National Audit Office

Report
by the Comptroller
and Auditor General

HM Revenue & Customs

The effective management of tax reliefs

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National Audit Office

HM Revenue & Customs

The effective management of tax reliefs

Report by the Comptroller and Auditor General

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Comptroller and Auditor General
National Audit Office

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This report examines whether HM Revenue & Customs administers tax reliefs effectively and rigorously.

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Contents

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Key facts

398	196	46
tax reliefs listed on HMRC's website	reliefs we identified that might support a particular group or activity towards economic or social objectives	'tax expenditures' that cost more than £50 million a year, according to HMRC

41%	reliefs we identified with possible social or economic objectives where HMRC has not estimated costs
14%	reliefs we identified with possible social or economic objectives where tax return data is collected but costs are not published
From £385 million to £1.2 billion	spike in value of losses for which share loss relief (before tax) was claimed in 2006-07, not identified by HMRC until 2013
£964 million	total value of share loss relief claims in 2006-07 that HMRC is currently investigating for suspected marketed avoidance
£2.9 billion	cost of entrepreneurs' relief in 2013-14, around three times more than HMRC original forecasts suggested

Summary

Introduction

1 In March 2014 we published a review of tax reliefs in the UK. We considered the opportunities and risks they present, and the way their design and implementation is managed by HM Treasury and HM Revenue & Customs (HMRC). Tax reliefs are diverse in nature, serving a variety of needs. Some are structural parts of the tax system, to improve progressivity or to ensure the correct calculation of profits. Other reliefs, sometimes described as 'tax expenditures', are designed to encourage a particular behaviour towards a social or economic policy objective.

2 The Committee of Public Accounts took evidence on our report and concluded there was a strong case for the exchequer departments – HM Treasury and HMRC – to monitor those reliefs which seek to influence taxpayers' behaviour to achieve social or economic objectives. It said the Departments should assess whether a relief is meeting its objectives, and report back to Parliament on the results. It encouraged the Departments to develop a clear framework to improve the management and accountability of tax reliefs.

3 Tax reliefs are an important part of public policy design, covering most aspects of government activity including welfare, housing, business, food, education, health and transport. They can also make the tax system more complex and less transparent, and pose risks to the exchequer because costs can rise unabated. Some have been the focus of tax avoidance. Decision makers and Parliament therefore need information about how tax reliefs are working and which reliefs require their attention. Making information available about the costs and uses of reliefs also provides transparency and accountability, thereby increasing confidence in the tax system.

4 For HMRC's management of tax reliefs to be effective, we consider its approach should vary depending on the nature of the relief and the risks it carries. We believe that effective administration of reliefs would require HMRC to:

- collect, analyse and report information about their costs and benefits;
- where relevant, review the extent to which they are achieving their objectives;
- identify and intervene to tackle risks to the exchequer, including evidence of abuse;
- have sufficient governance in place to manage its overall administration of tax reliefs, share knowledge and good practice, and achieve proportionality;
- be accountable as the custodian of the tax system for providing evidence to policy-makers and Parliament where tax reliefs are not working as intended.

Scope of this report

5 In this report we have focused on how HMRC manages those reliefs which seek to deliver economic or social objectives, either by influencing taxpayers' behaviour or providing targeted support to a particular group. HMRC does not distinguish between different types of tax relief or how they are managed. We therefore used a case study approach to look in detail at how HMRC administers 10 tax reliefs at different stages of maturity. We considered how well HMRC:

- collects and reports data on tax reliefs;
- assesses whether they are working as intended; and
- identifies and responds to evidence of abuse.

6 In light of our findings from the case studies, we have also looked at how HMRC could improve its administration of tax reliefs by reference to good practice HMRC exhibits for some reliefs and international comparisons. We have not sought in this report to assess whether tax reliefs themselves are working as intended or provide value for money.

7 HMRC has asked us to reflect in this report that it does not generally run its compliance regime by focusing on individual reliefs, but rather manages compliance risk through a three-dimensional approach: by customer group (eg large business or high net worth individuals), by customer behaviour (eg avoidance), and by tax product (eg patent box). HMRC provided us with material to support this shortly before we published this report, describing its entire compliance regime and its anti-avoidance approach. We have published this in Appendix Three (available online). It is certainly true that HMRC's compliance strategy is based on this approach, and we don't take issue with it. We will examine it in future reports. However, we do not think it prevents us from meaningfully examining the administration of tax reliefs for the following reasons:

a The taxpayer-centric approach alone does not address the risks to tax revenue, as is evidenced by our specific examples, until a considerable time after unexpected and possibly unintended use of a relief has occurred. This might arise from tax avoidance, or simply poor drafting giving rise to inadvertent opportunities for claimants not envisaged in the original legislation. Time is of the essence in picking up large increases in claiming and checking that the way reliefs are used supports Parliament's intention. A relief focused approach is likely to pick this up early if well administered.

b All reliefs have a dedicated product owner in place but there is considerable variation in the quality of the information they monitor and the speed of response where a relief is not behaving as expected.

c We think that our examples show that good administration of the tax system would be served by combining both approaches: a taxpayer-centric compliance strategy; and the conscious management and evaluation of tax reliefs as a class of policy instruments that share some common characteristics and risks.

8 Our audit approach and methodology are in Appendices One and Two. Appendix Four (available online) provides a detailed summary for each case study. Appendix Five (available online) contains a summary of international comparison work carried out by the Tax Administration Research Centre.

Review of 10 tax reliefs

9 To understand more about the way HMRC administers tax reliefs, we selected a group of 10 reliefs with social or economic objectives and carried out a comparative analysis (**Figure 1** overleaf). For each relief, we assessed the adequacy of the data HMRC collects and reports, how it assesses whether the relief is working as intended, how it identifies risks, and how it intervenes when it finds problems. We chose 10 tax reliefs to give us broad coverage across a range of factors including:

- type of tax;
- type of beneficiary;
- age of tax relief; and
- cost.

10 We included in our sample one relief where the cost is not known by HMRC (share loss relief) and one relief which HMRC nominated as an example of good practice in administration (R&D tax credits).

11 We chose our case studies to illustrate the issues HMRC faces and the action it takes, not to be representative of the way HMRC administers all tax reliefs. However, where there is wider relevance we consider the implications of our findings for the management of tax reliefs as a whole.

Key findings

Collecting and reporting data on tax reliefs

12 HMRC does not hold data on the cost of all tax reliefs. When deciding what data is necessary to administer the tax system, HMRC's primary considerations are what it needs to know about each tax to support the tax calculation and ensure compliance by taxpayers. It must also consider the administrative burden it places on taxpayers. Understanding the cost of a particular tax relief is normally a lower order priority. As a consequence, HMRC does not hold consistent or comprehensive data on the costs of reliefs (paragraphs 1.5 and 1.7).

Figure 1
Case study reliefs

We have looked at 10 case studies with social or economic objectives as part of our work

Description	Objective	Age	Cost (£m) 2013-14
The **patent box** gives companies a deduction equal to a 10% effective rate of corporation tax on profits from patented inventions.	Stimulate innovation	New reliefs (0–3 years)	350[1]
A **reduced rate of inheritance tax** of 36% applies if 10% of an estate is left to charity.	Increase charities' incomes		30[1]
Entrepreneurs' relief reduces capital gains tax to 10% for certain disposals, for instance all or part of a business.	Encourage enterprise	Recently introduced (3–10 years)	2,900[2]
Business premises renovation allowance provides 100% allowance for the renovation or conversion of unused business properties in disadvantaged areas.	Regenerate disadvantaged areas		40
Research and development (R&D) tax credits are an extra deduction from companies' taxable income for R&D expenditure. In some cases a payment is available to the company.	Support research and development activity	Established (11–40 years)	1,325[3]
Supplies of drugs on prescriptions are zero-rated for VAT.	Keep health costs low		2,950
Share loss relief allows a loss on disposal of shares in certain small unquoted trading companies to be set against income tax or corporation tax.	Reduce the financial risk of investment in smaller companies.		Unknown[4]
Construction of new dwellings. Supplies to build new homes are zero-rated for VAT.	Support housing construction	Long-standing (40+ years)	8,050
Business property relief grants 50% or 100% relief from inheritance tax on certain types of business assets including unlisted shares.	Support business continuity		415
Agricultural property relief grants relief from inheritance tax on agricultural property.	Support continuity of farming business		385

Notes

1 These figures are the forecast costs included in the tax impact and information notes (TIINs) for these tax reliefs.

2 HMRC's published cost of Entrepreneurs' relief is £3,200 million. HMRC has told us this figure is likely to be revised in its next publication of its 'tax expenditures, reliefs and ready reckoners statistics' to £2,900 million.

3 The forecast cost of the R&D relief includes the payable credit element and the research & development expenditure credit (RDEC) introduced in 2013-14.

4 HMRC cannot quantify the cost of share loss relief with certainty as the exact figure depends on whether the loss could alternatively have been set against gains in the same or future years.

5 The objectives summarised here are based on published material and discussions with officials. It is HMRC's view that the descriptions cannot always be defined narrowly and so may be partial.

Source: Tax Impact and Information Notes and HM Revenue & Customs

13 HMRC does not always hold complete data when the cost of the relief or risk to the exchequer is high. Looking beyond our sample, we found Lettings Relief (an exemption from capital gains tax for periods where a principal private residence is let) may cost at least £200 million a year but is reported as a 'cost not known' relief because HMRC is not confident it receives enough information to make a complete estimate. A tax return is only required on the sale of property when a tax payment is due. HMRC has concluded that its annual cost of processing tax returns from all taxpayers selling homes would be £3.6 million and is concerned that this would create a disproportionate burden. It has not assessed the benefits it would receive from collecting this data (paragraphs 1.8 and 1.9).

14 HMRC has an inconsistent approach to collecting, using and publishing data on tax reliefs. Government needs to know the costs of its policies to make sound decisions, and transparent reporting is important to provide accountability to Parliament and taxpayers. We identified 196 tax reliefs we thought might have social or economic objectives and found that HMRC published cost data on 115 of these. HMRC collects tax return data for 88 reliefs. In other cases, such as VAT reliefs, it uses national statistics to estimate the annual cost. We found 28 instances where data are collected through tax returns but are not published; and a further 53 cases where tax return data is not collected and a robust estimate of cost has not been made using data from other sources (paragraphs 1.6 and 1.10).

15 The data HMRC publishes on the costs of reliefs are estimates and are not sufficient to provide reliable information to Parliament or the public. HMRC publishes yearly data on the cost of reliefs in its 'tax expenditures, reliefs and ready reckoners statistics' to provide transparency and allow external monitoring of the cost of reliefs.[1] In most cases, these data are the only source of information on cost available to parliamentarians. These data are estimates, and in some cases HMRC adds the caveat that the estimates are 'particularly tentative and subject to a wide margin of error'. Data is first published as an end of year forecast 3 months before the completion of the tax year, and should be corrected with the actual cost of the relief when available. We found the published estimates for 4 of the reliefs we looked at (Entrepreneurs' relief, Seafarers' Earnings Deduction, Enterprise Management Incentives and Business Premises Renovation Allowance) were significantly different from the actual costs. The most significant difference was an understatement of the cost of Entrepreneurs' relief by £510 million in 2011-12. In no instances had the published statistics been restated, although HMRC had published amended cost data on Enterprise Management Incentives elsewhere. HMRC told us it publishes projections using the most recent data to provide timely information. In some cases the time lag in collecting and processing tax returns means that the year in question no longer features in its published table, so final costs are never published (paragraphs 2.8 to 2.10).

1 These can be found on the gov.uk website at: www.gov.uk/government/collections/tax-expenditures-and-ready-reckoners

Assessing whether reliefs are working as intended

16 **HMRC does not collect the data that would allow it to conclude on the effectiveness of tax reliefs.** HMRC does not routinely collect robust monitoring information that would allow it to assess the benefits of individual tax reliefs, the cost of abuse or the value of tax at risk. It does not identify differences in the way it administers tax reliefs, or the costs of that administrative effort. None of the 10 case studies we looked at regularly used or compared data in all of these areas. The teams responsible for the integrity of particular reliefs (known as product owners) are expected to work in partnership with the Department's risk and intelligence service to look at case data and consider avoidance risk for particular types of taxpayers; and with the Department's knowledge and analysis team to consider trends in the costs of reliefs and fiscal risks. In practice, we found the product owners of the reliefs we examined made little use of such analysis (paragraphs 1.12 and 1.13).

17 **We found little evidence that HMRC evaluates reliefs to see if their objectives are being met.** Of the 8 reliefs in our sample that had been in place for more than 3 years, HMRC had sought to evaluate the impact of the relief on taxpayers' behaviour only for R&D tax credits and Entrepreneurs' relief. Such evaluation can be both methodologically challenging and expensive, but without it, decision-makers lack the evidence to judge whether the costs of a relief to the exchequer are commensurate with the social or economic benefits it delivers (paragraphs 2.15, 2.21 and 2.22).

18 **Significant increases in costs do not automatically trigger a response to rule out abuse.** Using the data published by HMRC, we found that of 46 high-value reliefs with social or economic objectives (described as 'tax expenditures' on HMRC's website), 11 had increased in real terms by more than 25% above 2007 levels. We looked at the 3 tax reliefs reporting the biggest percentage increases. HMRC could explain why the costs might have shifted. However, it tended to seek the most obvious explanation and did not try to definitively rule out abuse. In one case HMRC analysed cost increases each year. In another, a rise in Seafarers' Earnings Deduction led it to search further to rule out unexpected behaviour or abuse but not until the fifth year of reported cost increases. Corrected data provided to us in November 2014 showed that cost increases over this time were less significant than the published cost data had suggested. However, HMRC also told us it expects the annual reporting of the costs of the most significant tax reliefs to inform product owners' assessment of the operation of the reliefs. HMRC does not publish this data with analysis of variations or provide internal analysis to its product owners unless they commission it (paragraphs 2.3, 2.6 and 2.7).

19 HMRC detected large scale abuse of share loss relief in 2006-07 but did not monitor changes in the use of the relief until 2013. A disclosure of tax avoidance schemes (DOTAS) disclosure for 2006-07 and HMRC's risk assessment processes identified 2 large and aggressively marketed tax avoidance schemes using share loss relief. In 2006-07, the amount of individuals' claims against taxable income for share loss relief rose in real terms from £385 million to £1,206 million, but HMRC only identified the scale of this increase in 2013 as part of a one-off exercise. Avoidance schemes detected by HMRC accounted for almost all the increase, but HMRC did not check the total amount of claims in 2006-07 or subsequent years to check whether there were other unexplained surges. HMRC is investigating 80% of the 2006-07 claims by value (£964 million). Avoidance activity has continued and HMRC has detected 20 undisclosed schemes between 2005-06 and 2011-12. It has opened investigations into 60% of claims by value made by individuals. HMRC now plans to monitor trends in the amount of share loss relief claimed in future (paragraphs 1.16 to 1.18).

20 In only one of our case studies, did HMRC make regular forecasts of the cost and monitored whether the actual costs were as expected. It is normal practice for HM Treasury and HMRC to produce forecasts of cost only when a new tax relief is introduced or a change in a relief is considered. Comparison of the actual costs of reliefs with such forecasts is very difficult because HM Treasury and HMRC calculate these on different bases. Forecasting the costs of significant reliefs helps to predict broader trends in tax revenues, but HMRC must balance the usefulness of forecasting against its cost. We found HMRC carried out regular forecasting of the cost of R&D tax credits but not for any other of the reliefs in our sample. HMRC plans to introduce such regular forecasting for some other corporate tax reliefs, but the practice is not used for reliefs in other tax streams (paragraphs 2.17 to 2.19).

21 HMRC has carried out limited high level analysis to understand why the cost of entrepreneurs' relief has significantly outstripped its forecast. Entrepreneurs' relief has risen by over 500% since it was introduced in 2008-09. Costs have continually exceeded forecasts. Its estimated cost of £2.9 billion in 2013-14 is 3 times greater than published forecasts predicted. There have been several changes to the relief that might help to explain the increase, but HMRC has not quantified these changes robustly or reviewed the accuracy of its forecasts. It cites recent policy changes as the reason for this, including increases in the amount of relief available to individuals and increases in the capital gains tax rate. However, HMRC's most recent forecast took these factors into account. Our analysis indicates the total of all policy forecasts, adjusted for changes in the tax rate, would suggest an expected cost of around £900 million in 2013-14. Rising asset values may have contributed to increased levels of both capital gains receipts and the value of Entrepreneurs' relief. HM Treasury told us that with so many policy changes in a relatively short amount of time, it has been difficult to fully investigate whether the cost increase might be influenced by misuse of the relief but HMRC has carried out checks of individual claims it considers to be high risk. The departments consider that a more complete evaluation on the impact of different factors will not be possible until the policy reaches a more steady state. HMRC is undertaking research in this area and exploring ways to gather more evidence (paragraphs 2.11 to 2.16).

Identifying and responding to evidence of abuse

22 **HMRC's approach to compliance risk is based on looking at the complete tax position of higher-risk taxpayers, rather than seeking to understand the specific risks attached to tax reliefs.** HMRC is developing a long-term strategy for compliance work to tackle behaviours leading to non-compliance. This strategy is based on customer segmentation, recognising that the majority of taxpayers are compliant, and focusing on those who carry higher risks. HMRC uses data from tax returns and other sources to understand how these taxpayers use all the tax rules taken together, allowing it to connect different taxpayers who organise their affairs in similar ways. The overall costs of particular reliefs are not considered by HMRC's risk and intelligence service. We found different levels of understanding and awareness of compliance risks among the product owners we interviewed, and in most cases we found little or no monitoring of particular tax reliefs to understand the potential scale of abuse (paragraphs 3.2 and 3.3).

23 **HMRC has not taken a systematic approach to managing the risks of tax reliefs, but has identified risks specific to each of those we examined.** HMRC does not assign risk ratings to tax reliefs, nor does it have an overall system for comparing tax reliefs or determining the resources required to manage them according to the level of risk. Nonetheless, the teams responsible for administering the tax reliefs we looked at had identified the main risks they perceived. We found 3 examples (patent box, agricultural property relief and business property relief) where HMRC managed known and emerging risks through the use of a risk register (paragraphs 3.2 to 3.7).

24 **In 6 of the 8 case study reliefs in place for three years or more, HMRC had not estimated the value of tax at risk.** HMRC held data on the value of tax at risk for 2 tax reliefs we looked at: share loss relief and business premises renovation allowance. HMRC requires risks with an impact of more than £250 million to be included in HMRC's top-level view of compliance risk so these can inform Senior Management decisions about whether compliance action or policy responses are needed. This includes consideration of measures from the tax gap, which incorporates the overall tax at risk from reliefs, although they are not separately identified. Without data on the level of tax at risk it is hard to determine where and whether further action is needed. Of the reliefs in our sample with known costs, 3 tax reliefs (Entrepreneurs' relief, zero-rated VAT on new dwellings, and zero-rated VAT on drugs and supplies on prescription) varied in cost by more than £250 million from one year to the next. Cost movements are not necessarily caused by abuse but the reasons for these cost increases had not been explored fully or included in HMRC's top-level view of compliance risk. HMRC considers the two VAT reliefs to be low/medium risk (paragraphs 3.11 to 3.15).

25 **HMRC has responded in different ways to evidence of abuse in respect of 3 of the tax reliefs we examined.** We looked at how HMRC had responded and the speed of response in 3 case examples where HMRC had evidence of avoidance activity. HMRC's response for each example was as follows:

- HMRC responded rapidly to high numbers of disclosure of tax avoidance schemes (DOTAS) declarations on business premises renovation allowance. It sought immediate changes to tax rules and published a warning to taxpayers within a year.

- HMRC published a warning to taxpayers in respect of marketed avoidance schemes using share loss relief in November 2012 after a period of in-depth investigation. It has identified and challenged 20 undisclosed avoidance schemes operating between 2005-06 and 2011-12. In total HMRC is investigating 60% of the value of relief claimed by individuals for suspected avoidance – equivalent to £780 million in tax. It has not proposed any changes to the mechanics of the relief because it considers that existing share loss rules and the targeted anti-avoidance rule will be effective in defeating these schemes. However, it expects new limits on income tax reliefs will reduce levels of avoidance. It has not estimated the cost of its activity to detect, investigate and challenge avoidance.

- Entrepreneurs' relief has seen the most significant rise in costs over its lifetime. HMRC received two DOTAS disclosures in 2010, and is monitoring use of the schemes. So far use has been limited. HMRC and HM Treasury reviewed the new schemes to consider the scale of risk and to inform policy development. No changes have been made or announced. However, HMRC is not able to estimate the amount of tax at risk because the tax advantage accrues when the individual shareholders dispose of their shares, which could be many years later (paragraphs 3.16 to 3.23).

Optimising the administration of tax reliefs

26 **We found examples of good practice but also inconsistency and fragmentation in the way HMRC administers tax reliefs.** Tax reliefs differ in design, method of delivery, target population, maturity and risks, so we would expect a differentiated approach in how they are administered; but the absence of a framework to govern the management of reliefs presents risks. For example, evidence that a relief is not achieving its objectives or is being misused by taxpayers, sometimes at considerable cost to the exchequer, may not be detected. We also see common characteristics among reliefs with social or economic objectives and suggest there would be synergies in considering them as a group and identifying how different types of relief should be administered in a structured way. Such a framework could help HMRC to be more methodical in how it deploys its resources to optimise its administrative effort (paragraphs 4.2 to 4.4 and 4.13 to 4.16).

27 **We found no shared understanding within HMRC about how tax reliefs should be administered and insufficient information sharing about their costs, risks and benefits.** Tax reliefs are administered by product owners who are accountable for ensuring that the tax products they manage deliver HMRC's objectives. The risks to tax collection are assessed separately within the enforcement and compliance division, and analysis of the usage and costs of reliefs is undertaken by the knowledge, analysis and intelligence directorate. We found little recognition among product owners of the analysis and data that were available on either cost or risk, and a lack of clarity about the extent to which their role required them to evaluate whether the reliefs they manage were working as intended. In most cases, when we asked for an assessment of the costs and risks of the reliefs they managed, the product owners were unable to provide us with relevant, up-to-date information (paragraphs 1.13, 3.6, 3.14 and 3.15).

28 HM Treasury and HMRC do not assess or report to Parliament on whether tax reliefs are achieving their objectives. In responding to the Committee of Public Accounts' report on tax reliefs in September 2014, HM Treasury and HMRC rejected the proposition that any tax relief should be subject to similar management and accountability arrangements as public spending. They argue that the design of tax policy, including tax reliefs, is subject to Parliamentary scrutiny by the Treasury Select Committee, while Parliament as a whole has an annual opportunity, through Finance Bills, to debate the design of tax reliefs and propose amendments, and must approve all tax reliefs before they can commence. While we recognise the distinction between tax and spending, we consider that this does not absolve the departments of responsibility to evaluate tax reliefs rigorously or to report to Parliament on whether their objectives, where these are measurable, are being achieved. The Committee of Public Accounts has said it is looking to the departments "to set out clear proposals on how to improve the management and accountability to Parliament of the cost and performance of tax reliefs". The departments have not proposed any alternative framework by which they should administer this form of policy instrument; nor have they described what features the effective management of tax reliefs should exhibit. As a consequence, neither HM Treasury nor HMRC:

- identify which tax reliefs are designed to deliver specific policy objectives by influencing taxpayers' behaviour;
- provide guidance to their teams on how tax reliefs should be monitored or evaluated;
- estimate the tax at risk should a tax relief be used in ways not intended by Parliament; and
- provide meaningful feedback to Parliament on whether tax reliefs are working effectively and at what cost (paragraphs 4.3 and 4.4).

29 HMRC has identified a number of different categories of tax reliefs by objective but has not identified which tax reliefs require the most monitoring. The departments do not categorise reliefs in any way (for example by objectives, level of risk, or parliamentary interest) to help prioritise administrative effort. HMRC has identified different categories of tax relief, including a class of relief it describes as *"Reliefs to provide incentives for behaviour that may be conducive to economic or social objectives"*. It has not sought to identify which reliefs meet this description because it considers this group has no administrative implications. We found examples where HMRC had commissioned research to test how effective a tax relief is in influencing behaviour change, but no system or guidance to require such analysis for all those reliefs that are intended to achieve a specific policy goal (paragraphs 4.5 and 4.6).

30 Other countries have developed a specific approach to monitoring certain types of tax reliefs. International practice varies considerably in how far tax authorities monitor tax reliefs and publish information about them. HMRC is one of only a handful of fiscal authorities we found that reports the costs of more than 100 tax reliefs and uses caps on the use of particular tax reliefs. Some other countries focus particularly on those reliefs with social or economic objectives and monitor and report on them more extensively than in the UK (paragraphs 4.17 to 4.21).

31 We estimate that about half of all tax reliefs have economic or social objectives targeted at certain activities or aimed at particular groups. HMRC has identified 46 tax reliefs on its website which it describes as 'tax expenditures'. We identified 196 reliefs that may have economic or social objectives from 398 tax reliefs listed on HMRC's website. Further analysis indicates many of these may have behavioural objectives, but this judgement is difficult because HMRC does not record the objectives of reliefs. The reliefs we have identified include 43 tax expenditures which appear to provide clear behavioural incentives; a further 70 which may be intended to influence taxpayers' behaviour; and 78 whose aim is to reduce the tax paid by particular sectors or groups. We found that costs were more often known for reliefs providing subsidies (83%) than for behavioural reliefs (63%), indicating HMRC could improve its understanding of the cost and impact of behavioural tax reliefs (paragraphs 4.8, 4.11 and 4.12).

Conclusion on value for money

32 Neither HM Treasury nor HMRC have established a framework or principles to guide the administration of tax reliefs. This reflects their view that tax reliefs do not have administrative implications that differentiate them from other parts of the tax system. It is our view that the defence of this principle, coupled with the desire not to be more directly accountable for reliefs, is costing the exchequer money. The departments have not identified which tax reliefs are intended to change behaviour in order to deliver policy objectives; and do not monitor or report their costs and benefits in a way that would allow government, Parliament or the public to know if such reliefs are working as intended. Not all reliefs lend themselves to such analysis, but some do. We believe this creates a significant gap in accountability to Parliament for administrating public finances effectively.

33 We found some examples where HMRC proactively monitors and evaluates tax reliefs, but in general it does not test whether tax reliefs are achieving their aims. This creates significant risks that may go undetected: that tax reliefs cost more than expected; that they are used in ways not intended by Parliament; or that they do not bring about intended behaviour change. Without monitoring the use or impact of tax reliefs, or acting promptly to analyse increases in their costs, HMRC's administration of tax reliefs cannot be value for money.

Recommendations

34 Our recommendations are designed to support the development of a systematic approach to administrating tax reliefs. Tax reliefs represent policy choices about what groups and activities government wishes to support, but they always have a cost to the exchequer. We would therefore expect to see clear feedback from HMRC to policymakers about whether they are working as intended and at what cost. HMRC considers its holistic approach to managing compliance risks is sufficient to detect and address the systemic abuse of a tax relief. But we observed a lack of clarity among product owners about the extent of their responsibility for evaluating the reliefs they manage, which demonstrates the analysis that would enable meaningful feedback is lacking.

35 Some tax reliefs will need a greater level of administration than others. HMRC should therefore develop a methodology for identifying groups of similar reliefs and determine what level of administration is appropriate for each type, taking into account factors such as objective, beneficiaries, cost, complexity and risk. We recommend HMRC, in partnership with HM Treasury, develops its approach in 5 key areas:

a **Drawing on good practice internally and internationally to develop principles and guidance for administrating and reporting on tax reliefs.** This should take into account the materiality of particular tax reliefs as well as issues of proportionality and the cost of collecting data.

b **Publishing data on the cost and effectiveness of significant tax reliefs.** HMRC should review tax returns so data collected are proportionate to cost and risk. It should consider how it can collect better data on reliefs as part of its digital strategy. It should publish the actual cost of tax reliefs and present these alongside any other published statistics on tax reliefs to aid comparison.

c **Tracking actual costs against forecasts.** For the most material tax reliefs, HMRC and HM Treasury should systematically track actual costs over time against mid-year projections and the forecasts made for policy changes, wherever data can be collected cost-effectively from tax returns or other sources. Mid-year cost projections should be updated with actual cost data when available, and explanations sought for significant changes.

d **Reporting to Parliament each year on the cost and impact of the tax reliefs posing the greatest risks.** HMRC should systematically assess the risks of tax reliefs. It should propose what form of reporting would be most effective to provide assurance to Parliament that tax reliefs, particularly those where the risks are greatest, are working as intended. Reports could include the cost and value to beneficiaries but also wider effects that could affect the value to society (such as evasion, interaction with other parts of the tax system, distributional effects with positive value to society and economic distortions).

e **Carrying out a pilot exercise to analyse behavioural reliefs systematically and identify and explore patterns and risks.** The exchequer departments could establish a small, dedicated team to examine areas such as assessing risk, monitoring costs and benefits and developing good practice. They should consider whether to commission expert advice from an independent source on how such a function could be framed and executed.

Part One

The information HMRC collects to oversee tax reliefs

1.1 HM Revenue & Customs (HMRC) administers the tax system and is responsible for putting tax rules into practice. Tax reliefs are tax rules and can be structural parts of the tax system or designed to relieve tax for particular groups or activities to achieve social or economic objectives. HM Treasury is responsible for the policy design of tax reliefs, which HMRC implements. HMRC may also use their experience of operating existing reliefs to recommend that tax reliefs are redesigned as part of its responsibility to maintain the tax system.

1.2 HMRC must also manage interactions in the tax system and ensure it is understandable and accessible to taxpayers. It may also promote customer awareness of certain tax reliefs in pursuit of high priority objectives. Product and process owners are responsible for the end-to-end administration of tax reliefs, along with other elements of the tax system. They are accountable for ensuring their respective regimes are optimised to deliver HMRC's strategic objectives of:

- maximising revenue flows;
- stabilising and improving customer experience (including reducing customer costs);
- creating sustainable cost reductions for HMRC; and
- managing the trade-offs between these objectives effectively.

1.3 HMRC needs information to assess whether tax reliefs are achieving their objectives. It must also administer the tax system with finite resources and balance its costs with the administrative burden it places on taxpayers.

1.4 In this part we consider whether HMRC:

- makes enough use of information and addresses gaps in information as necessary;
- could improve its information so it can track reliefs more comprehensively; and
- uses other sources of information to provide an early warning of the use of reliefs before it gets more definitive data from tax returns.

HMRC does not hold data on the cost of all tax reliefs

1.5 HMRC lists 398 tax reliefs on its website each year to provide transparency. Fewer than half of these include cost data. The reliefs on its website are:

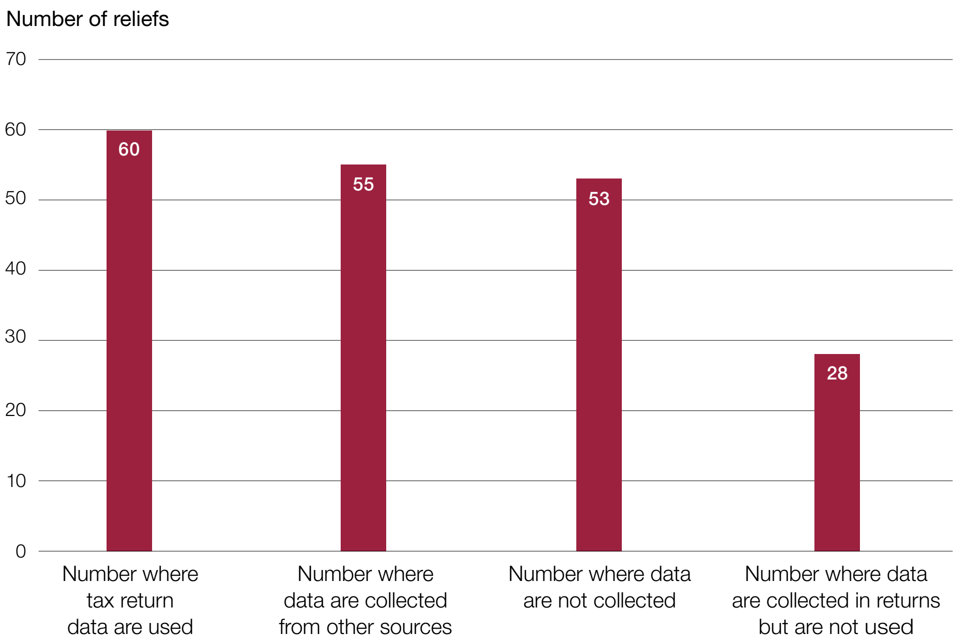
- 46 structural reliefs and 46 'tax expenditures' (reliefs with social or economic objectives) with a cost of more than £50 million a year;
- 87 minor reliefs with costs of less than £50 million a year; and
- 219 unclassified reliefs whose costs are not known.

1.6 We identified 196 tax reliefs we thought might have social or economic objectives. HMRC has collated and published the costs of 115 of these including 55 reliefs estimated using supplementary data (**Figure 2**). Some tax reliefs are applied at the source of income (such as employer-provided pension schemes and ISAs), so do not feature in tax returns. We identified 53 tax reliefs where HMRC does not collect data from tax returns and has not made a robust estimate of cost using data from other sources.

Figure 2

Number of reliefs with economic or social objectives where data are available

HMRC does not report the costs for 28 tax reliefs with economic or social objectives where it collects data



Source: National Audit Office analysis of HM Revenue & Customs' cost data and tax return forms

1.7 HMRC must keep tax returns manageable and decide what supporting evidence to ask for based on factors such as cost and risk. It must prioritise collecting the data needed to calculate the tax liability of taxpayers and balance its own data requirements with the administrative burden on customers and the department's own resource constraints. It uses the information available for statistical monitoring, and only seeks additional data from taxpayers if it sees compelling reasons.

1.8 We found cases where tax returns ask for data relating to tax reliefs of negligible cost while tax reliefs of higher value are not covered comprehensively by tax returns. For example, tax returns asked for information on 7 tax reliefs of negligible cost, such as Community Investment Tax Relief and Right to Buy transactions. Both of these cost less than £2.5 million a year.

1.9 Principal Private Residence relief is estimated to be worth £12.6 billion a year but HMRC does not require a tax return for capital gains on sales of homes unless taxpayers think a liability is due. The relief has several additions such as lettings relief which add complexity to the tax calculation, increasing the risk of mistakes. Lettings Relief (exemption for capital gains tax for periods where principal private residence is let) may cost at least £200 million a year but is reported as a 'cost not known' relief because HMRC is not confident it receives enough returns to make a complete estimate. HMRC estimates the cost of collecting returns for all sales would be at least £3.6 million a year but is concerned that requiring returns from all taxpayers selling homes would create a disproportionate customer burden. It has not assessed the burden of collecting this data as part of the house buying process. Nor has it estimated the cost burden of only collecting returns from taxpayers with two or more homes. A recent awareness campaign recouped £5.3 million of unpaid tax covering a number of years.

1.10 HMRC could make more use of the data it collects. We found 28 cases where data are collected in tax returns but the overall costs are not estimated or published. Some are significant, for example share loss relief and enterprise investment schemes. Most relate to reliefs for capital gains tax and inheritance tax where processing systems tend to be paper-based. HMRC plans to improve its inheritance tax systems as part of wider digitisation of its services.

HMRC has limited data for the tax reliefs we examined

1.11 HMRC does not have a system in place to identify different types of tax relief or how they are managed. We therefore used a case study approach to look in detail at how HMRC administers 10 tax reliefs at different stages of maturity.

1.12 HMRC estimates the cost of the tax reliefs we looked at but product and process owners have few data on the number of staff involved in administration, the scale of tax returns under investigation or the success rate. (**Figure 3** overleaf).

Figure 3

Data available for each case study tax relief

HMRC holds partial data for all of the tax reliefs we examined

	Objectives	Administrative data			Costs		Risk of abuse		
	The objectives are known	Cost of administering the relief is known	The number of people involved in administration is known	The proportion of claims that are checked is known	The cost of the tax relief is known	The cost of the tax relief is forecast for future years	The cost of abuse is estimated	The value of tax at risk is estimated	HMRC's success rate in investigations is known
Patent box	✔	✔	✔	✔	No cost data currently available	✔	n/a	n/a	n/a
Reduced rate for leaving 10% of an estate to charity	✔	✗	✗	✔	No cost data currently available	✔	n/a	n/a	n/a
Entrepreneurs' relief	✔	✗	✗	✗	✔	✔	✗	✗	✗
Business premises renovation allowance	✔	✗	✗	✗	✔	✗	✔	✔	✗
R&D tax credits	✔	✔	✔	✔	✔	✔	✗	✗	✗
Value added tax – zero rating of supplies of drugs on prescription	✔	✗	✗	✗	✔	✗	✗	✗	✗
Share loss relief	✔	✗	✗	✔	✗	✗	✔	✔	✔
Value added tax – construction of new dwellings (includes refunds to DIY builders)	✔	✗	✗	✗	✔	✗	✗	✗	✗
Agricultural property relief and business property relief	✔	✗	✗	✔	✔	✗	✗	✗	✔

Note

1 Data is collected from other sources of information (such as ONS National Accounts data) to estimate the cost of VAT reliefs. Patent box and reduced rate of inheritance tax have limited data from tax returns because these were introduced recently.

Source: National Audit Office analysis of HM Revenue & Customs' data

1.13 Product and process owners are responsible for risk identification and should be the focal point for all management information. HMRC requires product and process owners to have systems in place to understand whether tax reliefs are fit for purpose and to commission analysis if necessary. HMRC's risk and intelligence service look at case-flow data to manage particular avoidance cases, while HMRC's analysis unit monitors the overall cost for particular tax reliefs. Product owners do not have software licences that allow them to look at data directly and instead work in partnership with analysis, risk and compliance functions to consider the most relevant information to ensure the integrity of the relief. We have not seen evidence of product and process owners commissioning case-flow reports for any of our sample of reliefs. HMRC is looking at how the planned introduction of new software could enhance the information available to product owners on specific risks.

1.14 We found administrative cost data was clearest for tax reliefs with dedicated units (R&D tax credits and patent box). For example, HMRC told us an independent management system is maintained for R&D. For other tax reliefs processing costs are more difficult to disentangle from the wider processing of tax returns but we would expect the cost and performance of monitoring, investigations and legislative activity to be kept under review.

1.15 Product and process owners were able to estimate the cost of abuse for share loss relief and business premises renovation allowance. Extrapolating the overall tax at risk is not possible for most reliefs because compliance action focuses on high risk claims. HMRC has concluded that estimating the tax gap for all tax reliefs would be too costly because of the scale of the sample sizes required.

A large increase in the cost of share loss relief was not identified even though the relief was suspected of large-scale abuse

1.16 Data on share loss relief are not published because they are not sufficiently robust for official national statistics. We found that, without this requirement, data on costs were not routinely collated or used for internal monitoring. Data on the number and value of total claims are not routinely gathered, although HMRC told us it collects data relating to erroneous claims for management purposes.

1.17 In 2006-07, the value of share losses claimed in income tax calculations rose in real terms from £385 million to £1,206 million (**Figure 4**).[2] The increase in cost was caused by 2 large and aggressive avoidance schemes, only one of which was disclosed to HMRC under rules requiring disclosure of tax avoidance schemes (DOTAS). HMRC was aware of an increase in avoidance at the time and was proactive in placing new claims under investigation as HMRC's risk assessment strategy screens all share loss claims for potential compliance risk in line with risk rules. Around £330 million of tax is under consideration for these schemes. However, it did not check the overall amount of share loss relief until 2013 as part of a one-off exercise. HMRC was then able to identify that 80% of the value of share loss relief claimed in 2006-07 (equivalent to £964 million) is under investigation for suspected avoidance.

1.18 HMRC is investigating 24 suspected avoidance schemes marketed between 2005 and 2012, believed to cost up to £780 million in tax.[3] Schemes were identified through a combination of DOTAS, other intelligence and case-by-case monitoring of income tax returns. Measuring the total amount of claims has now enabled HMRC to identify that it opened investigations into 60% of all claims (by value) between 2005 and 2012. Total tax under consideration for the period is £780 million. However, it told us it cannot calculate how much tax is under investigation for each tax year without time-consuming reviews of claims in each year (it undertook this analysis for 2006-07 only). Such analysis could help provide additional assurance over the completeness of claims identified for investigation by HMRC's other methods.

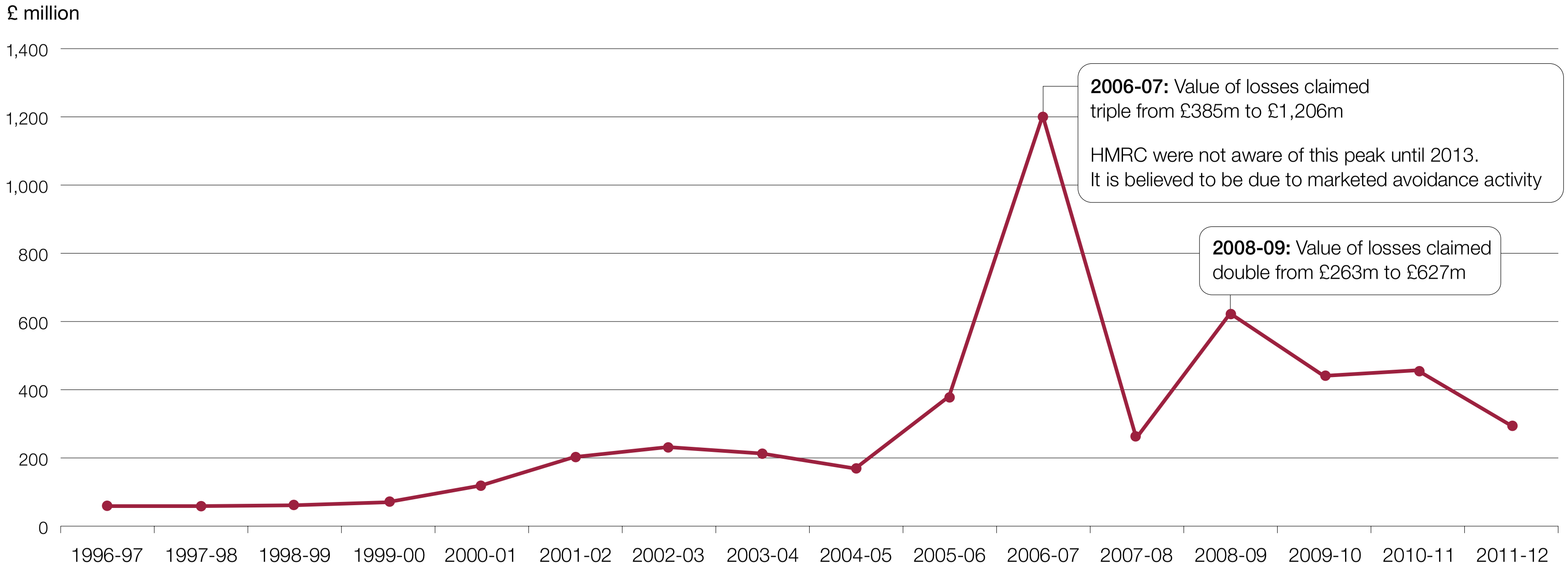
1.19 In 2013-14, when the scale of share loss relief was first calculated, there was little scope to open new enquiries into historic periods. The normal window for risk assessing and opening enquiries is one year after receipt of the return. However HMRC may investigate claims up to 6 years later in cases of carelessness. After 6 years there must be deliberate avoidance behaviour or failure to disclose under DOTAS. In October 2014, HMRC told us it now plans to monitor the total amount of share loss relief claims in future.

2 In nominal terms the value of claims increased from £320 million to £1,032 million.

3 This number is presented in nominal terms. We are unable to present this in real terms because time series data is not available.

Figure 4
Value of share losses claimed in income tax calculations

The increase in share loss relief claims since 2005-06 is due to marketed avoidance



Notes

1 Data show the value of claims, as the tax cost of share loss relief cannot be quantified with certainty. The overall tax cost depends on whether the loss could alternatively have been set against gains in the same or future years. However in cases of avoidance the tax cost is up to around 40% of the amounts shown.

2 Costs are shown in real terms.

Source: National Audit Office analysis

Part Two

How HMRC challenges and understands changes in the cost and use of tax reliefs

2.1 Tax reliefs are not normally subject to budget caps in the same way as public spending. If costs rise unabated they could carry a fiscal risk. Understanding the reasons why tax reliefs vary in cost can also help HM Revenue & Customs (HMRC) and HM Treasury interpret factors affecting tax revenues. In this part we consider how far tax reliefs are subject to changes in cost. We adopt a case study approach to consider:

- the scale of cost increases and HMRC's understanding of the reasons;
- HMRC's response and the extent to which administration is prompted by certain triggers;
- the speed of HMRC's response and the role forecasts play;
- HMRC's evaluation of the benefits arising from tax reliefs; and
- whether HMRC has sufficiently ruled out abuse.

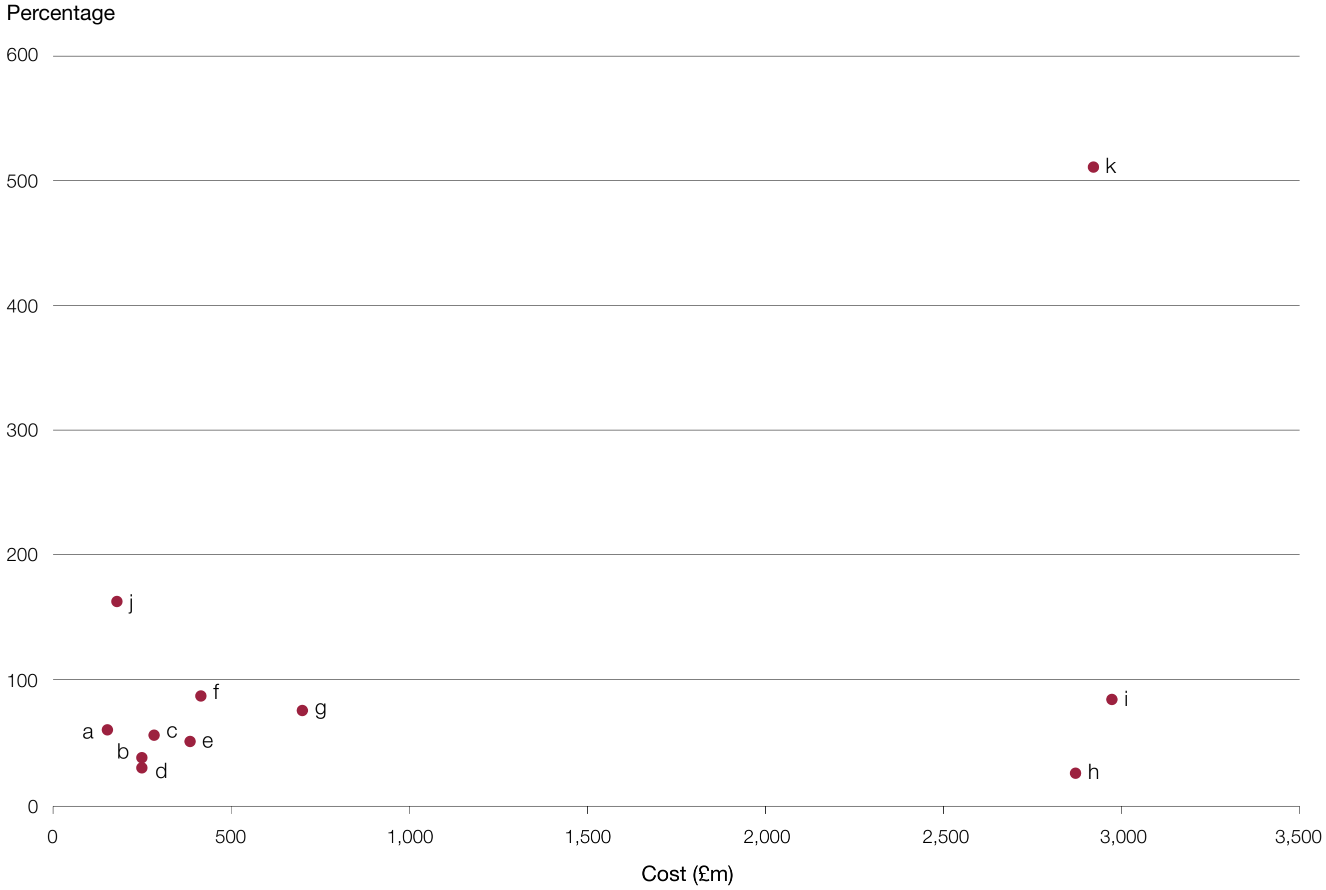
Tax reliefs may experience significant changes in cost

2.2 HMRC needs to monitor changes in actual costs closely. Costs can be affected by changes in the tax rate, economic changes such as asset values, policy changes to increase or reduce eligibility and changes in behaviour that mean more people are eligible for a tax relief. HMRC promotions may lead more people to benefit. Increased use of a tax relief may also be down to different interpretations of tax rules and guidance, mass-marketed avoidance schemes, or criminal attack on the tax system. It is essential, therefore, that HMRC product owners challenge changes in the cost and use of tax reliefs.

2.3 A quarter of the main tax reliefs reported by HMRC have increased substantially more than trend data. **Figure 5** shows that 11 tax reliefs have increased in real terms by more than 25% above 2007 levels. The cost of these reliefs increased from £5.5 billion in 2007-08 to £11.1 billion in 2013-14.

Figure 5
Tax reliefs with social or economic objectives reporting significant cost increases since 2007

Eleven reliefs report increases of over 25% in real terms since 2007



- a Venture Capital Trusts
- b Searfarers' Earnings Deduction
- c Enterprise Investment Scheme
- d Interest on National Savings Certificates including index-linked certificates
- e Agricultural property
- f Business reliefs including unlisted shares
- g Vehicles and other supplies to disabled people
- h Individual Savings Accounts
- i Drugs and supplies on prescription
- j Exemption from climate change levy for electricity generated from certain renewable sources
- k Entrepreneurs' relief

Source: National Audit Office analysis of HM Revenue & Customs' data

2.4 Some tax reliefs have also declined significantly in value. Seven tax reliefs with social or economic objectives have declined by more than 25% – a total fall in cost from £6.8 billion to £3.4 billion since 2007.

Significant changes in cost do not trigger a response to rule out abuse

2.5 HMRC requires product and process owners to take account of all information available – including published costs of significant 'tax expenditures' – to assess how well reliefs are operating. Product owners are expected to apply their knowledge and experience and consider the resources available in deciding whether action is needed.

2.6 We chose 6 of the reliefs that HMRC define as 'tax expenditures' – those showing the greatest increases and decreases – to test HMRC's understanding of the reasons for cost changes. In general we found HMRC identified the most likely reasons for changes. Alternative explanations were rarely tested, such as ruling out unexpected behaviour or abuse. In 3 cases we found published data were not accurate because they were estimated part way through the year, and the published tax expenditure tables had not been updated. **Figure 6** on pages 27 and 28 summarises our findings.

2.7 No tax reliefs had pre-defined triggers for action based on changes in cost. In the case of Seafarers' Earnings Deduction published data used by product owners showed there was a steady increase in costs over a long period of time before an internal assessment was carried out. The relief is attractive to taxpayers because income qualifies for 100% relief. The published cost of the relief increased from £110 million in 2007-08 to £230 million in 2012-13 before an investigation was commissioned in early 2014. The analysis found that the number of claims had increased, largely because of a rise in the number of security staff working on ships. In October 2014, HMRC told us that its latest data showed that the cost of the relief in 2007-08 was actually £182 million. The published data was an estimate in-year and had not been updated.

2.8 Overall we found the published data differed from the actual costs for 4 of the reliefs we looked at during the course of our work. The cost of enterprise management incentives were amended because of improvements in data processing. The most significant difference was an understatement of the cost of Entrepreneurs' relief by £510 million in 2011-12 (**Figure 7** on page 29).

2.9 HMRC and HM Treasury have described the data published annually on tax reliefs as a key mechanism for providing transparency and allowing monitoring of the cost of reliefs. Some of the cost data is published with the caveat that it is 'particularly tentative and subject to a wide margin of error'. Data is first published as an end of year forecast, 3 months before the completion of the tax year and should be corrected with the actual cost of the relief when available. In most cases, these data are the only source of information on cost available to parliamentarians.

Figure 6

Analysis of significant variances in the cost of tax reliefs with social or economic objectives

HMRC has done some work to explain variations in cost

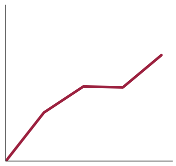
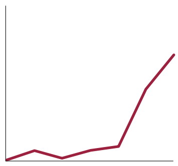
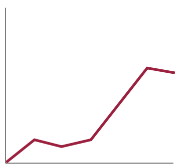
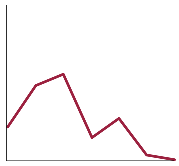
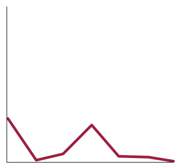
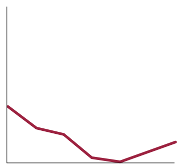
	Baseline value 2007-08 (£m)	Value 2013-14 (£m)	Variance between 2007-08 and 2013-14		HMRC reasons for variance in published data	Work carried out to validate
Tax reliefs where costs have risen						
Entrepreneurs' relief	475	2,900	511%		New relief introduced in 2008-09. Changes to policy to increase scope of the relief. Increase in tax rate for capital gains tax.	**2013** – Post implementation review No detailed analysis carried out to explain the increase – HMRC does not feel that a complete evaluation will be possible until the policy reaches a steady state. HMRC are currently undertaking small amounts of qualitative reasearch in this area to explore ways to gather more evidence.
Exemption from climate change levy for electricity generated from certain renewable sources	68	180	163%		Introduction of Carbon Price Floor in 2013 encouraged the use of renewables. DECC data shows that the use of renewables has increased. 22 million Levy Exemption Certificates were issued in 2012-13, up from 13.8 million in 2011. Raft of government policies introduced in recent years aimed at encouraging the use of renewables has had a cumulative effect.	**Annual**: The cost of this relief is estimated from third party data which HMRC review on an ongoing basis.
Seafarers' Earnings Deduction	182	250	37%		HMRC's review concluded that the size and number of claims has increased.	**Early 2014**: Review of costs, number of claims and value of claims – HMRC are still undertaking further investigations to rule out whether the increases could be due to abuse. **September 2014**: HMRC updated its cost estimates as more accurate data became available.

Figure 6 *continued*

Analysis of significant variances in the cost of tax reliefs with social or economic objectives

	Baseline value 2007-08 (£m)	Value 2013-14 (£m)	Variance between 2007-08 and 2013-14		HMRC reasons for variance in published data	Work carried out to validate
Tax reliefs where costs have fallen						
Rate differential for biofuels	125	0	-100%		Relief cost £230 million in final two years, compared to forecast costs of £20 million because the relief created a market for used cooking oil. Relief expired in 2012-13 – no action was taken to revise the relief before it expired to reduce costs.	**Annual**: Compared to forecast data following policy change in 2010-11. Analysis of industry activity to understand rise following policy change.
Enterprise Management Incentives	125	65	-48%		Fluctuations in the costs are not significant and largely due to timing of the exercise and the value of the gain. These relate to economic factors and are not something HMRC can respond to.	**2012**: HMRC discovered errors in published data and corrected these.
Reduced rate of climate change levy for participants in Climate Change agreements	399	250	-37%		Methodological changes in calculation. Changes in sectors able to use Climate Change Agreements. Changes in levels of manufacturing during recession.	**Annual**: The cost of this relief is estimated from third party data which HMRC review on an ongoing basis.

Notes

1 All data is in real 2013-14 prices.

2 Baseline year for Entrepreneurs' relief is 2009-10 to allow for settling in the first year.

3 Seafarers' Earnings Deduction was originally chosen as one of the 3 tax expenditures showing the greatest increases. In October 2014, HMRC told us its latest data showed the actual cost in the baseline year was £50 million higher than the original published data, meaning it was no longer in the top three.

4 For Entrepreneurs' relief, Enterprise Management Incentives and Seafarers' Earnings Deduction we have used unpublished data provided by HMRC. See Figure 7 for further details.

Source: HM Revenue & Customs' data

Figure 7

Published data for 4 reliefs have not been corrected

Published data for four reliefs have differed from actual cost by £1.5 billion in total

	Year	Published cost (£m)	Actual cost (£m)	Difference between published and actual cost (£m)
Enterprise management incentives (income tax relief element)	2007-08	190	80	+ 110
	2008-09	135	40	+ 95
	2009-10	120	50	+ 70
	2010-11	100	80	+ 20
	2011-12	80	50	+ 30
	2012-13	45	50	- 5
Seafarers' Earnings Deduction	2007-08	110	160	- 50
Entrepreneurs' relief	2010-11	1,200	1,500	- 300
	2011-12	1,600	2,110	- 510
	2012-13	2,400	2,100	+ 300
Business premises renovation allowance	2011-12	30	95	- 65

Notes

1 Data in this table is in nominal terms.

2 HMRC's published cost for Entrepreneurs' relief is £3,200 million in 2013-14. HMRC has told us that this figure is likely to be revised in its next publication of 'tax expenditures, reliefs and ready reckoners statistics' to £2,900 million.

Source: HM Revenue & Customs

2.10 HMRC told us it publishes projections using the most recent data to provide timely information. In some cases the time lag in collecting and processing tax returns means that the year in question no longer features in its published table, so final costs are never published.

HMRC has carried out limited analysis to understand why the cost of Entrepreneurs' relief has significantly outstripped its forecast

2.11 The cost of the relief has increased 500% in 5 years. The increase is partly explained by successive increases in the lifetime limit for claiming Entrepreneurs' relief. In the March 2010 budget the limit rose from £1 million to £2 million. It increased further in the June budget of that year to £5 million. A further increase in the lifetime limit to £10 million in 2011-12 also led to increased claims for the relief. In addition an increase in capital gains tax in June 2010 increased the relative value of the relief (providing an 18% reduction from the capital gains tax rate, instead of 8%).

2.12 The estimated cost of £2.9 billion in 2013-14 was 3 times more than the cumulative amount forecast as a result of policy changes. **Figure 8** illustrates how the cost of Entrepreneurs' relief has continually exceeded the total forecast cost of changes submitted to Parliament for approval. HMRC has not maintained a continuous forecast for comparative purposes. It produced new forecasts for each policy change. We have adjusted early forecasts to take account of changes to the rate of capital gains tax from 2010 onwards. Later forecasts took account of this effect.

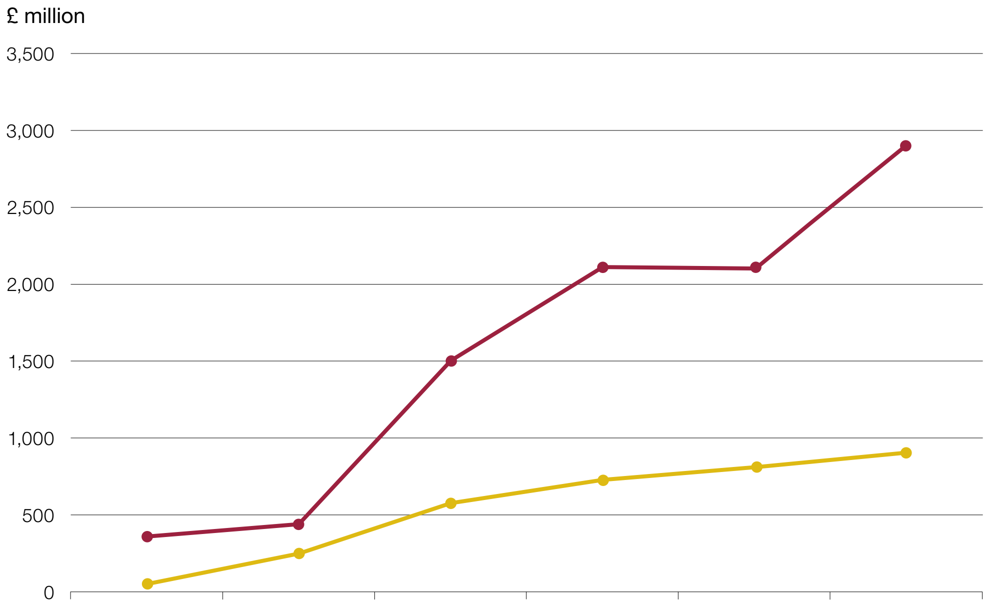
2.13 HMRC has not examined previous forecasts for accuracy before estimating the costs of new policy changes. The forecasts may have been prone to error because of a lack of data at the inception of the relief and time lags in collecting tax returns meant that HMRC had limited data available for making forecasts. When it forecast the cost of increasing the limit to £10 million in 2011-12 it only had 2009-10 data available, when the capital gains tax rate was 18% and a lifetime limit of £1 million applied. However, data also showed the cost of the relief was almost double the level forecast. The latest forecasts used new methods, but forecasts are rarely within £250 million of the value of claims received.

2.14 HMRC told us that increases in the asset values and disposals might also explain the increases but it is not able to attribute increases in cost to any factor until it has more evidence. It expects to wait until the policy background has reached a steady state before conducting more detailed quantitative analysis so it can make a conclusive evaluation.

Figure 8

The cost of Entrepreneurs' relief compared to policy change forecasts

The cost of Entrepreneurs' relief exceeds the total amount forecast by policy changes



	2008-09	2009-10	2010-11	2011-12	2012-13	2013-14
Actual cost (£m)	360	440	1,500	2,110	2,100	2,900
Cumulative exchequer impact of policy changes approved by Parliament (£m)	50	250	574	729	808	901

Notes

1 The cumulative exchequer impact is calculated from HMRC's published forecasts of the original cost of the relief and four subsequent extensions.

2 Note that the 2013-14 'actual cost' data is a forecast and may be revised by HMRC.

3 HMRC's forecasts for the original cost of the relief and the first extension (which increased the lifetime limit to £2 million) were published before the increase in CGT rate in June 2010 was known about. We have adjusted those forecasts to allow for the increase in the rate of CGT in June 2010.

4 When the relief was introduced in 2008-09, its cost was forecast up to 2012-13. We have carried forward 2012-13 cost (£450 million) into 2013-14. We have not used a growth factor in making this adjustment.

5 The exchequer impact forecast took account of behavioural change with the exception of how the rate change will effect those claiming under £2million in later years.

Source: HM Revenue & Customs' published data

2.15 In autumn 2013, HMRC carried out a preliminary assessment of Entrepreneurs' relief. It found that the relief may have formed a genuine incentive for entrepreneurs based on finding that the average age of beneficiaries had dropped from 59 to 53. The analysis did not explain or justify the link between age and entrepreneurship. HMRC told us that the lower average age may suggest people are not just selling businesses on retirement and that other motivations, such as encouraging entrepreneurship are contributing to its use. The analysis did not consider why the cost of the relief was greater than expected.

2.16 HMRC is exploring ways to do more detailed analysis such as external research on motivations for claiming the relief. In May 2014, HMRC commissioned a qualitative study of 50 people to find out why they claimed the relief.

Published forecasts and actual costs are difficult to compare

2.17 Budget forecasts estimate the net effect on tax receipts of a policy change. They do not estimate the total cost of the tax relief. Therefore, it is only possible to make limited comparisons of forecasts and actuals. HMRC produces forecasts for budget publication but these are not monitored against actuals or maintained.

2.18 Without maintaining forecasts unusual variances will go undetected and opportunities to learn how forecasts can be improved will be missed. More detailed forecasting of reliefs can also help understand broader trends in tax revenues. However, HMRC must also weigh the materiality of the relief with the usefulness and cost of forecasting.

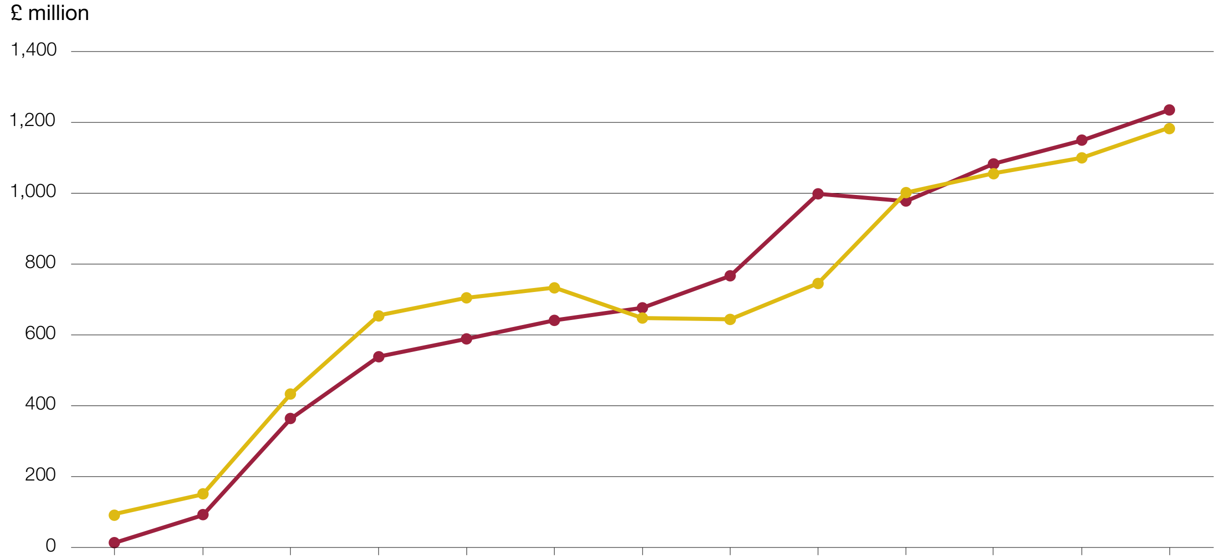
2.19 Some tax reliefs have more data to support accurate forecasting. Of the NAO case examples only R&D maintains a continuous forecast. The area is relatively data-rich because HMRC produces annual statistics, but so do other tax reliefs such as inheritance tax. Analysts who maintain a continuous forecast for R&D tax credits are adopting the practice for new tax reliefs to support creative industries including high-end TV, video games and animation.

2.20 For R&D tax credits HMRC uses survey data and produces an annual performance report. HMRC told us it investigated the £250 million difference in 2008-09 between outturn data and its original forecasts. Differences were due to forecasting methodology and a large claim from one company. HMRC revised its methodology in subsequent years (**Figure 9**).

Figure 9

R&D survey and claims data

Forecasting for R&D tax credits is generally accurate



	2000-01	2001-02	2002-03	2003-04	2004-05	2005-06	2006-07	2007-08	2008-09	2009-10	2010-11	2011-12	2012-13
Outturn	13	91	363	539	588	641	676	766	998	977	1,083	1,149	1,235
Forecast	94	150	433	655	704	733	647	644	746	1,002	1,056	1,100	1,185

Source: HM Revenue & Customs

HMRC has carried out monitoring of outcomes in most cases but evaluations are light-touch

2.21 Tax reliefs with social or economic objectives aim to distribute benefits to a particular group based on who they are or what they do. Success can depend on how much behaviour changes. The overall effect can be reduced if a large number of taxpayers already exhibit the behaviour. To monitor the success of a tax reliefs we would expect HMRC to:

a consult taxpayers about the impact of a relief and establish a baseline;

b monitor the total number of taxpayers benefiting from a tax relief;

c where possible estimate the number of taxpayers making behavioural changes as a result of the tax reliefs;

d weigh that against deadweight loss, leakage and avoidance;

e where possible, review the behavioural impact alongside the exchequer cost; and

f monitor outcomes.

2.22 Figure 10 assesses HMRC against these criteria. HMRC has applied a range of analytical techniques across the case studies, but not consistently.

Figure 10
HMRC analysis on the case studies

HMRC has used a range of evaluation techniques across the case studies, but not consistently

	Initial consultation and baseline	Total benefits assessed	Estimate behavioural change	Assess deadweight loss, avoidance and leakage	Quantify cost–benefit ratio	Monitoring of outcomes
Patent box	✔	planned	✔	✔	✗	✔✔
Reduced rate for leaving 10% of an estate to charity	✔	✔	✔	✔	✔	✔
Entrepreneurs' relief	✔	✔	✔	✗	✗	✔
Business premises renovation allowance	✔	✔	✗	✗	✗	✔
R&D tax credits	✔	✔	✔	✗	✔	✔
Value added tax – zero rating of supplies of drugs on prescription	unknown	✔	✗	✗	✗	✔
Share loss relief	unknown	✗	✗	✔	✗	✗
Value added tax – construction of new dwellings (includes refunds to DIY builders)	unknown	✔	✗	✗	✗	✗
Agricultural property relief and business property relief	unknown	✔	✗	✗	✗	✗

Notes

1 One tick indicates work has been carried out. Two ticks indicate good practice.

2 Since 2012-13, HMRC's policy is not to include behavioural effects in its costings of VAT reliefs to ensure consistency and comparability in VAT costings.

Source: National Audit Office analysis of HM Revenue & Customs' documents

Part Three

How HMRC identifies tax reliefs at risk and targets its response

3.1 In this part we consider how HM Revenue & Customs (HMRC) identifies risk in relation to tax reliefs. We also look at whether it appropriately targets its efforts to maximise its impact and reduce time lags. We examine how HMRC:

- considers risks posed by tax reliefs within its wider responsibilities;
- identifies the changing risk profile and initiates an effective response;
- manages risk in introducing new tax reliefs;
- maintains oversight of established tax expenditures and escalates risks; and
- responds to risks in a timely way.

Tax reliefs do not normally have their own risk rating or monitoring plans

3.2 HMRC manages tax reliefs as part of the tax system. In general, it would be unfeasible to manage them in isolation. Managing of the system includes, but is not limited to: collecting tax and duties as laid down by Parliament; identifying and managing risk; and tackling avoidance and evasion through compliance and enforcement activity. HMRC also implements and maintains tax policy in partnership with HM Treasury.

3.3 HMRC does not normally assign risk ratings to particular tax reliefs. Instead, it assigns responsibility of sections of the tax code to product and process owners. Product and process owners identify risks in relation to the broader range of measures of which tax reliefs form a part. If there are concerns, they should develop a handling strategy for any product risks or issues, or implement improvements. This allows a holistic approach with accountability for the end to end process of each product sitting with the product owner. The key output of this process is the product plan.

3.4 Most tax reliefs in our sample do not feature prominently in HMRC's product plans. Of our sample there are specific plans for R&D tax credits and patent box, which both have dedicated administration. Share loss relief and business premises renovation allowance are included within wider product plans. HMRC does not have separate plans for oversight of agricultural property relief, business property relief or the reduced rate of inheritance tax, the VAT reliefs or for Entrepreneurs' relief.

3.5 HMRC could provide risk registers for some of the case study reliefs. Patent box had a dedicated risk register. Risks in relation to agricultural property relief and business property relief featured prominently in the risk registers for their tax streams. Risks spanning all zero-rated VAT reliefs have been identified in the VAT risk register. The product plan for share loss relief also included 2 risks. The risk assessments were generally well developed.

Product owners have identified risks and mitigating actions

3.6 We asked product owners how they would assess the overall risk of the 10 case study reliefs. Of our sample, HMRC identified 2 reliefs as high/medium to high risk, 4 reliefs as medium risk and 4 as low or low to medium risk. Within the sample we found some correlation between the general level of oversight and product owners overall assessments of risk (**Figure 11**).

3.7 Product owners have identified specific actions to mitigate risks (**Figure 12** on page 38). Some actions are targeted towards the specific relief such as the patent box risk register. Others are wider actions such as the impact of a cap on income tax reliefs.

Predicting abuse is inherently difficult so strong oversight of new reliefs is needed

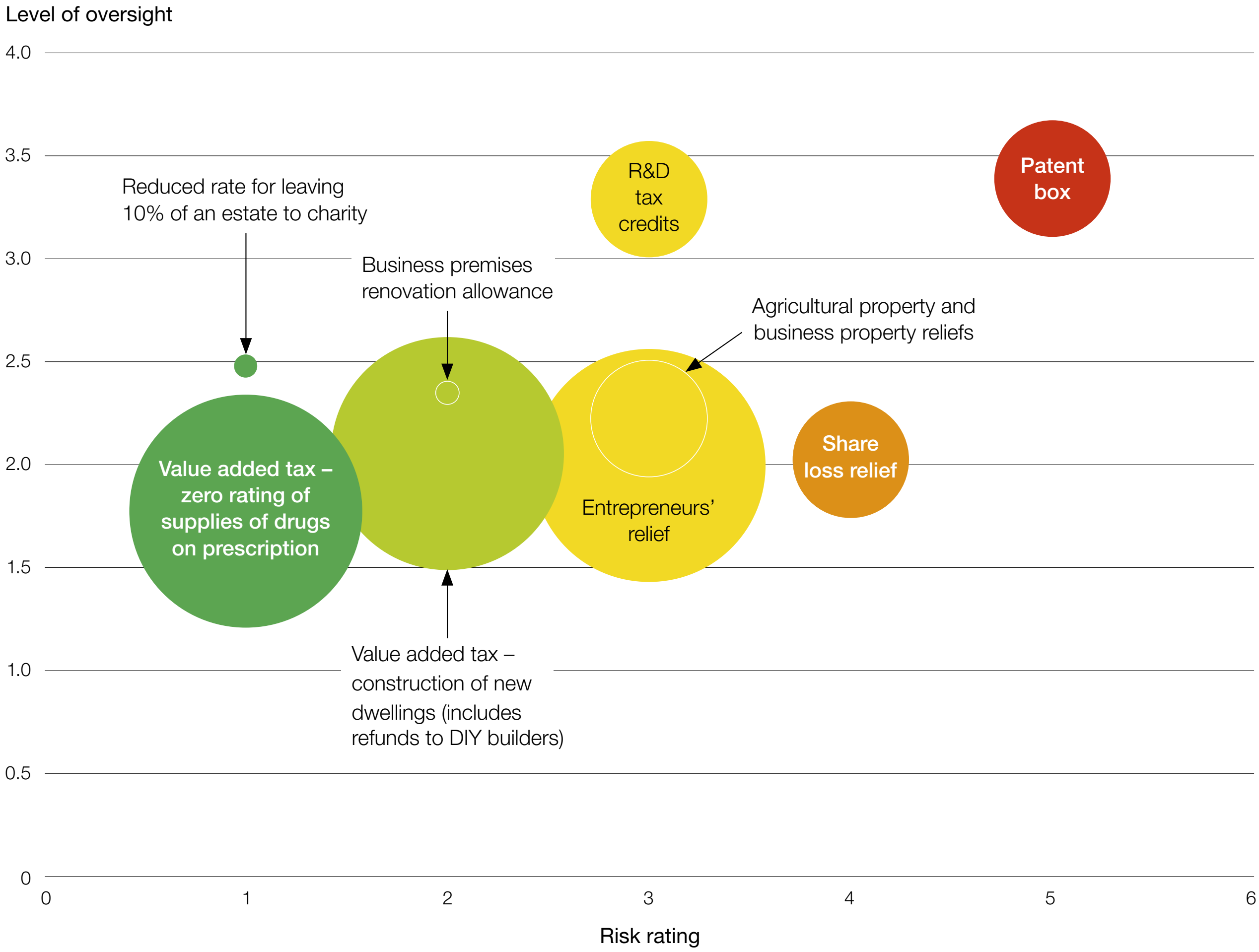
3.8 Introducing new tax reliefs includes consultation to understand how the relief will be used and whether it is designed appropriately. Taxpayers may not file returns until 2 years after a new relief is introduced. HMRC's administrative response has to be revised and adapted as it gets more taxpayer data. Within our sample we found generally higher levels of oversight for new tax reliefs (**Figure 13** on page 39).

3.9 The unit administering patent box is developing new techniques to monitor risk. This includes a risk taskforce to check whether new claims are in the spirit of legislation (**Figure 14** on page 40). HMRC has put in place a range of other measures including initial discussions with taxpayers about using the relief. It will also use longitudinal surveys to monitor take-up. The measures should help HMRC respond quickly to deviations in use.

3.10 We assessed oversight of the relief to reduce inheritance tax for charity donations at a lower level than for patent box. HMRC must decide where to focus its efforts and deploy resources. It concluded that the likelihood of abuse is low. This was based on feedback received during the consultation process and the level of regulation of charities. In implementing the relief, HMRC will still use some of the techniques it used for patent box. These include talking to taxpayers and agents about using the relief and monitoring outcomes through annual statistics. It has revised down its expectations of take-up following initial consultation.

Figure 11
Level of oversight versus HMRC's assessment of risk

Levels of oversight show some correlation with HMRC's assessments of risk



Notes

1 Colour code represents HMRC's risk rating.

2 The level of oversight is an average overall score based on questionnaire responses, interviews and documentary evidence.

3 The size of bubbles indicates the cost of the relief. The large bubbles indicate tax reliefs > £2 billion, medium > £50 million and < £2 billion, small < £50 million. The forecast cost figures for 2013-14 are used for reduced rate inheritance tax and patent box.

4 There is a moderate correlation (0.5) between level of oversight and risk rating.

Source: National Audit Office analysis of HM Revenue & Customs' questionnaires responses. Additional information on our methodology can be found in Appendix Two, and supporting analysis in Appendix Four (available online)

Figure 12

Areas of risk identified by HMRC

Areas of risk identified by HMRC		Case studies identifying risk	Examples of mitigating actions
Conflicting legislation	EU state aid rules	Patent box Business premises renovation allowance (BPRA)	Monitor developments and offer advice where appropriate – the BPRA team sought legislative change to ensure claimants cannot benefit more than once from state aid.
Unclear Guidance	Poorly drafted guidance resulting in computational errors or eligibility errors	Patent box Agricultural property and business property	Analysis of claims for areas of misunderstanding – A Risk Taskforce Team is undertaking detailed analysis of all patent box tax returns to identify where mistakes are made and to clarify guidance accordingly. Market Research – The patent box team is using the Large Business Survey to get an early indication of who is using the relief. Review of inheritance tax online guidance and notes – in response to new risks.
Assessment of complex rules	Insufficient staff numbers or expertise	R&D tax credits Patent box	Dedicated specialists – The patent box and R&D tax credits team includes specialists who advise on technical issues such as software development and transfer pricing.
Differences in interpreting legislation	Boundary pushing	BPRA Inheritance tax reliefs R&D tax credits VAT reliefs	Consultation and technical review – by the BPRA team to understand specific risks in relation to boundary pushing. Revised legislation – the scope of BPRA was clarified in the Finance Act 2014 to ensure the relief only applies to building costs and is not available when a project gets other forms of state aid. Litigation – The inheritance tax team monitor emerging issues and target litigation at new areas of difference to establish legal precedents.
Claims errors	New claims Computational errors Eligibility errors Insufficient documentation	Share loss relief Entrepreneurs' relief Agricultural property and business property VAT relief on DIY construction schemes Reduced rate for leaving 10% of an estate to charity	Compliance activity – includes check on whether Entrepreneurs' relief applications exceed the lifetime limit. Tools on the website to help claimants – an online calculator works out if an estate qualifies for the reduced rate of inheritance tax.
Avoidance activity		Share loss relief	Compliance activity – The share loss relief team identified 20 undisclosed schemes using risk assessment techniques to identify claims for further investigation.

Note

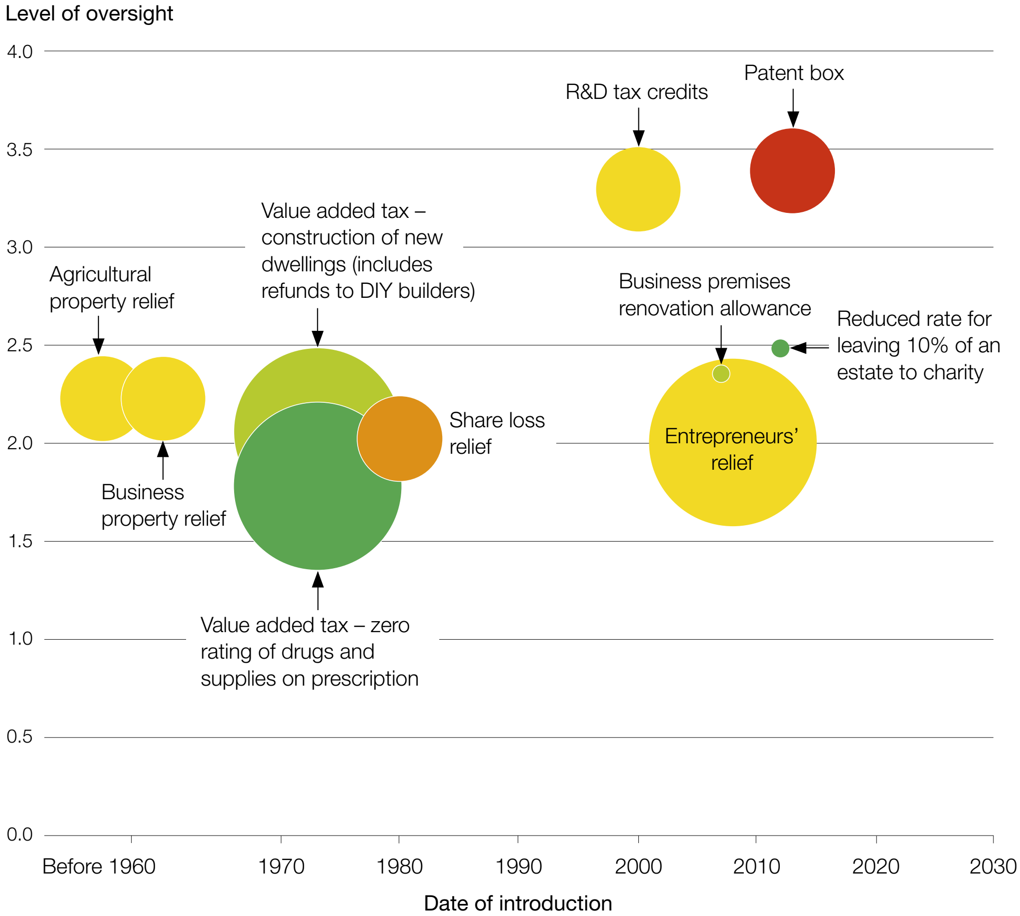
1 The examples here are not an exhaustive list. For example we have not included a wide range of compliance and avoidance measures where publication of their existence might prejudice how taxpayers interact with the tax system.

Source: National Audit Office

Figure 13

Age of tax relief versus level of oversight

Levels of oversight tended to be higher for new tax expenditures



Notes

1 The level of oversight is an average overall score based on questionnaire responses, interviews and documentary evidence.

2 The size of bubble is dependent on the cost of relief – the large bubbles are for tax expenditures > £2 billion, medium > £50 million and < £2 billion, small < £50 million. The forecast cost figures for 2013-14 are used for reduced rate inheritance tax and patent box.

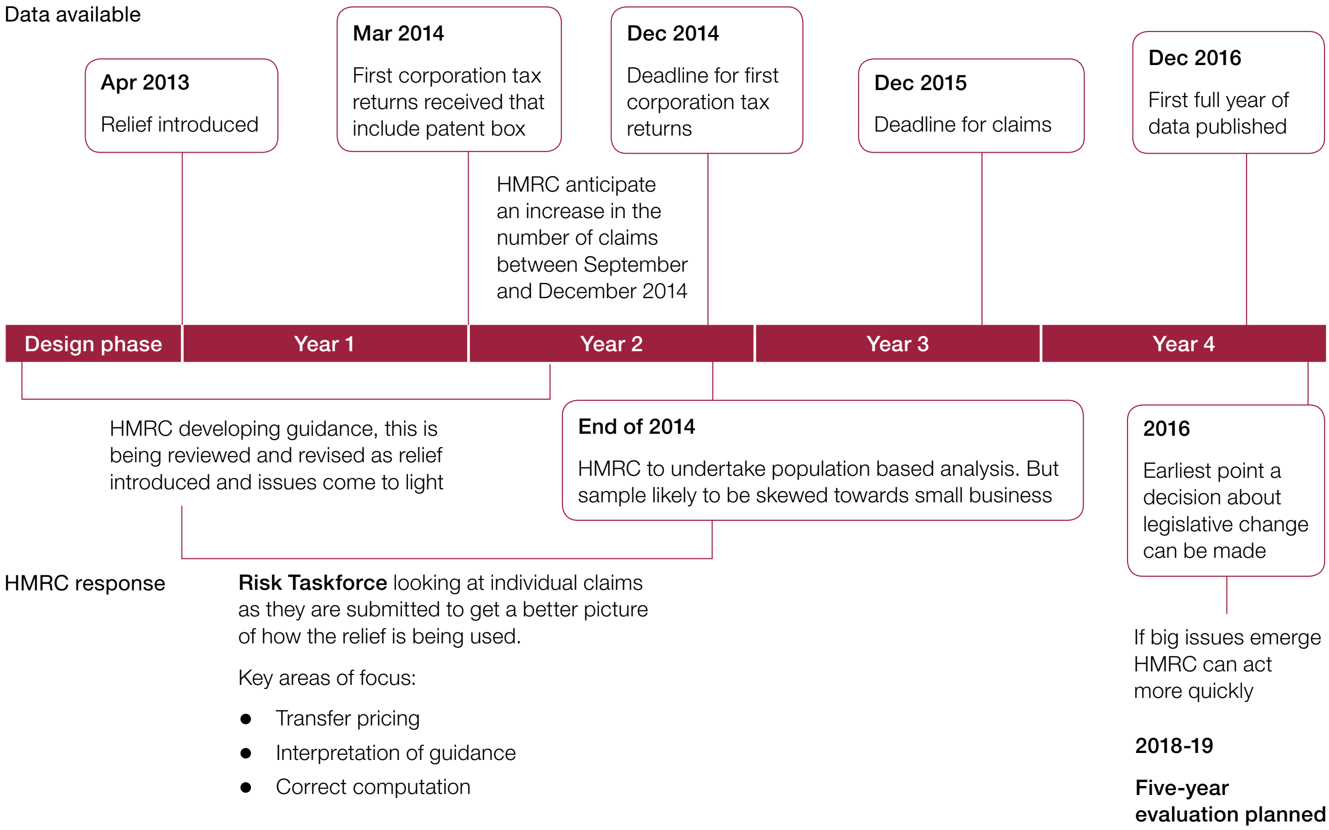
3 Colour code represents HMRC's risk rating.

Source: National Audit Office analysis of HM Revenue & Customs' questionnaires responses. Additional information on our methodology can be found in Appendix Two, and supporting analysis in Appendix Four (available online)

Figure 14

Patent box approach to managing risk

Patent box is deploying new techniques to manage risk



Source: National Audit Office analysis

HMRC requires risks of more than £250 million to be escalated but does not estimate the tax at risk for particular tax reliefs

3.11 HMRC has ways of targeting resources according to risk. Product owners should escalate risks of more than £250 million to the relevant parts of HMRC, as well as significant social or reputational risks.

3.12 HMRC does not normally measure the value of tax at risk for a tax relief so making judgements about whether to escalate risks is more difficult. Only 2 of 8 established tax reliefs in our sample – share loss relief and business premises renovation allowance – had estimates of tax at risk. HMRC also tracked the value of tax at risk for particular litigation cases of agricultural and business property reliefs but not in aggregate.

3.13 Of our sample, 4 tax reliefs (Entrepreneurs' relief, share loss relief, and zero-rated VAT on construction and drugs and supplies on prescription) showed variation in cost estimates of more than £250 million in any one year. In the case of share loss relief, abuse was identified and escalated in accordance with avoidance governance processes. In the other 3 cases there had been little investigation of the reasons for the movements. HMRC considers the 2 VAT reliefs to be low/medium risk. The estimated cost of Entrepreneurs' relief has rarely been within £250 million of policy forecasts. HMRC's risk management approach is based instead on assessing the tax at risk for individual customers. High net worth individuals are frequently checked and HMRC uses risk profiling for other customers. Compliance reviews for the latest year of Entrepreneurs' relief show a yield of £4 million out of £20 million investigated, or 20%. HMRC has a project under way to refine its risk profiling to take into account the characteristics of cases resulting in tax yield.

3.14 Product owners can commission HMRC's Risk and Intelligence Service (RIS) to do specific work for them when there is significant compliance risk, social impact or reputational impact (paragraph 1.13). They work with RIS to identify risk indicators in tax returns. The main data system used to identify risk is the CONNECT system. CONNECT combines information from over 75 data sources and analyses over 1 billion pieces of data to identify high-risk returns. The returns are rated using specific rules such as ratio rules to identify returns that require closer examination.

3.15 Product owners discuss which risks require further escalation in monthly management meetings for individual tax streams. We saw evidence that avoidance schemes using share loss relief were escalated through this process. HMRC has not been able to identify specific examples for the other case studies.

The speed of response to suspected abuse varies

3.16 The speed of recognising and responding to abuse of reliefs is critical to minimise tax lost through avoidance schemes. The risk of abuse of a relief can fluctuate during its lifetime. This means HMRC must monitor it continuously so it can respond quickly and minimise tax losses. HMRC established the 'Managing Avoidance Risk' governance process to help deal with avoidance risks quickly and consistently following their identification.

3.17 Three of the tax expenditures we examined have had disclosures of tax avoidance schemes (DOTAS). DOTAS give HMRC advanced warning of avoidance schemes that will be used in future years. There are limitations about how this information can be used, as the disclosure only gives high-level detail of the proposed schemes. It does not indicate the number of users or the scale of tax at stake.

3.18 We looked in more detail at the speed of response to avoidance for 3 case examples (**Figure 15** overleaf). In most instances the trigger for action was a DOTAS disclosure, rather than a change in cost. DOTAS is often the first indicator of a mass-marketed tax avoidance scheme. The types of response varied depending on the nature of the activity under suspicion.

Figure 15

Speed of response to avoidance schemes for 3 reliefs

The speed of response to suspected abuse varies between reliefs

Business premises renovation allowance

2007: relief introduced

Y1 to Y4	**Y5 (2011-12): costs surge**	Y6	Y7: complete returns data available; surge in costs identified	Y8: legislation revised

Response: less than 1 year

Y7 (July 2013) HMRC responses:

- Spotlight article
- Technical note published
- Written ministerial statement

HMRC expect these responses to have significantly reduced avoidance

Share loss relief

1980: relief introduced

2013 – cost surge in 2006-07 identified

Y1 to Y25	Y26: marketed avoidance activity began	**Y27: costs surge, 80% of claims brought under investigation**	Y28 to Y32	Y33: surge in costs identified	Y33 to Y35

Response: challenge of 24 schemes

HMRC responses:

- For 2 categories of scheme (total 2 schemes) HMRC opened all enquiry cases within a year of the return filing dates. Cases opened during Y28 (2007-08) and Y29 (2008-09) respectively
- Spotlight article published Y32 (November 2012)

HMRC are currently investigating 60% of claims by value for suspected avoidance but expect this figure to reduce following the introduction of the limit on income tax reliefs

Entrepreneurs' relief

2008: relief introduced

Y1	Y2: 3 DOTAS disclosures (2 of the same generic scheme)	**Y3: costs surge. DOTAS disclosures received but not considered sufficiently significant**	Y4 to Y7: Costs continue to rise. HMRC has risk assessed claims and carried out checks on individual claims it considers to be high risk

Response: HMRC have not undertaken formal analysis to identify the reason for rising costs

3 DOTAS disclosures, two of the same generic scheme, with 10 associated users being reported between Y2 and present

Scheme selected for the managing avoidance risk pilot in 2011

2014: Project underway to update risk profiling of claims

Source: National Audit Office analysis

Example (1) Business premises renovation allowance

3.19 HMRC responded quickly to suspected abuse of business premises renovation allowance (BPRA). In 2010-11, it acted immediately to prevent refunds of claims which appeared excessive. In the following accounting period it received high numbers of DOTAS declarations on BPRA. The response was a two-pronged approach; with an upstream response, involving a technical note, spotlight and legislative change, together with a downstream response, involving dedicated BPRA resources within counter-avoidance teams and withholding repayments. HMRC made these responses before receiving data on costs for BPRA. Tax return data for 2011-12 (available from July 2013) showed costs were 3 times the levels expected. This confirmed the scale of the avoidance risk identified from the DOTAS disclosures. HMRC will gauge its success in counter-avoidance if the number of DOTAS declarations falls by March 2015.

Example (2) Share loss relief

3.20 As much as 60% of share loss relief could be avoidance activity but HMRC has not pursued any specific changes to the relief. While there have been no legislative changes to the relief, HMRC is challenging 4 schemes identified under DOTAS and 20 from its own investigations. The total value of these claims is £1,979 million in share loss relief claimed between 2005 and 2012.[4] HMRC was not in a position to estimate the proportion of the relief which represented avoidance until 2013 when it looked at the total cost from tax returns as part of a one-off cost exercise.

3.21 HMRC published a warning to taxpayers about marketed avoidance schemes using share loss relief in November 2012 following a period of in-depth investigation. It told us it acts quickly to prevent repayments and to collect disputed tax but does not have data on how much tax under investigation is unpaid. Investigations can be slow and difficult if taxpayers do not cooperate. Avoidance schemes may only provide paper documentation to delay analysis and in some cases up to 2 million documents may be provided.

3.22 In 2013, the relief was included within a general cap on income tax reliefs. The cap is a wider measure to promote fairness among taxpayers and is not a specific reaction to limit risk for share loss relief. HMRC expects the cap will curb some avoidance but it will not prevent avoidance outright. Individuals can claim annual relief up to £50,000 or 25% of their annual income (if higher). They can deem shares to be of negligible value without a sale, effectively allowing some discretion about when the loss is realised.

4 This number is presented in nominal terms, we are unable to present this in real terms because time series data is not available. HMRC estimates the total tax at risk is £780 million in nominal terms.

Example (3) Entrepreneurs' relief

3.23 Entrepreneurs' relief has seen costs rise significantly over its lifetime. HMRC received DOTAS disclosures in 2010 circumventing eligibility limits. HMRC and HM Treasury reviewed the new scheme to consider the scale of risk and to inform policy development. No changes have been made or announced. HMRC has not monitored the scale of use of these arrangements or how much tax is at risk. In September 2014, HMRC found that there had been 10 uses of the disclosed scheme between 2010 and 2013. Complete data on the cost of the schemes is not available because the disposal of shares may not occur for many years.

Part Four

Optimising the administration of tax reliefs

4.1 In June 2014, the Committee of Public Accounts suggested the Departments set out clear proposals to improve the management and accountability to Parliament of the cost and performance of tax reliefs. It recommended in particular that reliefs with social and economic objectives (often described as 'tax expenditures') should be subject to more robust monitoring and oversight.

In this part of the report we consider:

- whether HMRC has a framework and guidance to govern administration of reliefs;
- whether there is a consistent and coordinated approach;
- how administration and reporting compare with other countries; and
- if it is useful and feasible to identify tax reliefs according to their type or objectives.

HMRC has no framework or guidance setting out how to administer tax reliefs

4.2 Tax reliefs differ in design, method of delivery, target population and risks of abuse, so we would expect to see a differentiated approach. HMRC does not maintain a database of tax reliefs and has not sought to categorise tax reliefs according to objective, the level of complexity or administrative challenge.

4.3 In responding to the Committee of Public Accounts, the departments rejected the proposition that any tax relief should be subject to similar management and accountability arrangements as those in place for public spending. Tax reliefs can pose different challenges for government. For example revenue is foregone, rather than spent, and costs can rise unabated because there are no budgetary limits. The costs of tax reliefs are not subject to annual challenge and there are no end or review dates. Strong monitoring and evaluation is needed because changes in how taxpayers use reliefs may not be immediately apparent.

4.4 The departments have not proposed an alternative framework by which they should be held to account for administering reliefs. HMRC and HM Treasury accept they have responsibility for evaluating whether tax reliefs are achieving their aims but do not track these objectives. They also accept they have responsibility to assess the costs and benefits of reliefs but do not systematically evaluate the performance of tax reliefs or draw comparisons between them.

HMRC has not categorised reliefs to identify what monitoring is appropriate

4.5 HMRC has identified six categories of relief by objective.[5] It has not assigned tax reliefs to its categories because it considers the exercise to be unfeasible and it does not consider that the categories imply a differentiated approach.

4.6 HMRC has therefore not identified which reliefs require most monitoring. It has identified 46 high-value 'tax expenditures' on its website but this is for transparency purposes and it does not consider the concept has any administrative implications.

4.7 We see common attributes among reliefs with social or economic objectives that suggest there would be synergies in considering them as a group. The key distinguishing feature of this category is that the purpose of the relief is to encourage or support an activity or behaviour which is conducive to an economic or social objective. They therefore seek to achieve an additional value to society by providing differential treatment to particular taxpayers based on their characteristics or actions. The administrative implications include:

- reviewing the relevance of social or economic objectives following changes in government policy;
- providing guidance to product owners on how objectives should be monitored or evaluated;
- systematically evaluating whether the intended impacts are being achieved and what they cost;
- considering whether a relief is being used in the ways intended by Parliament; and
- providing feedback to Parliament on the exchequer impact.

5 The categories are: reliefs to correctly measure income or profit, reliefs to ensure the scope of tax is as intended, reliefs to improve the progressivity of tax, reliefs to create simplicity, reliefs introduced by international agreements and reliefs to provide incentives for behaviour conducive to social or economic objectives (sometimes known as 'tax expenditures').

Administration of reliefs with social or economic objectives is a large task potentially involving many different government objectives and customer groups

4.8 Our analysis indicates that half the tax reliefs listed on HMRC's website are tax reliefs with social or economic objectives to support particular groups or activities. Using a definition developed by the Tax Administration Research Centre (TARC) we identified 196 tax reliefs.[6] The list is not complete. For example it excludes new tax reliefs not yet listed on HMRC's website such as the patent box. The total number of tax reliefs with social or economic objectives targeted at groups or activities may be significantly higher. The Office of Tax Simplification (OTS) has identified 1,140 reliefs of which around 500 are targeted at certain activities or aimed at special groups.[7]

4.9 HMRC could play an important role through more active administration of reliefs with social or economic objectives, for example in supporting industry and redistributing benefits across society. For example engagement with other departments may be needed because these reliefs cut across many areas of government policy. **Figure 16** on pages 48 and 49 illustrates how this type of tax relief could be categorised. Some reliefs seek to establish a financial incentive to encourage a particular type of behaviour such as encouraging saving and pensions, charitable giving, support with childcare and greener energy. Others simply provide financial support to particular groups, for example by exempting some welfare benefits from income tax. HM Treasury told us that it engages closely with HMRC to identify how the tax system helps meet social or economic objectives. However, it does not believe that tax reliefs should be considered in isolation from the contribution of the wider tax system towards these overall social and economic objectives.

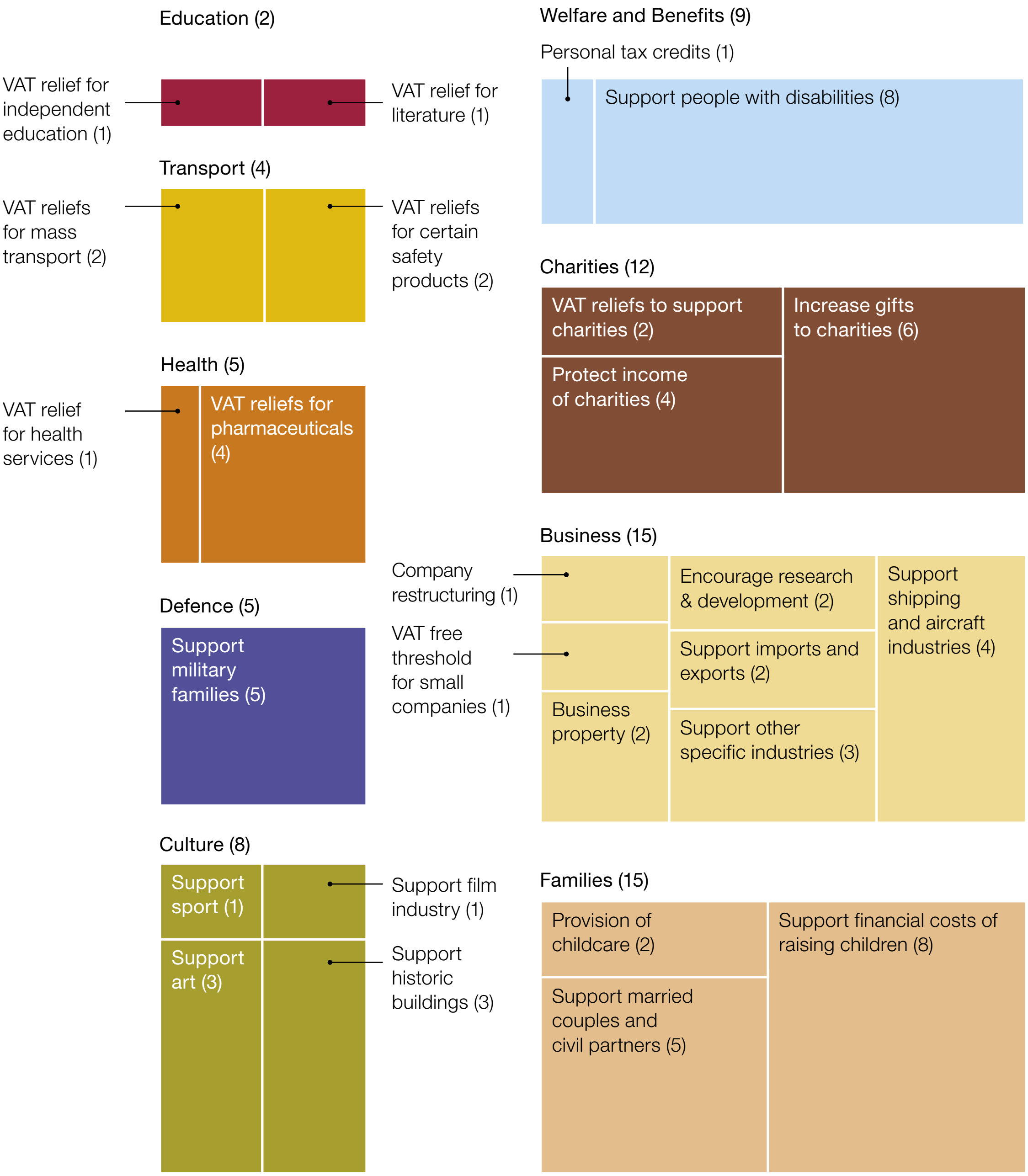
6 The definition is based on 5 characteristics: motivated by social or economic policy, reduces or defers potential revenue, provides a benefit to qualifying taxpayers or encourages an identified activity, potentially replaceable – can be replaced by a direct expenditure programme, conditional on characteristic or action.

7 Office of Tax Simplification, *Tax Reliefs Review*, March 2011. www.gov.uk/government/publications/tax-reliefs-review. The review identified 1,042 reliefs; the OTS updated its list earlier this year and now puts the total at 1,140.

Figure 16

Number of tax reliefs with social or economic objectives grouped by objective

Tax reliefs support a wide range of policies

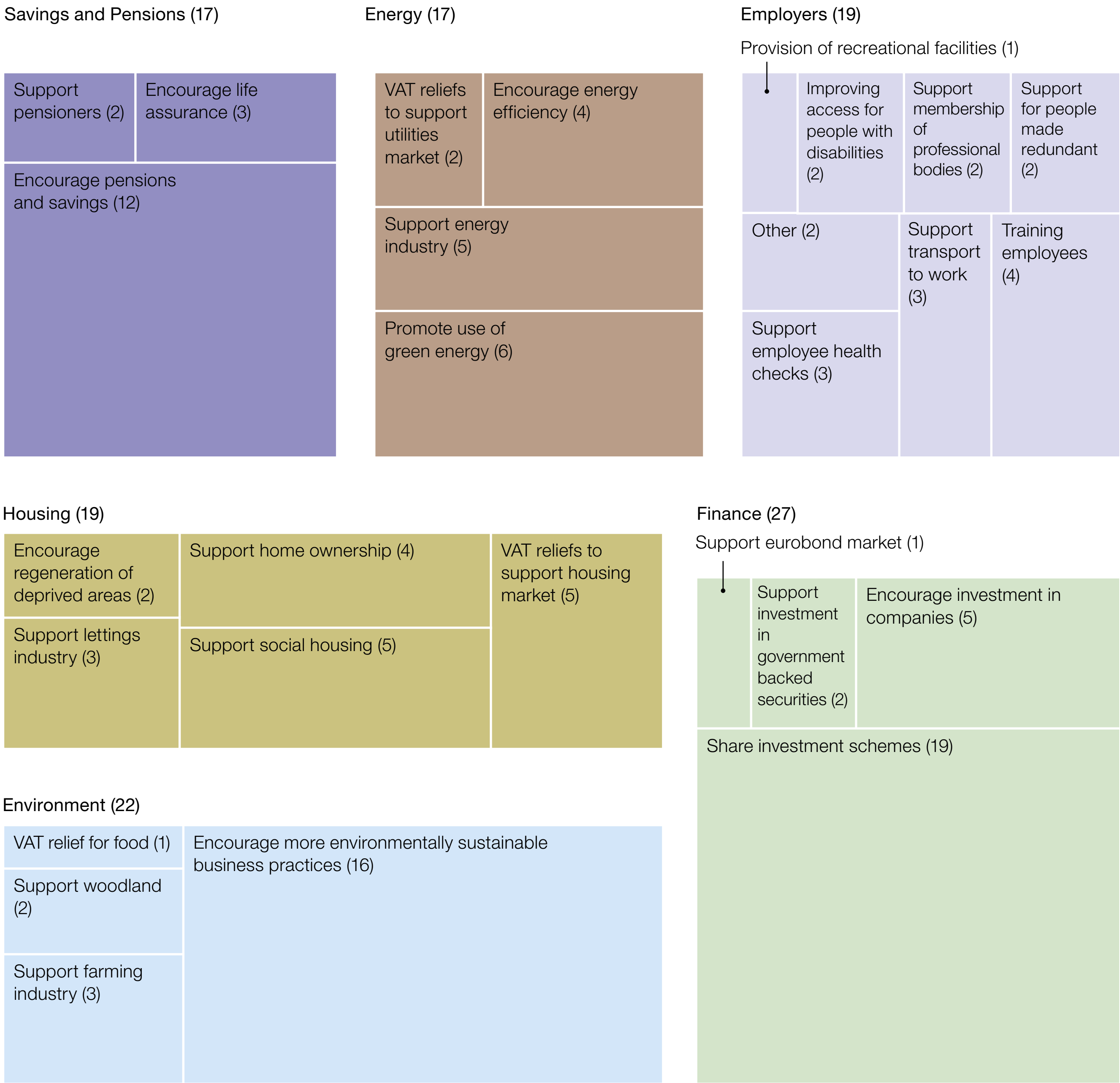


Notes

1 Patent box is new and not included here.

2 We identified 196 tax expenditures from 398 listed on HMRC's website. HMRC has not categorised any tax reliefs by objective and does not maintain a list of objectives for all reliefs. The categorisation is therefore a subjective exercise based on possible objectives we identified for the reliefs. We present it as an illustration of how reliefs could be categorised.

Source: National Audit Office analysis

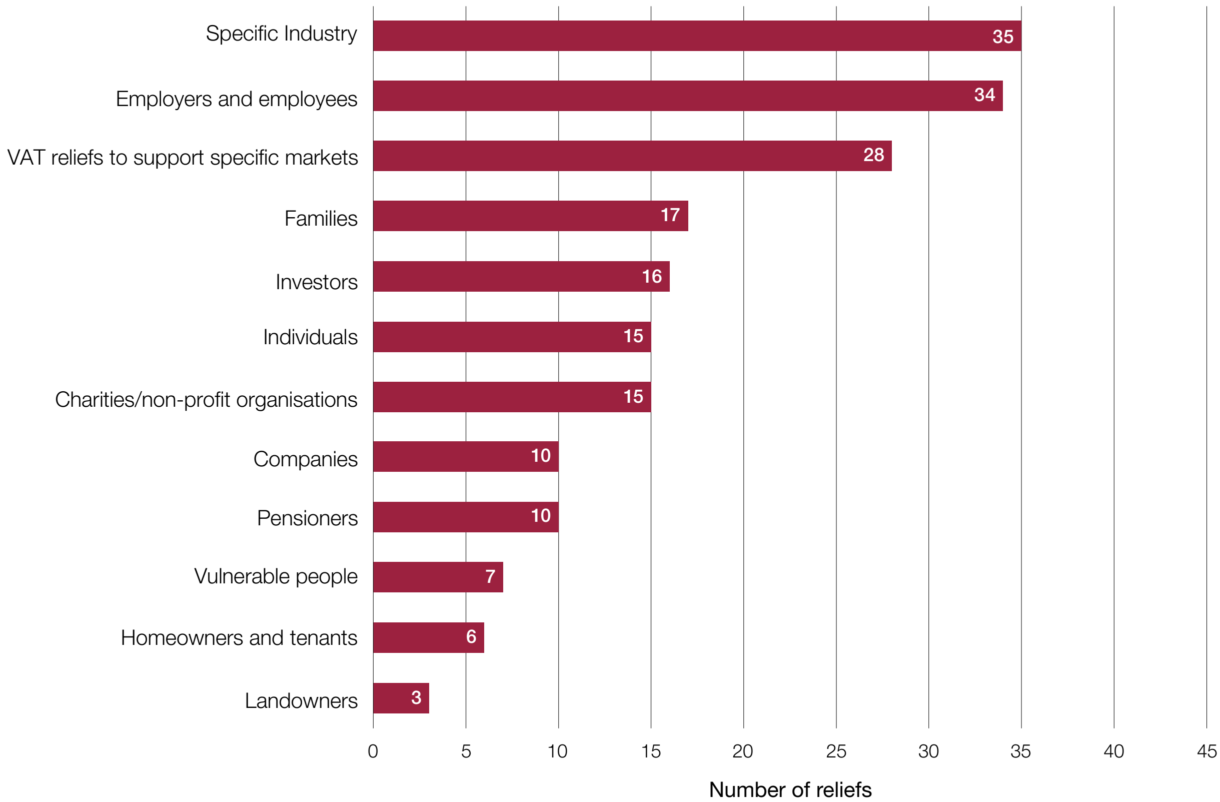

Savings and Pensions (17)
Support pensioners (2)
Encourage life assurance (3)
Encourage pensions and savings (12)
Energy (17)
VAT reliefs to support utilities market (2)
Encourage energy efficiency (4)
Support energy industry (5)
Promote use of green energy (6)
Employers (19)
Provision of recreational facilities (1)
Improving access for people with disabilities (2)
Support membership of professional bodies (2)
Support for people made redundant (2)
Other (2)
Support transport to work (3)
Training employees (4)
Support employee health checks (3)
Housing (19)
Encourage regeneration of deprived areas (2)
Support home ownership (4)
VAT reliefs to support housing market (5)
Support lettings industry (3)
Support social housing (5)
Finance (27)
Support eurobond market (1)
Support investment in government backed securities (2)
Encourage investment in companies (5)
Share investment schemes (19)
Environment (22)
VAT relief for food (1)
Encourage more environmentally sustainable business practices (16)
Support woodland (2)
Support farming industry (3)

4.10 Tax reliefs support many sectors of society and understanding who uses reliefs is important for HMRC to offer sufficient and proportionate levels of service, depending on the needs of particular types of customer. **Figure 17** illustrates the range of groups targeted by the reliefs we identified with social or economic objectives. Many have the direct effect of helping businesses or their owners, and are intended to encourage enterprise. The groups most frequently targeted were specific industries, such as the housing or farming industry, and reliefs to support employers and employees. We found more reliefs with social or economic objectives for individuals than for companies, and almost as many reliefs for charities as for investors.

Figure 17

Number of tax reliefs with social or economic objectives targeted at particular groups

Tax reliefs benefit many parts of society



Note

1 Patent box not included.

Source: National Audit Office analysis

Reliefs with behavioural objectives can be particularly challenging to monitor

4.11 Evaluating whether a relief is achieving its objectives can be particularly challenging for tax reliefs seeking to bring about a behavioural change. **Figure 18** overleaf provides a breakdown of tax reliefs with social or economic objectives between those which are behavioural and those which seek only to provide a reduction in tax to particular groups (described below as subsidies). The assessment is subjective because HMRC has not kept a record of the objectives of each relief. We have categorised some tax reliefs as possibly behavioural where the intention appears to be to provide support for existing behaviour, but where the existence of the tax relief may also encourage some taxpayers to change their behaviour.

4.12 Our analysis found that the costs of reliefs were more often known for reliefs providing subsidies than for behavioural reliefs, indicates HMRC could improve its understanding of the cost and impact of behavioural tax reliefs. Costs are estimated for 83% of reliefs that we identified as subsidies and 63% of behavioural reliefs (**Figure 19** on page 53). The least costed category was the 'possibly behavioural' group with only 29% of costs estimated. Without cost data it is difficult for HMRC to assess the impact of these reliefs.

We found examples of good practice but also inconsistency in the way HMRC administers behavioural reliefs

4.13 Most of the 10 case study reliefs we selected have behavioural objectives and we identified inconsistency in approaches used in administration (**Figure 20** on page 54). We found examples of good practice for all reliefs but these were not widely applied.

4.14 HMRC has created separate units to administer some corporation tax reliefs in technically challenging or niche areas when it considers this the most effective way to manage the relief. In 2006, HMRC established 7 regional units to administer R&D tax credits, responding to concerns that practices were inconsistent and the relief was not utilised as far as possible. Patent box specialists have now been included in the existing R&D units to administer the new regime. It has also established specialist units for the creative industry reliefs (film tax, high-end TV, video games and animation) and share incentive schemes.

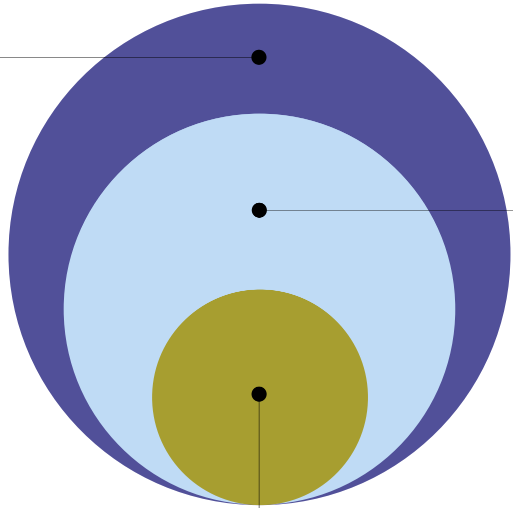
4.15 The specialist units administering R&D tax credits and patent box exhibited most good practice. The units demonstrated a strong culture to help taxpayers use the reliefs and attended roadshows to promote their use to target groups. We also found that R&D was the only relief to be regularly evaluated.

4.16 Product and process owners cannot draw on a central repository of good practice or lessons learned. **Figure 21** on page 55 provides examples of the good practice we observed for each relief. Appendix Four (available online) provides details of costs, benefits, risks and administrative approaches for each case study.

Figure 18

Tax reliefs which seek to influence behaviour

Different characteristics will affect the administration of tax expenditures



78 subsidies

These are tax expenditures which seek only to provide a reduction in tax to particular groups based on their characteristics.

Examples include:

- £10 Christmas bonus for pensioners;
- Age-related personal allowances;
- blind person's allowance;
- exemption of gains arising on disposal of only or main residence;
- married couple's allowance;
- reduced rate of VAT, eg children's car seats, domestic fuel and power; and
- VAT exemptions, eg education, health services, postal services.

70 possibly behavioural

These are tax expenditures where the intention appears to be to provide support for existing behaviour, but which may also encourage some taxpayers to change their behaviour.

Examples include:

- reliefs relating to aggregates levy;
- incentives to encourange employers to improve working conditions;
- agricultural property relief;
- business property relief; and
- cycles and cycle safety equipment.

43 behavioural

These are tax expenditures which seek to bring about behavioural change.

Examples include:

- incentives for saving and pensions;
- incentives to donate to charity; and
- support to specific industries, eg film tax reliefs, R&D tax credits.

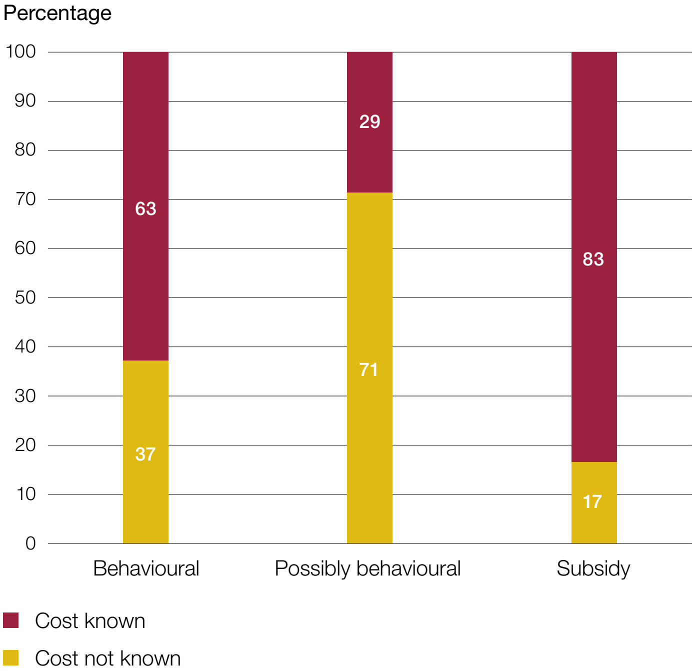
Notes

1 This is an NAO categorisation, it is not the opinion of HM Revenue & Customs

2 We have been unable to categorise 5 tax expenditures.

Source: National Audit Office analysis

Figure 19
Availability of cost data varies across the different groups of reliefs



Source: National Audit Office analysis

Figure 20

Good practice and areas for improvement

Specialist units administering R&D tax credits and patent box displayed most good practice

Case Study	Governance, accountability and reporting of tax expenditures	Design and options appraisal process	Implementation	Administration	Monitoring	Review	Average
Patent box	🟡	🟢	🟢	🟡	🟢	Not applicable	🟡
Reduced rate for leaving 10% of an estate to charity	🟡	🟡	🟡	🟡	🟠	Not applicable	🟡
Entrepreneurs' relief	🟡	🟠	🟠	🟠	🟠	🟠	🟠
Business premises renovation allowance	🟡	🟠	🟠	🟠	🟡	🟠	🟠
Research & Development tax credits	🟢	🟢	🟡	🟡	🟡	🟡	🟡
Value Added Tax – zero rating of drugs and supplies on prescription	🟡	No information	🔴	🟡	🟠	🔴	🟠
Share loss relief	🟡	No information	No information	🟡	🟠	🟠	🟠
Value Added Tax – construction of new dwellings (includes refunds to DIY builders)	🟡	No information	🔴	🟠	🟠	🟡	🟠
Agricultural property relief and business property relief	🟡	No information	🟠	🟡	🟠	🟠	🟠
Average	🟡	🟡	🟠	🟡	🟠	🟠	

🔴 No evidence of detailed understanding (score of 1)

🟠 Partially demonstrated (score of 2)

🟡 Practice demonstrated (score of 3)

🟢 Good practice (score of 4)

Notes

1 Scores represent an average for each area. Elements of good practice may be present in areas rated lower than 'good practice'

2 'No information' due to the age of the relief. It is not possible to provide information on the process for the design of the relief or the initial implementation.

Source: National Audit Office analysis of HM Revenue & Customs' questionnaires responses. Additional information on our methodology can be found in Appendix Two, and supporting analysis in Appendix Four (available online)

Figure 21
Examples of good practice

All case study reliefs demonstrated some good practice

Relief	Good practice
1 Patent box	engagement with stakeholders, including roadshows to publicise and explain the relief up-front discussions with taxpayers to help get claims right first time risk taskforce assesses all new claims for risk and specialists investigate claims post-implementation evaluation scheduled after 5 years
2 Reduced rate for leaving 10% of an estate to charity	cost forecasts include an estimate of the dead-weight loss online calculator to help individuals check if they qualify for the relief sharing of information within HMRC between the charities team, shares and assets valuation team and the Valuation Office Agency
3 Business premises renovation allowance	monitoring of DOTAS declarations to identify abuse prompt legislative response when avoidance activity was identified – HMRC now pays claims only where there is no disagreement dedicated avoidance team
4 Entrepreneurs' relief	publishes statistics about the number and size of claims annually initial analysis to evaluate the impact of the relief including analysis by age group of claimants survey of 50 claimants under way to understand awareness and behaviour of those claiming the relief
5 Research & Development tax credits	consultative committee with company and sector representatives up-front discussions with taxpayers to help get claims right first time governance committee oversees consistent application of the rules, particularly for transfer pricing monthly unit meetings to discuss national approach and emerging issues annual report on the number and size of claims periodic evaluations
6 VAT – zero rating of supplies of drugs on prescription **7** VAT – construction of new dwellings (includes refunds to DIY builders)	DIY unit maintain annual figures on the number, cost and success of claims well-developed risk register
8 Share loss relief	'Spotlight' published to deter taxpayers from using avoidance schemes with flawed methods identified 20 undisclosed tax avoidance schemes by using risk assessment techniques
9 Business property relief	well-developed risk register
10 Agricultural property relief	clear litigation strategy for challenging claims where there may be boundary pushing or avoidance activity

Source: National Audit Office analysis

Other countries have seen benefits in monitoring certain types of tax reliefs

4.17 Many OECD countries have identified groups of reliefs to focus on. Frequently these are reliefs with social or economic objectives. They are commonly referred to as ‘tax expenditures’, although definitions vary between countries.

4.18 In 2004, the UK participated in an OECD project to establish best practice guidelines for ‘off-budget and tax expenditures’ to ensure a ‘proper functioning budget’. The OECD determined that 4 functions were needed:

- the authorisation function: that all money spent from the public treasury be subject to legislative authorisation;
- the allocative/distributive function: that the budgetary authorities (executive and legislative branches) be able to compare and trade off all changes in expenditures and revenues;
- the macro-economic function: that the budgetary authorities (executive and legislative branches) be able to decide on the impact upon the economy of totals and composition of expenditure, revenues and the deficit; and
- the administrative function: that the budgetary authorities (executive and legislative branches) be able to control the cost efficiency of all public service delivery.

4.19 The OECD concluded that for both the allocative/distributive and administrative function of the budget, it is important that tax expenditures are reviewed in the same way as regular expenditures.

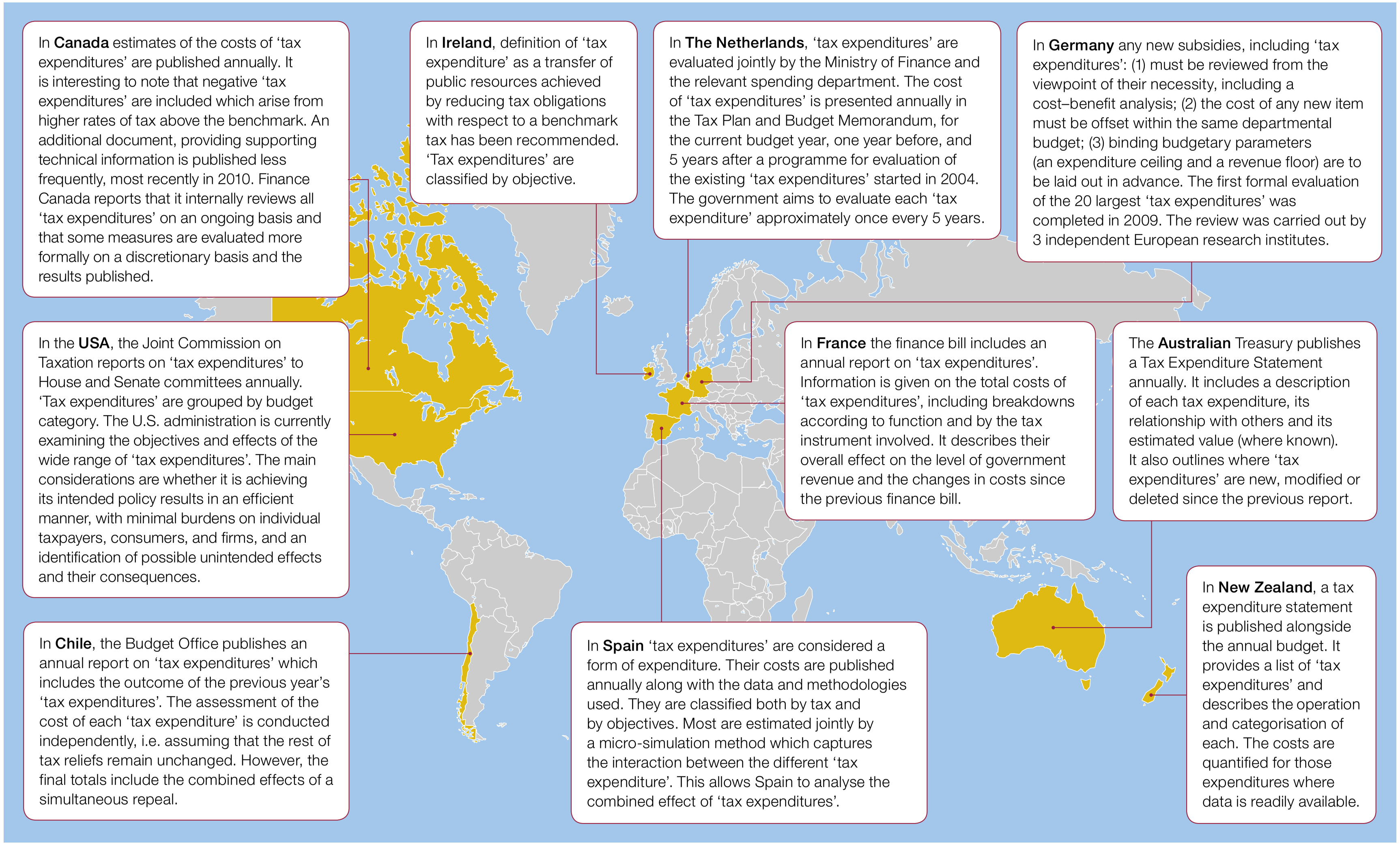
4.20 Many countries are considering how best to oversee tax expenditures and are experimenting with ways of administering them. We commissioned the Tax Administration Research Centre to compare administration of tax expenditures in 10 countries (**Figure 22**). It found a variety of approaches. Appendix Five (available online) contains a more detailed summary of the findings.

4.21 Practices in the UK are consistent with some practices commonly used in other countries. The UK is one of only a handful of countries to publish cost data for more than 100 tax reliefs and to use caps to limit use of some tax reliefs. The budgeting and review processes of other countries tend to be more sophisticated and transparent. Most have more examples of innovative practices. The UK could adopt other practices including categorising tax reliefs by objective, greater transparency around budgeting and reporting, and clearer requirements for the scope, timing and number of evaluations.

Figure 22

Administrative practices in other countries

Examples of alternative approaches that could be adopted in the UK



In **Canada** estimates of the costs of 'tax expenditures' are published annually. It is interesting to note that negative 'tax expenditures' are included which arise from higher rates of tax above the benchmark. An additional document, providing supporting technical information is published less frequently, most recently in 2010. Finance Canada reports that it internally reviews all 'tax expenditures' on an ongoing basis and that some measures are evaluated more formally on a discretionary basis and the results published.

In **Ireland**, definition of 'tax expenditure' as a transfer of public resources achieved by reducing tax obligations with respect to a benchmark tax has been recommended. 'Tax expenditures' are classified by objective.

In **The Netherlands**, 'tax expenditures' are evaluated jointly by the Ministry of Finance and the relevant spending department. The cost of 'tax expenditures' is presented annually in the Tax Plan and Budget Memorandum, for the current budget year, one year before, and 5 years after a programme for evaluation of the existing 'tax expenditures' started in 2004. The government aims to evaluate each 'tax expenditure' approximately once every 5 years.

In **Germany** any new subsidies, including 'tax expenditures': (1) must be reviewed from the viewpoint of their necessity, including a cost–benefit analysis; (2) the cost of any new item must be offset within the same departmental budget; (3) binding budgetary parameters (an expenditure ceiling and a revenue floor) are to be laid out in advance. The first formal evaluation of the 20 largest 'tax expenditures' was completed in 2009. The review was carried out by 3 independent European research institutes.

In the **USA**, the Joint Commission on Taxation reports on 'tax expenditures' to House and Senate committees annually. 'Tax expenditures' are grouped by budget category. The U.S. administration is currently examining the objectives and effects of the wide range of 'tax expenditures'. The main considerations are whether it is achieving its intended policy results in an efficient manner, with minimal burdens on individual taxpayers, consumers, and firms, and an identification of possible unintended effects and their consequences.

In **France** the finance bill includes an annual report on 'tax expenditures'. Information is given on the total costs of 'tax expenditures', including breakdowns according to function and by the tax instrument involved. It describes their overall effect on the level of government revenue and the changes in costs since the previous finance bill.

The **Australian** Treasury publishes a Tax Expenditure Statement annually. It includes a description of each tax expenditure, its relationship with others and its estimated value (where known). It also outlines where 'tax expenditures' are new, modified or deleted since the previous report.

In **Chile**, the Budget Office publishes an annual report on 'tax expenditures' which includes the outcome of the previous year's 'tax expenditures'. The assessment of the cost of each 'tax expenditure' is conducted independently, i.e. assuming that the rest of tax reliefs remain unchanged. However, the final totals include the combined effects of a simultaneous repeal.

In **Spain** 'tax expenditures' are considered a form of expenditure. Their costs are published annually along with the data and methodologies used. They are classified both by tax and by objectives. Most are estimated jointly by a micro-simulation method which captures the interaction between the different 'tax expenditure'. This allows Spain to analyse the combined effect of 'tax expenditures'.

In **New Zealand**, a tax expenditure statement is published alongside the annual budget. It provides a list of 'tax expenditures' and describes the operation and categorisation of each. The costs are quantified for those expenditures where data is readily available.

Source: Tax Administration Research Centre

Appendix One

Our audit approach

1 This report follows on from *Tax Reliefs* our non-evaluative report about the wider landscape of tax reliefs.[8] In this report we have examined whether HM Revenue & Customs (HMRC) administers tax reliefs effectively and rigorously. We have focused on tax reliefs that target particular groups or activities towards social or economic objectives (we refer to these as reliefs with social or economic objectives through the report).

2 We have looked at 10 tax reliefs with economic or social objectives in detail to understand how competing issues affect the way HMRC administers individual tax reliefs. We have not assessed the value for money of any individual tax relief. We have considered whether:

- HMRC collects and uses enough information to monitor and give assurance on how tax reliefs are used;
- HMRC challenges and understands changes in the cost and use of tax reliefs, and in particular whether it has ruled out significant abuse; and
- HMRC has responded to the abuse of tax reliefs in a timely and proportionate way.

3 Our audit approach is summarised in **Figure 23**. Our evidence base is described in Appendix Two.

8 Comptroller and Auditor General, *Tax Reliefs*, Session 2013-14, HC 1256, National Audit Office, April 2014.

Figure 23
Our audit approach

The objective of government

The coalition government wants to reform the tax system to make it more competitive, simpler, greener and fairer.

How this will be achieved

HM Treasury and HMRC share oversight of reliefs. HMRC is responsible for delivering and maintaining policy and the administration of the tax system. The Treasury is responsible for strategic tax policy design which will use the information collected by HMRC.

Our study

The study examined whether HMRC administers tax reliefs effectively.

Our key questions

Does HMRC collect sufficient information to monitor and understand how tax reliefs are used?

Does HMRC investigate and understand changes in the cost and use of tax reliefs, including ruling out abuse?

Does HMRC assess the risk of abuse effectively and respond to abuse in a timely and proportionate manner?

Our evidence

(see Appendix Two for details)

We reviewed HMRC's information collection by:

- reviewing HMRC's **information about 200 tax reliefs with economic and social objectives** we have identified;
- **interviewing HMRC staff to** understand the reasons for information collection decisions;
- assessing HMRC's internal reporting and information-sharing; and
- **reviewing published examples** and other literature to consider risks of reliefs.

We assessed the department's understanding by:

- **reviewing published and internal evaluations and statistics;**
- **reviewing the calculations and methodologies** underlying HMRC's figures;
- **interviewing staff** at HMRC;
- conducting **questionnaires** about our case studies; and
- comparing relief **claims data** and forecasts over time.

We reviewed the response of departments to the risk of abuse by:

- reviewing **HMRC reports** of the tax gap;
- examining claims levels of reliefs for large year-to-year differences or differences from forecasts and assessing HMRC's response;
- comparing HMRC management to practices identified by the **Tax Administration Research Centre** on overseas governance of tax expenditure;
- **interviewing staff** about HMRC's understanding of risk and response to it; and
- considering HMRC plans to reduce abuse relating to reliefs, as divulged to us through our **questionnaires** and **interviews**.

Our conclusions

HMRC could improve its administration of tax reliefs by:

- Collecting better information about the use of tax reliefs.
- Acting promptly on large changes and possible abuse.

Appendix Two

Our evidence base

1 We reached our findings about how well HMRC administers tax reliefs after analysing evidence collected between July and September 2014.

2 We assessed our evidence using the evaluative framework that covers 3 main areas relating to the administration of tax reliefs. This is described in more detail in Appendix One.

3 We carried out **semi-structured interviews with relevant staff at HMRC** about the monitoring, analysing risk-rating and implementing tax reliefs, and about information sharing with HM Treasury. These gave us an overview of administration arrangements which we recorded in meeting notes. They allowed us to identify supporting documents to confirm our findings.

4 We used evaluative criteria as described in our previous report on tax reliefs to **identify 196 tax reliefs with social or economic objectives** from the list of tax reliefs HMRC publish.

5 We reviewed the information HMRC collects about these tax reliefs, including their purpose and cost. We carried out variance analyses to find large changes in cost over time.

6 We commissioned **a report from the Tax Administration Research Centre (TARC)** regarding how other countries manage tax expenditures and describing best practice. This explored three questions:

- How do countries other than the UK administer and monitor tax expenditures?
- How does administration differ between countries?
- What does good administration look like?

7 **We selected 10 tax reliefs for detailed investigation ('case studies')**. We chose a sample that included large, small and un-costed tax reliefs with social or economic objectives.

8 We sent **questionnaires** to HMRC staff overseeing management of the case study tax reliefs. This was to understand the detailed governance of each of these. We received 10 responses – a response rate of 100%. The survey covered management, monitoring and risk assessment of the case studies. We used the responses to judge the overall governance standards for each case study and to identify areas of good practice for each case study. (See Online Appendix Four for case study dashboards).

9 We **examined relevant published information**, including:

- tax information and impact notes (TIINs);
- published HMRC statistics;
- internal statistics and forecasts; and
- HMRC evaluations of case studies.

10 We compared forecasts to claims costs. We adjusted figures to real monetary value where appropriate.

11 **We investigated the methodologies for producing the data** published in TIINs and HMRC statistics for our case studies to assess assumptions and quality of data. We assessed documents recording these calculations and interviewed HMRC staff about the calculations.

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