National Audit Office

Report
by the Comptroller
and Auditor General

The exchequer departments

Tax reliefs

HC 1256 SESSION 2013-14 7 APRIL 2014

Key contextual information

Tax reliefs

All tax systems include **tax reliefs**, which in many cases are an essential part of defining the scope and structure of a tax by providing rules which establish where the tax burden is and is not intended to fall.

Some reliefs, known as **tax expenditures**, are designed to deliver specific policy objectives by providing behavioural incentives to achieve economic and social objectives. These are often an alternative to public expenditure, and have similar effects.

1,128

tax reliefs enacted for individuals and businesses as at March 2013

180

tax reliefs for which HMRC has estimated a cost

£101bn

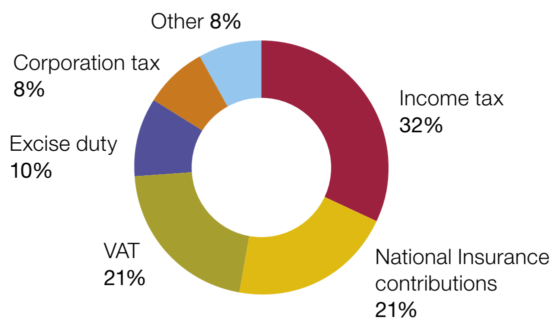
summed cost of tax expenditures (reliefs with similar objectives to spending programmes)

UK tax revenue

£476bn

UK tax revenue collected by HMRC in 2012-13

Analysis of taxes collected, 2012-13

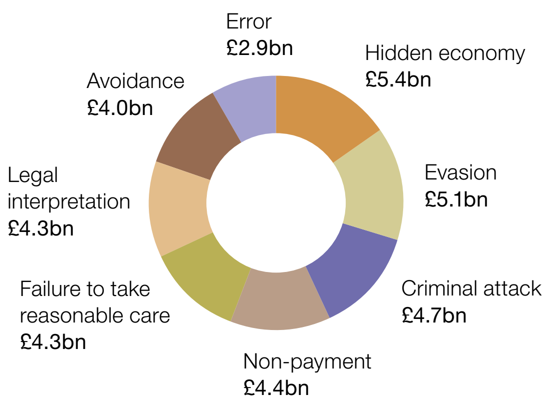


UK tax gap

7%

the tax gap in 2011-12 was £35 billion, or 7 per cent of tax liabilities in that year

Value of tax gap by behaviour, 2011-12



Summary

Introduction

1 The government collects taxes to fund public services, and can use the tax system to help people, households and businesses with targeted financial support. All tax systems include tax reliefs, which in many cases are an essential part of defining the scope and structure of a tax by providing rules which establish where the tax burden is and is not intended to fall.

2 There are more than 1,000 tax reliefs in the UK. Reliefs can help maintain the competitiveness of tax systems and governments can use tax reliefs as a mechanism to redistribute wealth, support economic growth and influence behaviour. Tax reliefs may also be used for practical purposes such as establishing the correct income and profit for tax purposes and making the tax system simpler to use. **Figure 1** summarises these different objectives as they are defined by HM Revenue & Customs (HMRC).

Figure 1
Different objectives of reliefs

HMRC classification	Purpose	Examples
Reliefs to correctly measure income or profits	To make sure that taxable amounts are correctly recognised, in the right year	Companies can deduct losses from previous years from current profits Companies must use a set rate of depreciation for each class of asset
Reliefs to ensure the scope of the tax is as intended	To make clear where a group or activity is not intended to be taxed. Usually this is to prevent unintended changes in behaviour	Cabin crew are exempt from air passenger duty Exemption of intermediaries from Stamp Duty (e.g. share traders)
Reliefs to improve the progressivity of tax	Allowances and thresholds to create different effective rates of tax	Income tax personal allowance Inheritance tax nil rate band threshold
Reliefs to create simplicity	Reliefs used to avoid disproportionate administrative costs	10 per cent wear and tear allowance for landlords Exemption of gifts below £250 from inheritance tax
Reliefs introduced by international agreements	To comply with international obligations or avoid double taxation	Double taxation relief Zero rate VAT for intra-community trade within the EU
Tax expenditures – reliefs to provide incentives for behaviour for economic and social objectives	To positively encourage a kind of behaviour, compensate for market failure or promote wider objectives	Enterprise Investment Scheme Income tax exemption for Individual Savings Account

Notes

1 Tax reliefs may have more than one purpose and so could fall under more than one category.

2 HM Revenue & Customs has categorised some but not all reliefs by objectives.

Source: HM Revenue & Customs

3 Some reliefs, known as 'tax expenditures', are designed to deliver specific policy objectives by providing behavioural incentives to achieve economic and social objectives. These are often an alternative to public expenditure, and have similar effects. Policy makers may prefer tax expenditures to spending programmes because they are thought to be the most effective and efficient way to achieve a policy objective.

4 Tax reliefs are delivered in various ways, and their design has implications for the complexity of the tax system, the costs of administration and the distribution of the taxpayer burden. This report uses a broad definition of the term 'tax reliefs' to include all of the tax mechanisms illustrated in **Figure 2**.

Figure 2
Tax relief mechanisms

Delivery mechanism	Example
Exemption – exclusion of an otherwise taxable amount from the tax base.	Principal private residence relief exempts the gain on disposal of a taxpayer's main place of residence from capital gains tax.
Deduction (also referred to as allowance) – an amount to be deducted when computing a taxable profit or gain.	Under income tax, corporation tax and capital gains tax, relief is allowed for losses (where expenditure exceeds revenue) on particular activities and transactions.
Credit (also known as 'offset') – an amount by which the tax liability is reduced. Some credits allow a payment to the taxpayer if the amount of relief exceeds the tax liability.	Under UK corporation tax, credit is available for up to £24.74 for every £100 of qualifying research and development (R&D) expenditure for loss-making companies.
Rate reliefs – a reduced rate of tax applicable to all or part of the tax base.	Certain goods are subject to reduced rates of VAT, and some are zero-rated.
Tax-free threshold – a specified portion of the tax base on which no tax is payable.	Personal allowance of £9,440 – in 2013-14 – before income tax is payable.
Deferral – a temporal delay in payment of a tax liability.	Companies use rollover relief to defer corporation tax from sales of certain assets where they reinvest in a replacement asset.
Modification for administrative simplicity – a special arrangement that modifies payment or compliance requirements for a specified group of taxpayers.	Income tax rules allow a deemed 5 per cent flat-rate deduction for the cost of personal service intermediaries.

Note

1 Variations of these mechanisms exist but are not listed here. Some reliefs use combinations of these mechanisms.

Source: Tax Administration Research Centre analysis for the National Audit Office

5 HMRC publishes cost estimates for some reliefs, but does not total these figures. Doing so would give only a broad indication of the scale of the tax reliefs landscape for two reasons. First, interactions between tax reliefs mean that simply combining the costs of individual reliefs will tend to overstate the true picture; and second, HMRC does not have cost data for a large number of reliefs, and the effect of excluding these will understate the overall position. It is important to recognise that, while the provision of reliefs reflects government's choices about where to place the tax burden, it would be unrealistic to assume that all of the revenue that appears to be foregone through tax reliefs could be collected. Some reliefs simply help define the tax base, such as the first three categories in Figure 1, and could not be otherwise collected. A higher overall tax burden could reduce economic productivity and the UK's global competitiveness, and may not be sustainable in the medium term.

6 In this report we have shown the total cost of tax reliefs compared to GDP in order to give a broad indication of the scale of the tax reliefs landscape. HMRC has asked us to include the following text: "*HMRC disagrees with the inclusion in Figure 3, paragraph 15 and paragraph 1.12 of the total of the costs of the separate tax reliefs. As the report itself explains at paragraph 5, HMRC does not publish this figure, because it does not represent an amount of money which might be obtained by Government – due, for example, to interactions between the reliefs. It is therefore misleading to refer to the figure*."

7 The cost of tax reliefs – so far as this is measureable – appears to be growing at a time when public spending is reducing. Each tax relief has an administration cost and carries the risk that revenue will be lost through error, tax avoidance and fraud. For tax expenditures, there is also the opportunity cost of the revenue foregone as a result of the policy decision to offer a relief. Reliefs may also have both intended and unintended consequences, such as the distortion of markets. The efficient and effective administration of the system of tax reliefs therefore presents a large and complex challenge for HMRC.

8 HM Treasury and HMRC (the exchequer departments) share oversight of tax reliefs and there is no single accounting officer responsible for their effectiveness. HMRC works with HM Treasury (the Treasury) to develop, design and deliver tax policy. The Treasury is responsible for strategic tax policy design and HMRC for delivering and maintaining policy and the administration of the tax system. The two departments share an analysis function, whose responsibilities include predicting the impact of changes to tax reliefs proposed in the budget and producing published statistics on tax reliefs and taxes in general.

Scope of this report

9 Under section 6 of the National Audit Act 1983, the Comptroller and Auditor General (C&AG) has powers to carry out examinations into the economy, efficiency and effectiveness of the way government departments use their resources in discharging their functions. The National Audit Act 1983 does *not* allow the C&AG to question the merits of policy objectives of the department which is being examined. This safeguards his independence and objectivity and makes him free from political influence. While our work therefore does not question policy intent, we do evaluate whether policy instruments are well-designed and adequate to deliver that intent.

10 HM Treasury has asked us to include the following text: *"The Treasury does not agree that the above paragraph reflects NAO's powers in relation to tax policy and therefore the scope of this report and future reports. The Treasury's position is that all tax reliefs reflect policy decisions about the incidence of taxation and distribution of the tax burden, taken by ministers and agreed by Parliament. As such the Treasury's view is that the design and impact of a relief are questions of policy and therefore outside of the NAO's remit. The Treasury does not believe this fetters the ability of the NAO to look at the effectiveness of the way in which tax reliefs are administered by HMRC."*

11 In future work evaluating how tax reliefs are developed and implemented, we expect to place greatest scrutiny on tax expenditures where there is a responsibility on the exchequer departments to assess whether they are meeting their stated policy objectives. But we are interested in the administration of all tax reliefs, as structural features of the tax system also require effective administration and control to ensure they are not abused.

12 We therefore describe in this report the complete landscape of tax reliefs and the main ways in which reliefs of different types are administered by the exchequer departments. We intend to evaluate the administration of particular reliefs in later work. We do not question whether a tax relief is the right choice of policy instrument.

13 This report covers:

- Part One: The landscape of tax reliefs in the UK; how they are used and the risks they carry;
- Part Two: How the exchequer departments assess the performance of reliefs and respond to emerging differences between their performance and their intended objectives; and
- Part Three: How the exchequer departments assess, monitor and respond to the risk that reliefs are abused.

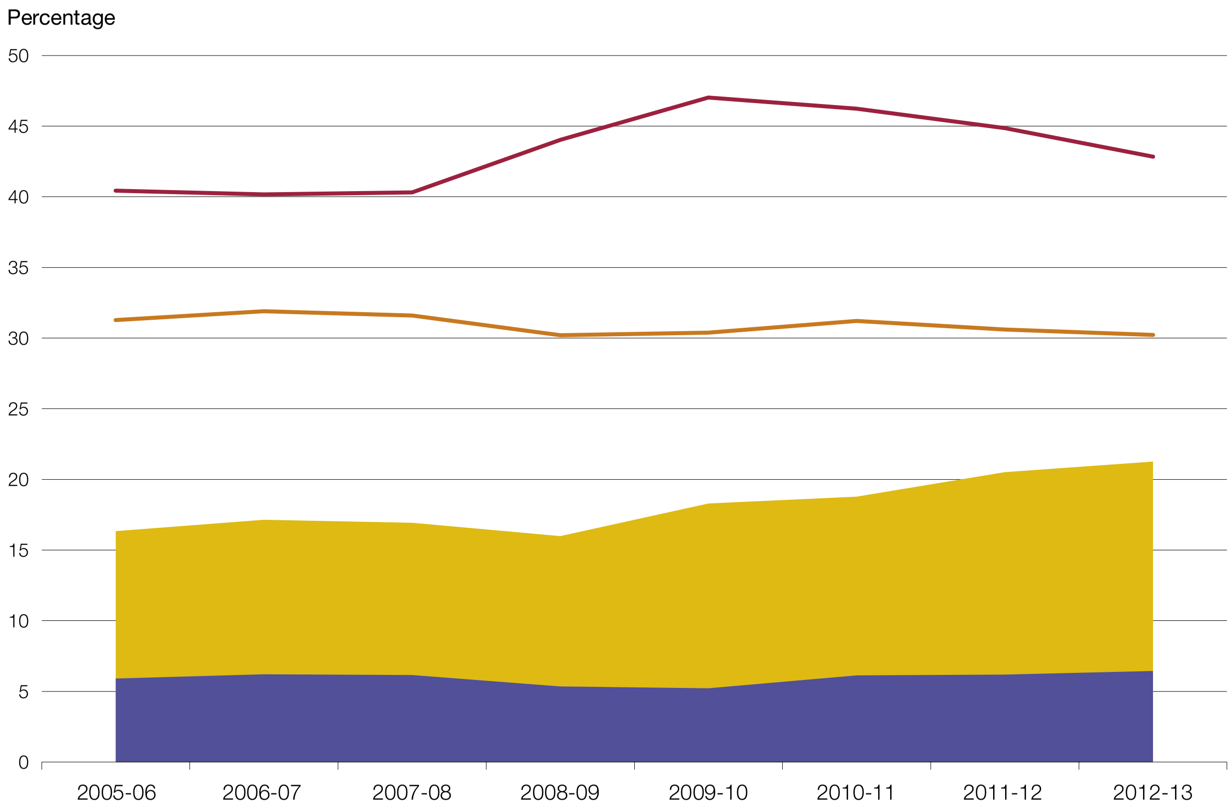
Number and scale of tax reliefs

14 The number of reliefs is growing. In March 2011 the Office of Tax Simplification identified 1,042 tax reliefs in the UK. It reviewed a sample of 155 and recommended that 47 should be abolished – either because they had expired, there was no longer a policy rationale, the value was negligible, or the administrative burden outweighed the benefit. Since then Parliament has abolished 48 reliefs but has introduced 134 new reliefs. By December 2013 the total number of reliefs had increased to 1,128 (paragraph 1.11).

15 The value of reliefs in relation to tax revenue and public spending has increased in recent years. As a proportion of GDP, the sum of all tax reliefs has increased from 16 to 21 per cent since 2005-06, while tax revenues have decreased marginally. This increase is mainly explained by increases in the income tax personal allowance, the thresholds for national insurance contributions, and the standard rate of VAT (because as the standard rate of VAT rises, so does the value of VAT reliefs). The value of tax expenditures has increased in real terms from £91 billion to £101 billion over this period (from 5.9 to 6.5 per cent of GDP). Since 2010-11, while public spending has fallen sharply, the value of reliefs has continued to rise (**Figure 3**) (paragraph 1.12).

Figure 3
The value of tax relief has increased relative to tax revenues

Total managed expenditure, tax revenues and tax reliefs as a percentage of GDP



	2005-06	2006-07	2007-08	2008-09	2009-10	2010-11	2011-12	2012-13
Total managed expenditure (%)	40.4	40.2	40.3	44.0	47.0	46.2	44.9	42.9
Tax revenues (%)	31.3	31.9	31.6	30.2	30.4	31.2	30.6	30.2
Tax reliefs (including tax expenditures)[3] (%)	16.3	17.1	16.9	16.0	18.3	18.8	20.5	21.3
Tax expenditures (%)	5.9	6.2	6.2	5.3	5.2	6.1	6.2	6.5

Notes

1 Figures shown in real terms.

2 Excludes minor reliefs.

3 Includes the impact of changes to the personal allowance threshold, VAT rates and the rate of National Insurance contributions.

Source: National Audit Office analysis of HM Revenue & Customs cost data of principal reliefs

16 HMRC has not systematically categorised tax reliefs according to the function they perform. HMRC publishes a list of the main tax reliefs and their costs annually, identifying separately those it regards as tax expenditures. However, HMRC acknowledges that its categorisation is crude: some reliefs classed as tax expenditures, such as the relief on registered pension schemes, also contain structural elements; many of the smaller reliefs are not categorised; and, in common with most other tax administrations, a lack of relevant data means that HMRC does not know the cost of many reliefs (paragraphs 1.4 and 1.10).

How reliefs work and the tax at risk from abuse

17 Tax reliefs are an essential part of the tax system. All taxpayers and consumers benefit to some extent from tax reliefs, which also offer practical advantages to the exchequer. For example, tax expenditures can offer low administrative costs and provide differentiated financial support that would not be cost-effective through means-tested spending programmes. They may also target support or deliver objectives more effectively than a spending programme. However, the nature of the tax system means that it would not be feasible for most reliefs to work within a finite budget and the cost of reliefs can therefore rise beyond expectations (paragraphs 1.13 to 1.14).

18 Tax reliefs play a significant role in defining the scope of tax and determining where the burden of tax falls. For example, the threshold set for inheritance tax defines the scope of tax by providing that no tax is payable on most estates. Corporation tax rules provide flexibility to reduce the risk that the viability of a business is threatened by having to pay a high tax bill when it can least afford it. For example, loss relief helps to smooth the taxation of profit over a company's lifespan, allowing trading losses to be carried back a year or carried forward to set off against future profits; and the deduction of interest from taxable profits can substantially reduce tax liabilities where major acquisitions have been funded by debt, thus making it easer for companies to invest (paragraphs 1.18 to 1.25).

19 All tax reliefs create opportunities to misuse and avoid tax. The number of reliefs and interaction between them adds to the complexity of the tax system and increases the risk of error. The risk of abuse varies according to many factors including the relief's objectives and value, how it works, and the customer group. The efficient and effective administration of the system of tax reliefs therefore presents a large and complex challenge for HMRC (paragraphs 1.16 and 1.39 to 1.41).

20 The boundary between the legitimate use of tax reliefs and tax avoidance is not always clear. HMRC describes tax avoidance as an attempt to exploit legislation to gain a tax advantage that Parliament did not intend. It publishes a description of the types of avoidance scheme that it will always challenge because it regards them as contrived arrangements designed to avoid tax. Six of the nineteen types of avoidance it describes are designed primarily to exploit tax reliefs (paragraphs 1.33 to 1.38).

21 Some tax reliefs are the target of illegal tax evasion and criminal attack. The way some reliefs work means that HMRC makes payments to customers following claims, making them attractive to fraudsters. Criminals have exploited reliefs which involve a cash payment or refund to extract money from HMRC. Examples have included fraudulent claims for film tax relief, payments made to charities under gift aid, and VAT refunds made against zero-rated items. In each case a common approach has involved creating fake transactions to trigger payments from HMRC (paragraphs 1.39 to 1.41).

22 The value of tax at risk from the abuse of reliefs is unknown but likely to be significant. HMRC does not separately identify the tax at risk or lost through the abuse of reliefs. It publishes an annual estimate of the tax gap, which it estimated to be £35 billion in 2011-12. It estimated that £4.3 billion of tax was lost from cases where individuals and businesses had challenged HMRC's interpretation of how the tax law, including rules for relief, should apply. It estimated that £4 billion of the tax gap arose from avoidance, a high proportion of which involves exploiting tax reliefs. Evasion and criminal attack accounted for a further £9.8 billion, some of which is explained by 'VAT carousel fraud' and other transaction based frauds that depend on certain products or activities being exempt from tax or taxed at a lower rate (paragraphs 1.43 to 1.44).

Monitoring performance

23 There is no documented framework specifically governing the introduction or modification of tax reliefs. In 2010 the Treasury increased the policy cycle for creating new reliefs from 7 to 18 months. This was to allow more time to consult on the objectives of a proposed measure, to appraise the options and to draft legislation. The Treasury also committed to developing a framework for the introduction of new reliefs, recognising that it should consider new reliefs carefully, and that these should only be introduced when there is a strong and proven case. It has yet to develop such a framework. Since 2011, the scope of tax impact notes has narrowed and an options appraisal is no longer required (paragraphs 2.8 to 2.12).

24 The monitoring arrangements for reliefs vary across HMRC, but it administers most reliefs as part of its wider administration of the tax streams. HMRC has over 100 analysts who routinely monitor trends and patterns in tax receipts and the impacts of tax policies. In doing so, they monitor those reliefs with the most significant impact on overall tax receipts and may undertake closer examination of a relief if its impact is not in line with expectations. HMRC has identified the need for more tailored monitoring arrangements for some reliefs. Of 46 reliefs identified on HMRC's website as tax expenditures, it has established dedicated units to oversee 9. HMRC created these units to concentrate expertise and to promote particular outcomes, such as encouraging investment. By concentrating expertise in these areas HMRC is better able to give customers a consistent service, ensure compliance, and promote the take-up of reliefs (paragraphs 2.13 to 2.17).

25 **HMRC does not evaluate tax reliefs systematically, and has commissioned few evaluations of their impact**. The Treasury depends on HMRC's feedback on the use of specific reliefs. Evaluation is important to understand the extent to which a tax relief is misused, its behavioural consequences and, in the case of tax expenditure, whether it is meeting its social or economic objectives. HMRC's analysis unit has undertaken some evaluation of reliefs and has commissioned and published 19 external evaluations of tax expenditures since 2003, for which it paid £1.8 million in total. Most have focused on how the reliefs have changed behaviour, rather than seeking to quantify the benefits or estimate the costs of revenue foregone, avoidance, or administration. The evaluations cover reliefs worth around £6 billion a year, which is around 6 per cent of the known value of tax expenditures. More systematic or comprehensive coverage would require HMRC to allocate a greater proportion of its resources to evaluative work (paragraphs 2.18 to 2.20).

26 **We found limited monitoring of changes in the cost of particular reliefs**. HMRC reports the cost of around 200 reliefs to provide transparency, but it does not routinely produce data on trends to track movements in reliefs unless policy changes are proposed. Around a quarter of 92 principal reliefs we examined had experienced significant changes in value. We identified 26 tax reliefs which had increased by more than 50 per cent in real terms in the past ten years, and 30 which had increased by more than 25 per cent in the last five. There are many reasons why the value of a relief might increase, including a rise in the underlying rate of tax, but none of the increases prompted the exchequer departments to evaluate the reliefs concerned (paragraphs 2.21 to 2.27).

Managing the risk of reliefs being abused

27 **HMRC responds proactively to the serious challenge of administering the complex system of tax reliefs and addressing the opportunities for abuse it creates**. It is evolving its business model to increase the range and volume of compliance interventions, including by reinvesting £994 million of department-wide efficiency savings to tackle tax avoidance, evasion, criminal attack and debt between 2010-11 and 2014-15. It has developed cutting-edge technology that uses data in powerful ways to help it detect fraud and criminal attack (paragraphs 3.2 and 3.7).

28 **The design of tax law is critical to reducing the scope for reliefs to be exploited by fraudsters or for the avoidance of tax**. Since 2009, HMRC has formally assessed all new tax reliefs while still in draft form, focusing in particular on the design of measures that might give rise to fraud or avoidance. It is inherently difficult to predict how a new relief might be abused, however, due to the complexity of the way measures interact across the tax system and the contrived structures or transactions that may be created to abuse them. Where abuse is detected, HMRC may advise that legislation is introduced quickly or retrospectively to close a loophole, particularly where a large amount of tax is at risk. Some loopholes have been closed within days of HMRC becoming aware of them (paragraphs 3.3 to 3.5 and 3.12 to 3.13).

29 HMRC has high success rates in challenging avoidance schemes that exploit tax reliefs, but avoidance cases can take a long time to investigate and resolve. Some scheme promoters deliberately slow down the process because tax rules normally allow taxpayers to hold on to disputed tax, no matter how unlikely they are to succeed in litigation. HMRC estimates there are around 65,000 open cases involving marketed tax avoidance schemes. Over 85 per cent of these date back to 2009-10 or earlier. HMRC has consulted on measures to accelerate the payment of disputed tax where similar claims have already failed and these will be included within Finance Bill 2014 (paragraphs 3.16 to 3.18).

30 The time needed to collect data and take remedial action places an onus on robust design and more proactive monitoring of the performance of reliefs. HMRC has introduced measures to require early disclosure of avoidance schemes seeking to exploit design weaknesses. By collecting data from across its business in real time – such as to track how a new relief or a significant change to relief is being exploited – HMRC could assess the extent of emerging threats sooner, allowing it to act more quickly to safeguard revenue. In the case of research and development (R&D) tax credits, we found that good practices – including the relief's phased introduction, annual reporting of its performance, independent evaluations, and an estimate of its costs and benefits – had meant that the cost of the relief had stayed in line with forecasts. Wider application of these practices by the exchequer departments' approaches could provide an effective control on the introduction of other reliefs (paragraphs 3.6 to 3.10 and 3.26 to 3.28).

Concluding comments

31 Tax reliefs are an important and longstanding element of fiscal policy and are growing in number. They are also essential to the effective operation of a tax system. This report is intended to describe the landscape across all tax reliefs in the UK, and to put Parliament in a position to consider whether the major elements in the management and responsiveness of the system are working adequately, or are in need of more focused attention.