National Audit Office

## HM REVENUE & CUSTOMS 2005-06 ACCOUNTS

# The Comptroller and Auditor General's Standard Report

Presented to the House of Commons under Section 2 of the Exchequer and Audit Departments Act 1921 as amended by the Government Resources and Accounts Act 2000

This Report is published alongside the 2005-06 Accounts of HM Revenue & Customs

**John Bourn**
**Comptroller and Auditor General**
**7 July 2006**

# EXECUTIVE SUMMARY

## Introduction

**1** Section 2 of the Exchequer and Audit Departments Act 1921 requires me to examine the accounts of HM Revenue & Customs on behalf of the House of Commons to ascertain that adequate regulations and procedure have been framed to secure an effective check on the assessment, collection and proper allocation of revenue, and that they are being duly carried out.
I am also required by that Act to examine the correctness of the sums brought to account; and to report the results to the House of Commons. My audit certificate and report on the Trust Statement account and this report together satisfy that requirement.

**2** Whilst recognising that no tax collection system can ensure that all those who have a tax liability comply with their obligations, the National Audit Office's work in 2005-06 provided overall assurance that HM Revenue & Customs regulations and procedure continued to provide an effective check on the assessment, collection and proper allocation of revenue, and that they were being duly carried out. That overall assurance is subject to reservations about the operation of tax credits. The report also includes observations on the collection of income tax through PAYE and the measures taken by HMRC to tackle Value Added Tax missing trader fraud.

## Creation of HM Revenue & Customs

**3** In March 2004, the Chancellor of the Exchequer announced the creation of a new Department to bring together the functions of HM Customs and Excise and the Inland Revenue, and the transfer of some tax policy work to HM Treasury. HMRC was established in April 2005[1] and brought together in one entity most of the functions of the Inland Revenue and HM Customs and Excise. HMRC has established a high level governance structure. It has also continued to develop its risk management arrangements, building on what it inherited from the Inland Revenue and HM Customs and Excise.

**4** HMRC is taking forward the compliance strategies of the Inland Revenue and HM Customs and Excise, which were focused around specific tax streams. It has also begun work on producing a comprehensive and unified approach across the whole of HMRC's activities. HMRC has developed a spectrum of compliance activities, designed to inform its approach to different types of compliant and non-compliant taxpayers, which is focused on making it easier for taxpayers to get it right first time and targeting its compliance effort on those who present the greatest threat of non-compliance.

1 The Commissioners for Revenue and Customs Act 2005.

## Tax credits

**5** The tax credits system was changed in April 2003 and in 2005-06 HMRC paid a net £17.3 billion to tax credit claimants and an average of 5.3 million families received provisional 2005-06 awards. HMRC uses the latest information it holds on claimants to calculate a provisional tax credit award and make payments. It makes a final assessment after the end of the year when the claimant's actual circumstances are known. The final award is often higher or lower than the provisional award, for example because the final income differs from the provisional income.

**6** HMRC estimates that it overpaid £1.8 billion and underpaid £556 million in tax credits in 2004-05 and that the position for 2005-06 awards will be similar. When HMRC identifies an underpayment it pays the claimant a lump sum and it seeks to recover overpayments from future awards or, if there is no ongoing entitlement, directly from the claimant. The recovery of overpayments has caused hardship to some families and HMRC has struggled to manage disputes about recovery. It cannot recover all overpayments and in 2005-06 wrote off £397 million and made a provision of £409 million for doubtful debts.

**7** The December 2005 Pre-Budget Report announced changes to the tax credits system which were designed to provide greater certainty to claimants, particularly when families see a rise in income. One important change will be to raise from £2,500 to £25,000 for 2006-07 awards the threshold for increases in income which will be disregarded when provisional awards are re-assessed. There will also be new responsibilities on claimants to tell HMRC promptly about changes in their circumstances. The Treasury has been unable to provide reliable costings for the individual elements of the package. The success of these measures in reducing overpayments and recoveries will become apparent only in 2008 following finalisation of 2006-07 awards.

**8** HMRC estimated that in 2003-04 claimant error and fraud resulted in tax credits of between £1.06 billion and £1.28 billion (8.8 to 10.6 per cent by value) being paid to claimants to which they were not entitled. It also estimates that claimant error resulted in between £190 million and £280 million (1.6 to 2.3 per cent by value) of tax credits not being paid to claimants when they were entitled to them. These are the first full results for the scheme since it was introduced in April 2003. These levels are unacceptably high and there is currently no evidence to justify a lower estimate for 2005-06. Consequently, I have qualified my opinion on the Trust Statement. Now HMRC has a baseline figure, it needs to target future reductions in levels of error and fraud.

**9** HMRC tries to maintain a balance between accessibility of the tax credits scheme to claimants and maintaining safeguards against the risk of error and fraud. It aims to achieve this by investigating claims which it judges present the highest risk and it checks these before or after claims are paid. In 2005-06, HMRC completed compliance checks and other actions against 195,000 claims, identifying incorrect payments made of £250 million and preventing incorrect payments of £447 million. HMRC prioritises its compliance activity on the claims it considers represent the highest risk. High risk claims that are not fully examined before payment are picked up for subsequent checking. HMRC has set a target for this compliance work which is based on the number of checks. It needs to consider how these can be developed into outcome based targets, such as reductions in fraud to provide better information on the effectiveness of its compliance work.

**10** In 2005 there was a serious attack on the tax credits system by organised criminals submitting false claims using stolen identities. HMRC identified incorrect payments of around £131 million in 2005-06. Its Organised Fraud Strategy Board is overseeing investigations into 41 separate organised tax credit fraud cases, most of which involve multiple claims using stolen identities. HMRC cannot yet give a precise figure for the overall sums involved, but its initial indications are that the total losses on these cases were £26 million. HMRC is conducting further work to establish firmer estimates to support the case for prosecution.

**11** HMRC closed the tax credits e-portal on 2 December 2005 as a consequence of these attacks and it accepts that additional controls need to be built into the e-portal before it can be re-opened. HMRC needs to ensure that the new system fully complies with established government standards on security. HMRC has reviewed the other channels through which tax credits can be claimed and has introduced new measures to safeguard against fraud. It needs to continue to assess the wider implications of the fraud and how organised criminals might respond to the closure of the tax credits e-portal.

## The collection of income tax through PAYE

**12** In 2005-06 HMRC collected £114 billion income tax through PAYE from some 41 million employment and pension sources operated by 1.9 million employer or pension schemes. HMRC aims to ensure that individuals pay the right amount of tax on their income and to make it as easy as possible for employers and employees to meet their obligations.

**13** The PAYE computer system was introduced in the 1980s and its records are structured around employments, rather than individual taxpayers. As a result, HMRC can have difficulty in ensuring that taxpayers with more than one source of income pay the correct amount of tax because it may not know about additional sources of income.

**14** To operate PAYE effectively, HMRC depends on employers and employees providing it with accurate and timely information on income and changes in employment. This does not always happen and can lead to the risk that taxpayers do not pay the right amount of tax. For example, HMRC estimates that for about 70 per cent of job changes employees do not immediately provide their new employer with the form P45, giving details of previous earnings and tax. And employers do not always update tax codes despite being instructed to do so.

**15** The difficulties in the operation of PAYE have been compounded by inconsistent working practices within HMRC. Staff have not always been aware of or followed Departmental policies, for example adjusting tax codes to reflect Benefits in Kind. Deficiencies in management information have also made it difficult for HMRC to prevent or detect errors made by staff. And several times in recent years HMRC has diverted PAYE resources to other areas of work which it considered had higher operational priority, such as tax credits.

**16** Over the last eighteen months HMRC has produced new information to provide a better picture of the scale of these problems and the amount of tax at stake. Based on a sampling exercise, its Internal Audit Office estimates that each year HMRC may not be pursuing some £1 billion of tax due, taxpayers may have overpaid around £500 million and consequently that 5.7 million taxpayers may not be paying the right amount of tax. These figures suggest an overall net under collection of tax revenue of some 0.5 per cent of the £114 billion collected through PAYE in 2005-06.

**17** HMRC has responded by reminding staff of the importance of following procedures, improving its internal quality monitoring procedures and has introduced a programme to deliver a better experience for the taxpayer. It has also allocated additional resources to PAYE work. Whilst it believes these changes should reduce the level of errors, it recognises that real improvement requires fundamental changes. Accordingly, HMRC plans to improve its internal processes as part of its 'Modernisation of PAYE Processes for Customers (MPPC)' project. This project should also provide a complete view of an employee's tax affairs by making better use of the information HMRC already holds. Successful implementation should reduce a major source of error but HMRC considers the computer changes cannot be achieved before 2008 because of the technical challenges. HMRC has developed a series of responses to manage the risks in the interim period, but it needs to articulate these more clearly into an overall strategy.

**18** Effective operation of PAYE also depends on employers and employees meeting their obligations and changing internal processes and systems will not address all the problems. HMRC needs to target and take further action to improve compliance by employers and employees who do not meet their obligations.

**19** HMRC first recognised the emerging difficulties in administering PAYE in 2001-02, when it launched a recovery programme to clear the increasing number of open cases. But it has only recently begun to quantify the effect of these difficulties on the collection of tax. This quantification, coupled with HMRC's new organisational structure, has provided additional impetus to tackle these difficulties through a programme of short, medium and longer term improvements. In taking forward these improvements, and as new systems are developed, HMRC must ensure that it has appropriate management information to monitor the effectiveness of its procedures in collecting tax. Within its new framework for managing PAYE, HMRC also needs to have appropriate arrangements for monitoring emerging trends in the labour market to allow it to develop an appropriately planned response to future changes in the taxpayer population.

## VAT: Missing Trader Fraud

**20** Missing trader fraud is one of the most serious attacks on the tax system ever seen. It is a systematic attack by organised criminal groups on the European Union VAT system. HMRC's strategy, launched in September 2000, reduced the losses: in 2003-04 the level of fraud fell for the second year running, to between £1.06 billion and £1.73 billion. However, 2004-05 saw an increase in losses of between £1.12 billion and £1.9 billion and the latest operational indicators suggest that the level of activity related to the fraud has increased. The organised criminals behind the fraud are very resourceful and have reacted quickly to measures implemented by HMRC, setting up sophisticated and contrived transaction chains to avoid detection. To address these latest developments, HMRC has further strengthened its operational activities and plans to introduce new legal measures to help tackle the fraud.

**21** Tax practitioners recommended the introduction of a reverse charge mechanism to the tackle the fraud in evidence to the House of Lords Economic Affairs Committee in 2003. This measure would remove the VAT from the distribution chain from wholesaler to retailer, and thus reduce the possibility of this type of fraud occurring. Other measures introduced in 2003 have proved successful in reducing the level of fraud. However, in 2005 the confidence of the fraudsters and the level of fraud increased. The Government sought a derogation in December 2005 from the European Commission to permit the introduction of a reverse charge for goods normally associated with the fraud, such as mobile phones and computer chips. HMRC has estimated that, if approved, this measure will yield an additional £1 billion of VAT receipts over the next three years. There is, however, a risk that the fraudsters will divert to goods not covered by the legislation.

**22** HMRC and other Member States, supported by the Commission, are working closely through administrative cooperation to tackle the fraud. However, fraudsters can obtain goods free of VAT and continue to perpetrate this type of fraud whilst the current arrangements in the VAT system remain. The Commission has considered an overhaul of the current VAT system, but due to a lack of consensus, Member States have not agreed a definitive system. HMRC should continue to lead work with the European Commission and other Member States to highlight the difficulties in tackling the fraud within the current legislative framework and to identify long term mechanisms through which tax authorities across the European Union may tackle the fraud.

**23** Within the current VAT framework, improvements could be made to the quality and timeliness of information shared between Member States. Through the introduction of scanning databases in the UK and other Member States, there will also be opportunities to share greater detailed information to identify consignments of goods and traders involved in fraudulent chains. This information will therefore help HMRC to target its resources to tackle the fraud. The UK and some other Member States are now experiencing missing trader fraud that transcends the external borders of the European Union into third countries. The Commission has recently stated that it would like to see a community approach to cooperation with third countries. HMRC should use its experience and influence to facilitate these arrangements.

**24** Several of the large accountancy firms and professional bodies have publicly supported HMRC's approach to tackle the fraud and sought to develop guidance for their clients and members who may come into contact with missing traders. HMRC should continue to work closely with these organisations to identify further measures that could be successfully introduced in the UK. Many of these organisations are also established or have affiliates across the European Union, and counterparts in these offices may have useful suggestions in tackling the fraud.

## Statement on Internal Control

**25** HMRC has introduced an effective process for preparing its annual Statement on Internal Control. This involves a reporting process that ensures that each of its Executive Committee members prepares an individual internal control statement. The Statement on Internal Control for 2005-06 acknowledges that the Department faces a number of significant control weaknesses. My report considers some of these issues, namely tax credits (Part two), Pay As You Earn (Part three) and VAT Missing Trader Fraud (Part four). Some of the other control matters in the Statement on Internal Control are discussed below.

### Delivering Efficiency Savings

**26** The 2004 Spending Review required HMRC to achieve by 1 April 2008 net staff reductions of 12,500 full time posts, the redeployment of 3,500 posts to front-line roles and annual efficiency savings of £507 million. HMRC reported to the Office of Government Commerce (OGC) that by 1 April 2006 it had reduced staff numbers by a net 4,322 full time equivalents and had made savings of £105 million. Additionally, HMRC has made over 2,600 re-deployments to front line activities, which together represented a gross reduction of some 7,000 full time posts.

**27** In December 2005 OGC raised concerns about potential gaps that had opened up in HMRC's plans for delivering headcount reductions and apparent gaps in detailed planning for efficiency following restructuring of the Department. HMRC and OGC subsequently carried out a joint priority review, which concluded with a series of agreed recommendations to improve the management of the Efficiency Programme. In line with the joint report's recommendation, HMRC's Executive Committee agreed to strengthen the Efficiency Programme Board's terms of reference to give it greater authority.

## National Insurance Debt

**28** Class 2 National Insurance is a flat rate contribution (currently £2.10 per week) paid by the self-employed. When HMRC is notified that a person is self-employed, it assumes they will continue to be liable for these contributions until it is told otherwise. Inevitably, therefore some of the debt balances held on the HMRC systems will not be amounts genuinely owed – for example, where a person has ceased self-employment, but has failed to notify HMRC. In my report for 2004-05, I noted that HMRC's systems recorded £616 million outstanding National Insurance debt at the end of 2004-05 which was over six years old and therefore time barred. HMRC concluded that of the £616 million recorded, £283 million was not actual debt and it also wrote off the balance of £333 million as time barred. HMRC sought to take urgent action to prevent further debts becoming time barred at 31 March 2006. But limitations in its computer system have hampered its ability to identify debt about to become time barred. HMRC has developed a strategy to ensure it manages these debts much more quickly in the future.

## Tax repayments

**29** In my 2004-05 Standard Report on the Inland Revenue I noted that a lack of formalised accountabilities had made it difficult for the Department to establish central oversight and responsibility, including the extent to which agreed controls over repayments were being operated. It also made it difficult to establish the degree to which these controls could prevent or detect error and irregularities. In response, the Finance Director has set up and chairs a Departmental Steering Group to establish central control and direction of HMRC's strategy on repayments and repayments security.

**30** In the spring of 2006 Internal Audit reported that there were continuing weaknesses in HMRC's controls over tax repayments. On the basis of a sample of Self Assessment and Pay As You Earn (PAYE) repayments, Internal Audit estimated that taxpayers had potentially been overpaid £203 million and underpaid £45 million as a result of these weaknesses. In addition, they reported that underlying papers could not be found for 16 per cent of the sample of PAYE repayments. To strengthen operational controls, HMRC has issued guidance to staff reminding them of the importance of following the correct processes and retaining supporting papers. The Finance Director's Steering Group has a responsibility to ensure that this guidance is followed.

# PART ONE

# SCOPE OF THE AUDIT AND SIGNIFICANT DEVELOPMENTS

## Introduction

**1.1** Section 2 of the Exchequer and Audit Departments Act 1921 requires me to examine the accounts of HM Revenue & Customs on behalf of the House of Commons to ascertain that adequate regulations and procedure have been framed to secure an effective check on the assessment, collection and proper allocation of revenue, and that they are being duly carried out. I am also required by that Act to examine the correctness of the sums brought to account; and to report the results to the House of Commons. My audit certificate and report on the Trust Statement account and this report together satisfy that requirement.

## Audit approach

**1.2** In examining the extent to which HM Revenue & Customs has established adequate regulations and procedure to secure an effective check on the assessment, collection and proper allocation of revenue and whether HMRC is properly carrying out these regulations and procedure, my staff have developed an audit approach that incorporates a range of audit work across the Department's activities and tax streams. Amongst other things, my staff have:

- Conducted specific work on areas of HMRC's operations and tax streams, including:
  - HMRC's response to the challenges of delivering Tax Credits effectively, which I have covered in Part 2 of this Report;
  - HMRC's management of Pay as You Earn, which I have dealt with in Part 3 of this Report; and
  - HMRC's response to managing VAT Missing Trader Fraud, which I have reported on in Part 4 of this Report.
- Carried out value for money studies under the National Audit Act 1983 that have contributed to my overall view of the Department's management of the tax systems, including reports on:
  - How the Department's area offices manage the Corporation Tax of small to medium sized businesses; (HC 678: 2005-06)
  - How HMRC deal with VAT on e-commerce; (HC 1051: 2005-06)
- Examined the governance arrangements for the new Department, including risk management and Information Systems governance. As part of this work, my staff have also considered the Department's Statement on Internal Control (paragraphs 1.14 to 1.25 below) that provides a source of assurance about the quality of HMRC's internal control framework.
- Followed up on previous developments in areas that I covered in my Standard Report on the 2004-05 Trust Statement and Resource Accounts of the Inland Revenue and HM Customs & Excise.
- Taken into account the results of my audit of tax revenues, as set out in the separate Report I have appended to my audit certificate on the 2005-06 Trust Statement (84 to 86).

## Conclusion

**1.3** Whilst recognising that no tax collection system can ensure that all those who have a tax liability comply with their obligations, the National Audit Office's work in 2005-06 provided overall assurance that HM Revenue & Customs regulations and procedure continued to provide an effective check on the assessment, collection and proper allocation of revenue, and that they were being duly carried out. That overall assurance is subject to reservations about the operation of tax credits. The report also includes observations on the collection of income tax through PAYE and the measures taken by HMRC to tackle Value Added Tax missing trader fraud.

## Creation of HM Revenue & Customs

**1.4** In March 2004, the Chancellor of the Exchequer announced the creation of a new Department to bring together the functions of HM Customs and Excise and the Inland Revenue, and the transfer of some tax policy work to HM Treasury. HMRC was established in April 2005[2] and brought together in one entity most of the functions of the Inland Revenue and HM Customs and Excise. Not all of the functions provided by the Inland Revenue and HM Customs and Excise transferred to the new Department. In April 2004, 150 full time posts responsible for providing advice to Ministers on aspects of tax policy transferred to HM Treasury. At 1 April 2005, 223 posts transferred to the Revenue and Customs Prosecutions Office, a newly created government department operating under the superintendence of the Attorney General. Finally, in April 2006, under legislation passed on 1 April 2005, 1,127 full time equivalent staff engaged in investigation and intelligence work on serious drug trafficking and related criminal finance transferred to the new Serious Organised Crime Agency[3].

## New governance arrangements

**1.5** To manage the new organisation, HMRC has established a high level governance structure; the main features of which are:

- **A Departmental Board** which comprises the Commissioners for HM Revenue & Customs, plus the other members of the Executive Committee, the Chief Executive of the Valuation Office Agency and HMRC's Non-Executive Directors. Its role is to set the Department's strategic direction and to provide advice to the Executive Committee.
- **An Executive Committee** which is the primary decision making forum for HMRC. Its members' responsibilities cover the whole of the core Department.
- **An Operating Committee** which supports the Executive Committee by providing oversight of HMRC's day to day performance.
- **An Audit Committee** which comprises non-executive board members and advises the Chairman in his responsibilities for risk management, internal control and corporate governance.

**1.6** The underlying structure of HMRC contains thirty six business units each of which is headed by a Director. These units are grouped into four business streams.

- **Operations**, which is responsible for delivering high quality, cost effective services. The core activities are delivering customer contact, processing and operational compliance; delivering enforcement capabilities; and debt management and banking;
- **Product and Process Groups**, which focus on taxes, duties, credits and benefits and the processes by which they are delivered;
- **Customer Units**, which focus on identifying and understanding the requirements and behaviours of its customers and the associated risks; and
- **Corporate Functions** such as Human Resources and Finance.

In addition to these business units, HMRC has established a number of cross-cutting operational working groups to help it deliver its aims and objectives. These include, for example, working groups that have oversight of HMRC's delivery against each of its Public Service Agreement (PSA) targets, as well as groups with a tax focus that help develop HMRC's strategy for compliance on particular tax streams.

## Risk management

**1.7** The governance structures I have described above provide the framework within which HMRC has continued to develop its risk management arrangements, building on what it inherited from the Inland Revenue and HM Customs and Excise. The HMRC Executive Committee is responsible for shaping the Department's risk management arrangements, determining the risk priorities and reviewing progress in managing HMRC's strategic risks. It is supported by a Risk Management Group, which is a peer-review group of risk owners who challenge the effectiveness of HMRC's actions in managing its top risks and identify new risks.

2 The Commissioners for Revenue and Customs Act 2005.
3 The Serious Organised Crime Agency was created in April 2006 under the Serious Organised Crime and Police Act 2005. It brought together the National Crime Squad, National Criminal Investigation Service, the Immigration Service's work on organised crime, and HMRC's investigation and intelligence work on serious drug trafficking and related criminal finances.

**1.8** In 2005-06 HMRC introduced important new elements to its risk management framework. These included a mechanism to ensure the upward reporting of risks in the Directors' regular reporting on performance. The Directors are held to account by the Chairman and Executive Committee members for their performance on a quarterly basis. Each Director provides a commentary on performance against plans and the likely year end position. This process helps inform HMRC's Chairman and Executive Committee of major and immediate risks and the current response to these risks. Executive Committee members also hold monthly meetings with Directors to discuss strategic issues facing the Department. HMRC is aware that it needs to do further work to continue to embed risk management into the management of business performance.

## Compliance

**1.9** Integration allows the new Department to focus on compliance activities across all tax streams. Whilst HMRC is taking forward the compliance strategies of the Inland Revenue and HM Customs and Excise, which were focused around specific tax streams, work has also begun on producing a comprehensive and unified approach across the whole of HMRC's activities. HMRC has developed a spectrum of compliance activities, designed to inform its approach to different types of compliant and non-compliant taxpayers, which is focused on making it easier for taxpayers to get it right first time and targeting its compliance effort on those who present the greatest threat of non-compliance.

**1.10** HMRC has started a programme of work to modernise its approach to taxpayer compliance by looking at both the quality of service it delivers to taxpayers and the effectiveness of its compliance activities. It has also begun to look at compliance from customer and behavioural perspectives. This involves identifying underlying causes of non-compliance (for example, owing to complexity of processes) and seeking to design these out wherever possible. Important strands in HMRC's programme involve:

- **implementing its anti-avoidance agenda** to know what avoidance schemes are marketed and used, to identify those individuals and organisations predisposed to avoidance, to deploy HMRC's investigation and litigation resources on the basis of that knowledge, and to improve its ability to combat avoidance through more effective 'avoidance proofing' of tax legislation;
- **developing relationships with tax advisers** to make better use of the contribution they can make in developing a more effective tax administration system and closer working with representative bodies and firms both to improve tax advisers' performance and to encourage them to stress the importance of ethical conduct;
- **developing front line compliance** by improving risk assessment, providing better information to support enquiries and investigations, redesigning the inquiry process to make it more effective, and developing a more effective framework of investigations; and
- **creating a central compliance team** to provide a focus for developing a more co-ordinated approach to compliance across HMRC, to quality assure the plans of all units engaged in compliance work, and to co-ordinate its work in delivering its Public Service Agreement targets for compliance.

## Information Systems

**1.11** Efficient and effective information systems are essential to the administration of taxes and integration offers the opportunity of improving the service that the information systems provide. HMRC currently spends over £1 billion each year on its Information Systems related activities, with over 250 major computer systems supporting the full range of HMRC's work.

**1.12** Both the Inland Revenue and HM Customs and Excise had built large computer systems, but many of these systems now need strengthening and updating. These systems were primarily created in reaction to the need to provide new work, such as Tax Credits or online services. In 2005 HMRC prepared a new Strategic Framework for IT which is designed to enable it to pro-actively use IT to improve the way it provides services. In the future, HMRC is looking to:

- enhance the links between IT development and its internal business areas to enable their needs to be identified;
- improve how it prioritises IT development work; and
- work closely with its IT supplier to review areas where services can be improved.

## Review of HMRC powers

**1.13** The creation of HMRC 'ring-fenced' the powers of each former Department and carried them forward into HMRC. But during the passage of the Commissioners for Revenue and Customs Bill, the Government announced a major review of the powers of HMRC. This aims to design a coherent framework of law and practice for HMRC to support the Government's objectives of a tax system that is fair and better adapted to the needs of customers. In June 2005, the Government established a Consultative Committee to provide advice on future powers, deterrents and safeguards that should underpin the tax system. This Committee includes representatives of the tax credits community, businesses, employees and the tax-related professions. In March 2006, HMRC issued a consultation document setting out its thinking following the early consultation on the requirements of a modern tax administration. As well as taking on board the results of this consultation, the review team plan to look at further areas of HMRC's powers throughout 2006-07.

## Statement on Internal Control

**1.14** To meet his reporting responsibilities to Parliament, the Principal Accounting Officer has provided in pages 1 to 9 of the 2005-06 Accounts a Statement on Internal Control. The Statement serves two reporting purposes:

- to provide Parliament with assurance that the Accounting Officer has put in place the necessary control framework to manage risk. This is set out in paragraphs 2.1 to 5.3 of the statement; and
- to give the Accounting Officer the opportunity to highlight to Parliament the areas of concern highlighted by his review of the effectiveness of internal control. These matters are described in paragraphs 6.1 to 6.30 of the Statement.

**1.15** Principally as part of my audit of the Trust Statement and the Resource Accounts, my role with regard to the Statement on Internal Control is to consider whether the Accounting Officer's statement reflects HMRC's compliance with HM Treasury's disclosure guidance. I report in my audit certificate if it does not. I also consider the Accounting Officer's Statement on Internal Control in reaching a conclusion about the adequacy of the systems for the assessment, collection and proper allocation of revenues brought to account by the Department. In doing so I consider whether the Statement properly reflects all material control weaknesses that have come to attention in my audit.

**1.16** HMRC has introduced an effective process for preparing its annual Statement on Internal Control. This involves a reporting process that ensures that each of its Executive Committee members prepares an individual internal control statement. The statements are underpinned by evidence reported from Directors. The Finance Director then considers which control matters should be included in the Departmental Statement having weighed the relative importance and materiality of the control matters reported by individual members of the Executive Committee. HMRC's Internal Audit has developed a robust process for scrutinising the Statement on Internal Control, including analysis of the underlying material, that is independent of the Executive Committee's own review procedures. HMRC's Audit Committee also examines and challenges the Statement on Internal Control, drawing on both the Finance Director's own review process as well as Internal Audit's work.

**1.17** The Statement on Internal Control for 2005-06 acknowledges that the Department faces a number of significant control weaknesses. My report considers some of these issues, namely tax credits (part two), Pay as You Earn (part three) and VAT missing trader fraud (part four). Some of the other control matters in the Statement on Internal Control are discussed below.

### Delivering Efficiency Savings

**1.18** The 2004 Spending Review required HMRC to achieve by 1 April 2008 net staff reductions of 12,500 full time posts, the redeployment of 3,500 posts to front-line roles and annual efficiency savings of £507 million. The Department's objective was to deliver the majority of these savings in 2006-07 and 2007-08, by putting in place plans involving:

- investment in Information and Communication Technology;
- reform of back office functions;
- savings in procurement of goods and services;
- improvements in productive time; and
- re-engineering of business processes.

As part of the governance arrangements HMRC's Executive Committee established an Efficiency Programme Board to help oversee and steer delivery of the efficiency and business change programme.

**1.19** HMRC reported to the Office of Government Commerce (OGC) that by 1 April 2006 it had reduced staff numbers by a net 4,322 full time equivalents and had made savings of £105 million. Additionally, HMRC has made over 2,600 re-deployments to front line activities, which together represented a gross reduction of some 7,000 full time posts. The Department has faced some IT capacity problems which have affected progress in delivering the savings and it has revised its plans to identify non IT solutions needed to delivery the efficiency savings.

**1.20** In December 2005 OGC raised concerns about potential gaps that had opened up in HMRC's plans for delivering headcount reductions and apparent gaps in detailed planning for efficiency following restructuring of the Department. HMRC and OGC subsequently carried out a joint priority review, which concluded with a series of agreed recommendations to improve the management of the Efficiency Programme. In line with the joint report's recommendation, HMRC's Executive Committee agreed to strengthen the Efficiency Programme Board's terms of reference to give it greater authority to provide:

- improved governance and accountability arrangements to hold others to account in relation to the delivery of change;
- better and more regular reporting of progress to the Executive Committee;
- more active risk management procedures and monitoring of the effect of failure or delays in the underlying programmes; and
- clear sign up by Directors to Delivery Plans and commitments to efficiency targets for 2006-07 and 2007-08.

Under the revised control arrangements, the membership of the Efficiency Programme Board has changed to include Directors who are responsible for the delivery of the significant efficiency targets. The Board membership is also aligned with the responsibilities the Executive Committee has allocated for implementing the various change portfolios.

**1.21** Following changes made as part of HMRC's 2006-07 business and resource planning process, the Efficiency Programme Board monitors the progress of the principal programmes that are aimed at delivering the efficiency savings set out in the 2004 spending review. HMRC has reshaped its change portfolio to focus on what is needed to deliver its April 2008 PSA and efficiency commitments and improve accountability.

## National Insurance Debt

**1.22** Class 2 National Insurance is a flat rate contribution (currently £2.10 per week) paid by the self-employed. When HMRC is notified that a person is self employed, it assumes they will continue to be liable for these contributions until it is told otherwise. Inevitably, therefore some of the debt balances held on the HMRC systems will not be amounts genuinely owed – for example, where a person has ceased self-employment, but has failed to notify HMRC. In my report for 2004-05, I noted that HMRC's systems recorded £616 million outstanding National Insurance debt at the end of 2004-05 which was over six years old and therefore time-barred. HMRC concluded that of the £616 million recorded, £283 million was not actual debt and it also wrote off the balance of £333 million as time-barred.

**1.23** HMRC sought to take urgent action to prevent further debts becoming time barred at 31 March 2006. But limitations in its computer system have hampered its ability to identify debt about to become time barred. HMRC has developed a strategy to ensure it manages these debts much more quickly in the future.

## Tax repayments

**1.24** In my 2004-05 Standard Report on the Inland Revenue I noted that a lack of formalised accountabilities had made it difficult for the Department to establish central oversight and responsibility, including the extent to which agreed controls over repayments were being operated. It also made it difficult to establish the degree to which these controls could prevent or detect error and irregularities. In response, the Finance Director has set up and chairs a Departmental Steering Group to establish central control and direction of HMRC's strategy on repayments and repayments security.

**1.25** In the spring of 2006 Internal Audit reported that there were continuing weaknesses in HMRC's controls over tax repayments. On the basis of a sample of Self Assessment and Pay As You Earn (PAYE) repayments, Internal Audit estimated that taxpayers had potentially been overpaid £203 million and underpaid £45 million as a result of these weaknesses. In addition, they reported that underlying papers could not be found for 16 per cent of the sample of PAYE repayments. To strengthen operational controls, HMRC has issued guidance to staff reminding them of the importance of following the correct processes and retaining supporting papers. The Finance Director's Steering Group has a responsibility to ensure that this guidance is followed.

## Other developments

### Reform of the Construction Industry Scheme

**1.26** In 1972 the Department established a special tax deduction scheme to deal with the practice, then endemic in the construction industry, of engaging workers on a "cash in hand" basis, coupled with a poor record of complying with tax obligations. The current Construction Industry Scheme was introduced in 1999. Contractors must deduct an amount from payments to subcontractors, unless the sub-contractor has met certain criteria which allow payment to be made gross. The amounts deducted are set against tax and National Insurance contributions, or in the case of companies, against their payment obligations as contractors or employers. The Scheme is intended to benefit businesses and sub-contractors since it encourages tax compliance across the industry and reduces the likelihood of tax evasion.

**1.27** In response to industry concerns about the cost of administering the 1999 scheme, in 2001, the Department began preparations for introducing a new Scheme designed to reduce the burden of operating the scheme on the construction business, improve the industry's compliance with its tax obligations and help the industry get the employment status of its workers right.

**1.28** In October 2005, the Government announced that the scheme would be introduced in April 2007, two years later than originally planned. The implementation was postponed to provide more time for the industry to be ready for the launch of the new scheme.

### Spend to raise

**1.29** The Finance Act 1998 provides for me to examine and report on conventions and assumptions underlying the fiscal projections that are submitted to me by the Treasury for examination. As a result of measures announced in the 2003 and 2004 Budgets, the Inland Revenue introduced two new packages: (i) designed to promote taxpayer compliance; and (ii) to counter tax avoidance and fraud. For Budget 2006, I undertook a review of progress with the 2003 package.

**1.30** I concluded in my review that the projections of additional revenue from the package were reasonable and incorporated caution, but that there were uncertainties and judgments underlying the projected impact. I therefore recommended that the projections should be revised if they appeared not to be cautious in practice. My review of progress with the 2003 package (HC 937, Session 2005-2006) showed that the projections made in the 2003 Budget did need to be adjusted to take account of both shortfalls and greater than expected yields in particular financial years in the period. There was a shortfall of £54 million in 2003-04, followed by surpluses of £32 million and £23 million in 2004-05 and 2005-06. The shortfall in the first year arose because:

- HMRC's processes for handling some cases of non-compliance did not initially operate as effectively as possible. The Department subsequently revised its procedures to improve the speed with which cases were handled;
- HMRC experienced some delays in recruiting the required number of appropriately experienced and qualified staff to undertake the planned work, and there were delays before some of the initiatives were fully operational;
- Some of the original assumptions supporting the forecast of future yields were too optimistic. These assumptions surrounded the levels of non-compliance that could be tackled under these initiatives.

PART TWO

# TAX CREDITS

## Introduction

**2.1** Child and Working Tax Credits (tax credits) were introduced in April 2003[4] as part of the Government's reforms of the tax and benefits system aimed at relieving child and in-work poverty. They were designed to provide additional financial support to families with children and working people on low incomes in accordance with their circumstances. They replaced the Working Families and the Disabled Person's Tax Credit which were introduced in 1999, and the Children's Tax Credit, introduced in 2001.

**2.2** During 2005-06, HMRC paid a net £17.3 billion in tax credits and an average of 5.3 million families received provisional 2005-06 awards. HMRC has estimated that 79 per cent of families with children entitled to tax credits in 2003-04 actually claimed awards; estimates for later years are not yet available. The cost of administering the scheme was £467 million (2004-05 £475 million).

**2.3** Child Tax Credit is designed to address the specific needs of families with children, and provides financial support based on the number of children and any disabilities they may have. It is available to those aged 16 or over, whether working or not, who are responsible for at least one child. Working Tax Credit is designed to support working people, both employed and self employed, by topping-up earnings; the amount depends on factors such as age or the number of hours worked. Additional support is available for childcare costs or where a member of the household suffers from disability. To be eligible for tax credits claimants need to be present, ordinarily resident and have a right to reside in the UK. The rates payable for each element of Child and Working Tax Credit in 2005-06 are shown in **Figure 2**.

**2.4** Some elements of Working Tax Credit were initially paid to claimants directly through their employers. From April 2006, these were replaced by direct payment from HMRC. Some families currently receive tax credit support for their children through income support and jobseekers' allowance. But the Government intends to provide all income-based support for children through tax credits in the future.

**2.5** My recent Standard Reports have covered a number of important issues in the administration of tax credits, including overpayments and their recovery, levels of error and fraud, problems with the computer system and the operation of controls. This part of my report considers the progress HMRC has made in dealing with these issues and examines some new challenges it has faced in 2005-06. It covers:

- The tax credits scheme;
- Overpayments and underpayments; and
- Managing error and fraud.

**1** Tax Credits: Scheme Overview

| | 2003-2004 | 2004-2005 | 2005-2006 (provisional[2]) |
|---|---|---|---|
| Families benefiting[1] | 4.6m | 5.0m | 5.3m |
| Of which: Child Tax Credit | 4.4m | 4.8m | 5.0m |
| Working Tax Credit | 1.6m | 1.7m | 1.8m |
| Net cash paid to claimants in year | £13.5bn | £15.8bn | £17.3bn |
| Final value of awards[3] | £12bn | £14.3bn | not available |
| Administrative cost to HMRC | £406m | £475m | £467m |
| Staff employed by HMRC | 7,300 | 8,200 | 8,750 |

*Source: HMRC*

NOTES

1 Figures represent the average number of families benefiting in the year for 2003-04 and 2004-05 in finalised awards and for 2005-06 in provisional awards. Some families benefit from both Child and Working Tax Credits. These figures exclude families receiving child support through in-work benefits (2003-04 1.1 million, 2004-05 0.9 million, 2005-06 0.7 million).

2 Actual information for 2005-06 will be available in April 2007, after 2005-06 awards have been finalised.

3 HMRC makes a final assessment of awards after the end of the year when the claimant's actual circumstances are known.

4 The Tax Credits Act 2002.

| **2** | Annual rates for tax credit elements |
|---|---|

| Tax Credit Element | 2005-06 Annual Rates |
|---|---|
| Child Tax Credit[1] | |
| Family Element (one per family) | £545 |
| Higher Family Element (in first year of child's life) | £545 |
| Child Element (for each child) | £1,690 |
| Disability Element (for each disabled child) | £2,285 |
| Severe Disability Element (for each severely disabled child) | £920 |
| Working Tax Credit[2] | |
| Basic Element | £1,620 |
| Second adult and Lone Parent Element | £1,595 |
| 30 Hour Element | £660 |
| Disabled Worker Element | £2,165 |
| Severe Disability Element | £920 |
| Element for claimants aged 50 and above, working 16-29 Hours | £1,110 |
| Element for claimants aged 50 and above, working 30+ Hours | £1,660 |
| Childcare Element – childcare costs cannot exceed £175 per week for one child and £300 per week for two or more children | 70 per cent of costs |

*Source: HMRC*

NOTES

1 The family element is reduced by 6.67p for every £1 of income over £50,000 in most cases. For families entitled to Child Tax Credit, but not Working Tax Credit, the Child Element is reduced by 37p for every £1 of income over a limit of £13,910. For families entitled to both Child Tax Credit and Working Tax Credit, the child element is reduced in the same way after Working Tax Credits, including any childcare element, has been withdrawn.

2 An award is reduced by 37p for every £1 of annual income over £5,220.

## The Tax Credits Scheme

**2.6** The amount of tax credits paid by HMRC is based on an annual entitlement. HMRC calculates a provisional award and makes payment using the latest information it holds about the claimant. It makes a final assessment after the end of the year once the claimant's actual income and circumstances are known. Most awards are finalised in the period between April and September, but this may be as late as the following January if claimants submitted an initial estimate, for example where claimants do not finalise their self-assessment return until January.

**2.7** Claimants must inform HMRC of changes in their circumstances. Some changes must be notified immediately, such as those that would bring an award to an end or significant reductions in childcare costs. Claimants can notify other changes after the end of the year, but HMRC encourages them to report as early as possible changes likely to affect their award so as to keep awards in line with entitlement. Changes in circumstances can result in both increased and decreased entitlement for the year in which the change occurred.

**2.8** After the end of the year HMRC asks claimants to review their circumstances for the year on which their award was based, to notify it of any changes and to report their income for that year. HMRC then reassesses the award in the light of actual circumstances and income for that year. The final award can be higher or lower than the provisional award, for example where the final income is different from the provisional income.

**2.9** HMRC pays the claimant a lump sum where it calculates that the provisional award resulted in an underpayment. Where the provisional award has resulted in an overpayment, HMRC seeks to recover it from future payments, subject to limits designed to protect the awards of low income families (as set out in paragraph 2.16 below) or, if there is no ongoing entitlement, directly from the claimant. An outline of the tax credit process is given in **Figure 3 overleaf**.

**3** Overview of the tax credits process

| Time | Actions by Claimant | Actions by HMRC |
|---|---|---|
| Before the start of the year | Claimant provides HMRC with details of income and circumstances | |
| | | HMRC calculates a provisional tax credits award |
| During the year | | HMRC makes provisional payments to the claimant |
| | Claimant may notify HMRC of change in their circumstances | |
| | | HMRC calculates a revised award and amends payment to reflect the latest information. |
| After the year-end | Claimant informs HMRC of their actual circumstances for the previous year | |
| | | HMRC finalises the award and pays underpayments as a lump sum or seeks recovery of overpayments. |

*Source: National Audit Office*

**2.10** When HMRC finalises awards it disregards any increases in claimant income over the previous year of up to £2,500 to limit the need for adjustments to the provisional award. HMRC estimates that final entitlements to Tax Credits in 2004-05 would have been around £700 million lower (£800 million in 2003-04) without the £2,500 'disregard'. The threshold below which income increases will be disregarded in calculating final awards will be increased to £25,000 for 2006-07 awards.

## Overpayments and underpayments

**2.11** Overpayments and underpayments are a feature of tax credits and occur where a claimant's income and circumstances change, for example between the calculation of the provisional and the final award.

### Causes of overpayments and underpayments

**2.12** The tax credit computer system does not automatically generate information on the underlying causes of overpayments and it would involve significant resources for HMRC to examine every award to determine why an overpayment occurred. HMRC's analysis of overpayments suggests that they result from a number of factors:

- income rises from one year to the next;
- families overestimating the extent to which their income has fallen when they seek extra support during the year;
- provisional payments made at the start of the tax year based on out of date information which is subsequently updated when the award is renewed; and
- delays in reporting changes in families' personal circumstances to HMRC.

Underpayments of tax credits primarily arise when claimants do not notify reductions in household income that would increase the award.

### Levels of overpayments and underpayments

**2.13** Tax credit awards for 2005-06 will not all be finalised until January 2007 and HMRC will not therefore be able to provide actual totals of overpayments and underpayments, or the number of families affected until after that date. It nevertheless estimates that the amounts will be broadly similar to those in 2004-05.

**2.14** HMRC completed the final assessment of awards for 2004-05 in January 2006. As shown in **Figure 4**, it identified overpayments of some £1.8 billion to two million families and underpayments of £556 million to 900,000 families. Overpayments in 2004-05 were £400 million less than for 2003-04 because HMRC had more up to date information on claimants' income during the year. In addition improved performance of the tax credit system has meant that fewer overpayments are caused by processing or software error. 529,000 families received overpayments of £1,000 or more, accounting for over 70 per cent of the total overpaid. An analysis of the bands of overpayments and underpayments is provided in **Figure 5 overleaf**.

**2.15** HMRC calculate that £395 million of overpayments relate to some 228,000 awards which were terminated because the claimant had not reported their actual 2003-04 income, failed to return a signed 2004-05 award notice or did not qualify for tax credits. HMRC also overpaid £144 million in respect of 285,000 awards that ceased during 2004-05.

## Recovery of overpayments and write-offs

**2.16** HMRC's approach to recovering overpayments is set out in its guidance to claimants.[5] It usually seeks immediate repayment where the claimant is no longer eligible for an award, although HMRC considers any request to pay by instalments. Where there is on-going entitlement, HMRC recovers overpayments from future tax credit payments. But HMRC restricts some recoveries made against the payment of future awards where it considers this would cause hardship and the maximum it recovers each year are:

- 10 per cent from claimants entitled to the maximum award;
- 25 per cent for those entitled to more than the family element of Child Tax Credit, or less than the maximum Working Tax Credit; and
- 100 per cent for those entitled to only the family element of Child Tax Credit.

HMRC expects complete recovery of overpayments from 2003-04 and 2004-05 to take several years.

**4** Tax Credits overpayments and underpayments

| | 2003-04 | 2004-05 |
|---|---|---|
| Net cash paid to claimants in year | £13.5bn | £15.8bn |
| Families benefiting | 4.6m | 5.0m |
| Overpayments | £2.2bn | £1.8bn |
| Families affected by overpayments | 1.9m | 2.0m |
| Underpayments | £464m | £556m |
| Families affected by underpayments | 0.7m | 0.9m |

*Source: HMRC*

**2.17** HMRC seeks to recover overpayments wherever possible, but it may write-off the debt or restrict the rate of recovery if it considers that repayment would cause hardship. HMRC writes-off overpayments on the grounds of 'official error' where it has made a mistake and the claimant could reasonably have thought the payment was right. In April 2006, the Department published revised guidance for recipients of tax credits, to provide further details of what it means by "reasonable".

**2.18** In 2005-06 HMRC wrote off £397 million of overpayments (£123 million in 2004-05). This was made up of £176 million for 2003-04 awards, £137 million for 2004-05 awards, and £84 million for 2005-06 awards. These amounts include £130 million written off in respect of organised fraud. In addition, a total provision of £1,370 million has been made in the Trust Statement account for overpayments on finalised 2003-04 to 2005-06 awards expected to be written off. An analysis of amounts written-off, provisions and amounts to be recovered is given in **Figure 6 overleaf**.

## Recent changes to the tax credits system

**2.19** The recovery of overpayments has caused difficulties for some claimants and HMRC has made changes designed to reduce hardship. Before November 2005, HMRC's computer systems automatically recovered overpayments, even if the claimants disputed them. In November 2005, HMRC adopted a manual process to suspend the recovery of any disputed overpayments until it had reviewed the case and decided whether or not the overpayment was recoverable. It plans to replace this manual arrangement with an automated process later this year.

5 COP 26, *What happens if we have paid you too much Tax Credits*.

## 5 Finalised 2004-05 awards overpaid or underpaid as at 5 April 2006

| Band of overpayment or underpayment | Overpayments | | | | Underpayments | | | |
|---|---|---|---|---|---|---|---|---|
| | Awards (thousands) | | Value (£m) | | Awards (thousands) | | Value (£m) | |
| Up to £200 | 611 | (448) | 56 | (41) | 372 | (274) | 32 | (24) |
| £200 to £500 | 454 | (414) | 150 | (141) | 219 | (170) | 72 | (56) |
| £500 to £1,000 | 364 | (388) | 260 | (280) | 152 | (124) | 108 | (88) |
| £1,000 to £2,000 | 293 | (347) | 414 | (493) | 102 | (92) | 143 | (129) |
| £2,000 to £5,000 | 207 | (243) | 619 | (725) | 54 | (47) | 157 | (136) |
| Over £5,000 | 29 | (40) | 196 | (252) | 7 | (5) | 43 | (29) |
| **Total** | **1,958** | **(1,879)** | **1,696** | **(1,931)** | **906** | **(713)** | **556** | **(464)** |

*Source: HMRC*

NOTES

1 Comparative figures for 2003-04 shown in brackets.

2 These figures are calculated as at 5 April and exclude overpayments arising from subsequent backdated payments. In 2003-04 overpayments arising from subsequent backdated payments were £0.3 billion, and for 2004-05 these are currently estimated at £0.1 billion. Figures may not sum due to rounding.

## 6 Recovery and write-offs of overpayments from 2003-04 and 2004-05

| | 2003-04 | 2004-05 | Total |
|---|---|---|---|
| **Overpayments** | **£2.2bn** | **£1.8bn** | **£4.0bn** |
| Amounts written off by 5 April 2006 | (£0.3bn) | (£0.2bn) | (£0.4bn) |
| Amounts recovered by 5 April 2006 | (£0.8bn) | (£0.2bn) | (£1.0bn) |
| Debt to be recovered at 5 April 2006 | £1.2bn | £1.4 bn | £2.6bn |
| Provision for doubtful debts for 2003-04 and 2004-05 overpayments at 5 April 2006 | n/a | n/a | £0.9bn |

*Source: HMRC*

NOTES

1 This table excludes amounts for 2005-06 awards, because overpayments for these awards will not be known for certain until they have been finalised.

2 n/a = not applicable.

3 Figures may not sum due to rounding.

**2.20** The December 2005 Pre-Budget Report announced changes which were designed to provide greater certainty to claimants, particularly when families see a rise in income. HMRC estimates that these changes will eventually reduce the value of overpayments by one third. The principal measures in this package, including HMRC's assessment of their impact on the level of overpayments are:

- For awards for 2006-07 and subsequent years, HMRC will raise the level at which increases in income are disregarded when finalising awards from £2,500 to £25,000. This will reduce overpayments arising from income changes above £2,500;
- From April 2006, additional responsibilities have been placed on claimants to notify HMRC promptly of changes in circumstances that affect their awards. This will reduce overpayments caused by awards being based on out of date information;
- For awards for 2005-06 and subsequent years, the period which claimants have to finalise their awards will be reduced from 30 September to 31 August. This will reduce overpayments caused by new awards being based on out of date information and will shorten the period where payments are made to claimants who no longer qualify for tax credits;

- From November 2006, HMRC will apply automatic limits on the recovery of overpayments where awards are adjusted in-year following a reported change in circumstance. HMRC believe this may encourage more families to report in-year changes of circumstances; and
- From April 2007, when claimants report a fall in income during the year, their tax credit payments will be adjusted for the rest of the year. But HMRC will not make a one-off payment for the earlier part of the year. After the end of the year their award will be finalised and HMRC will make a further payment if appropriate. Amongst other effects, this should reduce overpayments where families overestimate the extent to which their income has fallen when they seek extra support during the year.

**2.21** The Treasury estimates that the overall effect of the package on the net cost of the scheme to the Exchequer will be £100 million in 2006-07, followed by net savings of £200 million in 2007-08 and £50 million in 2008-09. It has not been able to provide reliable costings for the individual elements of the package. This is because it does not have comprehensive data to allow it to track individual awards on a continuous basis to identify and quantify precisely the contribution of each of the potential reasons that overpayments occur. In the absence of complete and certain information on tax credit overpayments in 2003-04, the costings are based on a number of policy-related assumptions about the impact of the measures, their likely interaction and their effect on claimant behaviour.

## Managing error and fraud

### Claimant Error and Fraud

**2.22** HMRC tries to maintain a balance between ensuring the accessibility of the scheme to claimants and maintaining safeguards against the risk of error and fraud. It aims to achieve this by investigating claims which it judges present the highest risk and it checks these before or, in certain cases, after claims are paid. Since the introduction of tax credits HMRC has placed greater emphasis on identifying error and fraud before payments are made as the most effective way to avoid financial loss. **Figure 7 overleaf** illustrates the main process by which HMRC checks tax credit claims.

**2.23** HMRC makes a number of pre-payment checks involving a series of steps, as set out in Figure 7, before authorising payment. All new tax credit claims, whether received on paper or over the internet, are subject to a series of verification checks and a risk assessment process. These involve:

- automatic verification of certain personal data claimants provide to check they are consistent with information that HMRC already holds for them. This verification check will not necessarily stop fraudulent claims involving stolen identities because the personal information provided in the claim is correct and matches the details held by HMRC.
- automatic risk assessment to identify high-risk cases, such as undeclared income, undeclared partners or fictitious child care costs. HMRC also checks for cases that display features of organised fraud. New claims posing the greatest risk are examined by the compliance unit before the awards are paid.

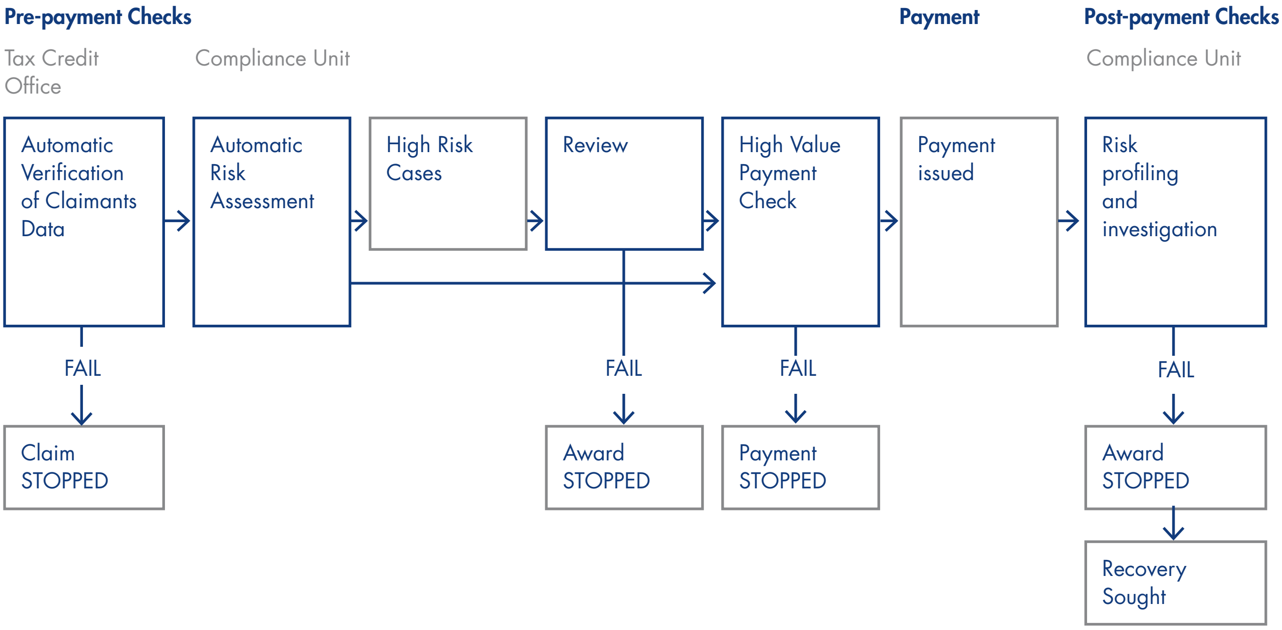
In addition, HMRC checks all payments over a certain value to identify any large payments that could indicate potential fraud. If the claim demonstrates known features of fraud HMRC stop the payment before it reaches the bank account.

**2.24** HMRC carries out further checks once claims are in payment. It carries out computer based interrogations against all awards in payment to identify those showing characteristics of fraud or non-compliance. It takes action, including withholding payment and undertaking further enquiries, where it considers there is sufficient evidence of risk.

**2.25** If HMRC identifies non-compliance, it corrects the claim and notifies the claimant to help avoid similar errors in future awards. For more serious cases, HMRC can impose a financial penalty and its Criminal Investigations Directorate may consider whether to recommend criminal proceedings[6]. In 2005-06, HMRC referred 1,721 cases to be considered for prosecution. Under Section 16 of the Tax Credits Act 2002, HMRC can also terminate payments without prior contact with the claimant where it considers there is evidence of potential organised fraud.

6 In April 2005, HM Revenue & Customs Prosecution Office became responsible for prosecutions in England and Wales. Responsibility in Northern Ireland and Scotland continues to rest with the Director of Public Prosecutions and the Procurator Fiscal.

## 7 Compliance Checks on new Tax Credit Claims




12 basic checks to verify claimant data.

The award will not go into payment if the claim fails certain key 'high severity' verification checks.

All new claims are scored against over 20 weighted risk criteria, applied independently and in combination, covering eligibility and other factors.

All claims scoring in excess of a pre-determined threshold ('high risk cases') are selected for review.

Review of High Risk Claims

The highest risk cases are identified for immediate compliance consideration. In cases taken up for full examination the claim will be rejected before any payment is made, if the compliance team are not satisfied that it is correct. High risk claims that are not considered for a full examination at this point will be picked up for post award action.

High Value Payment Check

All payments over a pre-determined threshold are checked against known features of organised fraud to confirm they relate to a genuine claimant.

Further intelligence driven profiling of genuine claimant population to identify claims demonstrating high risk characteristics as well as looking for known 'modus operandi' used by organised fraudsters.

*Source: National Audit Office*

**2.26** HMRC's performance against its targets for compliance checks on tax credits is shown in **Figure 8 overleaf**. In 2005-06, HMRC's compliance teams carried out 146,000 pre and post payment checks on the highest risk claims, which yielded £528 million. During 2005-06 HMRC changed the balance of its pre and post payment checking by increasing the number of checks carried out before the payment of the highest risk claims. In 2005-06, 45 per cent of all claims checked by the compliance unit were checked prior to payment (16 per cent in 2004-05). To make best use of its resources, HMRC's compliance work is focussed on those claims it considers show the highest risk of non-compliance.

**2.27** Throughout 2005-06 HMRC's pre-payment checking identified increasing numbers of claims which demonstrated the characteristics of organised fraud. In May 2005, it introduced weekly monitoring of cases classified as potentially organised fraud cases under its pre-award risk assessment process. The level of suspected organised fraud cases identified through this process gradually increased though 2005 to reach a peak in November and early December, as shown in **Figure 9 overleaf.** During this period the process of pre-payment checking came under heavy pressure, and HMRC directed a significant proportion of its compliance resources into checking suspected organised fraud cases. High risk claims that were not considered for a full examination at this point were reviewed post payment. In 2006-07, HMRC plans to dedicate at least a further 200 staff to its tax credit compliance teams and it has increased the target for the number of pre and post payment checks to 130,000.

**2.28** As described in paragraph 2.25, in addition to direct checks by tax credit compliance teams, HMRC may act in other ways to identify fraud and withhold tax credits payments. This can be either as a result of the work of its criminal investigation teams or through other procedures, such as the withholding of payments where the claimant fails to sign the award notice. An analysis of the outcomes arising from all HMRC actions to stop erroneous and fraudulent tax credit claims is given in **Figure 10 overleaf**. HMRC estimates that in 2005-06 it intervened in 195,000 cases and prevented payments of £447 million. The analysis also shows that HMRC found it had made incorrect payments of £250 million, including £131 million of suspected organised fraud.

**2.29** In addition to the checks on all tax credit claims, HMRC also carried out compliance work in specific areas it assessed as having higher risks of error and fraud. In 2003-04 and 2004-05, HMRC carried out two special exercises to check child care costs with the providers who were contacted to verify the details provided by all claimants whose award included an element for child care costs. In 2005-06, following concerns from child care providers about the amount of work these checks involved, HMRC instead contacted providers only in cases where it identified a high risk.

## Organised crime and the tax credits e-portal

**2.30** Until December 2005, tax credit claims could be made through the internet (the tax credits e-portal) or on paper. The ability to claim tax credits through the e-portal was particularly appealing to organised criminals as it allowed them to quickly submit multiple claims with anonymity. HMRC has always been aware of the risk that organised criminals may attempt to make fraudulent tax credit claims. As part of its pre-award checking, it has developed specific checks designed to identify applications that display the features of organised fraud.

**2.31** HMRC first became aware that attempted fraud through the e-portal was an emerging problem at the end of 2004, although it considered these risks could be managed through its existing compliance work. From April 2005, however, it began to see a growing threat of organised fraud through the tax credits e-portal, when its pre-award checks began to identify an increasing numbers of claims with the characteristics of organised fraud. In June 2005 HMRC advised its Ministers of this problem although it continued to consider that its existing controls were sufficient to manage the threat. The pattern of claims made each week can be subject to significant variation. However, throughout this period the volume of claims made through the tax credits e-portal had remained below 10,000 per week. HMRC found that the volume of claims made through the e-portal began however to rise significantly from August 2005 and by November 2005 these had reached some 30,000 per week as the system came under sustained attack. HMRC reassessed the risk of fraud against the tax credits system and it closed the e-portal on 2 December because of the increase in the volume of claims, the increased number of claims showing the characteristics of organised fraud, and new information from the Department of Work and Pensions that organised criminals were in possession of large numbers of stolen identities. HMRC's other online services were unaffected.

## 8 HMRC's direct compliance checks *(targets shown in brackets)*

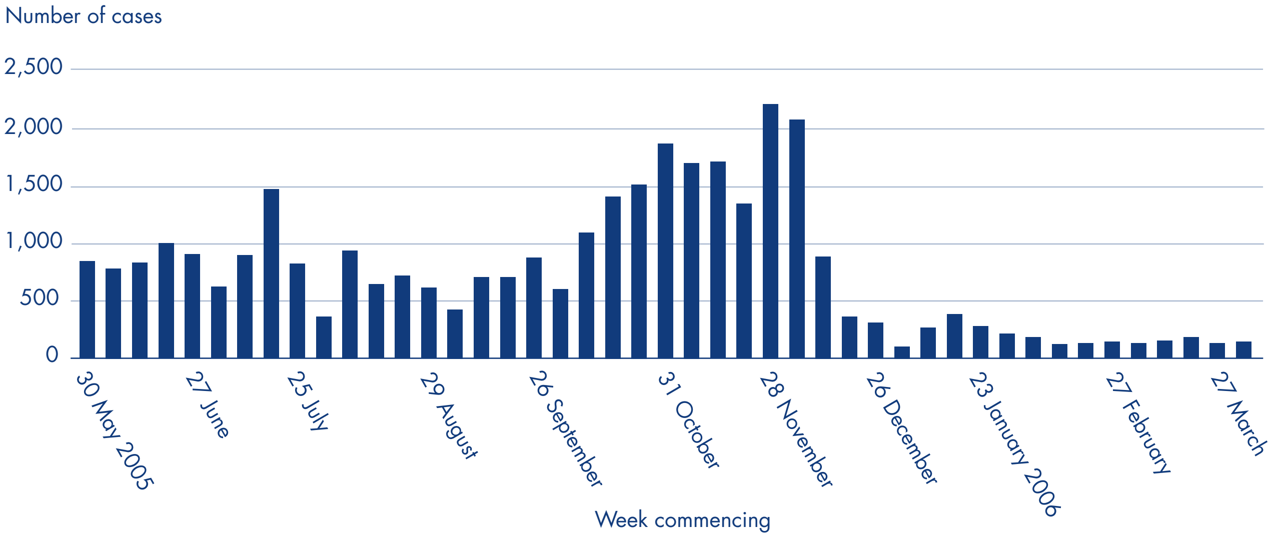
| | 2004-05 | 2005-06 |
|---|---|---|
| Volume of Checks | | |
| Pre and post payment checks | 107, 789 *(101,500)* | 146,376 *(110,000)* |
| Pre payment : post payment ratio | 16% : 84% | 45% : 55% |
| Effectiveness of checks | | |
| Yield | £130m *(HMRC did not set a target for yield in 2004-05)* | £528m[1] *(£143m)* |
| Checks resulting in change to award: | | |
| Pre award | 93% | 93% |
| Post award | 65% | 85% |
| Sanctions | | |
| Cases where a penalty was charged | 1,114 | 2,241 |
| Total value of penalties | £445,645 | £887,585 |
| Criminal prosecutions | 211 | 289 |

*Source: HMRC*

NOTE

1 Yield includes incorrect payments identified by HMRC of £221 million in 2005-06.

## 9 Potential organised fraud cases identified by HMRC's pre payment checks




*Source: HMRC*

NOTE

This figure shows the weekly intake of high risk cases on HMRC's pre-payment worklists which were classified as potential organised fraud. Data was not collected in this format before May 2005.

**10** Outcome of all HMRC compliance and other actions on tax credits fraud and error cases in 2005-06

| | **Overall** | | | **Suspected Organised Fraud** | | |
|---|---|---|---|---|---|---|
| | Compliance actions thousands | Incorrect payments identified £m | Incorrect payments prevented £m | Compliance actions thousands | Incorrect payments identified £m | Incorrect payments prevented £m |
| **Pre Award** | | | | | | |
| Compliance checks | 67 | nil | 219 | 58 | nil | 200 |
| Other actions | 33 | nil | 113 | 33 | nil | 113 |
| **Total** | **100** | **nil** | **332** | **91** | **nil** | **313** |
| **Post-Award** | | | | | | |
| Compliance checks | 80 | 221 | 88 | 37 | 102 | 69 |
| Other actions | 15 | 29 | 27 | 15 | 29 | 27 |
| **Total** | **95** | **250** | **115** | **52** | **131** | **96** |
| **Pre and Post Award** | | | | | | |
| Compliance checks | 147 | 221 | 307 | 95 | 102 | 269 |
| Other actions | 48 | 29 | 140 | 48 | 29 | 140 |
| **Total** | **195** | **250** | **447** | **143** | **131** | **409** |

*Source: HMRC*

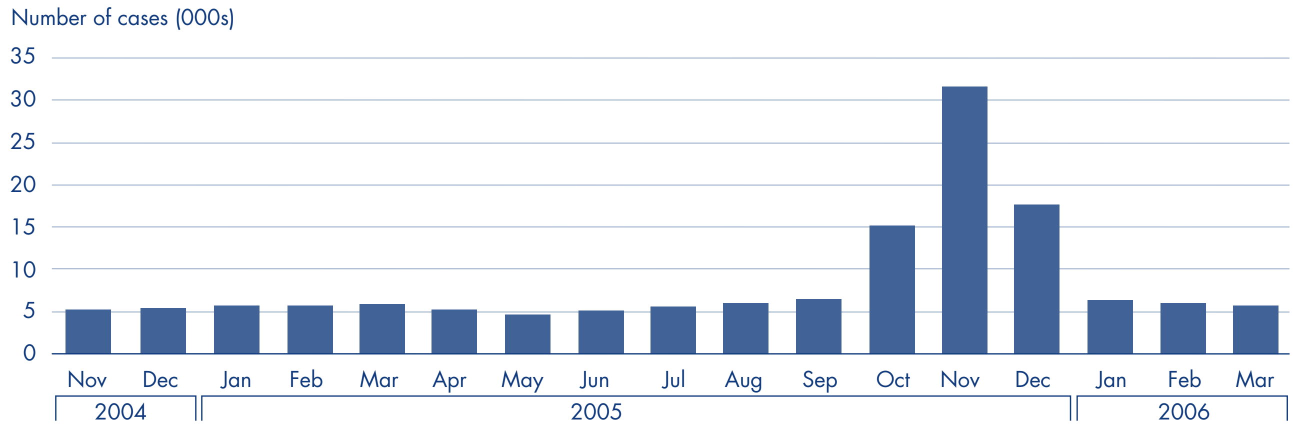
NOTE

The estimate of incorrect payments identified represents the value of payments made prior to the compliance or other action taking place.The estimate of incorrect payments prevented is the additional amounts that would have been paid for 2005-06 had payment not been withheld.

**2.32** Following the closure of the e-portal, HMRC has assessed the extent of the attacks on the tax credits system from organised criminals. Using knowledge gained from the attacks, it has reviewed all claims that were made through the tax credits e-portal in 2005-06 which shared the characteristics of the claims from organised fraudsters. It estimates that in late 2005 some 62,000 fraudulent claims were made through the e-portal using stolen identities, of which 33,000 were successful and passed into payment at a cost of around £55 million. This includes some 13,000 claims made using the identities of DWP and Network Rail staff, of which 7,000 were successful at a cost of around £10 million. HMRC has no evidence that the other attacks were based on the use of information systematically stolen from any one employer.

**2.33** Based on this work, HMRC believes there were around 5,000 to 6,000 genuine claims in payment in the first nine months of 2005 which had the same characteristics as the actual cases of organised fraud in late 2005. The analysis, as shown in **Figure 11 overleaf**, shows that the system came under heavy attack in November 2005 when fraudulent claims through the e-portal reached a peak of 33,000. The numbers fell in December 2005 following investigations by HMRC's compliance teams to stop payments. In 2005-06 HMRC stopped 143,000 suspect tax credit applications by organised fraudsters and it estimates that £131 million was lost due to organised fraud.

**11** Tax Credit cases in payment containing characteristics used in attacks by organised criminals in late 2005




Source: HMRC

NOTE

This figure shows the number of tax credit cases in payment which shared the characteristics used in the fraudulent claims submitted as part of the organised attack in late 2005, including around 5,000 - 6,000 genuine cases.

**2.34** At the time of my report, HMRC's Organised Tax Credit Fraud Strategy Board was overseeing investigations into 41 separate organised fraud cases, the majority of which involve multiple claims based on stolen or false identities. HMRC cannot yet give a precise figure on the overall sums involved, but its initial indications are that the total losses on these cases were £26 million. HMRC is conducting further work to establish firmer estimates of the frauds and whether prosecutions are possible. By June 2006, it had completed four prosecutions for organised fraud through the criminal court, which resulted in eight convictions and confiscation orders of £1.4 million.

**2.35** HMRC assessed that the tax credits e-portal complied with its internal security standards when it was introduced in August 2002. But it has accepted that additional controls need to be built into the tax credits e-portal before it can be re-opened to the public to conform to subsequent guidance issued by the Office of the e-Envoy for the registration of new users and the authentication of their identity each time they access the service[7]. Whilst the tax credits e-portal required limited verification of the claimant's identity against HMRC's records, claimants did not have to produce documentary evidence to prove their identity and address, such as a passport or bank statement.

**2.36** HMRC has considered how organised fraudsters might respond to the closure of the tax credits e-portal by attacking other channels. It has strengthened its controls over handling paper-based claims and has revised its procedures to improve controls over claimants' notification of changes of circumstances which affect their awards. It has also provided training to promote fraud awareness to contact centre staff and embedded compliance specialists within contact centres to prove additional support and specialist knowledge to these staff. HMRC intends these changes to create more of a 'challenge' function when handling tax credits claims in the future.

## Measuring the level of error and fraud

**2.37** In addition to its day to day management of compliance risks, HMRC also measures the overall level of error and fraud by investigating a random sample of awards, although the design of the tax credits scheme affects the speed with which it can complete this work. Under the Tax Credits Act 2002, HMRC cannot commence its investigation into randomly selected awards until they have been finalised. While most awards for 2003-04 were finalised by the end of September 2004, some could not be finalised until the end of January 2005 if taxpayers submitted an initial estimate. HMRC could not therefore start its investigation of some cases until February 2005.

7 In September 2002, the e-Envoy issued guidance on controls that should be built into systems where government services were provided electronically, *Registration and Authentication: e-Government Strategy Framework Policy and Guidelines*.

**2.38** In June 2006, HMRC completed its testing of 2003-04 awards, based on a sample of some 4,500 random enquiries against claimant records. As a result of this, HMRC estimates that claimant error and fraud resulted in between £1.06 billion and £1.28 billion (8.8 to 10.6 per cent by value) being paid to claimants to which they were not entitled. It also estimates that claimant error resulted in between £190 million and £280 million (1.6 to 2.3 per cent by value) not being paid to claimants to which they were entitled. As separately noted in my report on the 2005-06 Trust Statement, I concluded that this level was unacceptably high and, as there is currently no evidence to justify a lower estimate for 2005-06, I have qualified my audit opinion on the Trust Statement account in respect of tax credits.

**2.39** In conducting random enquiries of awards, HMRC tries to strike a balance between the risk of not detecting error and fraud and undue intrusion into claimants' circumstances. It decides on the level of enquiry based on an assessment of the risks of error and fraud in each case. My staff found that HMRC's work was primarily focused on identifying overpayments and that it did not always fully consider the risk of error leading to underpayments. 2003-04 was the first year HMRC undertook this work and it has introduced the following steps to learn from its experience:

- providing additional guidance to its compliance staff, emphasising the importance of undertaking a full enquiry;
- carrying out additional validation checks of the work of compliance staff, with detailed management review of all cases and independent reviews of randomly selected cases;
- closer working between tax credit and self-assessment teams within HMRC; and
- coaching individual staff who could have carried out more thorough work.

## Administrative Error

**2.40** Incorrect awards and payments can be made due to errors made by HMRC. It has established procedures intended to prevent errors in the first place and to identify any that do arise.

### Processing accuracy

**2.41** HMRC checks how accurately it processes information received from claimants by re-examining a sample of cases against the original information provided. This work was in progress at the time of my report, but **Figure 12** shows the provisional results of this review and highlights that HMRC should exceed its Public Service Agreement target of processing accurately 95 percent of claims and changes in circumstances. It has made significant improvements in processing information accurately since the introduction of tax credits, which reflect its continuing efforts to identify the reasons for inaccuracy and to introduce new procedures to prevent error. HMRC considers that the small sample size and low error rate means it cannot provide a statistically valid assessment of the financial effect of inaccurate processing and that a larger sample size would involve a disproportionate amount of resource. The Department's research indicated that the three main reasons for inaccurate processing were: incorrect amendments to historical records; inputting of incorrect income; and / or inputting of incorrect child care costs.

**2.42** My staff reviewed the accuracy of HMRC's checks on its processing. They were satisfied that the work was undertaken properly but found that in 15 per cent of cases HMRC was unable to locate documents it had selected for testing and these items were excluded from the results. HMRC replaces cases that cannot be found with another randomly selected item, and there is no evidence that the cases where documents are lost are less accurate than those HMRC was able to check. HMRC plans to improve how it maintains this information.

**12** Accuracy of processing and calculating tax credit awards

| | 2003-04 % | 2004-05 % | 2005-06 % *(provisional)* |
|---|---|---|---|
| Target | 90.0 | 90.0 | 95.0 |
| Actual | 78.6 | 96.5 | 98.3 |

*Source: HMRC*

### Software errors

**2.43** HMRC has recovered significantly from the early problems with its tax credits computer system, although at the end of October 2005, there were still 199 known software errors which potentially caused errors in payments. In October 2005, HMRC started a systematic review of all these errors to calculate the value of overpayments and underpayments they have caused. The Department has an ongoing programme of prioritising and correcting the underlying errors.

### Reconciling the information held by the HMRC

**2.44** HMRC also seeks to confirm the accuracy of its information by reconciling the different sources of information it holds and by comparing this with information held by third parties.

**2.45** In my previous reports, I noted that HMRC had not been able to perform the planned daily reconciliation of payments made against payments authorised. This is important as any differences indicate that an incorrect payment may have been made. As an alternative process HMRC performed checking retrospectively but this meant that some incorrect payments were not promptly identified. In November 2005, HMRC introduced an automated daily check of payments made against payments authorised, which should help it identify incorrect payments more quickly. But the new process suffered initially from computer difficulties and HMRC had to continue with some aspects of its old approach. HMRC has taken action to address these problems and considers that the system is now performing as intended.

**2.46** In 2005-06, HMRC made adjustments to its record of payments authorised of £8.2 million (2004-05 £7.9 million). But, it did not fully understand the causes of the discrepancies. HMRC has subsequently undertaken detailed work to understand how these problems arose and to address the faults. It has found that the number of discrepancies has now reduced substantially.

**2.47** HMRC continued to have difficulty in reconciling its own record of payments with those of its bank, largely because of limitations in the information produced by the Tax Credits computer system. In April 2006, HMRC enhanced the quality of information available, which has improved the bank reconciliation process and a further improvement is due in November 2006.

### Controls over tax credit payments made by employers

**2.48** Until April 2006, some elements of tax credits were paid directly to claimants through their employer. HMRC needs assurance that the amounts paid by employers conform with the actual award it has made. Since the introduction of Tax Credits in 2003, HMRC has found that employers' end of year returns have not provided sufficient information to allow a full reconciliation of amounts paid by employers against awards made by HMRC. The Department has instead sought to obtain assurance that the amount paid is correct by selecting a sample of employer records and reconciling the amounts reported as paid by the employer to its own record of awards.

**2.49** The 2004-05 reconciliation was completed in December 2005 and showed a reconciliation rate of 77.4 per cent compared with 78.9 per cent for 2003-04. HMRC was unable to reconcile the remaining 22.6 per cent and required employers to correct awards where it found errors. The exercise indicated that of the total £1.6 billion paid by employers in 2004-05, there was a likely net underpayment of £44 million (within an estimated net range of £18 million underpaid to £70 million underpaid). The 2005-06 reconciliations were in progress at the time of this report.

## Conclusions

**2.50** The tax credits system was changed in April 2003 and in 2005-06 HMRC paid a net £17.3 billion to tax credit claimants and an average of 5.3 million families received provisional 2005-06 awards. HMRC uses the latest information it holds on claimants to calculate a provisional tax credit award and make payments. It makes a final assessment after the end of the year when the claimant's actual circumstances are known. The final award is often higher or lower than the provisional award, for example because the final income differs from the provisional income.

**2.51** HMRC estimates that it overpaid £1.8 billion and underpaid £556 million in tax credits in 2004-05 and that the position for 2005-06 awards will be similar. When HMRC identifies an underpayment it pays the claimant a lump sum and it seeks to recover overpayments from future awards or, if there is no ongoing entitlement, directly from the claimant. The recovery of overpayments has caused hardship to some families and HMRC has struggled to manage disputes about recovery. It cannot recover all overpayments and in 2005-06 wrote off £397 million and made a provision of £409 million for doubtful debts.

**2.52** The December 2005 Pre-Budget Report announced changes to the tax credits system which were designed to provide greater certainty to claimants, particularly when families see a rise in income. One important change will be to raise from £2,500 to £25,000 for 2006-07 awards the threshold for increases in income which will be disregarded when provisional awards are re-assessed. There will also be new responsibilities on claimants to tell HMRC promptly about changes in their circumstances. The Treasury has been unable to provide reliable costings for the individual elements of the package. The success of these measures in reducing overpayments and recoveries will become apparent only in 2008 following finalisation of 2006-07 awards.

**2.53** HMRC estimated that in 2003-04 claimant error and fraud resulted in tax credits of between £1.06 billion and £1.28 billion (8.8 to 10.6 per cent by value) being paid to claimants to which they were not entitled. It also estimates that claimant error resulted in between £190 million and £280 million (1.6 to 2.3 per cent by value) of tax credits not being paid to claimants when they were entitled to them. These are the first full results for the scheme since it was introduced in April 2003. These levels are unacceptably high and there is currently no evidence to justify a lower estimate for 2005-06. Consequently, I have qualified my opinion on the Trust Statement. Now HMRC has a baseline figure, it needs to target future reductions in levels of error and fraud.

**2.54** HMRC tries to maintain a balance between accessibility of the tax credits scheme to claimants and maintaining safeguards against the risk of error and fraud. It aims to achieve this by investigating claims which it judges present the highest risk and it checks these before or after claims are paid. In 2005-06, HMRC completed compliance checks and other actions against 195,000 claims, identifying incorrect payments made of £250 million and preventing incorrect payments of £447 million. HMRC prioritises its compliance activity on the claims it considers represent the highest risk. High risk claims that are not fully examined before payment are selected for checking after payment. HMRC has set a target for this compliance work which is based on the number of checks. It needs to consider how these can be developed into outcome based targets, such as reductions in fraud to provide better information on the effectiveness of its compliance work.

**2.55** In 2005 there was a serious attack on the tax credits system by organised criminals submitting false claims using stolen identities. HMRC identified incorrect payments of around £131 million in 2005-06. Its Organised Fraud Strategy Board is overseeing investigations into 41 separate organised tax credit fraud cases, most of which involve multiple claims using stolen identities. HMRC cannot yet give a precise figure for the overall sums involved, but its initial indications are that the total losses on these cases were £26 million. HMRC is conducting further work to establish firmer estimates to support the case for prosecution.

**2.56** HMRC closed the tax credits e-portal on 2 December 2005 as a consequence of these attacks and it accepts that additional controls need to be built into the e-portal before it can be re-opened. HMRC needs to ensure that the new system fully complies with established government standards on security. HMRC has reviewed the other channels through which tax credits can be claimed and has introduced new measures to safeguard against fraud. It needs to continue to assess the wider implications of the fraud and how organised criminals might respond to the closure of the tax credits e-portal.

# PART THREE

# THE COLLECTION OF INCOME TAX THROUGH PAY AS YOU EARN

## Introduction

**3.1** Pay As You Earn (PAYE) was introduced in 1944 and collects tax on income from employment and pensions at source. In 2005-06 HMRC collected £114 billion income tax (£109 billion 2004-05) through PAYE, the largest source of tax revenue, from some 41 million employment and pension sources operated by 1.9 million PAYE employer and pension schemes. HMRC employs some 15,000 staff in directly administering PAYE.

**3.2** The PAYE process is designed so that employees and pensioners pay the right amount of tax in the tax year, so the only cases which need to be reviewed at the end of the year are those where that has not been possible. HMRC estimates that, in practice, the PAYE system handles about 70 per cent of cases automatically without the need for further work by the Department. Of those cases that need to be reviewed, HMRC's objective is to close as many as possible within a year after the end of the tax year. Although this is not stated as a formal business objective, HMRC aims to ensure that individuals who receive earnings pay the right amount of tax and to make it as easy as possible for employers and employees to meet their obligations.

**3.3** HMRC's principal computer systems for administering PAYE were introduced in the 1980s. Since that time the size and complexity of the UK labour market has grown significantly and the number of PAYE schemes has increased. Over the same period additional requirements have been placed on employers through the mechanics of the PAYE system. HMRC and employers have therefore been faced with increased volumes of more complex transactions to process through the PAYE system.

**3.4** My Standard Report for 2004-05 commented on some of the work carried out by HMRC's Internal Audit and highlighted that 3.8 million taxpayers could have paid too much or too little tax because HMRC was not calculating tax liabilities correctly, in particular where individuals had more than one job at the same time. This part of my report covers:

- The PAYE process;
- Challenges faced by HMRC in operating PAYE;
- Weaknesses and inconsistencies in HMRC's processes and operations;
- The effect of those challenges; and
- Action being taken by HMRC to improve the PAYE process.

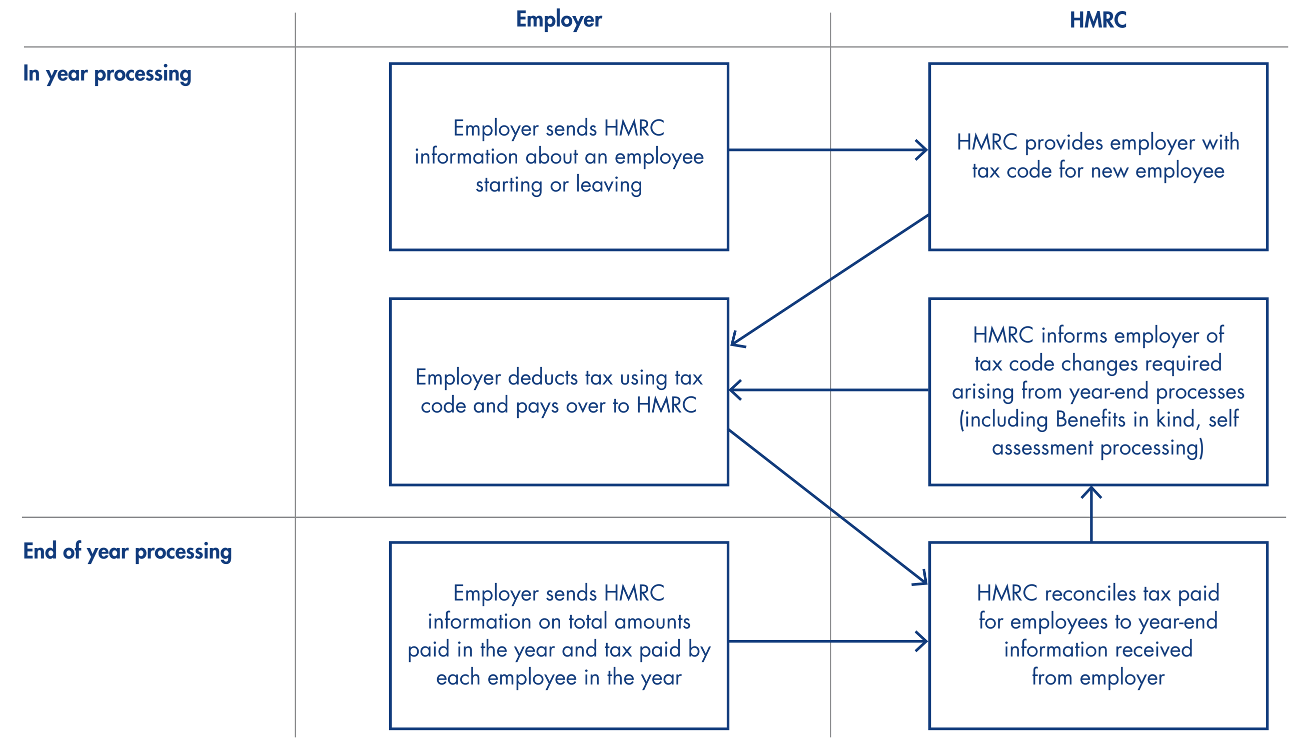
## The PAYE Process

**3.5** Employers are responsible for administering PAYE schemes on behalf of HMRC, ensuring that the correct amounts of tax and national insurance contributions are deducted from employees' earnings and paid over to HMRC. PAYE involves a number of processes designed to ensure that taxpayers pay the right tax **(see Figure 13)**.

**3.6** PAYE is designed to work such that the total tax deducted from earnings up to any point in the year is the correct proportion of total tax likely to be due for the whole year. To achieve this, HMRC issues a tax code for each employee, where necessary, to help the employer to calculate how much tax to deduct from the earnings week by week or month by month. Tax Codes are determined by individual taxpayers' circumstances and are revised to reflect relevant changes notified to HMRC.

**3.7** When an employee changes jobs, the new employer needs certain information to deduct the right amount of tax from earnings. Employers are required to issue a form P45 to an employee who leaves a job, showing total earnings, tax deducted to date and their tax code. The individual should present the form P45 to a new employer to allow the right amount of tax to continue to be deducted from earnings. When a new employee is unable to produce a form P45, an employer instead sends a form P46 to HMRC with information about the new employment. HMRC uses this information to trace

**13** The PAYE process




*Source: National Audit Office*

previous tax records, check the employee's circumstances, update its records and issue the new employer with a tax code if necessary. In the interim, the employer uses one of a limited number of codes, based on the information provided by the employee, for example, whether they have more than one job.

**3.8** HMRC relates tax payments received in the year to individual employees when it has received and processed employers' annual PAYE returns. These returns show total earnings and tax deducted under each PAYE scheme (form P35) and information on individual employees (form P14). HMRC reconciles the amounts actually paid by employers to this information and records tax paid by individual taxpayers.

**3.9** Employers also inform HMRC of expenses and benefits in kind, such as a company car or private health care, provided to employees in the year. HMRC enters this information onto its computer systems and checks if the individual has paid the correct amount of tax. The tax code is updated if necessary to reflect the latest information. If HMRC finds that additional tax is payable, it may adjust the tax code for a subsequent year to collect the balance through the PAYE system, or the individual can pay the amount in full immediately. HMRC repays any overpayments of tax.

## Expansion of the scope of PAYE

**3.10** PAYE was originally set up in 1944 with the limited objective of collecting income tax. The scope of the PAYE system has been expanded to cover the collection of certain self assessment liabilities, student loan repayments, accounting for statutory payments, and - until April 2006 – the payment of tax credits via employers. **Figure 14 overleaf** sets out the changes which have increased the task of administering PAYE.

**14 Expansion of the PAYE system**

| | |
|---|---|
| 1944 | Introduction of PAYE to collect income tax |
| 1948 | Collection of National Insurance Contributions |
| 1976 | Changes in taxation of Benefits in Kind |
| 1983 | Statutory sick pay |
| 1987 | Statutory maternity pay |
| 1997 | Introduction of Self Assessment |
| 2001 | Collection of Student loan repayments. |
| 2002 | Tax credit payments to employees.[1] |
| 2003 | Statutory adoption and paternity pay |

Source: HMRC

NOTE

1 Payment of Tax Credits via employers was withdrawn in April 2006.

## Online filing of PAYE Returns

**3.11** In April 2002, the Chancellor of the Exchequer announced that the Government would implement the recommendations from the first Review of Payroll Services by Lord Carter of Coles to introduce online filing of employers' end of year returns. Regulations were introduced requiring online filing of large and medium employers' end of year returns and encouraging, currently, voluntary online filing by small employers. In 2003, HMRC established a Modernising PAYE Processes for Customers (MPPC) Programme to provide the new business processes and support employers in meeting their new responsibilities.

**3.12** Phase one of the MPPC programme concentrated on implementing Lord Carter's recommendations and the online system opened on 6 April 2005. In 2005-06, HMRC received some 935,000 annual returns (form P35) online (over 60 per cent), compared to some 85,000 (6 per cent) of returns filed online in 2004-05. HMRC's early indications are that, of the approximately 1.6 million employer returns received for 2005-06, about three quarters are being filed online.

**3.13** In accordance with legislation[8], HMRC implemented an incentive scheme[9] to encourage small employers to file online, but found in its initial stages the scheme was abused by a small number of employers who artificially split their payroll to claim the incentive several times. The original regulations contained anti-abuse provisions covering incentive payments but in March 2005 the Government changed the regulations with the intention of strengthening defences against such abuse[10]. HMRC is also investigating whether some returns were submitted in circumstances where no return was strictly due. It considers there are probably fewer than 100 cases of potential abuse, out of the population of 1.9 million employers. In 2005-06 HMRC paid in total £225 million in incentives, £250 per small employer.

**3.14** HMRC introduced a new computer system to process automatically online returns for 2004-05. But the implementation of this system was delayed causing significant backlogs of returns, some of which required manual processing. Most of these backlogs have now been cleared but at the end of May 2006 there were some 3.7 million items (around seven percent of the total) which had not been processed onto the PAYE system. HMRC expected to have cleared the majority of these in July 2006, apart from a small proportion of cases (some two per cent) which arise each year that require clerical action to clear.

**3.15** Lord Carter's second review was published in March 2006 and it recommended that businesses should be required to file in year returns (forms P45 and P46) electronically, starting with large and medium sized employers from April 2008. HMRC plans to implement this as part of its future work on MPPC.

## Challenges faced by HMRC in operating PAYE

**3.16** HMRC's computer system for administering PAYE was introduced in the early 1980s and automated the manual processes in operation at that time. It is structured around individual employments and does not automatically bring together all the information for a particular employee. HMRC considers this may reflect the fact that the original PAYE mechanism was designed at a time where individuals generally had one source of income and a relatively stable employment history. As a consequence of changes in working patterns, HMRC's records on employees may be fragmented, particularly if they have more than one job or change jobs during the year. The problems associated with this have been exacerbated in recent years following changes in size and complexity of the labour market, and the growth in the UK employer population. There is also evidence that employers and employees are not following PAYE procedures.

8 Section 143 and Schedule 38 of the Finance Act, 2000.
9 Regulations covering incentive payments are in SI 2003/2495.
10 SI 2005/826 added further anti-abuse provisions to regulation 4 of SI 2003/2495.

## Changes in size and complexity of the labour market

**3.17** HMRC and employers are now administering PAYE for more people. The size of the UK workforce has increased steadily from 25.3 million in 1993 to 28.7 million[11] in 2005, which has produced more work for HMRC and employers in administering the PAYE system.

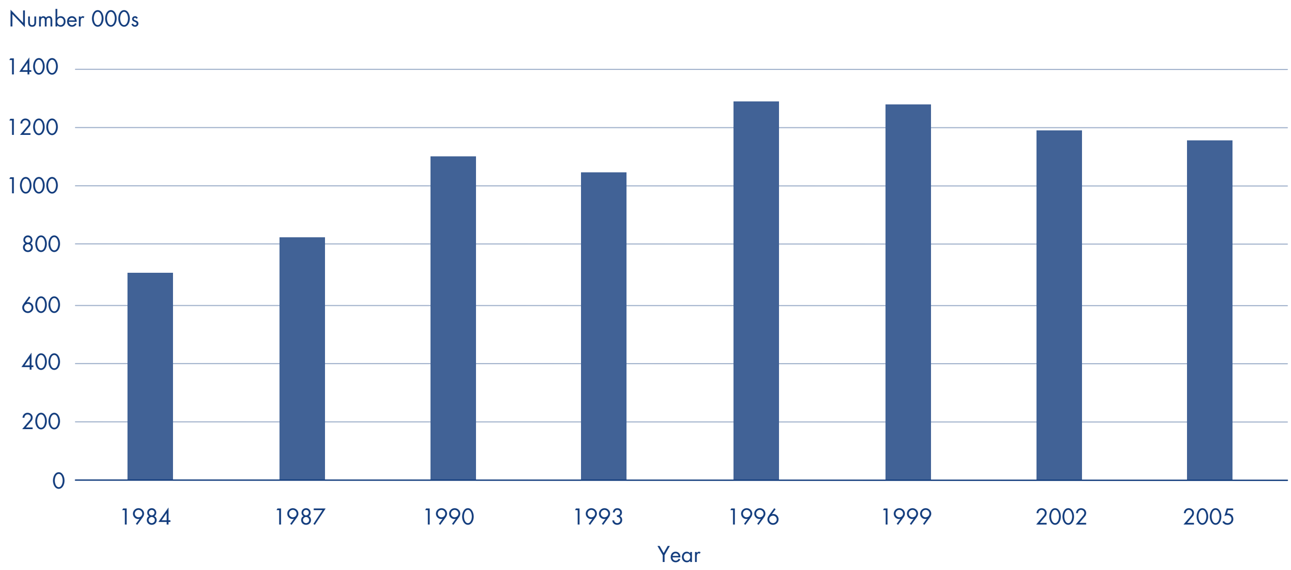
**3.18** There are growing numbers of taxpayers with temporary reference numbers, which makes it difficult for HMRC to associate the information it receives against individual taxpayer records. HMRC creates a temporary reference number for each employment where an individual's National Insurance number is not known. This is usually because a new employee fails or is unable to provide an employer with a National Insurance number on starting work. This includes non-UK nationals entering the UK to work for the first time who will not have a National Insurance number.

**3.19** HMRC takes action to clear temporary reference numbers, but the volume of them is currently growing at a faster rate than HMRC are clearing. In 2005, there were 7.7 million temporary reference numbers and HMRC estimates that this is growing by over one million a year. It estimates that in 4.2 per cent of these cases the same individual had more than one temporary reference number. This increases the risk that incorrect amounts of tax will be deducted as HMRC may not be able to bring together a complete picture of an individual's employments.

**3.20** ONS Labour Force Survey data show that for any one quarter in 2005 there were some one million workers with income from more than one employment **(Figure 15)**. Although this is slightly below the levels recorded in the mid-1990s, it is significantly greater than the numbers of individuals with more than one employment at the time the PAYE systems were computerised in the 1980s. HMRC has 4.2 million computer records for sources of PAYE income which are not the main source of income for the individual concerned. As the PAYE computer system is based around employments rather than employees, HMRC can be unaware that there is another source of income when checking if the correct tax has been paid in these cases.

**3.21** There has been a growth in employment of groups for whom PAYE is difficult to operate, including students who either have more than one job or frequently move jobs. HMRC believes that around 1.8 million full time students held a job at some time during 2005. The growth in taxpayers with multiple sources of income has also been fuelled by increasing numbers of working pensioners, which rose from eight to ten percent of the pensioner population between 1993 and 2005 and there are now 1.1 million working pensioners.

**15** Employees with multiple jobs 1984-2005




*Source: ONS Labour Force Statistics*

11 ONS Labour force statistics.

## Changes in the UK employer population

**3.22** In addition to the increasing complexity of the UK workforce, the volume and complexity of the UK employer population has increased. The number of PAYE schemes is currently growing by approximately 100,000 (net) each year and there were 1.9 million PAYE schemes in 2005. HMRC considers that this increase is due to a number of factors, such as economic growth and more small company incorporations.

**3.23** Along with growth in the number of PAYE schemes, there is a greater diversity of schemes and how they are operated. The largest 10 per cent of employers account for 94 per cent of tax receipts, but the vast majority of schemes are very small with fewer than five employees. Employers are also making more use of third party agents to administer their payroll operations and HMRC's information indicates that 24 per cent of employers now use an agent. HMRC considers this is a helpful trend, as third parties have specialist skills and knowledge in administering PAYE.

## Difficulties in operating the system

**3.24** HMRC relies on employers and employees providing timely and accurate information to enable it to administer the PAYE process. But the quality of this information varies considerably, presenting HMRC with an increased workload in order to maintain up to date and accurate information on individuals.

**3.25** The process for tracking movements in employment is not always providing HMRC with the information it needs to maintain a complete picture of an individual's tax affairs. Turnover in the workforce is high; approximately 20 per cent of jobs last less than one year and 5 per cent are for periods of less than three months. HMRC's management information shows that about 70 per cent of employees starting a new job do not immediately provide their new employer with a P45 form carrying their National Insurance number and information about previous pay and tax. This may be because the P45 form has not yet been issued by the previous employer, it has been lost or mislaid, or because the employee has chosen not to provide it. This creates the risk that the new employer may deduct incorrect amounts of tax or that the correct National Insurance number is not used. HMRC has also found that the quality of information it receives from employers on job movements varies and that some large employers continually submit incorrect forms, including failure to provide important information such as National Insurance numbers. Even when the correct forms are submitted, they are often incomplete. These problems hinder HMRC's ability to process this information against its own records. The Department estimates that, in 2004-05, it failed to match four million records to a known individual at the first attempt and had to ask the employer and/or the employee for more information. Some HMRC offices contact employers who regularly submit inadequate information to explain what is required and to monitor their future performance. HMRC plans to extend this nationally.

**3.26** Employees do not always respond to HMRC's requests for information. If HMRC does not have a complete history of a taxpayer - for example following a break in employment - it sends them a form P91 to try to obtain this information. But currently less than 30 per cent of these forms are returned. In such cases it is likely that the taxpayer will not pay the right amount of tax.

**3.27** Employers are not always following HMRC's instructions to amend tax codes. HMRC notifies employers of changes to tax codes to ensure that the right tax is deducted. HMRC's Internal Audit reviews identified that employers were not always using the latest tax code despite being instructed to do so. This increases the risk that employees are paying incorrect amounts of tax and may necessitate further work by HMRC to repay any overpayments or collect any underpayments.

# Weaknesses and inconsistencies in HMRC's processes and operations

**3.28** HMRC's problems in administering PAYE have been aggravated by weaknesses and inconsistencies in its own approach. These include inadequate management information, the relative priority given to PAYE work as against other operational demands and failure by staff to comply consistently with Departmental procedures.

**3.29** HMRC suffers from inadequate Management Information Systems to help it risk-assess and control PAYE effectively. Numerous PAYE activities are taking place at any one time, but limited management information makes it difficult for HMRC to coordinate this work and promptly identify problems. The inadequacies include a lack of information on volumes, resourcing and costs of PAYE work.

**3.30** Over a number of years, HMRC has given PAYE processing a lower priority than other areas of work. PAYE staff have been diverted to other areas where the Department considered additional resources were needed because the immediate risk was greater. For example, PAYE staff have been deployed periodically on tax credit work since it was introduced in 2003. This may have created a perception that HMRC regards PAYE as less important than other areas and affected both the amount of work which could be done and the quality of the work undertaken.

**3.31** HMRC staff have not always been aware of or followed Departmental policies, for example, processing computer reports or in calculating tax code changes. HMRC's internal quality monitoring figures suggest that 7.9 per cent of all 2005-06 codes were incorrect. Error rates were higher where individuals had more complex tax affairs and in 2005-06 Internal Audit found that in 21 per cent of cases where individuals had more than one job, the correct code had not been identified and issued. Although some of the problems were caused by incomplete and inaccurate information from employers or individuals, HMRC also made errors in processing information.

**3.32** HMRC staff have also found some departmental guidance to be contradictory and confusing resulting in different local practices. The PAYE system places heavy reliance on paper records such as error reports and returns from employers being correctly dealt with. But HMRC staff have not always processed these properly or performed the work in a timely manner.

## Assessing the effect of the challenges in administering PAYE

**3.33** In 2004-05 HMRC's Internal Audit began a programme of work to understand better the financial effect of these issues, which supplemented other HMRC initiatives to improve the quality of its PAYE work. The areas considered by Internal Audit include handling taxpayers with multiple incomes, checking tax paid on benefits in kind and using PAYE to collect tax identified under self-assessment.

### Handling taxpayers with multiple incomes

**3.34** Internal Audit examined a sample of records for employees with more than one source of income to assess whether the correct amount of tax was being collected in these cases. It concluded that in many cases HMRC is not correctly bringing together information on different sources of income and that incorrect amounts of tax are being paid. On the basis of results from a sample of cases, Internal Audit estimated that for 2003-04 potentially£275 million tax was overpaid and £490 million underpaid, affecting some 1.9 million taxpayers. Overpayments of tax arise where taxpayers do not get the benefit of all the personal allowances they should, for example when they change jobs and are not taxed on a cumulative basis across the year. Underpayments of tax may arise if taxpayers are allocated personal allowances at two different jobs, but HMRC does not bring together their total income and calculate their correct tax liability.

**3.35** In June 2005, HMRC reminded staff of the need to consider all information received about second jobs to help identify and correct any overpayments and underpayments of tax. It has also made this work high priority for its staff in 2006-07. But computer changes are needed to fully resolve these problems and I discuss HMRC's plans to improve this area later in my report (paragraph 3.52).

### Checking tax paid on Benefits in Kind

**3.36** Employers who provide their employees with non-cash benefits, for example a company car, are required to report these benefits on an annual basis to HMRC by completing a form P11D. HMRC uses the information to adjust the employee's tax code in the next tax year to collect any tax due. HMRC received 5.6 million P11Ds in 2004-05, with a value of £9 billion in benefits provided.

**3.37** The process for handling this information is partly automated and partly manual. The computer checks the tax paid against what should have been paid. Where there are differences, clerical action is required to make repayments or collect underpayments and to change the tax code so that the taxpayer pays the correct amount. Internal Audit reported in 2005-06 that the necessary clerical action is not always taken and computer printouts are not being worked accurately or in a timely manner, because of competing work priorities. Through a sampling exercise Internal Audit estimated that potentially this meant that £181 million tax was overpaid and some £519 million tax underpaid for 2003-04. These problems are thought to affect over 1.9 million taxpayers.

**3.38** HMRC has examined how it can improve its performance in response to these findings. In January 2006, it reminded staff of the importance of handling promptly changes to tax codes and from April 2006, HMRC has given higher priority to this area of work. In April 2007 HMRC plans to introduce an automated process for managing changes to tax codes for Benefits in Kind. This should reduce the risk of the necessary changes not being processed by staff and reduce the number of cases that need to be reviewed after the year end. HMRC has also recently enhanced a computer tool provided to help staff calculate tax codes and use of the tool is now mandatory in all but the simplest cases.

## Using PAYE to collect tax identified under Self Assessment

**3.39** 3.7 million PAYE taxpayers are also covered by the self assessment process. Final self assessment liabilities that are less than £2,000 can be settled through the PAYE system and HMRC amends tax codes to collect the amount due. There is no check in the automated process that the PAYE income is sufficient or that the adjustment to the tax code will collect the full amount due within 12 months, but HMRC is now considering how it could introduce such a check.

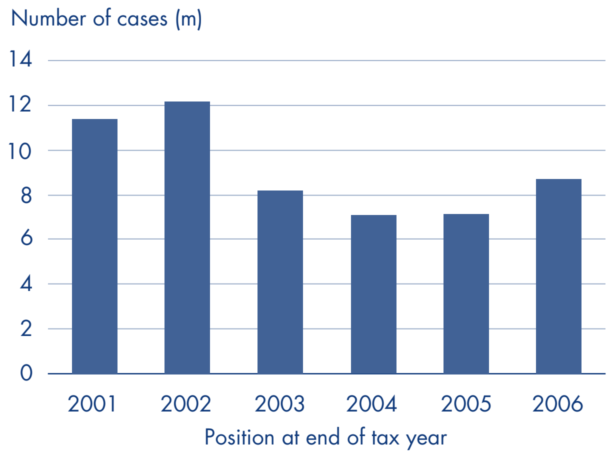
**3.40** Internal Audit examined a sample of cases to check the accuracy of the changes in the codes to collect these liabilities. It calculated that in 2004/05 £36.5 million was lost because tax due was removed from the Self Assessment system but not processed through PAYE for collection. HMRC found that some of this was caused by problems when the interface between the self assessment and the PAYE computer systems was not working, which have now been resolved. Other failures were due to HMRC staff not following procedures to correctly update individual tax codes, and amounts due from taxpayers were not correctly processed through the PAYE system. HMRC's policy is that self assessment liabilities collected though PAYE should be settled in full in the year following that to which the charge relates. But its instructions to staff do not make this explicit and it did not happen in all cases, which delayed the recovery of £25.5 million tax. HMRC are reviewing this process with the aim of implementing changes by April 2007.

## Managing levels of 'Open Cases'

**3.41** At the year end, HMRC's computer system checks whether the tax an employee has paid in the year is consistent with year-end pay and tax information received from employers. The computer identifies discrepancies or fails to match information to a taxpayer's record in approximately 30 per cent of cases, which are known as "open cases" and must be checked manually. HMRC may also have to wait some time before it has sufficient information to complete these checks, for example, when it does not have complete employment details. Based on the current number of PAYE records, HMRC expects about 12 million records would need manual checking as part of its normal PAYE business. But it is undertaking work to improve data quality and HMRC expects that this will increase the number of cases where it automatically matches employer returns against taxpayer records.

**3.42** Between 2001-02 and 2004-05, HMRC operated a National Open Case Recovery Team to manage all aspects of open case recovery, including providing staff with better computer support, and the volume of open cases fell within this period. But volumes increased in 2005-06, as shown in **Figure 16** and there were 8.7 million cases outstanding at March 2006. The increase was caused partly by HMRC's difficulties in managing the online filing of employer returns (paragraph 3.14) which delayed the processing of returns and meant that open cases were identified later in the year than would normally be the case. There were also 2004-05 cases awaiting processing at the end of March 2006. HMRC expects that many of these will be cleared automatically when processed.

**16** Numbers of open cases




*Source: HMRC*

**3.43** HMRC estimates that three quarters of open cases arise from it not having full information on a taxpayer's employment history, failures by employers to provide the correct information or HMRC being unable to match information received to a National Insurance number. Complexities in an individual's tax affairs, such as multiple employments or frequent changes in work are more likely to mean a case needs manual review. Errors by HMRC staff have also contributed to open cases, for example failing to ask taxpayers for information where they have gaps in their employment history, failure to follow established procedures, and incorrectly estimating dates of starting and leaving work. In addition, HMRC has found that many taxpayers who are asked for further information needed to check whether they have overpaid tax simply do not reply.

**3.44** In 2006, HMRC introduced a more rigorous process for validating end of year returns from employers who filed online. This increased the risk that more returns would be rejected and returned to employers, although overall the change should reduce the need for clerical action by HMRC staff and help improve the quality of incoming data. To reduce the adverse impact on employers, HMRC undertook a communications exercise with industry and individual employers and worked with software companies to improve the quality of data. HMRC's early findings suggest that failures to meet the quality standards have fallen from 13 percent in the first year to 5 per cent in returns filed online in April 2006.

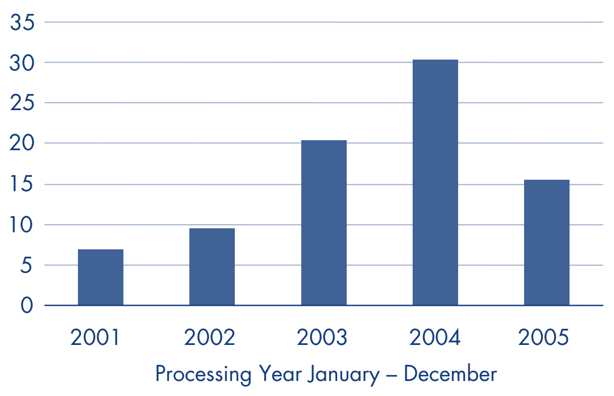
**3.45** HMRC has also allocated additional resources to help reduce the backlog of open cases to a manageable level. It has recruited some 200 new staff to work on open cases and has also used staff in other areas to help it deal with the easier cases. HMRC has also offered overtime for its more experienced staff to handle the more difficult cases and it estimates that 2 million cases have been cleared this way. It is also taking steps to improve the quality of work undertaken on open cases, including introducing earlier and more frequent checks to identify errors and ensure they can be corrected more quickly. Internal Audit also plan work during 2006-07 to evaluate the end to end Open Case process and provide an assurance that procedures and guidance are being correctly followed.

**3.46** Under the terms of an Extra Statutory Concession (ESC A19), HMRC staff are authorised to clear an outstanding open case by waiving any tax due, if the Department failed to act on information it held within a reasonable period and the taxpayer had reason to believe that their tax affairs were correct. The amount of tax waived has grown considerably during the last few years due to the drive to reduce the backlogs of open cases and peaked in 2004 at some £30.3 million. **Figure 17** shows the amounts waived over the last 5 years.

**3.47** Internal Audit found cases where HMRC staff did not properly record details of tax waived and some that were cleared inappropriately. Internal Audit believed that a culture might have developed where staff considered it acceptable and normal for cases to be closed without following the correct process and obtaining proper authorisation.

**3.48** In 2005, HMRC improved its instructions to staff on the procedures to be followed. As shown in Figure 17, the amounts of tax waived in 2005 were reduced significantly. HMRC expects this downward trend to continue in future years.

**17** Tax waived or remitted 2001-2005 £million




Source: HMRC

## Action being taken by HMRC to improve the PAYE process

**3.49** In addition to the specific responses to the issues identified above, HMRC is looking at how it can improve the PAYE process generally. In May 2005, it established a PAYE Steering Group, which is responsible for identifying improvements across the entire PAYE process and implementing recommendations made by Internal Audit. The Group has overseen a series of "health checks" and risk assessments and HMRC has now identified important areas where the PAYE process can be improved. In June 2005 it put in place an Action Plan to manage its future work in achieving these improvements, although it will take a number of years before these changes are fully effective.

### Making better use of information on taxpayers

**3.50** Many of the problems with the PAYE process are caused by HMRC not having, or bringing together, a full picture of the tax affairs of individual employees. It is initially tackling this issue by making better use of the information it already holds and, in the future, expects its project 'Modernising PAYE Process for Customers' (MPPC) to result in significant improvements.

**3.51** HMRC holds information on individual taxpayers on its computer systems for PAYE and National Insurance. The PAYE computer system is organised around employments, whereas the National Insurance system is organised around employees. But these systems are not integrated and the National Insurance system holds information that would help HMRC obtain a fuller picture of individual taxpayers.

**3.52** The current phase of MPPC will be completed in September 2006 and is intended to provide PAYE staff with access to taxpayers' information held on the National Insurance system. This should provide PAYE staff with full details of an employee's employment history and make it easier to check if the right amount of tax has been paid. HMRC believes its initial findings from a trial project are encouraging. It also plans to move to its National Insurance computer system as the basis for administering the PAYE process, which will allow information on individuals to be brought together by reference to their National Insurance number, provide a complete view of an employee's income and enable that single view to be maintained effectively. Successful implementation should reduce significantly the major sources of errors, but HMRC consider the scale of the migration to a different system and its technical challenges mean that the computer changes are unlikely to be made before 2008-09.

**3.53** The MPPC programme is designed to result in wider improvements in management information over the next two years. In addition, HMRC plan to introduce a modern work management system, to enable managers to direct priority work to appropriately skilled staff.

### Better compliance with procedures

**3.54** HMRC has to ensure that its staff fully comply with its procedures as well as making better use of the information it holds. It has therefore impressed on operational managers that staff must follow existing instructions. It is also looking at how it can introduce a more risk based approach to managing its work, to allow it to assign resources to those cases that have higher amounts of tax at risk. HMRC is introducing new processes in its offices, which include real time checks on quality and has introduced monthly quality monitoring checks to allow managers to target areas which need improvement. HMRC considers that these have resulted in fewer errors being made.

**3.55** HMRC has set up a programme to help its processing operations meet the challenge of delivering a better experience for the taxpayer, whilst also achieving the efficiency savings required by the Gershon and Lyons reviews. One element includes a review of existing PAYE (and other) processes from the taxpayer's perspective with the aim of eliminating waste, duplication and inconsistency. Another important element is intended to support a more robust and visible approach to managing HMRC's work. It is still early in the life of the programme but HMRC believe initial results are promising with improvements in key performance indicators including turnaround time, quality and productivity.

## Conclusions

**3.56** In 2005-06 HMRC collected £114 billion income tax through PAYE from some 41 million employment and pension sources operated by 1.9 million employer or pension schemes. HMRC aims to ensure that individuals pay the right amount of tax on their income and to make it as easy as possible for employers and employees to meet their obligations.

**3.57** The PAYE computer system was introduced in the 1980s and its records are structured around employments, rather than individual taxpayers. As a result, HMRC can have difficulty in ensuring that taxpayers with more than one source of income pay the correct amount of tax because it may not know about additional sources of income.

**3.58** To operate PAYE effectively, HMRC depends on employers and employees providing it with accurate and timely information on income and changes in employment. This does not always happen and can lead to the risk that taxpayers do not pay the right amount of tax. For example, HMRC estimates that for about 70 per cent of job changes employees do not immediately provide their new employer with the form P45, giving details of previous earnings and tax. And employers do not always update tax codes despite being instructed to do so.

**3.59** The difficulties in the operation of PAYE have been compounded by inconsistent working practices within HMRC. Staff have not always been aware of or followed Departmental policies, for example adjusting tax codes to reflect Benefits in Kind. Deficiencies in management information have also made it difficult for HMRC to prevent or detect errors made by staff. And several times in recent years HMRC has diverted PAYE resources to other areas of work which it considered had higher operational priority, such as tax credits.

**3.60** Over the last eighteen months HMRC has produced new information to provide a better picture of the scale of these problems and the amount of tax at stake. Based on a sampling exercise, its Internal Audit Office estimates that each year HMRC may not be pursuing some £1 billion of tax due, taxpayers may have overpaid around £500 million and consequently that 5.7 million taxpayers may not be paying the right amount of tax. These figures suggest an overall net under collection of tax revenue of some 0.5 per cent of the £114 billion collected through PAYE in 2005-06.

**3.61** HMRC has responded by reminding staff of the importance of following procedures, improving its internal quality monitoring procedures and has introduced a programme to deliver a better experience for the taxpayer. It has also allocated additional resources to PAYE work. Whilst it believes these changes should reduce the level of errors, it recognises that real improvement requires fundamental changes. Accordingly, HMRC plans to improve its internal processes as part of its 'Modernisation of PAYE Processes for Customers (MPPC)' project. This project should also provide a complete view of an employee's tax affairs by making better use of the information HMRC already holds. Successful implementation should reduce a major source of error but HMRC considers the computer changes cannot be achieved before 2008 because of the technical challenges. HMRC has developed a series of responses to manage the risks in the interim period, but it needs to articulate these more clearly into an overall strategy.

**3.62** Effective operation of PAYE also depends on employers and employees meeting their obligations and changing internal processes and systems will not address all the problems. HMRC needs to target and take further action to improve compliance by employers and employees who do not meet their obligations.

**3.63** HMRC first recognised the emerging difficulties in administering PAYE in 2001-02, when it launched a recovery programme to clear the increasing number of open cases. But it has only recently begun to quantify the effect of these difficulties on the collection of tax. This quantification, coupled with HMRC's new organisational structure, has provided additional impetus to tackle these difficulties through a programme of short, medium and longer term improvements. In taking forward these improvements, and as new systems are developed, HMRC must ensure that it has appropriate management information to monitor the effectiveness of its procedures in collecting tax. Within its new framework for managing PAYE, HMRC also needs to have appropriate arrangements for monitoring emerging trends in the labour market to allow it to develop an appropriately planned response to future changes in the taxpayer population.

# VAT: MISSING TRADER FRAUD

## Scope of report

**4.1** Missing trader fraud is one of the most serious attacks on the tax system ever seen. This report provides a background to the fraud and examines how HMRC is tackling the problem.

## Background

**4.2** Missing trader fraud is a systematic attack by organised criminal groups on the European Union VAT system. HMRC estimates that missing trader fraud cost the Exchequer between £1.12 billion and £1.90 billion during 2004-05 **(Figure 18)**. Operational indicators show that the level of activity related to the fraud has increased in 2005-06. HMRC attributes the rise in activity to the increased confidence of fraudsters following legal challenges to key measures. HMRC does not yet have all the data required to produce an estimate of VAT losses from missing trader fraud for 2005-06 and expects, in line with its own established practice, to publish this estimate alongside the 2006 Pre Budget Report later this year.

**4.3** Fraudsters exploit the current VAT arrangements which were introduced in 1993 as part of the Single Market. The arrangements allow registered traders to acquire goods from traders in other Member States without paying VAT. This system was designed to ensure that VAT was accounted for and paid in the Member State where the goods were finally consumed. In its simplest form the fraud involves a business obtaining a VAT registration number in the UK for the purpose of purchasing goods free of VAT from another Member State. The business sells these goods at a VAT inclusive price in the UK and then disappears without paying the VAT to HMRC. In its most abusive form, commonly referred to as carousel fraud, fraudsters sell the same goods repeatedly through contrived supply chains involving traders in the UK and other Member States of the European Union. Fraudsters extract the VAT on each circuit, as illustrated in **Figure 19**. The most commonly-used goods in missing trader frauds are mobile phones and computer chips, but any high value compact goods are suitable.

**4.4** Fraudsters have changed their methods in response to measures adopted by HMRC. Instead of going missing, fraudsters now continue to trade to generate greater tax losses before defaulting on payment of VAT.

**18** Estimated tax loss of missing trader fraud

| Financial Year | Lower Estimate (£bn) | Upper Estimate (£bn) |
|---|---|---|
| 1999-00 | 1.17 | 2.29 |
| 2000-01 | 1.31 | 2.47 |
| 2001-02 | 1.72 | 2.53 |
| 2002-03 | 1.54 | 2.34 |
| 2003-04 | 1.06 | 1.73 |
| 2004-05 | 1.12 | 1.90 |

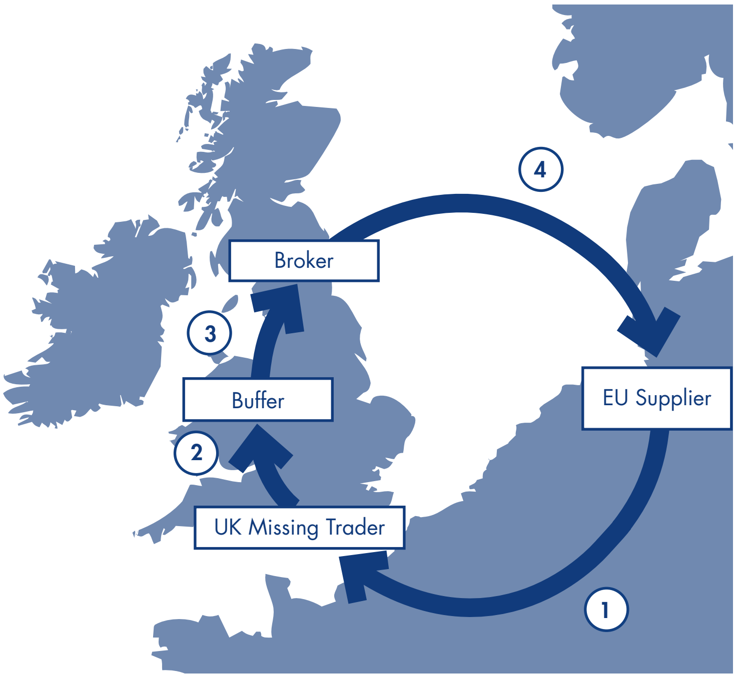
*Source: HMRC*

Fraudulent supply chains have also become more complex involving more buffer companies and the sale of goods between several chains in different Member States **(Figure 20)**. In addition, during 2005 HMRC noted an increase in chains exporting goods to third countries outside the European Union with which, until recently, there were no arrangements to exchange information. Goods, invoices and money may also follow different trails, creating further problems for HMRC to identify and prosecute criminals behind the fraud.

**4.5** Missing trader fraud affects other European Union Member States, including Germany, Denmark and the Netherlands. In Denmark and the Netherlands fraudsters often sell goods as part of an apparently legitimate link in a larger chain and the tax is stolen in other Member States, such as the UK. The VAT loss in both these countries is comparatively low: Denmark estimates it at €134 million (approximately £92 million) between 1994 and 2005; and the Netherlands estimates an annual loss of €25 million (approximately £17 million). Germany, like the UK, is a target for the fraudsters. Although Germany has no formal estimate of missing trader fraud, it recognises that it is a significant problem. Unfortunately, the European Commission has no detailed figures on the total amount of missing trader fraud within the European Union. This is mainly because, unlike the UK, very few Member States estimate the level of the fraud. To have a clearer picture of the nature and extent of VAT fraud, the Commission is to examine different methods to assess fraud, estimate the total amount of VAT fraud across the European Union and gather comparable data for all Member States[12].

12 Memo 60/221, Commission of the European Communities, 31 May 2006.

## 19 An example of a basic chain




**1.** An EU supplier from another Member State sells goods for £1,000,000 to a trader based in the UK free of VAT. Sales of goods between VAT registered companies in the EU are zero-rated for VAT.

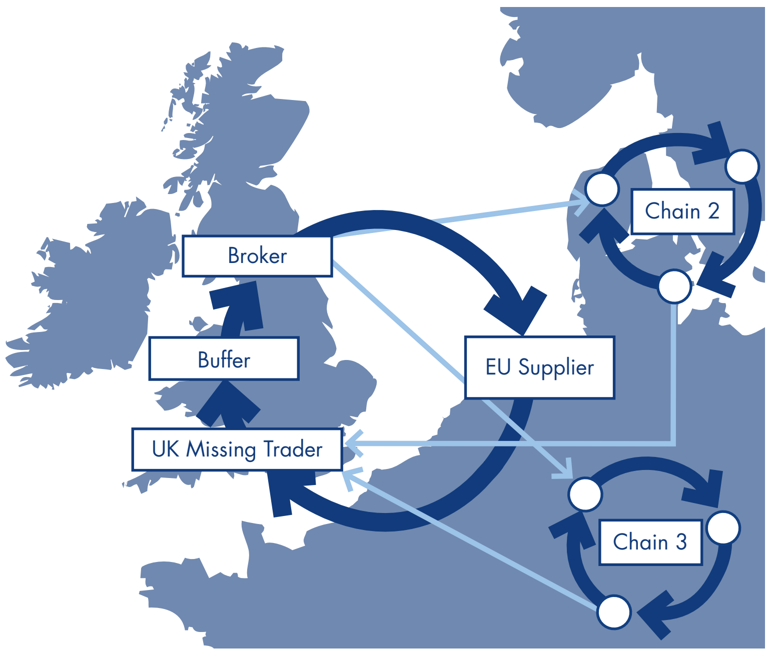
**2.** The trader sells the goods to another trader commonly known as the buffer at a reduced price of £900,000 plus £157,500 VAT. In order to avoid the price of the goods spiralling upwards each time the carousel turns, one business in the chain must sell at a loss. Following an intensive period of trading the initial UK trader goes missing without paying the VAT due to HMRC.

**3.** The buffer accounts for VAT correctly and sells the goods to a trader at the end of the UK chain, termed the broker, for £950,000 plus £166,250 VAT.

**4.** The broker makes a zero-rated VAT sale back to the original EU supplier for £970,000 and is entitled to reclaim the input VAT of £166,250 on the goods purchased from the buffer. HMRC pays the claim and incurs a cash loss because the missing trader did not pay the VAT due on the sale to the buffer.

*Source: National Audit Office*

## 20 An example of a complex chain




In response to efforts by tax authorities, fraudsters have begun more complex chains involving greater numbers of buffers and sales of goods between several different chains. Brokers may split consignments and sell goods through a series of chains in other Member States before goods return to the UK.

In one case identified by HMRC, a trader had supplied goods to over 200 different missing trader chains. HMRC requires assistance from other Member States to verify transaction chains.

*Source: National Audit Office*

**4.6** In the European Commission's view, the introduction of a VAT system based on the origin of the supply of goods would remove the opportunity for the current type of missing trader fraud. Under this system VAT would be charged on all transactions between Member States, which would eliminate traders acquiring goods free of VAT. The Commission has found little support among Member States for the wholesale reform of the VAT system along these lines, as such a regime would demand a greater degree of tax harmonisation than currently exists to avoid the new system being burdensome for traders. In addition there would have to be a system of VAT allocation from the country of origin to the country of destination. HMRC's view is that an origin system would open up major new fraud opportunities. The current arrangements, which were only meant to be in place until the 31 December 1996, have therefore continued in the absence of an agreement on a definitive system.

**4.7** In June 2000, the Commission launched a five year programme to improve the operation of the present system and in 2004 it published a review of the use of administrative cooperation to tackle VAT fraud[13]. It welcomed the fact that Member States had either introduced or were in the process of introducing legislative measures to protect the VAT system against missing trader fraud. It also concluded that, before making any modification to the VAT system, Member States should continue efforts to tackle fraud under the current system by working to improve administrative cooperation and national VAT control regimes. The UK and other Member States have therefore developed their strategies within the existing VAT framework.

**4.8** On 31 May 2006 the European Commission adopted a Communication[14], the aim being to launch a debate with all parties concerned on a European Strategy to combat tax fraud. Although the proposal covers direct and indirect taxes, the fight against missing trader fraud is deemed a major issue. The Communication sets out a number of issues for discussion including: reinforcing cooperation between Member States; increasing cooperation with third countries; and the need to modify the current community VAT legislation.

## HMRC's strategic response

**4.9** In September 2000 a national strategy was launched to tackle missing trader fraud. It aimed to minimise VAT losses by preventing the fraud, detecting and disrupting fraudulent transaction chains, prosecuting fraudsters where appropriate and using civil measures to recover debts. For these activities to be effective, cooperation with other Member States, third countries and the legitimate trade is essential. HMRC has updated the strategy on a number of occasions and sought to introduce new legislation in response to changes in the fraud. Missing trader fraud is currently HMRC's top VAT fraud priority with around 1,000 staff deployed to tackle it.

## Previous NAO and Parliamentary Scrutiny

**4.10** On the basis of a report by the NAO, the Committee of Public Accounts took evidence from HM Customs and Excise in June 2004 on its activities to tackle VAT fraud[15]. On missing trader fraud the Committee recommended[16]:

- updating estimates of fraud to assess progress on a regular basis;
- adoption of legislation to allow best use of information and data sharing between the direct and indirect tax areas in HMRC;
- working closely with the European Commission to achieve prompt exchange with other Member States of information on traders; and
- working with the business community and professional bodies to agree criteria for reporting of misconduct by professionals.

**4.11** HMRC's response to missing trader fraud has addressed the Committee's recommendations by:

- revising the methodology for estimating the level of the fraud to provide a more accurate figure;
- establishing mechanisms to help facilitate the sharing of information between the direct and indirect tax areas of the organisation;
- continuing to work closely with the European Commission and other Member States to improve the mechanisms for sharing information and joint detection exercises to tackle the fraud; and
- working with the tax and accountancy professions to develop guidelines to raise awareness of missing trader fraud.

13 Report from the Commission to the Council and the European Parliament on the use of administrative cooperation arrangements in the fight against VAT fraud, April 2004.
14 Communication from the Commission to the Council, the European Parliament and the European Economic and Social Committee concerning the need to develop a coordinated strategy to improve the fight against fiscal fraud, May 2006.
15 Tackling VAT Fraud, NAO, HC 357, March 2004.
16 Tackling VAT Fraud, Report from the Committee of Public Accounts, HC 512, June 2004.

## Measures to tackle missing trader fraud

**4.12** HMRC recognises that different measures or a combination of measures may be required to tackle the different participants in the fraud. **Figure 21** illustrates the range of interventions that HMRC deploys to tackle suspected traders in fraudulent supply chains. In 2000 a national strategy was launched to tackle missing trader fraud, creating a centralised team to coordinate the gathering and dissemination of intelligence on traders. The use of a centralised approach has been very successful in the Netherlands, where the level of estimated fraud has fallen significantly from €250 million per year (£173 million) in the early 1990s to €25 million (£17 million) in 2005-06. HMRC has also introduced new integrated systems and shareable databases which have been of great benefit in enhancing the quality of intelligence and identifying those traders involved in the fraud.

**21** HMRC has a range of measures to tackle suspected fraudulent traders

| | HMRC Action | Measure |
|---|---|---|
| Trader begins business and applies for VAT registration number | Checks and risk assessments prior to registration | Application rejected<br>Registration granted<br>Registered with conditions<br>Security requested |
| Trader defaults or goes missing owing VAT to HMRC | ■ HMRC monitors activity of suspect traders and performs visits to check nature of activity<br>■ Intelligence gathering and investigation for prosecutions<br>■ Accounting period brought to an end and debt established<br>■ Use of asset recovery tools where debts owed to HMRC<br>■ Cooperation with other tax authorities to gather evidence | Deregistration<br>Provisional liquidation<br>Enhanced civil recovery<br>Criminal prosecution |
| Contrived trading by buffers and brokers generates VAT repayment claims | ■ HMRC monitors activity of buffers and brokers<br>■ Suspect repayment claims verified<br>■ Goods inspected and recorded | Joint and several liability for unpaid VAT<br>Incorrect, unsubstantiated or abusive VAT repayment claim denied<br>Criminal investigation and prosecution<br>Traders placed on quarterly returns |

*Source: National Audit Office*

## Measures to prevent 'missing traders' from registering for VAT

**4.13** A key part of HMRC's strategy for tackling missing trader fraud is to deny fraudsters the registration without which the fraud cannot be perpetrated. During 2005-06 HMRC received 284,804 applications for VAT registrations. The majority of applications are from businesses that wish to trade lawfully. For these HMRC has performance targets in processing applications that it aspires to meet, but it must also protect VAT revenue. HMRC reviews all applications to confirm the validity and accuracy of the information submitted. Registration units seek to identify potential fraudsters through a combination of data-matching exercises and risk assessments. High risk cases are referred to intelligence teams for further checks and HMRC may also visit traders during this period to verify the legitimate nature of their activity.

**4.14** During 2005-06 3,629 cases were referred to the intelligence teams **(Figure 22)**. Although the number of such referrals has fallen since 2004-05, the number of suspect applications refused by both the intelligence teams and the registration units has increased to 2,271 (1,484 by registration sites; 787 after further checks by intelligence teams) compared to 1,866 in 2004-05. The significant rise in the refusals by the registration sites in 2005-06 compared to 680 in 2004-05 is attributed to the introduction of risk advisors in each registration unit, coupled with revised parameters to ensure only the highest risk cases are referred for more detailed checking by intelligence teams. In addition, where HMRC believes tax revenue may be at risk, it can request financial security against future tax losses or impose other conditions such as the shortening of the first VAT period to make an early assessment of compliance. During 2005-06 there were 645 cases where registration was granted with conditions. The registration units also deregistered 387 traders involved in the fraud that had been identified.

**4.15** In response to changes in the nature of the fraud HMRC developed new guidance for registration teams. Additional risk checks and registration procedures were introduced to identify fraudsters who try to bypass initial registration checks by acquiring control of a VAT registered company and applying to HMRC to amend their details to reflect the new business activity. HMRC monitors these requests to identify suspect activity which may indicate the occurrence of fraud.

**22** Outcomes of registration checks

| | 2002-03 | 2003-04 | 2004-05 | 2005-06 |
|---|---|---|---|---|
| Total number of applications for VAT registration | 257,139 | 299,043 | 269,515 | 284,804 |
| Number of referrals for detailed check | 7,416 | 9,545 | 4,573 | 3,629 |
| Number of suspect applications refused | 914 | 929 | 1,866 | 2,271 |

*Source: HMRC*

## Activities to monitor and disrupt suspected fraudulent chains

**4.16** HMRC's non-criminal compliance work consists of a series of activities: visits to traders prior to registration to check their entitlement for a VAT number; identification and deregistration of missing and defaulting traders; monitoring activity of suspected buffers and brokers; verification checks of suspect VAT repayment claims; inspections of goods; and requests for financial security where there is evidence that VAT may be at risk. Previously these checks were implemented by compliance staff within the Regional Business Services structure. This had caused difficulties when requesting visits to traders as there was no central liaison point. In December 2005 HMRC transferred the 230 non-criminal compliance officers, who at that time dealt with missing trader fraud, to a central team to tackle compliance issues. The new structure enables national deployment of resources as well as central direction and coordination of day-to-day activity and a more flexible use of resources. This helps HMRC tackle the national risk of missing trader fraud in a more effective manner.

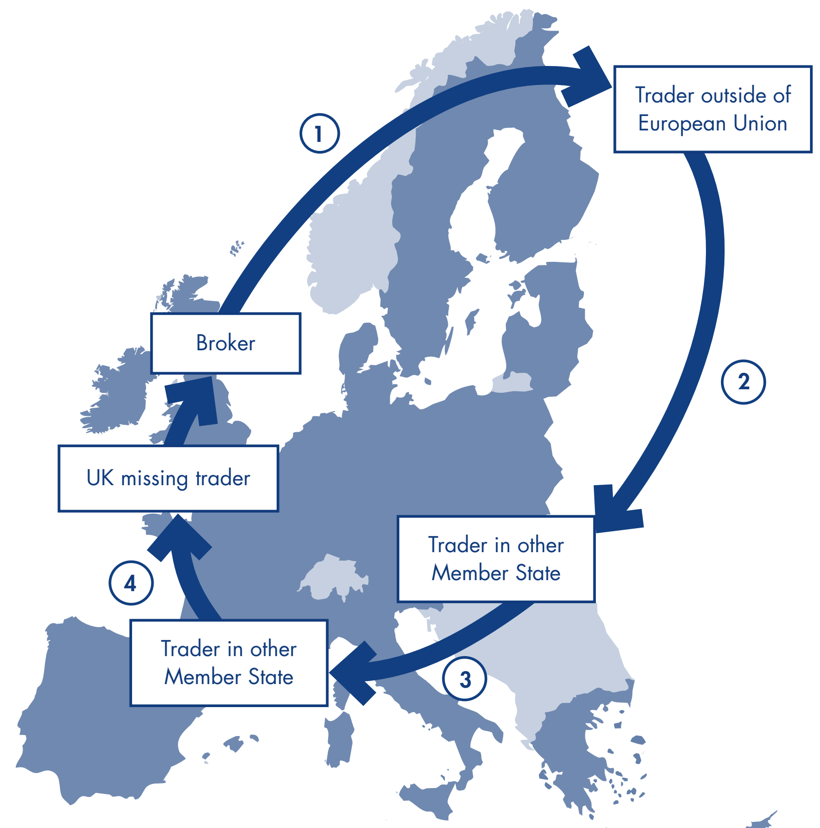
**4.17** Under the VAT Act 1994[17], HMRC may request traders to provide a financial security to cover the estimated value of tax that may be at risk. The security may be a payment to HMRC or a guarantee from a financial institution, which must be provided to enable the trader to continue to trade lawfully. The use of security has proved to be a successful disruption technique. HMRC requested security from 74 registered companies between April 2004 and February 2006 and 18 of these either ceased to trade or were deregistered.

17 VAT Act 1994 paragraph 4(2) of Schedule 11.

**4.18** To reinforce the effectiveness of this measure, Budget 2003 introduced the concept of extended security. This allowed HMRC to issue a warning letter to a company purchasing from a trader involved in the fraud, advising that the company would be required to provide security if it continued to purchase from this supplier. HMRC issued 126 warning letters to traders up to December 2005 and most of them stopped trading with the respective supplier. When companies did not respond HMRC required them to provide a financial security which it did on seven occasions. The measure was challenged and the High Court referred the case to the European Court of Justice, which ruled, in May 2006, that it was not in line with the European VAT legislation (4.38).

**4.19** During 2005 HMRC identified a change in the trading patterns of suspect traders noticing a substantial rise in UK exports of mobile phones to third countries outside of the European Union. HMRC believes that this is a direct response to greater cooperation between Member States to successfully disrupt the fraud within the European Union. The diversion of goods through a third country makes it more difficult for HMRC to obtain evidence of the trail and prove the contrived nature of the supply chain **(Figure 23)**. HMRC believed that the underlying economic and commercial trends did not support such an increase regarding two of these countries. Therefore, it began to check and document exports to both countries of mobile phones. Checks were performed concurrently at different UK ports, reconciling export documents to the actual volume of goods, date-stamping packaging and scanning of unique identification numbers and barcodes on goods. In December 2005 exports of mobile phones to both countries fell significantly. HMRC attributed this to the deterrent effect of the exercises (partially at least in cooperation with the relevant Customs Authorities) and the likelihood that the original increase did not represent real sales. It also noted the diversion of goods through other countries. The exercises have provided valuable operational knowledge and the opportunity to pilot scanning equipment. During one exercise HMRC scanned 272,000 mobile phones, of which 36,000 (13 per cent) had previously been stamped in the UK proving the circular sale of the goods.

**23** An illustrative example of a missing trader chain through a third country outside the European Union




**1.** The broker at the end of the UK chain exports to a third country outside the European Union and is entitled to repayment of input VAT from HMRC. Fraudsters typically export to third countries with low duties on imports or free trade zones.

**2.** Within a few hours, the fraudsters transport the goods back to the European Union with final destination stated as the UK. On entering the European Union, import duties are deferred under Community Transit rules until goods reach the final country of destination.

**3.** Consignments may be split and sold through a number of traders in different Member States to mask the true identity of the goods.

**4.** Goods emerge as intra-community supplies, which are sold free of VAT to the UK missing trader. The chain can then begin again.

**Key:**

European Union Countries

Non-European Union Countries

*Source: National Audit Office*

**4.20** Following the success of the scanning exercises HMRC introduced a new electronic scanning database in January 2006 and equipped teams at major UK ports with scanning equipment. Teams are able to scan the unique identification number of phones or any goods with a barcode and download the information to the database. This allows HMRC to identify traders who participate in fraudulent chains and to follow the movement of goods within UK ports. This information may be shared with other Member States to aid their respective controls over VAT. HMRC plans to allocate an additional 40 to 60 staff in 2006-07 to deal with missing trader checks on exports.

**4.21** Within the European Union, HMRC seeks mutual assistance to gather trading information from other Member States. However, with third countries, HMRC is dependent on the content of agreements of administrative or legal assistance and has sought to address this by establishing bilateral agreements or memoranda of understanding to facilitate the exchange of information. Other Member States have also experienced similar problems with goods normally associated with the fraud: Denmark has seen a significant increase in both exports and imports of mobile phones and computer chips to and from third countries, whereas the Netherlands has observed an increase in third country imports, most of which the NAO was informed, were destined for the UK. The Commission recognises that missing trader fraud transcends the external borders of the European Union, and in its Communication in May 2006 outlined a Community approach to cooperation with third countries.

**4.22** HMRC has also worked closely with Switzerland within the framework of an agreement in the form of an exchange of letters between the European Community and Swiss Confederation. This builds on the Agreement between the European Community and the Swiss Confederation on mutual administrative assistance in customs matters[18] signed on 9 June 1997. This has enabled HMRC to ask the Swiss authorities to visit freight forwarders in Switzerland to help identify companies involved in a number of carousel chains operating in the UK. Member States are currently reviewing the 'Cooperation Agreement between the European Community and its Member States (EU Commission) and the Swiss Confederation to Combat Fraud'. The UK ratified the agreement on 14 February 2006[19]. Although Switzerland has signed the agreement, it has not yet been ratified by the Swiss Parliament. Once ratified HMRC will be able to request information on traders and individuals including details of banking operations by those involved in the fraud[20]. This could provide evidence to bring cases against companies trading through Switzerland as part of the fraudulent chain, or identify assets of those individuals holding monies outside of the UK.

**4.23** In October 2005 HMRC also established a compliance pilot project to review the use of direct taxes to tackle those participating in the fraud. The aim is to assess whether fraudsters declare total earnings on which corporation tax, national insurance contributions or income tax may be due. The new measures include a risk intelligence team to facilitate the exchange of information between the direct tax and indirect tax areas of the organisation. This is a welcome development in line with recommendations made by the Committee of Public Accounts in 2004[21].

## Investigating fraudsters

**4.24** HMRC is responsible for investigating criminal cases of revenue fraud[22] and providing evidence to the Revenue and Customs Prosecutions Office, which is an independent government department responsible for the prosecution of major drug-trafficking and tax fraud cases in the UK. Criminal cases are complex as a result of the sophistication of the fraud and it may take a number of years to complete investigations and prosecutions. As at December 2005 HMRC was investigating 70 missing trader fraud cases, of which 38 cases started before April 2003; all of which HMRC expects to reach trial before 2008. During 2005-06 HMRC began 16 new cases, which provide valuable insight into the way the fraud is changing and HMRC can use this intelligence to allocate resources to areas of risk. Up to March 2006, HMRC had secured 111 convictions in missing trader fraud cases resulting in jail sentences of 342 years and just under £60 million worth of confiscation orders made. **Figure 24** summarises a successful case brought against fraudsters in August 2005.

18 The term 'customs matters' means the laws and regulations enforced by the Customs Administrations concerning the importation, exportation, and transit or circulation of goods as they relate to customs duties, charges, and other taxes or to prohibitions, restrictions, and other similar controls respecting the movement of controlled items across national boundaries.

19 Statutory Instrument 2006 No. 307 The European Communities Order 2006.

20 Proposal for a Council Decision on the conclusion of the Agreement between the European Community and its Member States and the Swiss Confederation to combat fraud and any other illegal activity to the detriment of their financial interests, Article 32.

21 Tackling VAT Fraud, Report from the Committee of Public Accounts, HC 512, June 2004.

22 Revenue fraud includes fraud relating to taxes, duties and National Insurance contributions.

**24** Successful prosecution results in 22 years jail for fraudsters

In August 2005, four people were found guilty of their part in a carousel fraud worth an estimated £40 million over a two year period. The fraud involved setting up twelve fictitious companies in the UK which were clones of legitimate UK companies dealing in mobile phones. The cloned companies sold consignments of goods to UK traders and issued fraudulent invoices using the names and VAT registration details of the legitimate UK businesses. The fraudsters requested payments be made to bank accounts in Hong Kong, where the funds could be dispersed and the VAT on the sales was never paid over to HMRC. In September 2005 the individuals were sentenced to a total of 22 years in jail.

*Source: HMRC*

**4.25** During the course of an investigation and prosecution, HMRC may suspend the collection of VAT assessments in selected instances until the outcome of the trial process, so as not to jeopardise the cases. These debts are pursued at the earliest opportunity after the conclusion of the proceedings. Where there are successful prosecutions, confiscation of assets is always pursued to cover established debts. At March 2006 the level of missing trader fraud suspended debt was £702 million. A significant proportion of this debt will not be recoverable for some time and may ultimately have to be written off if there are few assets to liquidate.

**4.26** During 2005-06 HMRC employed 212 dedicated missing trader fraud full time equivalent investigators. In addition it allocated another 200 full time equivalent staff to investigate missing trader fraud cases from VAT and Criminal Finance Investigations. An additional 48 individual staff were recruited during the year to the dedicated missing trader team. Financial resources for the additional staff were approved in April 2005, but complications in the recruitment process meant that they were not appointed until January 2006. They are expected to be fully operational by 2007 following completion of an accredited investigations qualification. The staff resources allocated reflects the recognition of the growing problem of missing trader fraud during the year.

**4.27** The Serious Organised Crime Agency was established in April 2006[23] with the statutory responsibility of preventing and detecting serious organised crime. However, the responsibility for the investigation of revenue fraud has remained with HMRC. The two organisations have signed a memorandum of understanding detailing their responsibilities and identifying potential areas for collaboration, such as joint working and sharing of intelligence. During 2005-06, approximately 711 full time equivalent staff transferred from HMRC's investigations teams to the Agency[24]. HMRC considers that this has not delayed the completion and commencement of existing and new missing trader cases respectively, given that most of the transferred staff were primarily involved in drug investigations.

## Recovery of VAT in missing trader cases

**4.28** HMRC faces considerable challenges to recover debts owed by missing traders who cannot be located and defaulting traders who have insufficient assets to cover the debts. HMRC can invoke provisional liquidation where significant levels of VAT are owed and the company refuses or is unable to pay the debt. HMRC provides evidence that the company is unable to pay its debts and presents a petition to court to wind up the company. The court may authorise the freezing of the company's assets and appoint a liquidator to sell them to cover the debts. In furtherance of this action HMRC asks the Court to examine the evidence regarding transactions with other companies that led to the defaulter not being able to pay the VAT and to freeze the accounts of those companies. It also assists the liquidator in recovery action.

**4.29** Provisional liquidation immediately stops the trader's activity and therefore prevents further tax losses. During 2004 and 2005 HMRC initiated 38 provisional liquidation cases. NAO reviewed 12 of these with total VAT debts of £91.6 million. HMRC had recovered a total of £4.1 million from the liquidators in relation to these cases by March 2006 and expected to receive a further £3.9 million. Of the 12 cases only one had been completed and in many others there were limited or no assets to recover. However, HMRC's action had prevented further tax losses. One of the companies had accumulated a VAT debt of £6.4 million in just four weeks of trading.

23 The Serious Organised Crime Agency takes over the functions of the National Crime Squad, the National Criminal Intelligence Service, the role of HMRC in investigating drug trafficking and related criminal finance and some of the functions of the UK Immigration Service in dealing with organised immigration crime.

24 The figure of 1,127 staff transferring to SOCA shown in HMRC's 2005-06 Annual Report includes both investigations and intelligence staff.

**4.30** HMRC may also use other civil measures to recover debts such as a creditor's liquidation. But this option may take between six to eight weeks longer and the fraudster may continue to trade and accumulate further VAT losses. HMRC has estimated a future revenue benefit of £48 million for the 12 cases examined based on the potential tax loss in a six week period. An additional benefit of taking provisional liquidation action is that it freezes the bank accounts of the company and allows HMRC to gather further intelligence which may be used to identify and disrupt other fraudulent companies that may be involved in the supply chain.

## Cooperation with other Member States, the tax and accountancy professions and the trade

**4.31** The exchange of information between Member States is a key tool in combating missing trader fraud within the European Union. The Council regulation on administrative cooperation allows Member States to exchange information with another member that may help to effect a correct assessment of VAT[25]. The regulation sets a deadline of 90 days for the response to a request for information. During 2004 HMRC received 854 requests and responded to 449 (53 per cent) within the deadline. In September 2004 it set up a designated coordination team to speed up the time taken to respond to these requests. However, there has only been a slight improvement in responses in 2005: HMRC received 664 requests and provided responses to 367 (55 per cent) within the required deadline during the period.

**4.32** The Council regulation also allows Member States to provide information on a particular trader in another Member State through a 'spontaneous' exchange. However, there is no requirement to inform the sending Member State of the benefit of the information supplied. By February 2006 HMRC had received 2,066 exchanges of spontaneous information, 214 of them from the Danish Tax Authority. The Tax Authority told the NAO that they suspected some Danish companies were involved in supply chains with missing traders in the UK. However, there was no tax loss in Denmark and therefore only limited criminal investigations could be undertaken. The Tax Authority added that if formal feedback procedures were adopted, it could use this information to undertake further investigation of Danish companies that persistently participated in fraudulent chains.

**4.33** The current regulation on mutual assistance does not provide for formal feedback on the quality of information exchanged other than at annual meetings of Member States. HMRC plans to review a sample of exchanges from April 2006 in conjunction with another Member State to identify ways in which the exchange of information could be improved. Key findings will be developed further in conjunction with other Member States. The Commission has recently stated that mutual cooperation is one of the areas where it would like to see further improvements, and included it in its Communication, published on 31 May 2006, for further debate on a European Strategy to combat tax fraud.

**4.34** The VAT Information Exchange System (VIES) is a computerised system that allows users to check information about VAT registered traders and the value of their sales to traders in other Member States. Traders are required to submit records of their transactions every three months. The system was introduced in 1993 following the abolition of border controls. It was originally a temporary measure to allow tax authorities to check the value of a trader's sales to other Member States and to make enquiries where necessary and issue VAT assessments where appropriate. There are difficulties in using trader information on the system since the data is at least three months old and traders may not record their transactions. In 2004, the Committee of Public Accounts recommended that HM Customs and Excise work closely with the European Commission to improve the system[26]. The Commission has put forward proposals which, subject to implementation by Member States, will improve the collection and quality of data, enhance the current VIES functionality, and provide more efficient tools to fight intra-community fraud. HMRC is currently providing assistance to the Commission during the development phase of the new system.

**4.35** HMRC has also worked with the tax and accountancy professionals to raise awareness of the fraud. In December 2005, Deloitte, PricewaterhouseCoopers, KPMG and Ernst & Young published a joint statement to assist with HMRC's approach to tackling missing trader fraud. They stated that they would provide guidance to those clients who may be at risk from dealing with traders in missing trader chains and remind their staff of the requirement under the Proceeds of Crime Act 2002 and Money Laundering Regulations 2003 to report any suspicions of fraudulent activity. During 2006 several other accountancy firms have followed with similar statements. In addition, a number of professional bodies,

25 Council Regulation No 1798/2003 an administrative cooperation in the field of value added tax.
26 Tackling VAT Fraud, Report from the Committee of Public Accounts, HC 512, June 2004.

including the Institute of Chartered Accountants in England and Wales and the Chartered Institute of Taxation, have also expressed their willingness to cooperate with HMRC to tackle missing trader fraud. In March 2006, HMRC held a workshop with members of the Joint VAT Consultative Committee[27]. The objective was to discuss further ways to tackle missing trader fraud, create a shared understanding of the key issues and discuss guidelines for legitimate businesses and tax practitioners. These guidelines cover areas such as hallmarks to identify suspect activity and details on how to report this to HMRC. In addition, mechanisms for reporting the misconduct of members to the relevant professional body are currently being formalised by HMRC.

**4.36** HMRC has worked closely with manufacturers from the key sectors affected by carousel fraud. Intel, a major manufacturer of computer chips, has provided training to HMRC teams to detect counterfeit chips and loaned scanning equipment to check whether goods had been involved in previous missing trader chains. Furthermore, HMRC has sought expert witnesses to provide statements in cases against fraudsters in respect of the commodities used to perpetrate the fraud.

## Legal developments

**4.37** In January 2006 the European Court of Justice upheld a challenge to HMRC's use of the 'non-economic activity argument'. VAT repayments were withheld to companies on the grounds that they were part of an overall chain to defraud and that the circular sales of goods in the chains had no economic substance. The Court ruled that the measure was inconsistent with the European Union Sixth VAT Directive and stated that the right to deduct VAT could not be affected by the fact that the transaction chain was vitiated by fraud. But, the Court's judgement also stated that where the trader knew or had means of knowledge that fraud has occurred[28], this may affect the right of the trader to deduct input tax. In light of this decision, HMRC has developed a series of checks which it is now using to tackle suspected traders.

**4.38** In 2005 the Federation of Technological Industries challenged two measures introduced by HMRC in the Finance Act 2003, the joint and several liability and the extended security measure, arguing that there was no authority under European Legislation to impose them. The Court of Appeal referred the case to the European Court of Justice as the matter related to the interpretation of European Legislation and the Court gave its ruling in May 2006. HMRC has interpreted the ruling that the Sixth VAT Directive does provide that Member States may enact legislation to make one taxable person jointly and severally liable for the VAT debt. The Court states that such a measure could be applied if the individual had knowledge or reasonable grounds to suspect that VAT would go unpaid in the supply chain, provided that such a measure is proportional[29]. HMRC has accepted that the ruling on the extended security measure means that it cannot use this as widely as it has, although the measure may be used where traders are found jointly and severally liable for a debt. HMRC is reviewing this and other rulings by the European Court of Justice in VAT-related cases, to identify the ramifications of these judgements on tackling missing trader fraud in the UK.

**4.39** In March 2006 the Government announced that it would introduce legislation to support HMRC in intensifying its operational activities. This included: making explicit HMRC's power to evidence the inspection of goods which will enable it to identify subsequent movements of goods and traders involved in fraudulent chains; and directing individual businesses to maintain relevant records, such as the unique identification numbers of mobile phones. In addition, the Government sought a derogation from the European Commission in December 2005 to permit the introduction of a 'reverse charge' for mobile phones, computer parts and related goods. The measure would effectively remove the VAT from the distribution chain from wholesaler to retailer but it would be invoiced at the end of the chain to the final customer. An example is detailed in **Figure 25**. There is a risk that there may be a diversion to goods not covered by the legislation or to other types of fraud. HMRC is aware of this potential risk and said that it will deploy existing operational tactics to deal with this problem if it becomes apparent that other goods are being used to perpetrate the fraud. However, it believes that there are only a limited number of goods to which it could mutate. HMRC will also need to undertake additional administrative checks on traders to ensure compliance with the new system.

27 The Joint VAT Consultative Committee is comprised of representatives from HMRC, accountancy and tax professional bodies and representatives from industry and finance.

28 Judgement made on 12 January 2006 in case of Optigen Ltd, Fulcrum Electronics Ltd and Bond House Systems Ltd v Commissioners of Customs and Excise.

29 Judgement made on 11 May 2006 in case of Commissioners of Customs and Excise, Attorney General v Federation of Technological Industries and others.

**25** An illustrative example of how the reverse charge mechanism works

A trader in the UK buys goods for £100 from a trader in another Member State. The UK trader pays no VAT as sales of goods between registered companies in the European Union are zero- rated. Under the current system, the UK trader sells the goods for £200 plus £35 output VAT to a business customer. The UK trader pays £35 to HMRC and the business customer is able to reclaim £35 input VAT from HMRC. The UK trader could defraud HMRC by withholding the £35 output VAT.

Under the reverse charge, no VAT would be paid to the UK trader. Instead the business customer would buy the goods for £200 and self account for both the input and output VAT of £35. The net effect is that there is no VAT to reclaim from HMRC.

The effect of this mechanism is that VAT in the chain is not held as cash and therefore cannot be stolen. If the business customer sells to an individual, it charges VAT in the sale price and accounts for this in the normal way.

*Source: National Audit Office*

**4.40** The Commission is required to reach a decision on the derogation before presenting a proposal to the Council of Ministers. The UK will be able to implement the proposed legislation if approved by the Council. Although the decision is not expected until late 2006 or early 2007, the Commission indicated in its recent Communication (May 2006) that it is prepared to consider extending the reverse charge mechanism to domestic transactions in a Member State. However, it stipulates that any change to the VAT system must considerably reduce the possibilities for fraud, exclude any opportunities for new types of fraud, generate no disproportionate administrative burden for companies and the authorities, achieve tax neutrality and ensure non-discriminatory treatment of operators.

**4.41** Tax advisors had recommended the reverse charge mechanism in 2003 in evidence on the Finance Bill 2003 to the House of Lords Select Committee on Economic Affairs[30]. At the time HM Customs and Excise did not take up the recommendation, believing that the fraud may be pushed further up the supply chain and that the charge would require businesses to set up dual accounting systems for VAT in the sectors involved. The Finance Bill introduced other measures which, along with the practice of withholding VAT repayments where no economic activity could be shown, contributed to the continued reduction in losses in 2003-04. The Financial Statement and Budget Report 2006 sets out estimates of the expected tax yield from implementing the reverse charge system in future financial periods (**Figure 26**).

**26** Expected additional tax yield on introduction of the reverse charge

| 2006-07 £m | 2007-08 £m | 2008-09 £m |
|---|---|---|
| 100 | 500 | 425 |

*Source: Financial Statement and Budget Report 2006, Her Majesty's Treasury*

30 The Finance Bill 2003: Evidence – Volume II, Select Committee on Economic Affairs, House of Lords, 10 June 2003.

## Conclusions

**4.42** Missing trader fraud is one of the most serious attacks on the tax system ever seen. It is a systematic attack by organised criminal groups on the European Union VAT system. HMRC's strategy, launched in September 2000, reduced the losses: in 2003-04 the level of fraud fell for the second year running, to between £1.06 billion and £1.73 billion. However, 2004-05 saw an increase in losses of between £1.12 billion and £1.9 billion and the latest operational indicators suggest that the level of activity related to the fraud has increased. The organised criminals behind the fraud are very resourceful and have reacted quickly to measures implemented by HMRC, setting up sophisticated and contrived transaction chains to avoid detection. To address these latest developments, HMRC has further strengthened its operational activities and plans to introduce new legal measures to help tackle the fraud.

**4.43** Tax practitioners recommended the introduction of a reverse charge mechanism to the tackle the fraud in evidence to the House of Lords Economic Affairs Committee in 2003. This measure would remove the VAT from the distribution chain from wholesaler to retailer, and thus reduce the possibility of this type of fraud occurring. Other measures introduced in 2003 have proved successful in reducing the level of fraud. However, in 2005 the confidence of the fraudsters and the level of fraud increased. The Government sought a derogation in December 2005 from the European Commission to permit the introduction of a reverse charge for goods normally associated with the fraud, such as mobile phones and computer chips. HMRC has estimated that, if approved, this measure will yield an additional £1 billion of VAT receipts over the next three years. There is, however, a risk that the fraudsters will divert to goods not covered by the legislation.

**4.44** HMRC and other Member States, supported by the Commission, are working closely through administrative cooperation to tackle the fraud. However, fraudsters can obtain goods free of VAT and continue to perpetrate this type of fraud whilst the current arrangements in the VAT system remain. The Commission has considered an overhaul of the current VAT system, but due to a lack of consensus, Member States have not agreed a definitive system. HMRC should continue to lead work with the European Commission and other Member States to highlight the difficulties in tackling the fraud within the current legislative framework and to identify long term mechanisms through which tax authorities across the European Union may tackle the fraud.

**4.45** Within the current VAT framework, improvements could be made to the quality and timeliness of information shared between Member States. Through the introduction of scanning databases in the UK and other Member States, there will also be opportunities to share greater detailed information to identify consignments of goods and traders involved in fraudulent chains. This information will therefore help HMRC to target its resources to tackle the fraud. The UK and some other Member States are now experiencing missing trader fraud that transcends the external borders of the European Union into third countries. The Commission has recently stated that it would like to see a community approach to cooperation with third countries. HMRC should use its experience and influence to facilitate these arrangements.

**4.46** Several of the large accountancy firms and professional bodies have publicly supported HMRC's approach to tackle the fraud and sought to develop guidance for their clients and members who may come into contact with missing traders. HMRC should continue to work closely with these organisations to identify further measures that could be successfully introduced in the UK. Many of these organisations are also established or have affiliates across the European Union, and counterparts in these offices may have useful suggestions in tackling the fraud.