

# Appendix 3

## HMRC Administration of customer non-compliance

HMRC has asked us to reflect in this report that it does not run its compliance regime by focusing on individual reliefs, but rather manages compliance risk through a 'three dimensional' approach: by customer group (e.g. Large Business; High Net Worth Individuals), by customer behaviour (e.g. avoidance) and by tax product (e.g. patent box). HMRC provided us with material to support this shortly before we published this report, describing its overall approach to managing compliance. This material is included below. We have not audited the information provided and cannot offer any view over the balance or accuracy of the content.

# HMRC Administration of customer non-compliance

## NAO The effective management of tax reliefs

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### Executive summary

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The majority of HMRC customers are compliant. For those who are not, HMRC has a compliance strategy to change non-compliant behaviour focusing on: (1) promoting good compliance design; (2) preventing non-compliance; and (3) responding to residual non-compliance robustly. The management of non-compliance, to include reliefs, forms part of HMRC's holistic administration of the tax system which is addressed by customer group; customer behaviour; and tax product.

Significant tax risks are brought together at a departmental level in a 'Strategic Picture of Risk' (SPR) which draws on a mix of internal/external information and data to enhance HMRC's understanding of customer behaviour and tax risk. The SPR includes reliefs featured in the NAO's report.

The overall delivery of HMRC's customer and compliance strategy is underpinned by an effective, cost efficient, tax system driven out through a collaborative relationship across HMRC between Product & Process Owners (P&POs) and customer owners. P&POs ensure HMRC's interconnected functions align, are responsible for the law which defines the various taxes and for ensuring both tax law and systems are optimised to deliver HMRC's strategic objectives.

Since 2013/14, the strategy for marketed avoidance, policy and operations has been centralised. HMRC identifies avoidance behaviour in a number of ways and has robust and effective procedures in place to tackle avoidance; this includes moving swiftly to close down perceived loopholes.

Large Business (LB), Specialist Personal Tax (SPT) and Enforcement & Compliance (E&C) are responsible for the majority of HMRC's customers. Customer Relationship Managers (CRMs) are in place for the largest, most complex customers, as a cost effective way to ensure the correct amount of tax is paid. This is a hard-edged compliance tool which underpins HMRC's approach to compliance. Since 2013, and in LB, compliance capacity has been further increased through the creation of the Large Business Risk Taskforce - a national team that targets big picture tax risks through cutting edge risk assessment activity.

### Introduction

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This note provides an overview of how HMRC manages risks of customer non-compliance and in particular how customer behaviour drives our response.

HMRC consists of various interconnected functions each of which contribute to the delivery of our strategy to maximise revenues at the lowest overall cost to customers and ourselves while stabilising and improving customer experience.

HMRC's compliance interventions (and services) are designed from a deep understanding of our customers' needs and behaviours. HMRC uses accumulated research knowledge into our different customer types to both understand (1) our customers' needs; and (2) what drives customer behaviours.

Customer understanding allows HMRC to focus our efforts where they will have the biggest effect, tailoring our services - and the way we work - to the needs, abilities and motivations of our customers. Our aim is to shift the behaviour of customers, keeping our costs in dealing with them to a minimum, maximise revenue and at the same time maintain customer experience.

## Compliance Strategy

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As the Comptroller & Auditor General notes in his report on HMRC's 2013/14 Accounts (para 3.22) HMRC is developing a long-term strategy for compliance work to tackle behaviours leading to non-compliance. As part of this customer-centric strategy, which again is based on in-depth segmentation, explicitly recognising that the majority of HMRC's customers are compliant, HMRC will:

- promote and design good compliance into all systems and processes to make it easier for customers to get it right first time when they send us tax returns
- prevent non-compliance by making it harder for people to make mistakes or deliberately cheat the system when they file tax returns or update their circumstances
- respond to non-compliance firmly by tailoring our activity to maximise its impact when we have to intervene to address compliance risks.

The blending of operational experience and customer insight has driven a number of change initiatives across HMRC and where processes have been designed around customers. Specific examples of this across the population of tax reliefs that are the subject of the NAO Report on 'The effective management of tax reliefs' are: (1) the online calculator which works out whether an estate qualifies for the reduced rate of inheritance tax; (2) we use education to support customers and have published a number of guides on YouTube, including one on the Patent Box; and (3) we stop transactions we know are wrong - our TRUCE system provides real time alerts to stop repayments of VAT on fraudulent and incorrect VAT returns (with zero rating of VAT on prescription drugs and new dwellings also being part of the tax reliefs population reviewed by the NAO).

## Holistic management of tax risk

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HMRC manages tax risk, to include those around reliefs, as part of the overall administration and processing of returns, whether that is for businesses, individuals or IHT etc. We take a 3 dimensional approach tackling tax risk holistically by,

### Customer group

- In Large Business and High Net Worth Units (HNWU) risk identification is driven through Customer Relationship models. The HNWU is most closely involved with two of the ten tax reliefs reviewed by the NAO, viz., share loss relief and entrepreneur relief and they also work with the Specialist Personal Tax Trust and Estates team with regard to inheritance tax reliefs (three of which are the subject of the current NAO review).
- Identifying and prioritising compliance work via the Large Business Tactical Delivery Plan discussed further below (page 5).
- Large Business Risk Task Force which is discussed further below (page 7).
- Planning groups that look at the allocation of resource to tackle risk.

### Customer Behaviour

- Governance processes including the Managing Avoidance Risk process established in Counter Avoidance Directorate;
- Governance Boards including Anti Avoidance Board and Tax Dispute Resolution Board
- Risk identification through profiling and DOTAS disclosures in E&C
- Strategic Risk Assessment which is discussed further below (page 5).

### Product

- Product and Process Ownership which is discussed below (page 3).
- A clear line of sight through to Business Plans.
- Performance hub processes e.g. regime monitoring and escalation of risk, the monthly slides of which are passed to the NAO.

## Product & Process Ownership

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Product and Process Owners (P&POs) ensure HMRC's interconnecting functions align and are responsible for the legislative frameworks which define the various taxes ('products') and the systems and other work processes by which taxes are administered ('processes'). This ensures, as far as possible, that HMRC delivers its objectives.

Each of HMRC's P&POs are accountable for ensuring that the respective tax regimes are optimised to deliver HMRC's strategic objectives and to manage the trade-offs between these effectively. This includes,

- direct responsibility for delivering policy changes that close the tax gap in their regime; and
- agreeing what is required from customer owners (for example Large Business) in terms of their regime.

P&POs have a mix of systems in place to understand whether their products or processes are fit for purpose (from both a policy and strategic objective perspective) and where success is driven by effective partnerships at all stages. Clear lines of sight are created through,

- Product/process plans (360 degree view of whether a product or process is fit for purpose; evidence base for prioritisation and options for change; handling strategies for risks and issues)
- Risk Registers
- Regime plans
- Lines of Business Plan
- HMRC Business Plan

This is a collaborative relationship, a genuine partnership, with customer owners and which is built on, (1) P&POs having a clear understanding of the policy objectives for individual regimes, products and processes; and (2) stakeholders possessing a clear understanding of both customer behaviour and best practice in the design of compliance interventions etc.

## Clear line of sight to departmental planning

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The schematic at Appendix 1 illustrates the annual review that takes place to monitor the products and process to consider risks and issues (new/emerging) plus new legislation or initiatives leading from this. This annual review is underpinned by regular discussions to identify regime and product priorities feeding through into operational or policy plans. The example used refers to Corporation Tax but the general principles are transferable.

Elements of the regime are reviewed monthly/quarterly via Corporation Tax & Business Income Tax's Performance Hub and are already made available to the NAO on a rolling basis as part of the annual Section 2 work. Illustrative slides are included below for information.  
[REDACTED]

These two slides, as part of a larger suite, identify the flow of operational cases, per product, on which technical advice is sought (slide 1) and the stock/value of compliance cases, per product (slide 2). In both cases, reliefs form one element in a wider, regime level picture of risk.

## Strategic Risk Assessment

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HMRC regularly assesses the risks to tax revenue. This process makes use of the Tax Gap and is used to influence the planning of response to risk. The assessment also uses operational data, business intelligence, and external information to enhance our ability to understand customer behaviour, and the risks we manage.

The approach closely involves P&POs, and is helping HMRC to gain a deep(er) understanding of specific risks, spot trends and changes in customer behaviour giving an up-to-date picture of compliance risk and our performance in tackling it. The work feeds directly into planning and resource allocation and will help deliver HMRC's 'Promote, Prevent, Respond' compliance strategy.

Specifically in terms of the tax reliefs reviewed by the NAO, share loss relief where tax at risk due to suspected marketed avoidance is £741m is included as part of a set of risks categorised as 'Sideways Loss Relief'.

## Large Business Compliance

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Large Business (LB) is responsible for the largest 2,100 businesses and Customer Relationship Managers (CRMs) are in place as a cost-effective way to ensure the right tax is paid. The CRM model is a 'hard edged' compliance tool that works for both parties through a deep customer understanding of both the business itself and the wider economic and commercial environment in which they operate.

LB's approach to tax compliance is therefore underpinned firstly by the CRM relationship with the customer, then by, a risk classification of either (1) Low Risk or (2) non Low Risk (allowing the targeting of resources at customers who represent the greatest risk); and for customers who are not Low Risk, to understand in what respects they are not Low Risk so that we can target our resources on these areas.

Low Risk/Non Low Risk status is determined by the Business Risk Review (BRR). This considers the inherent risk the customer represents (for example size/complexity) and then

how they effectively mitigate this risk through their behaviour (for example, their attitude to tax avoidance, their systems and processes and their openness with HMRC).

In addition to the BRR LB will also risk assess the tax returns and other data to identify specific tax risks. The results of this will provide some indicators of behaviour and, along with discussions with the customer i.e. how they manage real time risks, this will inform the BRR.

Customers identified as Low Risk can expect more certainty over their tax position and less formal contact from LB. The vast majority of our low risk businesses will however have some contact with LB on an annual basis, for example to discuss their wider business structure and organisational issues.

In cases where customers are not Low Risk, LB still aims to develop and maintain an open and transparent relationship and to work collaboratively in real time to reduce the level of tax compliance risk. Working in this way helps both sides manage their resources better and provides the customer with more certainty about their tax position. In general, customers who are not Low Risk can expect,

- annual Business Risk Reviews;
- regular risk assessment of their tax returns to identify areas of potential risk (though we will target this based on our understanding of where risk may lie); and
- more regular interventions to test the information we have been given.

In cases where customers represent an ongoing and significant risk, LB assembles task forces of specialists to deal with the risk intensively and will engage at Board level to persuade that customer to change the behaviours that are generating those risks.

LB, in addition to a business specific risk view, prioritises compliance work generally focusing on the bigger and wider risks through the Tactical Delivery Plan (TDP). Prioritised risks are arrived at in collaboration with P&POs (as mentioned above). There are currently c50 risk themes, of which more than 10% relate to reliefs, being a mix of historic and emerging compliance risks. TDP sets out our priorities for large business customers but does not constrain LB risk assessment or risk working activities.

The current TDP includes Patent Box as an emerging theme and due to its recent introduction the risk working strategy is under review. All Patent Box elections (regardless of whether there were pre-filing discussions or not) will have a central review. This will help HMRC to ensure consistency in its approach to Patent Box risk, and also maintain accurate data on the use of the relief. HMRC has encouraged Large Business customers to discuss

Patent Box implementation plans with their CRM prior to filing returns, with a view to resolving any areas of disagreement collaboratively and efficiently in line with LB's approach to tax compliance. If there has been no pre-filing discussion before an election is submitted, the extent of the action taken by HMRC will depend on a range of circumstances and risk factors. The fact that a customer has not engaged with HMRC prior to submission may be an indicator of risk (particularly where there is an existing relationship between the customer and HMRC), but it would not in itself lead to an enquiry. HMRC would also take into account other factors and indicators within the election itself, and wider factors such as HMRC's overall view of the customer's risk status.

Any focus on a collection of risk themes and/or the risk assessment of a single piece of data in isolation; for example on a claim to a particular relief, would however carry inherent risk in a LB context. The facts surrounding the claim to relief may, on an initial and isolated review, suggest the claim is valid. However, when the claim is viewed using a wider holistic approach we often see changes in structures within the group and flows of revenue / capital that enable us to identify that the true nature of the transaction(s) underlying the claim are, for example, circulatory. This holistic approach means that we can apply our resources in the most effective and efficient manner.

### **Large Business Risk Task Force**

The Large Business Risk Task Force (RTF) is a national team working to improve the pipeline of Large Business tax risk. It brings together tax specialists from across all the tax regimes to target 'big picture' risk assessment and complements the LB Customer Relationship Management model by taking on, at pace, a portfolio of cutting edge risk assessment activities.

Since formation in April 2013, the RTF has worked collaboratively with case teams and strategic leads on a range of customer risk assessments, across former LBS and L&C populations and the recently formed LB directorate, which have produced significant amounts of risk.

Additionally the RTF runs projects and campaigns on particular sectors and customer groups on significant crosscutting themes, or on areas of emerging risk. By developing a more strategic view of tax risk the aim is to help LB prioritise interventions more effectively.

The RTF are also contributing to on-going policy development by working collaboratively with Product and Process teams, sharing knowledge and supporting 'upstream' solutions to counter tax risk effectively, in accordance with LB's strategy.

The RTF currently has a range of projects covering a number of different regimes and themes such as the Patent Box Regime and Research and Development.



## Enforcement and Compliance

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Enforcement & Compliance is made up of nine directorates including:

- Counter-Avoidance: which brings together marketed avoidance strategy, policy and operations from across HMRC and E&C (see Avoidance section for more detail)
- Criminal Investigation: providing HMRC with an effective and efficient investigation arm to enforce the department's compliance policies and protect the UK tax base.
- Debt Management and Banking: processing and accounting for payments of tax and other liabilities, and pursuing late returns and payments using a risk based campaign approach.
- Local Compliance: responsible for operational compliance work across the full range of taxes and duties, National Minimum Wage and Anti-Money Laundering Supervision.
- Risk & Intelligence Service: providing comprehensive high quality risk and intelligence products and services, enabling HMRC to understand and manage the risks to the tax system. The use of RIS in profiling for share loss relief, entrepreneur relief, BPRA, VAT and the links between RIS and the Specialist Personal Tax Trust & Estates Team in terms of inheritance tax reliefs is detailed in separate papers provided to the NAO or throughout this paper.
- Specialist Investigations: deploying investigators nationwide to provide a civil response to prevent, deter and disrupt organised criminals, rule breakers and boundary pushers

E&C's operational compliance policy is constantly under review to ensure the impact of all compliance interventions and activities is maximised. A range of information sources and risk identification systems are used to identify, from a base of 31 million customers, those who potentially may not have declared the correct amount of tax.

E&C has invested in ground-breaking IT solutions to improve risking, such as Connect, and has developed behaviour tailored approaches, such as campaigns and taskforces.

As an example of compliance risking capability, in April 2014 RIS produced a national Business Premises Renovation Allowance risk profile, which focused on the identification of participating partners. The profile identifies individual claims which, when amalgamated with other avoidance activity by the same customer allows for a more targeted approach to be taken to address the overall avoidance behaviour.

On the operational side, the 'mass market' campaign approach which HMRC has developed over the last few years aims to improve compliance in targeted groups, using a co-ordinated

series of interventions aimed at making compliance the 'default option', and promoting sustained long term behaviour change. Risk and behaviours within the population are identified and researched, tested and agreed with specialists in RIS, KAI and experts across HMRC before proceeding to the campaign design and development stage with cross HMRC input and approval.

Typically, a national campaign will seek to provide tailored education and support to help customers within the target population to 'get it right first time' and understand their obligations, while using behavioural insight techniques to encourage customers who need to correct non-compliance to come forward and get back on track in a simple, cost-effective way. Where individuals or businesses choose not to comply voluntarily, the campaign approach allows HMRC to target other compliance interventions, including 1:2:1 enquiries or taskforce activity, to identify, tackle and deter the non-compliant more effectively. This approach also supports our aims of increasing the skills and professionalism of staff so they can make the best use of the information and IT systems they use.

Since 2010, HMRC's national campaigns have raised additional revenue of over £270 million across a range of populations including medics and other health professionals, and property sales and lettings.

#### **Avoidance**

HMRC's Counter-Avoidance Directorate (C-A), brings together the operational casework on marketed avoidance and policy and strategy, on avoidance, including from the former Anti Avoidance Group, Specialist Investigations and Local Compliance.

As mentioned elsewhere, avoidance behaviour may be identified in a number of ways; for example through: a Disclosure of Tax Avoidance Schemes (DOTAS); risks identified in day-to-day work; intelligence gathering or through profiling work carried out by Risk and Intelligence Service (RIS), Knowledge, Analysis and Intelligence (KAI), High Risk Profiling Unit (HRPU), either in isolation or in connection with known avoidance schemes.

The DOTAS regime allows HMRC to obtain early information on the types of tax avoidance schemes in circulation and how they operate. HMRC considers the DOTAS disclosure and issues the scheme with a scheme reference number (SRN) which users are required to declare on their tax return. DOTAS has been a very effective tool for HMRC in identifying users of avoidance schemes.

All avoidance, or potential avoidance, once identified, is notified to C-A. This ensures: (1) a complete picture of avoidance is held to inform the strategic picture of avoidance; (2) brings the risk to the attention of P&POs ensuring a handling strategy is developed with 90 days; (3) any potential challenge of non-compliance with the DOTAS regime can be mounted.

Once an avoidance risk is identified, P&POs will prepare a handling strategy (agreed with the relevant Compliance Directorates and other HMRC stakeholders) and, submit to the Anti-Avoidance Board (AAB) for consideration and agreement. This process does not preclude more urgent legislative action, via Ministerial Statement, when appropriate (for example a scheme to exploit post-cessation trade relief was closed in January 2012 through this route.)

Where a scheme does not require legislative action it is worked operationally and a Technical Lead is appointed to coordinate activity. The Technical Lead works closely with the P&PO, formally reporting progress quarterly. AAB reviews progress, and recommendations are made to AAB on settlement parameters. At any time the P&PO can ask AAB to agree a revised handling strategy, or revised parameters for settlement where for example the evidence/facts change the initial view of the scheme.

This co-ordinated action underpins the approach taken to address, for example, the potential for abuse of Share loss relief, initially through investigation and challenge and then through litigation where users refuse to settle. More widely, whilst it was principally designed to promote fairness, the behavioural consequence of the FA2013 general cap on income tax reliefs has been to make avoidance schemes less attractive to affluent individuals. A description of C-A work in respect of one of the tax reliefs reviewed by the NAO (share loss relief) is included in the share loss relief paper which has been provided to the NAO.

More generally, C-A are working to change avoidance behaviour, influencing more customers to settle or simply not enter schemes in the first place. HMRC's piloting of this approach has proved effective and we continue to exploit leverage opportunities such as publicity around court successes, publishing user education material and issuing targeted communications to those HMRC believes should settle. Following one recent campaign to encourage users of a single avoidance scheme to settle, nearly 700 users contacted us in under a month to discuss settling.

## Specialist Personal Tax

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Specialist Personal Tax is one of the Personal Tax (PT) operational group of directorates. Our customers are often dealt with elsewhere in HMRC for their day to day tax affairs – PAYE, NIC, SA, Self Employment and Corporation Tax, but at times their needs are more specialist and that's where Specialist PT comes in. This can be when they need help around life events in relation to specialist taxes and reliefs like Inheritance Tax, Gift Aid and Capital Gains Tax. We also deal with specialist customer groups for example, the very wealthiest customers,

Lloyd's underwriters, foreign employees working in the UK, non-resident landlords, pension schemes, trusts, employers operating share schemes and many more.

We have eight main business areas:

- Capital Gains Tax
- Charities
- High Net Worth Unit
- Pensions Schemes Services
- Personal Tax International
- Savings and Share Schemes
- Shares and Assets Valuation
- Trust and Estates.

### **Managing risk within SPT**

SPT works closely with partners in E&C, including Counter Avoidance, RIS and LC, to ensure policy, product and compliance risks are tackled effectively and consistently. Each of our operational compliance businesses have their own risk teams and compliance boards and these feed into a cross-SPT risk forum and a cross-cutting compliance group that meet regularly to monitor risk and compliance performance and consider HMRC best practice.

SPT utilises the RIS functionality but also has its own Analysis & Intelligence Unit that works closely with RIS and each of our individual businesses to inform compliance planning and case identification and development. Their functions combine the gathering and dissemination of operational intelligence with a significant data analytics capability and is resourced by experienced officers with an in depth knowledge of the specialist taxes, reliefs and customers handled by SPT.

SPT are currently designing a strategic risk panel that will comprise planning, policy and compliance experts to jointly consider the central Strategic Picture of Risk with the key current and future business risks for SPT in order to prioritise our risk challenges, identify the most effective 'promote, prevent, respond' response activity and inform our resource planning.

### **Examples referring specifically to NAO case studies**

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#### **Inheritance Tax - Agricultural Property Relief (APR) and Business Property Relief BPR**

Claims for APR and BPR are dealt with as part of the overall administration and processing of IHT returns within Specialist Personal Tax (SPT) Trusts & Estates (T&E) which includes customer service, risk, compliance and technical functions. APR & BPR are components of a niche regime within the wider tax system and typically risks cover several different areas of inheritance tax of which these are just one part. Customer non-compliance typically covers several different areas of inheritance tax, consequently interventions often cover several areas rather than just these two reliefs which were the subject of the NAO review on administration of tax expenditures.

Risks on individual estates vary and depend on individual facts. All taxpaying estates and claims to relief are reviewed with the risk team filtering cases according to the level of risk represented. Certain risks e.g. values of assets for BPR are worked in partnership with Shares and Assets Valuation (SAV). Unlike other areas of HMRC, SPT T&E have their own risk team for IHT which is separate from RIS but with links to it. For example, risk teams will use RIS systems such as Connect to cross-check Self-Assessment (SA) returns and other data with information on IHT returns (e.g. checking if a venture claimed for IHT to be a business has had income returned on SA). As part of wider risk work, data is shared between different areas of HMRC, such as Specialist Investigations, High Net Worth Unit, and others. Specific examples are:

- Cases where Agents and/or Executors have deliberately over claimed relief. In a current case a penalty for deliberate behaviour is being sought from the Executor as well as meeting with agents to correct behaviour,
- Team working of enquiry into investment business between Compliance and SAV,
- Sharing information concerning attempts to mitigate CGT using inflated acquisition cost where a high value returned for IHT for 100% relievable property. Value not 'ascertained' when account received.

Customer errors and risks which are identified at the risking stage are corrected at the compliance stage. Internal governance procedures review interventions, outcomes and overall yield stats to ensure effectiveness. The SPT T&E team work with Policy to consider changes to legislation when abuse is detected through risk working, e.g. in the past some individuals claimed relief on the gross value of an asset rather than the net value after taking off any relevant liabilities. This could result in a deduction for the liability against the rest of the estate as well as a greater claim to inheritance tax relief. Changes were introduced by FA 2013 to restrict the deduction for liabilities where these have been used to fund purchase of relievable property<sup>1</sup>.

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<sup>1</sup> TIIN - <http://www.hmrc.gov.uk/budget2013/tiin-2006.pdf>.

In addition litigation is undertaken where necessary to clarify the existing law regarding grey areas. Recent litigation cases include HMRC v Pawson [2013] UKUT 050 (TCC) re BPR and holiday letting business

### **Share Loss relief (ShLR)**

HMRC has provided a separate and detailed paper setting out HMRCs approach to the management of avoidance risk arising in Share Loss relief and we shall not repeat the detail here. This is a clear example that demonstrates that the three dimensional approach to managing tax risk is effective. Through monitoring customer behaviour, HMRC was able to identify and challenge avoidance before full data was available highlighting an increase in ShLR claims.

### **VAT Zero Rates: Supplies of drugs on prescription / Construction of new dwellings**

The VAT returns of those businesses that make zero rated supplies sometimes result in a net repayment of tax being due. These are known as "Repayment Returns". Repayment Returns submitted by those making zero-rated supplies of drugs on prescription, or, zero-rated supplies of the construction of new dwellings are subjected to the same credibility process as all other Repayment Returns

Repayment Returns are subject to prepayment checks to prevent repayments for fraudulent claims and those made in error. HMRC uses an automated risk assessment system, TRUCE (Transaction Risking Upstream in the Connect Environment) to profile VAT repayment returns in real time and identify those where there is an increased risk of error or fraud. Those identified as low risk have their repayments released automatically. Where high or medium risk returns are identified, HMRC conducts an assessment of the return, which may involve visiting the trader before the repayments are authorised and, in some instances, will reject them.