The Department had intended to start processing the backlog of 2006-07 cases in the summer of 2010, but was not able to implement its plan due to the diversion of resources to support the annual coding recovery. In October 2010, it decided not to pursue the notional £500 million of tax underpaid relating to these 2006-07 cases, because it estimated that only £25 million was recoverable at that stage, outweighing the cost of recovery. The Department accepts that, had it commenced the processing of these cases in the summer of 2010 as planned, it may have had the opportunity to recover up to £100 million of those underpayments.

3.12 The problems encountered in the annual coding for 2010-11, the delay in reconciling the 2008-09 tax year and the backlog of cases from previous years has resulted in reputational damage for the Department. In October and November 2010, the Committee of Public Accounts examined the implementation of NPS and concluded that the Department had failed in its duty to process PAYE accurately and on time, deliver an acceptable standard of service to PAYE taxpayers, and to understand the risks of poor quality data.

Stabilising PAYE in 2010-11

3.13 Following the problems encountered in the initial implementation of NPS and execution of annual coding for 2010-11, the Department established a programme to stabilise NPS, and to allow it to realise improvements in efficiency and productivity under the new system.

3.14 In this section, we consider the Department's progress in stabilising the administration of PAYE by:

- learning the lessons from annual coding for 2010-11;
- bringing taxpayers' affairs for 2008-09 and 2009-10 up to date, by completing the end of year reconciliations for these tax years;
- getting taxpayers on the right codes, by delivering annual coding for 2011-12;
- managing work items arising from in-year PAYE changes; and
- clearing the backlog of legacy open cases.

\textsuperscript{15} The Department cannot determine the precise make-up and value of the open case population until the cases are actually worked.
Lessons learned from annual coding for 2010-11

3.15 The Department reviewed the lessons learned from issues encountered during annual coding for 2010-11. In the light of this review, it introduced a more rigorous process for testing NPS releases to confirm that the system functionality was operating as intended and accurate outputs were being generated. The principal changes involved:

- greater business stakeholder involvement in development and approval of the test strategy as well as in the testing and implementation;
- the detailed testing of NPS outputs to taxpayer records performed and quality assured by personal tax experts to ensure that accurate PAYE calculations and tax codes were issued to taxpayers;
- excluding NPS records from live processing where results of testing fell below pre-determined accuracy targets, while the underlying causes of inaccuracy were investigated and corrected; and
- the Department’s senior management taking the formal ‘go/no go’ decision on the live running of end of year reconciliations and annual coding.

3.16 The Department first implemented these changes in its approach as part of its testing of NPS functionality and data quality in preparation for the end of year reconciliation of the 2008-09 and 2009-10 tax years. It further refined its testing approach in the delivery of annual coding for 2011-12, to improve its analysis of errors and their tax effect, and to continue to monitor the accuracy of annual coding notices issued to taxpayers during live processing.

3.17 The Department assessed the overall accuracy of annual coding against an internal target of 97 per cent prior to its decision to start live processing. It continued to monitor the accuracy of codes issued to ensure that the overall accuracy target was being achieved. The Department plans for this approach to be the standard test process to be applied to NPS in advance of all key PAYE business events.

3.18 The poor quality of the data and the NPS specification has continued to have a major impact on the processing of PAYE. To undertake its processing of the end of the year reconciliations for 2008-09 and 2009-10 and annual coding for 2011-12, the Department has reviewed over 11 million taxpayer records, almost 25 per cent of the NPS database, and as necessary, repaired the records. It still has to repair approximately 2.4 million of the reviewed records before reconciliations for 2008-09 and 2009-10 can take place.

3.19 The need to review and repair NPS records in advance of processing should reduce significantly in the future as the Department improves the quality of data on NPS and introduces changes to the system’s functionality. It currently estimates that between 5 and 8 per cent of NPS records will need to be reviewed and repaired as part of the end of year reconciliation for the 2010-11 tax year.
End of year reconciliations for 2008-09 and 2009-10

3.20 Having decided to defer the end of year reconciliation for 2008-09, the Department had to complete the 2008-09 and 2009-10 reconciliations together. It started these reconciliations in September 2010, once it had completed its testing of the NPS end of year reconciliation functionality. By March 2011, the Department had completed the reconciliation of the vast majority of the 2008-09 and 2009-10 records where it had all the information necessary for automated reconciliation.

3.21 In April 2011, the Department started the review of a forecast 6.7 million taxpayers’ records relating to the 2008-09 and 2009-10 tax years where it had not yet received the information from the employer or the information had not matched automatically to the NPS record. It is necessary for the Department to investigate each of the records manually. Under NPS, the Department expects to manually review 3 to 4 million of these records annually, compared with 16 to 17 million records in each year immediately before its implementation. The Department plans to clear the remaining 2008-09 and 2009-10 end of year reconciliations by March 2012. It also expects that when the information has been received and matched to NPS, some 85 per cent of the records will reconcile without resulting in an over or underpayment of tax.

3.22 The Department estimates that at 31 March 2011, its reconciliation of the 2008-09 and 2009-10 tax years had identified 5.6 million overpayments of tax totalling £1.9 billion and 1.1 million underpayments of tax totalling £1.1 billion across the two years. Figure 9 shows the total volume and value of overpaid and underpaid tax for the two years combined to date.

3.23 To keep workloads to a manageable level, the Commissioners used their collection and management powers to temporarily raise the threshold for not reclaiming underpayments of tax identified as part of the end of year reconciliation for 2008-09 and 2009-10 from £50 to £300. The temporary rise in the threshold to £300 was applied to all underpayments of tax from PAYE reconciliations processed from September 2010 to March 2011, including 2007-08 legacy open cases. By March 2011, this had excluded underpayments of tax totalling an estimated £266 million from recovery across all open years.

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**Figure 9**

Outturn for 2008-09 and 2009-10 end of year reconciliations

<table>
<thead>
<tr>
<th></th>
<th>Estimated</th>
<th>Position at 31 March 2011</th>
</tr>
</thead>
<tbody>
<tr>
<td></td>
<td>Number</td>
<td>Value (£)</td>
</tr>
<tr>
<td>Overpayments</td>
<td>4.3m</td>
<td>1.8bn</td>
</tr>
<tr>
<td>Underpayments, greater than £300</td>
<td>1.4m</td>
<td>2.0bn</td>
</tr>
<tr>
<td>Underpayments between £50 to £300</td>
<td>900,000</td>
<td>160m</td>
</tr>
<tr>
<td></td>
<td>Number</td>
<td>Value (£)</td>
</tr>
<tr>
<td></td>
<td>Not known</td>
<td>Not known</td>
</tr>
</tbody>
</table>

**NOTE**

1 The Department is unable to analyse underpayments between £50 and £300 by tax year.

Source: HM Revenue & Customs
3.24 The Department’s decision to delay its reconciliation of the 2008-09 tax year has also resulted in it foregoing the recovery of some underpayments of tax. Some taxpayers have successfully claimed under Extra Statutory Concession A19 (ESC A19) that the Department had failed to make proper and timely use of the information available to it. By June 2011, the Department had received 111,000 claims for the remission of income tax underpayments for 2008-09 and 2009-10 under ESC A19, of which it had remitted 28,000 at a cost of £41 million.

3.25 The Department also chose to forego the recovery of underpayments of income tax from 250,000 pensioners where their tax codes for 2008-09 and/or 2009-10 had failed to reflect they were receiving state pension as well as other income, because it considered that a substantial number of this group of pensioners could reasonably claim a remission under ESC A19. The Department has been unable to obtain a reliable estimate of the value of the tax foregone in these cases.

Annual coding for 2011-12

3.26 Between January and the end of March 2011, the Department issued 17.4 million coding notices for the 2011-12 tax year, representing 99.4 per cent of the total expected to be issued. The high levels of accuracy achieved in annual coding for 2011-12 led to lower levels of taxpayer contact, with only 4 per cent of coding notices issued leading to calls to the Department’s contact centres, compared with 8 per cent for the annual coding for 2009-10.

PAYE work management

3.27 Work items are produced by the PAYE work management system for manual clearance when user intervention is required to complete the automated processing in NPS. The system has produced high volumes of work items from in-year processing, compounded in the short term by the recovery work associated with annual coding and end of year reconciliations, including the need to work two years of reconciliations together.

3.28 The Department has had to actively manage the higher volumes of work items to keep them within the work management system's operating capacity of 12.5 million work items. This has included staggering the production of items for manual end of year reconciliation and focusing its resources on the highest priority work items. Additionally, it has reviewed categories of work items to determine if their production can be temporarily inhibited where they are considered redundant or low priority. It has also deleted work items that were redundant or no longer relevant.

16 The Department will issue a coding notice to an individual and their employer where changes in income or circumstances have an impact on the tax they will have to pay. This includes those in receipt of a state pension, taxable state benefits and changes to benefits in kind.
Outstanding work items may result in some taxpayers’ records not being up to date for a period. A potential consequence of not processing these work items is that for some taxpayers, over and underpayments identified as part of the Department’s end of year reconciliation may be higher than they would otherwise have been. In response to this risk, the Department prioritised its clearance of work items based on its assessment of the impact on the taxpayer, the tax involved and the availability of resources to undertake the work.

The Department is still working to fully understand the impact of not clearing work items that are generated by NPS on the PAYE process, including whether it is necessary to clear certain categories of work item at all. It is aiming to reduce the volume of work items produced through enhancements to NPS functionality. The Department plans to introduce changes to NPS functionality in April 2012. It is also working to increase the efficiency of its manual clearance of work items through improvements to operational instructions issued to staff.

Clearing legacy open cases

The Department established a programme in late 2010 to work the 2007-08 underpayment cases manually to allow it time to recover any underpaid tax within the four year statutory window. By the end of March 2011, it completed processing of 416,000 underpayment cases, against a target of 400,000, and identified £228 million in underpaid tax. It is collecting £100 million of this through adjustments to the 2011-12 tax codes where individuals have sufficient income subject to PAYE to make the recoveries and has written to taxpayers to arrange direct payment of the remaining £122 million. The Department estimates there is a further £136 million in underpayments of tax to be identified from cases yet to be worked for the 2007-08 tax year.

The Department has committed to completing clearance of all outstanding legacy cases by the end of 2012. It is currently testing an automated solution based on NPS functionality, which it expects to implement in October 2011. It will use this solution to classify the remaining population of 16.8 million cases and target its resources in clearing overpayments of tax across the tax years 2003-04 to 2007-08. It estimates that the new functionality will allow it to clear at least 60 per cent of these cases automatically, leaving the residual to be cleared by clerical staff. This figure may be lower if the automated solution can be applied to a larger proportion of the population. The Department’s best estimate is that overpayments of tax of up to a total of £2.8 billion may have to be repaid for the period 2003-04 to 2007-08.

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17. The Commissioners extended their decision to temporarily raise the threshold for not reclaiming underpayments of tax below £300 to include 2007-08.
18. £6 million of the £228 million has been set off completely against overpayments in other years (or reduces the underpayment to below £300 once set off).
19. The Department has recognised a provision of £2.5 billion in its 2010-11 Accounts as not all of the £2.8 billion repayments issued as payable orders will be cashed, for example, where the taxpayer is not contactable.
Costs

3.33 The stabilisation of PAYE was initially managed under two programmes, one to stabilise NPS and the other to clear legacy open cases. The Department has estimated the cost of the programmes over the period 2010-11 to 2012-13 at £23.6 million and £57.3 million, respectively.20

A Stabilised PAYE Service

3.34 The Department’s aim for a stabilised PAYE service is that it would be dealing with only three open years in any one year. This means that in any year the Department would be:

- completing the reconciliation of taxpayer accounts for the previous year;
- making in-year adjustments to reflect changes in circumstances, thereby keeping taxpayer accounts up to date; and
- calculating and issuing correct codes for the following year.

3.35 The Department plans to deliver a stabilised PAYE service by 2013. It intends to achieve this by focussing on three areas:

- efficient clearance of post – it plans to speed up the turnaround of taxpayer correspondence, including a target clearance of 80 per cent of post in 15 days, by the summer of 2011, in order to minimise the level of repeat taxpayer contact chasing progress and thus free up resources;

- clearance of arrears – it plans to clear outstanding end of year reconciliation cases for 2008-09 and 2009-10 by March 2012, and legacy open cases relating to the 2003-04 to 2007-08 tax years by December 2012; and

- advancing the processing timetable – it has announced plans to start the automated end of year reconciliation for the 2010-11 tax year in July 2011, two months earlier than the previous year. Initially the Department will prioritise the processing of overpayments of tax so taxpayers will receive the money they are owed promptly. It will then begin its processing of underpayments in the autumn so they can be included in the tax codes for 2012-13.21 It will then identify and manually process incomplete records excluded from automated reconciliation.

Figure 10 overleaf illustrates the estimated timeline to meet the Department’s target of a stabilised PAYE service by 2013.

20 The cost of NPS stabilisation excludes the costs of the manual working of cases by the Department’s operational staff.
21 The reconciliation is expected to generate 1.7–3.5 million repayments to the taxpayer by the end of September 2011, and approximately 1.2 million underpayment notices between September and December 2011.
The Department has recognised the priority of PAYE recovery and stabilisation in allocating the Personal Tax business area for 2011-12 another £34 million for recovery activity through manual processing in addition to the amounts stated in paragraph 3.33. The Department has informed us that it will recognise this priority again when considering the allocations for 2012–13 as part of the business planning process, which will take place in the autumn of this year.

The Department has not been resourced to clear all exceptions arising from in-year processing while it is engaged in clearing processing arrears and cleansing NPS data. While it plans to accelerate its end of year reconciliation and clear legacy backlogs, as well as introduce further efficiencies to NPS in 2012, the Department will not be able to finalise its plans until it fully understands the volume of work items that will be produced from in-year processing and its capacity to work them. Until it has a comprehensive plan that embraces in-year work management, the Department cannot achieve its goal to deliver a stabilised PAYE service.

NOTES
1 In 2010-11, the Department completed the majority of annual coding for 2011-12 and end of year reconciliations for 2008-09 and 2009-10 where all information for automated reconciliation was available, in addition to processing 2007-08 underpayments from legacy open cases. In 2011-12, the Department plans to complete the manual end of year reconciliations for 2008-09 and 2009-10, progress the clearance of legacy open cases and commence the end of year reconciliation for 2010-11.

2 In-year PAYE processing is a year-round activity and is not represented in the diagram.

Source: National Audit Office analysis of HM Revenue & Customs data
Real Time Information for PAYE and Data Improvement

3.38 The Department plans to introduce Real Time Information (RTI), where employers will be required to report employees’ Income Tax and National Insurance deductions at the same time as they pay them rather than at year end. Under RTI, some elements of the PAYE process will no longer be required, such as employer end of year returns and in-year forms for starters and leavers.

3.39 RTI is a key component in the Department for Work and Pensions’ plans for the introduction of Universal Credit from 2013, where it will use real time PAYE information on employment and pension income to award and adjust Universal Credit. To meet this timetable, the Department will begin to pilot RTI in April 2012 with volunteer employers and software developers for a full year. Employers not already on RTI as a result of the pilot will be mandated to join RTI in the period April to October 2013. Small and medium employers will be brought on in April 2013 with the remaining larger employers progressively taken on in the period to October 2013. All employers will be under RTI from October 2013.

3.40 The Department identified poor data quality as the key cause of the issues experienced during annual coding for 2010-11 and the current volumes of over and underpayments. It recognises that it has to address these data quality issues in PAYE if it is to realise the benefits of NPS. It also recognises that improvements in PAYE data quality are a precursor to the successful implementation and operation of RTI and Universal Credit, where the maintenance of data quality will be critical. In particular, PAYE information submitted in real time will need to be matched to the correct taxpayer’s record on receipt.

3.41 The Department launched a PAYE data improvement project, within its wider RTI programme. The objectives of the data improvement project, include amongst other things, to:

- understand and address the root causes of data quality issues that could impact on the successful implementation of RTI;
- improve the current standard of data quality within PAYE to reduce the risk to the RTI programme;
- deliver changes to the PAYE operating model to ensure that data quality improvements can be sustained; and
- support and inform data cleansing activities required in advance of the delivery of RTI.

The detailed planning phase of the project was completed at the end of June 2011. The Department has now entered into the evaluation and pilot phase from July to October, prior to full implementation from November 2011.
Cost reductions

3.42 The Department faces further challenges in the delivery of the PAYE service beyond its plans to stabilise the service by 2013, and the implementation of RTI. Following the 2010 Spending Review, the Department committed to reducing running costs by 25 per cent in real terms by 2014-15, which will involve significant cost reductions in the administration of personal tax. The Department’s Personal Tax business area is currently expected to reduce its overall staffing from 24,900 as at April 2011 to 16,400 by April 2015. It is planned that the full time employee and cost reductions will be enabled by a number of new programmes, including RTI, under the umbrella of a central Change Programme identified in and funded through the Spending Review settlement. We intend to report separately on the Department’s cost reduction proposals.

22 National Audit Office report on Reducing Cost in HMRC with a publication date of 20 July 2011.
Part Four

Tax Credits

Introduction

4.1 Child and Working Tax Credits (tax credits) offer financial support to more than seven million families, supporting around 10 million children. 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. In 2010-11 it spent around £28.1 billion on tax credits.

4.2 The tax credits scheme is designed to be flexible and to react to the changes in claimants’ circumstances. The process is complex, however, and claimants have not always understood their obligations to tell the Department when their circumstances change and to report their actual income and circumstances at the end of the year. Claimants also make genuine errors in their applications that result in incorrect awards, for example, because they misunderstand what should be reported as income, or calculate childcare costs incorrectly.

4.3 In February 2011, the Government announced its intention to introduce a new Universal Credit to replace many of the current working-age benefits, including working and child tax credits, with a single means tested payment. The aim of the Universal Credit is to create a single streamlined working age benefit, to reduce or remove some of the current complexities around benefit entitlement, verification of customer circumstances and administrative burden that can increase the opportunities for error and fraud. The Universal Credit is scheduled for introduction in 2013, but it is anticipated that some tax credits claimants will not be transferred onto the new scheme until 2017.

Reducing error and fraud

4.4 The Department’s latest estimate, based on finalised awards for 2009-10, indicates that the overall level of error and fraud has decreased from between 8.3 and 9.6 per cent in 2008-09 to between 6.6 and 8.1 per cent in 2009-10. This equates to payments of between £1.75 billion and £2.14 billion being made to claimants incorrectly because of error or fraud and further amounts of between £250 million and £550 million not being paid to claimants due to error (Figure 11 overleaf). The levels of error and fraud are material within the context of the £28.1 billion spent on tax credits. As 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, the Comptroller and Auditor General qualified his opinion on the regularity of the tax credits expenditure reported in the 2010-11 Trust Statement.
In July 2008, the Department announced a target to reduce tax credits losses due to error and fraud to no more than 5 per cent of the value of finalised entitlement by March 2011. It will only be able to measure its performance against this target in summer 2012, once the estimate of error and fraud in the finalised awards for 2010-11 is available.

In April 2009, the Department launched a revised strategy to reduce the level of error and fraud in tax credits. The strategy is based on getting a better understanding of tax credits claimants and their behaviours to support a tailored approach to reducing error and fraud. It includes:

- **better support to claimants** – by offering more support to claimants to help them get their claims right first time by assisting them through the claim and renewals process and by contacting existing claimants to confirm that information held is accurate;
- **preventing error and fraud** – by increasing the Department’s focus on stopping error and fraud from entering the system at the application, change of circumstance and renewal stages; and
- **tackling non-compliance** – by continuing to identify tax credits claims for compliance and other enquiries based on specified verification and risk scoring criteria applied at the time awards are processed.

**Figure 11**

HM Revenue & Customs’ estimates of error and fraud

<table>
<thead>
<tr>
<th></th>
<th>2009-10</th>
<th>2008-09</th>
<th>2007-08</th>
</tr>
</thead>
<tbody>
<tr>
<td><strong>Value of finalised awards</strong></td>
<td>£26.4bn</td>
<td>£23.6bn</td>
<td>£19.9bn</td>
</tr>
<tr>
<td><strong>Error and fraud favouring the claimant</strong>&lt;sup&gt;1&lt;/sup&gt; (Overpayments)</td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>Percentage of finalised awards&lt;sup&gt;2&lt;/sup&gt;</td>
<td>6.6-8.1%</td>
<td>8.3-9.6%</td>
<td>8.3-9.7%</td>
</tr>
<tr>
<td>Value</td>
<td>£1.75bn-£2.14bn</td>
<td>£1.95bn-£2.27bn</td>
<td>£1.65bn-£1.93bn</td>
</tr>
<tr>
<td><strong>Error favouring HMRC</strong>&lt;sup&gt;1&lt;/sup&gt; (Underpayments)</td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>Percentage&lt;sup&gt;2&lt;/sup&gt;</td>
<td>1.0-2.1%</td>
<td>0.8-1.3%</td>
<td>1.0-1.6%</td>
</tr>
<tr>
<td>Value</td>
<td>£0.25bn-£0.55bn</td>
<td>£0.20bn-£0.31bn</td>
<td>£0.20bn-£0.32bn</td>
</tr>
</tbody>
</table>

**NOTES**

1 The Department estimates levels of error and fraud based on the examination of a random sample of 2,696 finalised awards under its annual Error and Fraud Analytical Programme. As awards for 2010-11 are not due to be finalised until July 2011 and in some cases later, the Department will not be able to complete its error and fraud analysis of these awards until summer 2012.

2 The percentages shown in Figure 11 represent the estimated ranges of error and fraud as a percentage of finalised tax credits entitlement, ranges are used as the estimated mid points are subject to margins of error. The Department publishes Child and Working Tax Credits Error and Fraud Statistics each year from where further details may be obtained: http://www.hmrc.gov.uk/stats/personal-tax-credits/menu.htm

**Source:** National Audit Office analysis of HM Revenue & Customs’ data
4.7 Since the introduction of the revised strategy in 2009, the Department has significantly increased the number of interventions to almost 1.8 million in 2010-11 and identified losses attributable to error and fraud of £792 million, compared with £253 million in 2008-09 (Figure 12).

Figure 12
HM Revenue & Customs Error and Fraud – Outcomes from Interventions

<table>
<thead>
<tr>
<th>Interventions</th>
<th>2010-11</th>
<th>2009-10</th>
<th>2008-09</th>
</tr>
</thead>
<tbody>
<tr>
<td></td>
<td>Number</td>
<td>Estimate of loss prevented (£m)</td>
<td>Number</td>
</tr>
<tr>
<td>Better Support to Claimants</td>
<td>(000)</td>
<td>(000)</td>
<td>(000)</td>
</tr>
<tr>
<td></td>
<td>470</td>
<td>215</td>
<td>524</td>
</tr>
<tr>
<td>Preventing Error and Fraud</td>
<td>340</td>
<td>238</td>
<td>104</td>
</tr>
<tr>
<td>Tackling Non-Compliance</td>
<td>984</td>
<td>339</td>
<td>653</td>
</tr>
<tr>
<td>Total</td>
<td>1,794</td>
<td>792</td>
<td>1,281</td>
</tr>
</tbody>
</table>

NOTES
1. Each category includes an amount arising from interventions undertaken by Compliance, Operations and Customer Contact Directorate.
2. Some of these measures impact on more than one area.

Source: HM Revenue & Customs and National Audit Office

4.8 A key feature in the Department’s delivery of the strategy has been to increase the number of interventions against those tax credits awards likely to contain error and fraud and, in particular, to identify error and fraud before awards pass into payment (‘Check First, Then Pay’) rather than limit the checks to compliance enquiries against awards in payment. During 2010-11, it increased its interventions at the primary points where error and fraud enters the tax credits system – application, changes of circumstance and renewals – to deliver 450,000 checks against high risk awards and prevent an estimated loss of £200 million. In comparison, in 2009-10, it performed 34,000 of these pre-capture checks, identifying an estimated £5 million of error and fraud losses.

4.9 There is scope for the Department to improve its targeting of high risk awards. We found that between 13 and 16 per cent of high risk awards selected for intervention prior to processing resulted in the identification of error or fraud. We also found that rules-based guidance applied to support the selection of high risk change of circumstances and renewal cases did not allow the Department to identify which of its risk criteria were most likely to target error or fraud. Work to develop this functionality has now been commissioned.
Measuring performance

4.10 The Department can only measure the underlying level of tax credits error and fraud in any year once the awards for that year are finalised. It has therefore developed proxy indicators to allow it to track progress in reducing error and fraud through the year. It estimates that by the end of March 2011 it had identified £1,054 million of error and fraud in 2010-11 awards against a target of £1 billion. The Department has a target to identify £1.4 billion of error and fraud by July 2011, once the majority of 2010-11 awards are finalised. For 2011-12, it plans to identify £1.2 billion of error and fraud by March 2012 and £1.7 billion by July 2012.

4.11 The Department’s estimate of £1,054 million of error and fraud identified by March 2011 comprises £792 million of loss prevented from its interventions on individual awards, plus estimates for the wider deterrent effect of its strategy and for sustained improvements in compliance as a result of interventions in previous years. It is undertaking a review of its estimated level of error and fraud for 2009-10, and plans to link the outcome with the direct and indirect effect of its interventions measured against its proxy target.

4.12 In our 2009-10 report, we recommended that the Department improve the accuracy and reliability of its measurement of intervention yields. During 2010-11, it issued new guidance and training for tax credits teams on measuring interventions and introduced new assurance arrangements. We have continued to find inconsistency in measurement and some instances where the results of interventions were inaccurately recorded, resulting in both the over and under reporting of loss prevented. However, the Department is strengthening its approach to quality assurance including the independent sampling of intervention results.

Joint Fraud and Error Strategy

4.13 In October 2010, as part of the Spending Review, the Department launched a Joint Fraud and Error Strategy with the Department for Work and Pensions. Within the context of the Strategy, and as part of Spending Review 2010, the Department has a target to prevent £8 billion of tax credits losses, through interventions, over the next four years.

4.14 The Joint Strategy commits the departments to delivering an integrated approach to tackling error and fraud based on five fundamental components: prevent; detect; correct; punish; and deter. The departments are developing a common governance and reporting framework and have established a new Joint Programme Management Office and a senior level Joint Strategy Programme Board to manage delivery of the Strategy. The integrated approach will include better data sharing between the departments and the creation of integrated teams to provide the departments with a combined risk and intelligence, analytical, fraud investigation, and mobile task force capability.
Recovering tax credits debt

4.15 In 2009-10, the Department prepared a Tax Credits Debt Tactical Delivery Plan, designed to reduce tax credits debt. The plan included objectives to reduce the amount of tax credits debt by £0.2 billion to £4.3 billion by March 2011, and reduce the level of tax credits debt going forward. As we reported last year, during 2010-11 the Department intended to work to:

- stem the creation of debt by reducing the amount of error and fraud entering the system and by better understanding and measuring the impact of other interventions that reduce overpayments;
- develop a more active approach to engaging with claimants with a tax credits debt and support Debt Management and Banking directorate in its 2010 Debt Campaign; and
- review and remit uneconomic and unenforceable debts where there is no possibility of collection by March 2011.

4.16 The Department has not met its target to reduce the overall level of debt. At 31 March 2011, the total value of tax credits debt was £4.7 billion, compared with £4.5 billion at March 2010. Not all of this balance is likely to be recoverable as, at 31 March 2011, the Department estimates that the collection of £3.0 billion as doubtful (£2.5 billion at 31 March 2010). The majority of the debt for which collection is assessed as doubtful relates to the £2.6 billion of terminated tax credits awards which have been passed to the Department’s Debt Management and Banking directorate for direct recovery.

4.17 Tax credits debt will continue to increase if the Department does not take any further steps to improve the recovery and clearance of debt. In 2010-11, £1.5 billion of new tax credits debt was generated which was almost £300 million more than expected. This increase is in part a consequence of the increase in overpayments identified as a result of the increase in the number of error and fraud interventions. Tax credits debt levels are likely to increase further from 2011-12 onwards, as Budget changes affect eligibility to tax credits and the threshold for disregarding income changes affecting awards is reduced. The Department estimates that £1.7 billion of new tax credits debt is likely to be generated in 2011-12 and, without any further intervention, overall debts could increase to £7.4 billion by 2014-15.
4.18 The Department’s efforts to increase engagement with tax credits debtors through its 2010 debt campaign has so far had a limited impact on debt recovery. The Department’s current tax credits debt campaign, launched in December 2010, is focusing on 330,000 overpayment cases totalling £550 million passed to the Debt Management Directorate between April and November 2010. By the end of April 2011, fewer than 9,000 cases with a value of £12 million had been recovered by payment, £103 million put into time to pay arrangements for recovery over a number of years or other recovery activity, and 21,000 cases totalling £55 million had been remitted or otherwise cleared.

4.19 The Department also sought to identify uneconomic and unenforceable tax credits debt and assess the scope for remission. During 2010-11, it undertook an exercise to assess the value for money of collecting £1.7 billion of tax credits debt not under active recovery, and will make decisions about what debt should be remitted by the end of July.