National Audit Office

HM REVENUE & CUSTOMS 2007-08 ACCOUNTS

Report by the Comptroller and Auditor General

Issued under Section 2 of the Exchequer and Audit Departments Act 1921

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SUMMARY

Introduction

1 Section 2 of the Exchequer and Audit Departments Act 1921 requires me to examine the accounts of HM Revenue & Customs (the Department) to ascertain that adequate regulations and procedure have been framed to secure an effective check on the assessment, collection and proper allocation of revenue, and that they are being duly carried out. 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 2007-08 provided assurance that HM Revenue & Customs has framed adequate regulations and procedure to secure an effective check on the assessment, collection and proper allocation of revenue, and that they were being duly carried out. That assurance is subject to reservations about the level of error and fraud in the award of tax credits (see Part 2 of this report). The report also considers the collection of income tax through PAYE and Self Assessment, the administration of Value Added Tax registrations, and Excise Duties – The Alcohol Strategy.

Tax Credits

3 During 2007-08, the Department paid a net £20.0 billion in tax credits and an average of 5.7 million families received awards. The Department estimated that year end adjustments to awards meant it overpaid £1.0 billion in 2006-07, compared with £1.7 billion in 2005-06. This fall is mainly because of the increase from £2,500 to £25,000 in income rises which are disregarded when finalising awards. Other measures announced in the 2005 Pre-Budget Report together with operational improvements by the Department have also contributed to the fall.

4 In the first four years since the scheme was introduced, the Department calculates that year end adjustments, and other small changes to entitlement after the finalisation of awards, have led to a debt of £7.3 billion. It has also identified £700 million from in year adjustments to 2007-08 awards and will identify further overpayments for this year once awards are finalised. By the end of March 2008 the Department had collected £2.7 billion of this debt and written off £1.0 billion. £4.3 billion remains to be collected of which £1.8 billion is in doubt. Some £0.9 billion of debt was not subject to active recovery, for example where recovery is temporarily halted due to a disputed overpayment or the debt was in the process of being transferred to direct recovery.

5 The tax credits scheme relies on claimants telling the Department when their circumstances change so that it can update their awards. Claimants have not always understood their obligations under the scheme or received the support they needed from the Department. As a consequence over and underpayments have occurred because the Department has made payments based on out of date information. As part of its Tax Credits Transformation Programme the Department is evaluating service improvement pilots that are designed to assist claimants who need extra support in making a claim and reporting changes in circumstances. It anticipates that most of these will be implemented by April 2009.

6 Since the tax credits scheme was introduced in April 2003 it has suffered from high levels of error and fraud. The Department's latest estimate is that in 2006-07 error and fraud resulted in between £1.31 billion and £1.54 billion (7.2 to 8.4 per cent of the final value of awards) being paid to claimants to which they were not entitled. I have qualified my opinion on the regularity of the expenditure reported in the Trust Statement in respect of tax credits error and fraud. The Department's estimate's of error and fraud from 2005-06 are based on a more robust approach to evaluating the results of its random enquiry of finalised awards. The estimate, however, excludes error and fraud on terminated awards included within the £148 million of incorrect payments identified during 2006-07 through the Department's compliance activity.

7 The Department has set a target to reduce the current level of claimant error and fraud to not more than 5 per cent by 2011. It is also strengthening its response to those claimants who represent the highest risk of error and fraud as well as considering other measures which it will pilot through 2008-09. The Department is aware of the need to carefully evaluate these pilots and use the results to direct its compliance activity to areas that have the greatest effect in reducing error and fraud.

8 The 2002 Tax Credits Act gave the Department certain powers to adjust awards after finalisation. The Department made adjustments to some finalised awards which were outside the circumstances provided for in legislation. The Department's specification for the computer system did not reflect the requirements of the Act and the day to day guidance used by staff was incorrect. The Department is reviewing 250,000 awards to determine whether repayments are due and it estimates this work will take three years to complete. Of these cases, it estimates it owes around 20,000 claimants an average repayment of between £800 – £1,000.

Follow up on the collection of Income Tax

9 In 2007-08 the Department collected £155.1 billion in income tax and £98.2 billion in National Insurance Contributions. Our 2006-07 Report considered a number of issues relating to the collection of income tax through Pay As You Earn (PAYE) and Self Assessment. During 2007-08 we have followed up on the progress made by the Department on some of the key aspects of its administration of income tax.

The collection of income tax through PAYE

10 Following the introduction of online filing in 2005, the Department continues to improve its processing of employer end of year returns. By 31 October 2007 it had processed 92.5 per cent of 2006-07 returns received, and 98.6 per cent of returns received from employers met the Department's quality standards. It still needs to develop better management information to support its governance of the end of year filing process. Following the automation in May 2007 of changes to tax codes for benefits in kind it has updated 72 per cent without manual intervention.

11 In 2008 the Department is planning to transfer its processing of PAYE for individuals on to the National Insurance Recording System and so allow it to bring all information on individuals' employment and pensions income together. The Department has deferred this change from April 2008 to October 2008 to allow more time to assure supporting systems.

12 At the end of the tax year, the Department's computer system may identify discrepancies in taxpayer records or be unable to match a return to a record and so it will establish an 'open case' for manual checking. Delays in clearing 'open cases' can mean that taxpayers are not notified on a timely basis of additional tax payable or refunds due. At the end of March 2008 the Department had 16.2 million open cases, which exceeded its target of 12.5 million, because computer system developments did not deliver the reduction in cases expected, staff were released to other work and there was lower than anticipated overtime. The Department plans to reach a steady state position by 2010 where open cases for each tax year are cleared within a year and there are no backlogs for 2006-07 and earlier years. The number of cases that will require manual intervention following the implementation of the computer changes cannot be predicted with absolute certainty, so the Department needs to consider the processing resources necessary to clear the backlog of 'open cases', should this exceed its current estimate.

13 Since 1983 the Department has not collected all the tax due from some pensioners because of a failure to apply the PAYE regulations properly. It estimates that this error could affect some 420,000 pensions with a tax loss of some £135 million per annum. It has taken steps to correct the tax treatment, but because of the deferral of the transfer of processing to the National Insurance Recording System, the Department will not now be in a position to correct tax codes until 2009-10. The Department has exercised its management discretion to waive the tax due for 2007-08 because it could not now give the taxpayers concerned reasonable notice of the tax payable. It will therefore not collect the estimated £135 million of tax due for 2007-08 as it originally planned. It will start to tax these pensions from 2008-09.

The collection of income tax through Self Assessment

14 The Department is introducing a number of important changes to the Self Assessment process in 2008. It has introduced a shorter, simplified return for the 2007-08 tax year and will bring forward the deadline for those who file paper returns from 31 January to 31 October. The Department did not achieve its previous target for the submission of returns by the 31 January deadline, although this target was always a challenge following the removal from Self Assessment of certain taxpayers with a better compliance record. The Department has planned publicity campaigns to remind taxpayers of the new deadline.

15 The Department has made good progress in the number of returns filed online. In 2007-08, 46 per cent of returns (3.8 million) were filed online and on time significantly exceeding its target of 35 per cent. A record number of 204,000 taxpayers submitted online returns on 31 January, but between 10,000 and 15,000 taxpayers could not on that day because of a hardware problem in the computer systems supporting the service. The Department and its supplier have updated the Self Assessment online system and reviewed the testing of online services to ensure peak demands are met in the future. It is also reviewing the wider lessons learned to enhance the speed with which it responds to such events.

16 The Department's latest estimates based on the 2002-03 tax year indicate that 34 per cent of filed returns were inaccurate putting between £2.9 billion to £3.7 billion tax at risk. This estimate is based on registered Self Assessment taxpayers and does not cover under-declared income from people working in the informal economy.

17 Self Assessment taxpayers can appeal against assessments, penalties, surcharges or amendments. These items are "stood over" as not collectible and not forwarded for collection until the appeal is cleared. The Department's latest estimate of the value of these amounts is £1.1 billion. The Department's Internal Audit found that "stoodover" items were given little attention and substantial backlogs of uncleared items had built up. The Department reviewed the process for handling standovers to identify areas for improvement and is now starting to address these issues.

Value Added Tax

18 In 2007-08 the Department collected net Value Added Tax receipts of £81.2 billion, and processed around eight million VAT returns. Traders are required to register for VAT if their taxable business turnover exceeds a defined threshold. The Department receives some 280,000 VAT registration applications a year. The Department faces two key challenges on VAT registrations. Firstly, to facilitate trade by ensuring that registration applications are processed as quickly as possible. Secondly, to ensure that potential fraudsters are prevented from entering the system. Since 2004-05, the Department has faced a sustained attack from fraudsters and has strengthened, among other things, its registration controls to prevent fraudsters from obtaining a VAT registration number.

19 In 2006 the Department introduced long term measures to increase registration performance which were initially successful. However, its registration performance deteriorated significantly in the early part of 2007 when the level of registration applications on hand increased from around 29,000 in January 2007 to a peak of 58,000 in June 2007, and the average number of days taken to process an application rose from 29 days in March 2007 to around 42 days in August 2007.

20 A combination of factors contributed to the deterioration of VAT registration performance.

- Increased checks to counter the threat from fraudulent traders, together with other measures, helped the Department to tackle missing trader fraud, reducing the estimated VAT losses by £1 billion. But some risk parameters were poorly targeted, resulting in more legitimate applications being subjected to delays whilst being checked than might otherwise have been necessary.
- These additional checks coincided with the reorganisation of the Registration Units which did not happen as planned and resulted in significant staff shortages. The Department released experienced casual staff before it had redeployed permanent staff from other parts of the Department. This situation was exacerbated by an increase in general staff turnover. Staff also took longer to process applications against a background of increased computer problems, and a significant increase in applications from traders seeking to circumvent legislative changes.
- The restructured risk team initially took longer to process the registration applications owing to the inexperience of the new team and the lack of access to the appropriate computer systems.
- The VAT registration computer systems could not provide reliable information on the level of work on hand as the data was not robust. Also, staff shortages meant that some applications were not entered promptly on to the registration computer systems. The Department was not fully aware of the increase in work on hand until it undertook a manual exercise in August 2007, which assessed the level at 48,000 applications.

21 In July 2007, the Department prepared an action plan to improve the registration performance by January 2008. The long lead time reflected the need to tackle the existing backlogs and to allow time for new staff to be fully trained. As at January 2008 the Department had made significant improvements in processing registration applications, achieving its target of processing 70 per cent of applications within 14 days. By March this figure had risen to 83 per cent. But the focus of resources on improving this part of the registration service has not been without detriment to the timeliness of the de-registration process, where performance has dropped.

22 The Department has now prepared an action plan to address the de-registration backlogs and is continuing to monitor the registration staffing position. It has also prepared a contingency plan which will be implemented should the registration problems re-emerge. In the longer term the Department aims to use the computer systems to monitor work on hand and is currently performing data cleansing exercises to ensure that they record reliable information.

Excise Duties: The Alcohol Strategy

23 In 2007-08, the Department collected excise duties of £8.3 billion on alcohol, comprising: spirits £2.4 billion, wine £2.6 billion and beer and cider £3.3 billion. Excise duty is liable at the time the alcohol is either produced or imported, although under duty suspension arrangements authorised traders are allowed to defer payment nearer to the time when they release their goods for consumption. Excise diversion fraud occurs where goods intended for export or delivery to another excise warehouse under duty suspension are diverted for consumption in the UK without the UK duty being paid.

24 The Department launched its Alcohol Strategy in 2005 in response to the estimated £250 million in lost excise duty due to spirits fraud. It has made good progress in embedding the measures underlying the Strategy, which is underpinned by a robust governance system. The Department has a Public Service Agreement Target to reduce the illicit spirits market to three per cent by March 2008. The latest data available shows the illicit market share mid-point at five per cent in 2005-06, a decrease of three per cent since 2003-04.

25 The Department has addressed the recommendations made by the Committee of Public Accounts in 2004 to strengthen its response to alcohol fraud. In particular, the Department has:

- Revised its methodology for estimating the illicit spirits market. The United Kingdom is one of the few countries to try to make such estimates, which are inherently difficult. The Department has not yet found an acceptable method for measuring potential tax gaps for other alcohol products, such as beer and wine, which in total comprise around 60 per cent of the duties collected. The Department recognises that it needs to do more and is working with the industry to establish a robust methodology to estimate the extent of the illicit market for all alcohol products.
- Established Memoranda of Understanding (MoUs) with the alcohol industry to provide a framework for cooperation in tackling alcohol fraud. The Department intends to agree memoranda with the British Beer and Pub Association and Transporters, which would extend the MoUs to other sectors involved with the acquisition, distribution and sales of alcohol.
- Developed an internal coordinated response to tackle suspected high risk traders. The Alcohol Strategy Delivery Group (ASDG), comprising representatives of all the internal operational groups involved in tackling alcohol fraud, coordinates the Strategy and ensures that all teams work together either through national or collaborative projects. The Department has developed a delivery agreement with the newly established UK Border Agency for 2008-09, which sets performance targets and ensures that this new body will continue to play a full role in the development and implementation of the Alcohol Strategy.
- Introduced tax stamps in October 2006 to make it easier to identify illicit bottles of spirits. Measures have been introduced to mitigate the associated compliance costs. The Department has delayed the full enforcement of the legislation in the retail sector to allow legitimate unstamped spirits to be sold making it easier to identify illicit bottles, but it plans shortly to implement an assurance programme to detect and deter fraudsters.

26 The Department is also working with the European Union to tackle alcohol fraud. The Department's response to requests from other EU Member States has been reasonable, but there is still room for improvement. In 2007-08, the Department responded to 74 per cent of requests within the statutory deadline but recognises that it should aim to provide replies to 95 per cent of requests within the deadline. The Department is working with the European Union to improve the performance of other Member States in responding to requests from the United Kingdom, with on average, only 53 per cent of outgoing requests receiving replies within the statutory three month period.

Summary of Recommendations

Tax Credits

27 During 2008-09, the Department will be introducing a range of service improvements to assist claimants as part of its Tax Credits Transformation Programme. The Department has taken steps to assess the pilots of the individual modules prior to their implementation. It needs to maintain a rigorous approach to the evaluation of the service improvement modules so it can continue to assess their effects following implementation.

28 The Department should continue its work to provide a more reliable estimate of the level of error and fraud in tax credits. In particular, it should build on its decision to use a dedicated team to carry out the random enquiries into finalised awards by enhancing its guidance to staff on the steps to be followed in examining cases and documenting judgements made to ensure that the quality of the testing is of a consistently high standard.

29 When reporting the overall estimate of the level of error and fraud, the Department should combine the results from its random enquiry of finalised awards with its estimate error and fraud on awards terminated during the year as a consequence of its compliance activity.

30 In implementing the strategy for reducing error and fraud, the Department also needs to develop its monitoring to support a more timely assessment of how the measures are contributing to the achievement of its target.

31 The Department is seeking to collect £4.3 billion of tax credit debt, of which £1.8 billion is in doubt. In the light of its recent work to introduce service improvements and refresh its compliance strategy, it may wish to consider extending this review of its processes to cover its debt collection procedures.

32 The Department found that aspects of its day to day guidance to staff on tax credits were incorrect and it is taking action to address this. It needs to set a clear timetable for completing this work.

Income Tax

33 The Department's is currently testing its arrangements in the run-up for the transfer of processing to the National Insurance Recording system. In the past its implementation of computer system changes to modernise PAYE processing have met with initial difficulties leading to increased workloads. The Department needs to:

- draw on its most recent experience with its computer systems changes to ensure the risk of disruption from unforeseen increases in workloads is minimised; and
- recognising that the number of cases requiring manual intervention following the transfer cannot be predicted with absolute certainty, it should establish appropriate contingency arrangements to clear processing backlogs.

34 The Department's computerisation of benefits in kind processing has allowed it to clear 72 per cent of all cases automatically. It needs to ensure that it maintains sufficient processing capacity to clear promptly the 28 per cent of cases which require manual intervention.

35 The Department should consider extending its estimate of tax at risk from Self Assessment taxpayers to cover under-declared income from people working in the informal economy. It should also consider how it could produce its estimates of tax at risk more quickly so that it can better assess the effectiveness of its compliance activities. The Department should also develop a strategy for increasing the levels of accuracy in filed returns.

Value Added Tax

36 The Department should continue to monitor VAT registration performance and ensure that:

- it strikes the right balance between stopping criminals from entering the VAT system and ensuring that legitimate traders receive their VAT registrations without undue delay; and
- it responds quickly to any management information indicators which show that VAT registration performance is deteriorating.

37 The Department should prepare and implement a phased action plan to further improve the speed of registration application processing beyond the current performance level of 83 per cent within 14 days.

38 The work on hand figure is a key indicator of performance and, as such, it is important that the information is robust and prepared regularly, at least once a month. This information is currently being generated by manual counts. The Department should prepare an action plan to address the VAT registration computer problems. This will enable it to use computer generated information and avoid the need for resource-intensive manual counts.

Excise Duties – The Alcohol Strategy

39 Both beer and wine excise duties account for around 60 per cent of the alcohol tax receipts collected by the Department. It should continue to work with the alcohol industry to establish a robust methodology for estimating the beer and wine illicit markets.

40 The Department should prepare an action plan to increase its current response rate to requests for administrative assistance from EU Member States, from currently 74 per cent to 95 per cent.

41 The delivery agreement signed by the Department and UK Border Agency should be reviewed frequently to ensure that the arrangements are delivering the planned outcomes. Additionally, discussions regarding future arrangements should be agreed as soon as possible.

42 A comprehensive compliance assurance programme should be prepared and implemented as soon as possible to identify non duty stamped bottles on retail shelves. Moreover, successful operations should be communicated to the alcohol industry as evidence that duty stamps are effective and to deter potential fraudsters.

PART ONE Introduction

Background

1.1 Section 2 of the Exchequer and Audit Departments Act 1921 requires me to examine the accounts of HM Revenue & Customs (the Department) to ascertain that adequate regulations and procedure have been framed to secure an effective check on the assessment, collection and proper allocation of revenue, and that they are being duly carried out. 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.

1.2 This part of my report explains the scope of my audit, the audit approach applied and the audit conclusion from my examination of the revenue accounts.

Scope of the audit

1.3 We have undertaken a programme of revenue audits across the Department's activities and tax streams. The findings from of our revenue audit are further informed by other work that has contributed to our overall view of the Department's management of the tax systems, including:

- the findings emerging from our value for money studies on revenue issues conducted under the National Audit Act 1983; and
- our consideration of the Department's Statement on Internal Control (paragraphs 1.8 to 1.10).

Audit of Revenue

1.4 We conduct specific work on the principal tax streams to gather sufficient and appropriate evidence on the adequacy of the systems and procedures the Department has developed to secure an effective check on tax revenues and to assess their application. This embraces:

- the overall control framework for the assessment, collection and proper allocation of revenue for each tax, including the arrangements for:
  - the effective governance of individual tax streams and the management of key risks to revenue collection;
  - framing of regulations and procedures for the collection of the tax or duty;
  - the information and key indicators used by the Department to monitor and assess its performance in the collection of revenues; and
  - the strategies and other plans the Department has established to help ensure taxpayer compliance, including its response to the risk of fraud and error.
- the systems and processes in support of the tax stream covering registration, filing, assessment, collection, allocation, debt management, repayments and accounting. This includes the periodic examination of the computer systems which support the key stages in the tax process; and
- changes to the regulations and procedure, including changes in the tax process and underlying computer systems.

1.5 As part of this work we have also conducted examinations into specific aspects of the Department's operation of the tax system and tax credits systems. Our 2007-08 Report covers four such examinations which deal with the Department's:

- administration of Tax Credits (Part 2);
- collection of income tax through Pay As You Earn (PAYE) and Self Assessment, a follow up of the issues raised in our 2006-07 Report (Part 3);
- administration of Value Added Tax registration (Part 4); and
- progress in tackling fraud on Alcohol Duty (Part 5).

1.6 In addition to this work we have also taken into account the results of our audit of tax revenues collected and reported in the Department's Trust Statement. The results of this work are set out in the separate Report appended to the Comptroller and Auditor General's audit certificate on the 2007-08 Trust Statement (pages 86 to 92).

Value for Money Audit

1.7 In 2007-08 we carried out four 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 its:

- management of large business Corporation Tax (HC 614, Parliamentary Session 2006-07);
- approach to tackling the hidden economy (HC 341, Parliamentary Session 2007-08);
- transformation programme (to be published shortly); and
- the control and facilitation of imports (to be published shortly).

Statement on Internal Control

1.8 The Accounting Officer's Statement on Internal Control (pages 1 to 10 of the 2007-08 Accounts) covers the Department's Resource Account and the Trust Statement. The Statement serves two purposes:

- to provide Parliament with assurance that the Accounting Officer has put in place the necessary control framework to manage risk (paragraphs 2.1 to 5.10 of the Statement); and
- to highlight the areas of concern identified by his review of the effectiveness of internal control (paragraphs 6.1 to 6.40 of the Statement).

1.9 We consider whether the Accounting Officer's statement reflects the Department's compliance with HM Treasury's disclosure guidance and whether the Statement properly reflects all material control weaknesses that have come to attention in our audit. We also consider the 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.

1.10 The Statement on Internal Control for 2007-08 acknowledges a number of significant control weaknesses which affect its administration of tax and tax credits. Our report considers some of these issues, namely Tax Credits (Part 2), Pay as You Earn and Self Assessment (Part 3) and Value Added Tax (Part 4).

Conclusion

1.11 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 2007-08 provided assurance that HM Revenue and Customs has framed adequate regulations and procedure to secure an effective check on the assessment, collection and proper allocation of revenue, and that they were being duly carried out. That assurance is subject to reservations about the level of error and fraud in the award of tax credits (see Part 2 of this report).

PART TWO

Tax Credits

Introduction

2.1 The current tax credits system forms part of the personal tax system administered by the Department and uses tax definitions of income. Tax credits are not voted by Parliament under the Supply process but defrayed out of tax collected before the payment of the net revenues into the Consolidated Fund. The Department accounts for its expenditure on tax credits in its Trust Statement for taxes, duties and other revenues and related expenditure. We have therefore examined the Department's administration of tax credits as part of the Comptroller and Auditor General's overall responsibilities for the audit of revenue under Section 2 of the Exchequer and Audit Department Act 1921.

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

2.3 During 2007-08, the Department paid a net £20.0 billion in tax credits and an average of 5.7 million families received awards. The cost of administering the scheme was £581 million. **Figure 1** gives an overview of the tax credits scheme since its introduction in April 2003.

2.4 Our previous Reports have covered a number of important issues in the administration of tax credits, including overpayments and recoveries, levels of error and fraud and the steps taken by the Department to improve the service provided to claimants. As part of my work in 2007-08 I have examined the progress the Department has made in dealing with these issues and my report covers:

- the Tax Credits Scheme;
- the Tax Credits Transformation Programme;

1 Tax Credits: Scheme Overview

	2003-04	2004-05	2005-06	2006-07	2007-08 provisional[2]
Families benefiting[1]	4.6m	5.0m	5.3m	5.5m	5.7m
Net cash paid to claimants in year	£13.5bn	£15.8bn	£17.3bn	£18.7bn	£20.0bn
Final value of awards[3]	£12.0bn	£14.3bn	£16.0bn	£18.2bn	Not yet known
Administrative cost	£406m	£475m	£467m	£587m	£581m
Staff employed by the Department	7,300	8,200	8,750	10,120	9,200

Source: HM Revenue & Customs

NOTES

1 Figures represent the average number of families benefiting in the years up to and including 2006-07 in finalised awards and for 2007-08 in provisional awards.

2 Actual information for 2007-08 will be available in May 2009, after awards have been finalised.

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

- the Department's approach to reducing claimant error and fraud;
- its management of overpayments caused by adjustments to awards; and
- inappropriate adjustments to finalised awards.

The Tax Credits Scheme

2.5 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 intended to support working people, both employed and self employed, by topping-up earnings; the amount depends on factors such as age and/or the number of hours worked. Additional support is available for eligible childcare costs or where a member of the household is disabled.

2.6 Tax credits are paid on the basis of an annual entitlement, which depends on a claimant's income and family circumstances. The Department initially calculates a provisional award based on the claimant's income for the previous year and their current family circumstances. Awards can be adjusted if claimants tell the Department of a change in their circumstances during the year. After the end of the year, the Department asks claimants to confirm by 31 July 2008 their actual circumstances and income. The Department uses this information to assess the final award and where appropriate establish a provisional award for the new year. The timetable for the calculation and payment of 2007-08 awards is in **Figure 2**.

The Tax Credits Transformation Programme

2.7 Claimants have not always understood their role and obligations in the tax credits system or received the support they needed from the Department. In November 2006 the Department established the Tax Credits Transformation Programme to assess and identify the root causes of these problems and define an action plan to address them. This work included developing a future operating model to guide the transformation of tax credits. The Department's aim was to allow claimants to complete transactions in one contact and for queries to be resolved immediately with a clear outcome. The model and the process of transformation towards it is summarised in **Figure 3**.

2 Timetable for the calculation and payment of 2007-08 awards

	Stages in the Tax Credits cycle	Payment/ recoveries
	New Claim/Renewal of 2006-07 Award for 2007-08	
2007-08	A claimant's prior year income is used as the initial basis for the 2007-08 provisional award.	Provisional payments made for 2007-08 awards.
	Changes in circumstances	
	Claimants may notify HMRC of changes in circumstances. HMRC then calculates a revised award.	Payments amended to reflect the latest information.
	Finalisation of 2007-08 Award and Renewal for 2008-09	
2008-09 April - July	The claimant informs HMRC of actual circumstances and income for 2007-08 to enable HMRC to finalise the award and processes renewal for 2008-09.	HMRC seeks recovery of overpayments and pays underpayments as lump sum.

Source: National Audit Office

3 HMRC's business change objectives for the Tax Credits Transformation Programme

i Delivering a customer service tailored to individual needs informed by better data to support a segmented approach.

ii Aligning the delivery of tax credits and child benefit, so claimants need to contact the Department only once to apply for and report changes of circumstances for both schemes.

iii More efficient and secure delivery systems, including improved authentication procedures to give claimants greater assurance that the tax credits system is secure.

iv Clearer communication with claimants to ensure more helpful interactions, more easily understandable outputs, and improved claimants' trust.

Source: National Audit Office adapted from HMRC's Tax Credits Transformation Programme and Benefits Realisation Management Plan

2.8 The Department's immediate focus for the Transformation Programme is to improve the service provided to claimants and its communications with them. However, the Department's scope for making service improvements is constrained by the current computer system, which makes it difficult for the Department to tell claimants with certainty, at the time they report a change of circumstance, how it will affect their entitlement. By May 2008 the Department had developed and piloted eight service improvement modules under the Programme. It is evaluating these and plans further pilots over the coming year. **Figure 4** opposite summarises the planned service improvements. The household breakdown telephone claims service was the first module to be implemented in November 2007. The Department expects most of the other improvements to be implemented by April 2009.

2.9 The Department is also trialling a new range of simple and clear communication products to help improve claimants' understanding of tax credits. It plans to launch these communication products in 2008-09. They will cover the overall tax credits process, and each stage in that process, from claiming, checking award notices, reporting changes in circumstances, and renewing awards.

Reducing claimant error and fraud

Overall levels of claimant error and fraud

2.10 The current tax credits scheme has suffered from high levels of error and fraud since it was introduced in April 2003. The Department's latest estimate, based on the examination of a random sample of 4,250 awards, is that error and fraud resulted in between £1.31 billion and £1.54 billion (7.2 to 8.4 per cent of the final value of awards) being paid to claimants to which they were not entitled. A summary of the Department's estimated ranges of error and fraud in each of the first four years of the scheme is given in **Figure 5 on page R14**. The C&AG has qualified his opinion on the regularity of the expenditure reported in the Trust Statement in respect of tax credits error and fraud.

2.11 The Department improved its methodology in 2005-06 to provide a more robust estimate of the overall levels of error and fraud in tax credits. In the past, the Department's source of data for selecting the sample was based on a snap-shot of the status of an award at finalisation. It was concerned that this method and the comparatively simple approach applied to the stratification of the population would lead to an increasingly inaccurate estimate of error and fraud. The Department's new approach is based on an analysis of information directly from the tax credits computer system, which provides more information about the nature of awards throughout the year, and supports a more detailed stratification of the population. It estimates that had it continued to sample from its original data source in previous years the estimate of error and fraud would have been overstated by as much as £240 million. The Department has not applied its revised methodology to updating its estimates of error and fraud for 2003-04 and 2004-05 because it does not consider this would be an effective use of its resources.

2.12 The Department reorganised and accelerated the testing process for awards made for 2006-07 to allow it to produce an of error and fraud in June 2008, almost a year in advance of the timetable for producing estimates in previous years.

2.13 The Department took steps to enhance the quality of its random enquiry of 2005-06 awards to provide a more reliable estimate of levels of error and fraud in individual cases. These included concentrating its review of random enquiries in four compliance offices to promote more consistent and higher quality case work. The Department also extended its random enquiry testing from 2005-06 to measure the extent of official error. It estimates that in 2006-07 official error led to £30 million being paid to claimants to which they were not entitled and £50 million not being paid to claimants to which they were entitled.

4 The Tax Credits Transformation Programme: Service Improvements

Stages in the tax credits cycle	Service Improvement Modules
Claims	**Household Breakdown Telephone Claims Service:** Claimants who suffer a household breakdown could have experienced a significant period of time without tax credits as their joint award ends and new single paper claim are processed into payment. The Household Breakdown Telephone Claims Service is now putting some 90 per cent of claimants back into payment within five days ensuring no break in payment.
	Assisted Claims: This module aims to understand the needs of claimants and match them with the right level of support to ensure they can get into payment as quickly, accurately and painlessly as possible.
Changes of circumstances	**Tax Credits/Child Benefit alignment:** at present, claimants using the telephone have to report the same piece of information separately for Child Benefit and Tax Credits. The Department has piloted a service to handle both regimes in the single contact.
	Find, Check and Amend: Where the Department has good quality data from a reliable source that shows a claimant has not reported a change of circumstance, it will either amend their award and notify the claimant of the change or proactively contact them to seek confirmation of the change.
	Health Check: The Department is contacting claimants who have not notified them of any change of circumstances for several years. During the pilot some claimants reported significant changes in circumstances which resulted in changes to their awards and in some cases generated overpayments.
	Proactive Questioning: Many claimants do not understand what changes of circumstances they need to report and the consequences of not reporting them. A pilot project in March 2007 found that 34 per cent of all claimants' calling with a change of circumstance, when prompted, had at least one further material change to report.
	The Department has run a further pilot to test its ability to better target callers at times when changes may have occurred that would impact their award i.e. when a child reaches 16 and leaves full time education.
	After Care: This project will focus on claimants who have received support through the Assisted Claims module. The Department will proactively contact these claimants and offer assistance to make sure they understand what they need to do and to provide advice on any problems encountered.
	Outreach Through Children's Centres: The Department will work with Children's centres to pilot different ways and different locations for providing advice and services to families with children under five.
	Avoiding Overpayments: Claimants will be offered a series of services designed to help them avoid overpayments.
Renewal	**Reach Out Renewal:** Around 250,000 claimants fail to renew their tax credits claims and many of those have ongoing entitlement. These claimants face losing their entitlement and having to reclaim and will also have to repay all the provisional payments they have received between April and July.
	In August 2007, the Department ran Phase 1 of its Reach Out Renewal service targeting those who had not renewed in time and who potentially face the biggest potential overpayment. It will be implementing this exercise on a larger scale in August 2008 and in subsequent years.
	In addition, the Department will contact claimants with large entitlements to Tax Credits during the renewal period to attempt to get them to renew earlier than they might otherwise, thus reducing the size of any overpayment which may have arisen due to unreported changes in circumstances.
	Assisted Renewals: Selected claimants will receive extra assistance when they call to enquire about renewals or to renew their award.

Source: HM Revenue & Customs

5 HMRC's estimates of claimant error and fraud on finalised awards[1]

Year	2003-04	2004-05	2005-06	2006-07
Value of finalised awards				
£ billion	£12.0bn	£14.3bn	£16.0bn	£18.2bn
Error and fraud favouring the claimant				
Estimated range (per cent)	8.8 – 10.6%	7.3 – 9.1%	8.5 – 10.6%	7.2 – 8.4%
Estimated value (£ billion)	£1.06bn – £1.28bn	£1.04bn – £1.30bn	£1.36bn – £1.69bn	£1.31bn – £1.54bn
Error favouring HMRC				
Estimated range (per cent)	1.6% – 2.3%	1.4% – 2.4%	1.4 – 2.4%	1.3 – 2.1%
Estimated value (£ billion)	£0.19bn – £0.28bn	£0.20bn – £0.35bn	£0.23bn – £0.39bn	£0.24bn – £0.39bn

Source: HM Revenue & Customs

NOTE

1 The Department estimates levels of error and fraud based on the examination of a random sample of finalised awards.

2.14 Our examination of the Department's estimate of error and fraud and the underlying random enquiries has raised two issues.

- Establishing a dedicated team to carry out the work has helped to accelerate the testing programme. But the Department needs to enhance its guidance to staff on the steps that should be undertaken when examining cases and the documentation of judgements made to ensure that the quality of the testing is of a consistently high standard.
- The estimates of claimant error and fraud are based on finalised awards at the end of the year. The estimate excludes error and fraud already identified during the period through the Department's compliance activity. These amounts are shown within the figures in **Figure 6 opposite** and should be taken into account when reporting the overall level of error and fraud.

The current compliance regime

2.15 The Department 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 uses a risk-based approach to identify the highest risk claims that might need a compliance investigation and on the most significant cases looks to do so before any payment is made.

2.16 In 2007-08, the Department's compliance teams carried out over 157,000 pre and post payment checks, which identified incorrect payments of £187 million and prevented incorrect payments of £150 million. Since April 2005, the Department has increased the number of checks undertaken before awards are paid, so that the highest risk claims are checked at an early stage and to reduce the risk of incorrect payments. During 2007-08 it performed 43 per cent of its compliance checks on claims before they were paid. The Department also uses profiling techniques to identify awards in payment which contain certain risks for further examination. An analysis of the number of compliance checks performed and their estimated yield over the past four years is given in Figure 6.

2.17 Where a compliance investigation identifies an error affecting a claim in payment, the Department corrects the award and adjusts future payments to take account of any amounts wrongly paid. In some cases these errors may also affect claims for previous years. Where a claim is no longer in payment the Department seeks recovery of these overpayments.

2.18 The Department considers imposing a financial penalty where it concludes there has been a deliberate attempt to over-claim or where the claimant has been negligent and provided the wrong information. The Department is introducing a new approach to penalties in 2008-09, where the size of the penalty will be related to the level of non-compliance and the claimant's behaviour. It expects this approach will better target and deter those who seek to overclaim because of carelessness or deliberate intent. The Department can also pursue criminal prosecution, but it limits this to the more serious cases of tax credits fraud and those involving organised attacks on the system. An analysis of penalties imposed and cases selected for criminal prosecution is given in **Figure 7 opposite**.

6 HMRC's compliance checks on tax credit awards

	2004-05	2005-06	2006-07	2007-08
Number of Checks				
Target	101,500	110,000	130,000	150,000
Actual checks	107, 789	146,376	137,930	157,468
Pre payment: post payment ratio	16%:84%	45%:55%	41%:59%	43%:57%
Estimated Yield				
Yield comprising:	£130m	£528m	£286m	£337m
Incorrect payments prevented[1]	Not available	£307m	£138m	£150m
Incorrect payments found[2]	Not available	£221m	£148m	£187m
Checks resulting in change to award:				
Pre award	93%	93%	68%	65%
Post award	65%	85%	81%	78%

Source: HM Revenue & Customs

NOTES

1 The estimate of incorrect payments prevented is the additional amounts that would have been paid during the year had payment not been stopped.

2 The estimate of incorrect payments found is the value of payments made before HMRC took action.

7 Tax Credits Sanctions

	2004-05	2005-06	2006-07	2007-08
Cases where a penalty was charged	1,114	2,241	1,365	1,040
Total value of penalties charged	£445,645	£887,585	£610,000	£750, 000
Cases selected for criminal prosecutions	211	289	183	165

Source: HM Revenue & Customs

Tackling the threat of organised fraud

2.19 The tax credits system has experienced attacks from organised criminals. As previously reported, in 2005 there was a serious attack on the system by organised criminals submitting false claims using stolen identities via the internet. The Department closed the tax credits e-portal on 2 December 2005 as a consequence of these attacks. The Department is developing a framework for validating the identity of individuals for both telephone and internet channels. It will only re-open the internet system once this work is complete and it is assured of its effectiveness.

2.20 In addition to the closure of the e-portal, the Department has responded to the risk that fraudsters target the system by paper claims or by notifying false changes of circumstances to tax credit call centres. The Department's Organised Criminal Attacks Strategy embraces a range of activities which cover its understanding of the risk of fraud, enhancing its intelligence and the response to fraud threats. In accordance with the strategy it has implemented a range of measures designed to restrict the opportunity for fraudsters to abuse the system, including tighter control on the issue of claim forms, fraud awareness training for staff, and deploying compliance officers in tax credit call centres. The Department has also introduced a number of checks designed to identify and prevent payments to fraudsters. These measures, combined with the closure of the e-portal, have significantly reduced the level of identified losses due to organised fraud from the levels in 2005-06.

2.21 The examinations by the Department's Organised Fraud Team and other procedures, such as inspecting claim forms prior to processing for evidence of organised fraud, have prevented some £66 million of incorrect payments, comprising £41 million from checks on claims before they were paid and £25 million from checks on awards in payment. The Department's checks of awards in payment also found it had made incorrect payments of some £20 million relating to suspected organised fraud.

2.22 The Department has to address the risk that its staff or Department for Work and Pensions (DWP) Jobcentre Plus staff, who also have access to the tax credits system, may abuse their access rights to provide information which could be used by organised fraudsters to make false claims. The Department's Anti Fraud Assurance Team (AFAT) has identified six cases of suspicious access to tax credits data by DWP staff since October 2006. In response, the DWP has worked closely with the Department throughout the year to investigate these cases of suspicious access, ensuring that appropriate measures are taken with staff and to address any identified control weaknesses. The Department is analysing the potential loss as part of its preparation for criminal prosecution. It is also considering placing tax credits data on the DWP's Customer Information System (CIS) to facilitate better local authority access. As part of its security controls under the proposed arrangements, AFAT will review local authority staff access to tax credit claimant records.

The Department's future strategy for reducing error and fraud

2.23 Tax credits are vulnerable to fraud where applicants provide false information, for example by understating or failing to declare income, or by misrepresenting their circumstances, for example by failing to declare the existence of a partner or overstating the hours worked. Claimants may also make genuine errors in their applications which result in incorrect awards, for example misunderstanding what should be reported as income or incorrectly calculating childcare costs.

2.24 The Department's compliance strategy has a range of measures which are designed to address the underlying causes of error and fraud. These include risk-based investigation of certain awards, comparison with the information held elsewhere in the Department and by third parties and providing guidance and assistance to claimants.

2.25 During 2007 the Department undertook a review to better understand the exposure to losses from particular risks, the breakdown between error and fraud for each risk, and the various responses available to tackle each risk. The losses attributable to the most significant causes of error and fraud for 2006-07, in terms of value and the proportion of cases affected, are shown in **Figure 8 opposite**.

2.26 In the light of its work to understand the underlying causes of error and fraud, the Department has developed a plan to reduce the level of clamant error and fraud to not more than 5 per cent of the value of finalised awards by 2011. It aims to increasingly tailor its approach to address the root causes of error and fraud in different claimant groups and ensure it has robust measures to identify and tackle deliberate non-compliance. Its responses are designed to supplement and enhance existing measures for deterrence and prevention and involve:

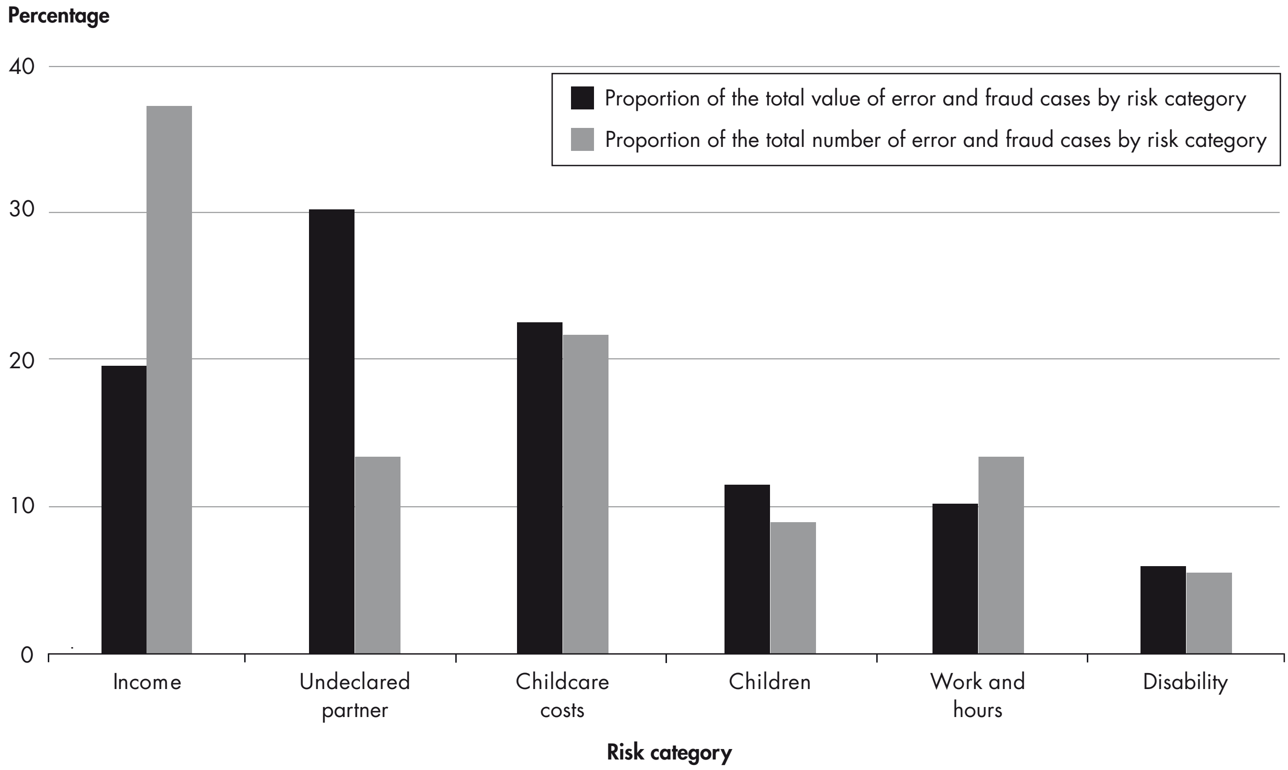
- introducing more sophisticated risk profiling of claims to assist in the identification and targeting of high risk cases and claimant groups;
- adopting a more structured approach to the deployment of compliance resources to ensure the systematic examination of high risk cases, including the use of specialist teams to tackle different types of error and fraud; and
- making more use of internal data and that held by other government departments to corroborate information provided to the Department across a larger proportion of the claimant population than that currently examined through compliance enquiries.

2.27 Through its compliance work and the Transformation Programme, the Department aims to enhance the education and support provided to those claimants who want to get it right by allowing them to better understand their obligations. The improvements to communication products and the future compliance strategy should also help to support claimants who may not be receiving their full entitlement.

Managing overpayments caused by adjustments to awards

2.28 As described in paragraph 2.6, the Department initially calculates a provisional award based on the information it holds on the claimant's income and family circumstances. It will adjust the award when changes in the claimants circumstances and income are reported. This adjustment can occur either during the year or as part of the end of year finalisation process. Where the provisional award resulted in an overpayment, the Department will seek to recover the overpayment from future awards or, if there is no ongoing entitlement, directly from the claimant. The Department pays the claimant the balance if the provisional award was lower than the final award.

8 Tax credits error and fraud in 2006-07 by risk category



Source: HM Revenue & Customs

NOTE

This figure shows the breakdown of error and fraud by risk category as a proportion of the total value of estimated losses and the estimated number of cases involved. Thus, for example, the mis-declaration of income accounted for 37.1 per cent of all cases involving error and fraud but only 19.7 per cent of the estimated value of losses.

2.29 In 2006-07 overpayments were £1.0 billion, significantly lower than the first three years of the scheme, as shown in **Figure 9 overleaf**. In accordance with the Department's normal approach, this figure excludes remissions and recoveries of overpayments made before the end of the year. Tax credit awards for 2007-08 are not all due to be finalised until the end of January 2009. The Department will publish overpayment statistics on these awards in May 2009.

2.30 To limit the need for adjustments to provisional awards, rises in the claimant's income during the previous year are disregarded up to a set level when awards are finalised. This level was initially set at £2,500, but as part of the 2005 Pre-Budget Report, the Government increased it to £25,000. This change, as well as other administrative changes to the scheme announced in the 2005 Pre-Budget Report, came into effect in 2006-07. The Department anticipated that the 2005 Pre-Budget package as a whole would reduce the value of overpayments by a third from the level they would have been had the package not been implemented. It estimated the increase in the disregard would contribute between £400 million and £600 million to this reduction and the indications from the finalisation of 2006-07 awards are broadly consistent with this estimate.

2.31 The Department also implemented administrative improvements in its processing of tax credits changes in circumstances which are also likely to have contributed to the fall in overpayments. But the respective contribution of the policy and operational changes cannot be quantified.

2.32 In addition to the fall in the overall level of overpayments the value of overpayments as a proportion of the value of finalised awards is now 5.5 per cent compared with 19.2 per cent in the first year of the scheme, as **Figure 10 overleaf**. The number of families affected by overpayments and the average value of overpayments are also lower in 2006-07 than in previous years.

9 Tax Credits Overpayments and Underpayments to 31 March 2007

	2003-04	2004-05	2005-06	2006-07
Families benefiting	4.6m	5.0m	5.3m	5.5m
Families affected by overpayments	1.9m	2.0m	1.9m	1.3m
Families affected by underpayments	0.7m	0.9m	0.9m	0.8m
Net cash paid to claimants in year	£13.5bn	£15.8bn	£17.3bn	£18.7bn
Overpayments	£2.2bn	£1.8bn	£1.7bn	£1.0bn
Subsequent changes to entitlement[1]	£0.1bn	£0.3bn	£0.2bn	–
Total to be recovered	£2.3bn	£2.1bn	£1.9bn	£1.0bn
Underpayments	£464m	£556m	£ 549m	£525m

Source: HM Revenue & Customs

NOTE

1 This is mainly individual error and fraud subsequently identified in finalised awards through the Department's compliance activity.

Figures may not sum due to rounding.

10 Tax Credits Overpayments

	2003-04	2004-05	2005-06	2006-07
Final value of awards	£12bn	£14.3bn	£16.0bn	£18.2bn
Total to be recovered[1]	£2.3bn	£2.1bn	£1.9bn	£1.0bn
Overpayments as a percentage of final value of awards	19.2%	14.7%	11.9%	5.5%
Average overpayment	£1,211	£1,050	£1,000	£769
Families affected by overpayments	1.9m	2.0m	1.9m	1.3m

Source: HM Revenue & Customs

NOTES

1 Comprising total overpayments plus subsequent changes in entitlement, see Figure 9.

Recovering tax credit debt

2.33 Overpayments arise where the Department has paid the claimant more money than they are entitled to. Where there is on-going entitlement, the Department recovers overpayments from future tax credit payments. But it restricts recoveries made against the payment of future awards to prevent hardship. It seeks direct recovery of overpayments where the claim is no longer in payment. The Department expects that in some cases complete recovery of overpayments may take several years.

2.34 At the end of March 2008, £4.3 billion was owed to the Department in respect of overpayments. Of this debt, £1.6 billion was being recovered from ongoing awards and £1.8 billion directly from claimants. In addition, some £0.9 billion of debt was not subject to active recovery action, for example where recovery action is temporarily halted when the claimant has disputed the recovery of an overpayment, or where the debt is sufficiently new that the Department has not or has only recently issued a notice to pay. It is now taking action to enhance its monitoring of this debt.

2.35 Over the first five years of the scheme the Department has recovered £2.1 billion of overpayments from ongoing tax credit awards. It is seeking to collect a further £1.6 billion against future payments. By the end of 2007-08, it had collected £0.6 billion directly from claimants and £1.8 billion was outstanding.

2.36 The Department has to form a view on the tax credit debt that may not be recovered and may eventually be written off. In the first four years of the scheme, it has written off £1.0 billion of the £7.3 billion overpayments shown in **Figure 11**. It has also written off £0.2 billion in respect of amounts paid and written off in the same year, before awards were finalised, for example where it has identified organised fraud. In addition, a total provision of £1.8 billion has been made in the Trust Statement for overpayments expected to be written off.

Disputed Overpayments

2.37 The Department has established procedures for resolving disputes about overpayments and their recovery. **Figure 12** provides details of the number of overpayments that have been disputed since the Department began to recover overpayments in 2004-05. The Department aims to deal with disputed overpayments within four weeks. At the end of 2007-08 it had 69,000 disputed overpayment cases on hand.

2.38 The Department's policy for the recovery of overpayments is set out in its Code of Practice 26, 'What happens if we have paid you too much tax credit." Until December 2007 the Department did not seek to recover overpayments where it had made a mistake and the claimant could reasonably have thought the payment was right. In January 2008, it introduced a new approach which moves away from reliance on judgments of what claimants could be expected to know and sets out the responsibilities the Department and claimants need to fulfil. Under the new approach, the Department will accept responsibility for processing information received from a claimant within 30 days.

11 Recovery and write-offs of overpayments from 2003-04 – 2006-07

	2003-04	2004-05	2005-06	2006-07	Total
Total to be recovered[2]	£2.3bn	£2.1bn	£1.9bn	£1.0bn	£7.3bn
Amounts written off by 5 April 2008	(£0.4bn)	(£0.3bn)	(£0.2bn)	(£0.1bn)	(£1.0bn)
Amounts recovered by 5 April 2008	(£1.3bn)	(£0.8bn)	(£0.6bn)	(£0.1bn)	(£2.7bn)
Debt to be recovered at 5 April 2008	£0.7bn	£1.0bn	£1.1bn	£0.8bn	£3.6bn

Source: HM Revenue & Customs

NOTES

1 This table excludes amounts for 2007-08 awards. The overall level of overpayments for these awards will not be known until they have been finalised.

2 Comprising total overpayments plus subsequent changes in entitlement, see Figure 9.

3 Figures may not sum due to rounding.

12 Disputed Overpayments

	2004-05	2005-06	2006-07	2007-08
Disputes received	216,679	364,380	371,282	240,786
Number of overpayments written off following the dispute	10,300	160,702	9,912	6,816

Source: HM Revenue & Customs

Inappropriate adjustments to finalised awards

2.39 The 2002 Tax Credits Act gives the Department certain powers to adjust awards after finalisation. In 2007 the Department found that it had made adjustments to some finalised awards beyond the circumstances provided for in legislation. Although these adjustments brought the revised award into line with the claimant's actual circumstances, the Department did not always follow the correct process, in particular:

- The 2002 Act requires it to write to the claimant if it makes enquiries into a finalised award, but there have been cases where it effectively opened enquiries without informing the claimant.
- In other cases it has made adjustments to awards that were beyond its powers. Under Section 21 of the Tax Credits Act, the Department can adjust finalised awards in the claimants favour in cases of official error. But the Department has also recovered overpayments on finalised awards caused by official error. It therefore needs to repay these amounts.

2.40 The Department has written to claimants whose awards it considers might have been affected, but it needs to examine each of these in detail to determine if it made incorrect adjustments. It is now reviewing 250,000 awards to regularise its enquiries by informing the claimant and making repayments where these are due. The Department estimates this work will take three years to complete. Of these cases, it estimates it owes around 20,000 claimants an average repayment of between £800 – £1,000.

2.41 The Department has taken action to correct its procedures. It is developing computer changes to ensure staff are warned when there is a danger of incorrectly adjusting a finalised award, which it plans to implement in April 2009. In the interim period, it has introduced revised manual procedures to prevent incorrect adjustments.

2.42 The Department's review of why its procedures failed to comply with legislation concluded that the provisions of the Tax Credits Act were not fully reflected in the computer system specification. In particular, the system does not prevent or warn staff from reopening a finalised award. The Department also found that certain aspects of the day to day guidance used by staff were incorrect. The Tax Credits Technical Manual, as the highest level of guidance, should have formed the basis for more detailed desk guidance but this was not in place for the launch of tax credits in 2003. Instead the Department prepared desk guidance based on the computer system specification, which did not fully reflect the legislation. The Department did not re-examine its desk guidance to assess its consistency with the Technical Manual once it was in place in 2004. The Department is now taking action to ensure that all tax credits guidance provided to staff is correct. It has also undertaken a wider programme of work to provide assurance over the full tax credits process.

Conclusions

2.43 The tax credits scheme relies on claimants telling the Department when their circumstances change so that it can update their awards. Claimants have not always understood their obligations under the scheme or received the support they needed from the Department. As a consequence over and underpayments have occurred because the Department has made payments based on out of date information.

2.44 In November 2006 the Department established the Tax Credits Transformation Programme to identify and deliver improvements. It is currently evaluating some service improvement pilots designed to assist claimants who need extra support in making a claim and reporting changes in circumstances. It anticipates that most of these will be implemented by April 2009. To date its work on tax credits transformation has been limited to changes that can be made within the framework of the existing computer system.

2.45 Since the tax credits scheme was introduced in April 2003 it has suffered from high levels of error and fraud. The Department's latest estimate is that in 2006-07 error and fraud resulted in between £1.31 billion and £1.54 billion (7.2 to 8.4 per cent of the final value of awards) being paid to claimants to which they were not entitled. I have qualified my opinion on the regularity of the expenditure reported in the Trust Statement in respect of tax credits error and fraud. The Department's estimate's of error and fraud from 2005-06 are based on a more robust approach to evaluating the results of its random enquiry of finalised awards. The estimate, however, excludes error and fraud on terminated awards included within the £148 million of incorrect payments identified during 2006-07 through the Department's compliance activity.

2.46 The Department has set a target to reduce the current level of claimant error and fraud to not more than 5 per cent by 2011. It is also strengthening its response to those claimants who represent the highest risk of error and fraud as well as considering other measures which it will pilot through 2008-09. The Department is aware of the need to carefully evaluate these pilots and use the results to direct its compliance activity to areas that have the greatest effect in reducing error and fraud.

2.47 The Department estimated that year end adjustments to awards meant it overpaid £1.0 billion in 2006-07, compared with £1.7 billion in 2005-06. This fall in overpayments is mainly because of the increase from £2,500 to £25,000 in income rises which are disregarded when finalising awards. Other measures announced in the 2005 Pre-Budget Report together with operational improvements by the Department have also contributed to the fall.

2.48 In the first four years since the scheme was introduced, the Department calculates that year end adjustments, and other small changes to entitlement after the finalisation of awards, have led to a debt of £7.3 billion. It has also identified £700 million from in year adjustments to 2007-08 awards and will identify further overpayments for this year once awards are finalised. By the end of March 2008 the Department had collected £2.7 billion of this debt and written off £1.0 billion. £4.3 billion remains to be collected of which £1.8 billion is in doubt. Some £0.9 billion of debt was not subject to active recovery, for example where recovery is temporarily halted due to a disputed overpayment or the debt was in the process of being transferred to direct recovery.

2.49 The 2002 Tax Credits Act gave the Department certain powers to adjust awards after finalisation. The Department made adjustments to some finalised awards which were outside the circumstances provided for in legislation. The Department's specification for the computer system did not reflect the requirements of the Act and the day to day guidance used by staff was incorrect. The Department is reviewing 250,000 awards to determine whether repayments are due and it estimates this work will take three years to complete. Of these cases, it estimates it owes around 20,000 claimants an average repayment of between £800 – £1,000.

PART THREE

Follow up on the collection of Income Tax

Developments in the administration of PAYE

Introduction

3.1 Pay As You Earn (PAYE) collects income tax at source from employment and pensions. In 2007-08 the Department collected £127 billion in income tax and £98 billion in National Insurance Contributions through PAYE. Our recent reports on the Department's accounts have commented on the increasing complexity of the employment market which the Department's PAYE computer systems are not well suited to administer and the inconsistent working practices because staff are not aware of or are failing to follow Departmental procedures. In 2008 we have examined the Department's progress in dealing with these issues.

The PAYE System

3.2 Employers and pension schemes usually make a single monthly payment to the Department for all income tax and National Insurance deducted from employees' earnings and pensions. But these payments are not accompanied by information about the individual employees or pensioners to whom they relate. The Department cannot allocate payments to individuals until the year end when employers and pensions schemes submit their annual returns reconciling the totals paid with deductions made from each employee or pensioner. These returns show total earnings, tax deducted, National Insurance Contributions and statutory payments under each PAYE scheme (form P35) and information on individual employees (form P14). The Department reconciles amounts received from employers to this information and records income received and tax and national insurance paid by individual taxpayers.

Filing of Employer Returns

3.3 In April 2002, the Chancellor of the Exchequer announced that the Government would implement the recommendations of Lord Carter of Coles' Review of Payroll Services to mandate online filing of employers' end of year returns. The Department has made consistent improvements in the filing and processing of employer end of year returns following the introduction of online filing in 2005. Whereas only 50,000 employers were mandated to file online in 2006-07, 1.4 million returns were received this way, as shown by **Figure 1 opposite**. The Department also exceeded its targets to process 98 per cent of employers' annual returns by 31 December and 99 per cent by 31 March. However, the Department still lacks management information to allow it to track processing of P14s through the key stages in the end of year filing process. This can make it difficult for the Department to monitor the precice status of the returns within the end of year process prior to the updating of the relevant PAYE and National Insurance systems.

3.4 A further review of the Department's online services by Lord Carter, published in March 2006, recommended that employers should be required to file in year returns (forms P45 and P46 which record changes in employments) electronically, starting with large and medium sized employers from April 2008. Following the consultation process, mandatory online filing was deferred until April 2009 to provide employers with additional time to prepare for the change. In 2007-08 the Department received 4.6 million in-year forms over the internet.

Benefits in Kind

3.5 Employers inform the Department of expenses and benefits in kind provided to employees in the year, such as a company car or private health care, using forms P11D. The processing of this information involves computer checks of the tax paid against the liability. Where there are differences, clerical action is required to make repayments

1 Filing and processing of employer end of year PAYE returns

Tax Year	2004-05	2005-06	2006-07	2007-08[1]
Processing of P14s by end of October	57%	86%	92.5%	89.2%
Percentage of returns that failed to meet HMRC's quality standards	13%	5%	1.4%	0.9%
Returns received online by end of May	1.1 million	1.2 million	1.4 million	1.4 million

Source: HM Revenue & Customs

NOTES

1 The figures for 2007-08 record the position as at 3 June 2008.

or collect underpayments and to change tax codes for the future so that taxpayers pay the correct amount. Our 2006-07 Report noted that the clerical action was not always being undertaken and computer printouts were not being worked accurately or in a timely manner because of competing work priorities. In May 2007 the Department introduced an automated process for managing changes to tax codes for benefits in kind. The Department estimates that this process has resulted in 72 per cent of tax codes being automatically updated following the receipt of P11Ds. Tax codes for 2.0 million taxpayers have therefore been updated much earlier than had been possible when they were handled manually. The automated process also means that there are fewer exceptions that need to be reviewed clerically. But there is a risk that competing work priorities will continue to affect the Department's ability to work exceptions in a timely manner, and these exceptions are not a current priority.

Employees with Multiple Sources of Income

3.6 The PAYE system was introduced when it was usual for employees to have a single stable, full-time employment. Changes in work patterns, with much more fluid employment patterns being typical, have made it more difficult for the Department to ensure the right amount of tax is collected during the year and that all the necessary information is brought together at the end of the year to check the accuracy of deductions. The Department's PAYE computer systems structure records around employers rather than individual taxpayers and records are held in 12 regional databases. As a result, it can have difficulty identifying all relevant sources of income when calculating tax that should be paid.

3.7 In April 2007 the Department implemented an interim solution to this problem by automatically bringing together P14 returns for all the employments of a taxpayer before making its year-end checks. The aim was to make it easier to identify cases where too much or too little tax has been paid. This change increased by 2.6 million the number of cases where the Department matched information received to a taxpayer's record automatically. But the new process identified an additional 2.3 million cases that did not automatically reconcile and required manual checking to ensure the right amount of tax was paid.

3.8 The Department recognises that significant improvement in the operation of PAYE can only be achieved through fundamental changes in its computer systems. It therefore plans to transfer the computer support for PAYE on to the National Insurance Recording system which will progressively become the main system which processes PAYE information. This system will allow all information on individuals to be brought alongside their national insurance record and provide the Department with a more complete view of a taxpayer's employment income. The Department originally planned to introduce this change in April 2008, but deferred implementation until October 2008 to allow more time to assure itself that there were adequate supporting systems.

Open cases

3.9 At the year end the Department's computer system checks whether the tax an employee should have paid in the year is consistent with year-end pay and tax information received from employers. The computer identifies approximately 30 per cent of cases that have to be checked clerically (open cases). These might be where there are doubts that the right amount of tax has been paid or there are difficulties matching information to a taxpayer's record. The Department has an annual programme to check cases manually, but it gives priority to individuals who contact them if they think their tax affairs are incorrect. Delays in clearing these records can mean that taxpayers are not notified on a timely basis if additional tax is payable or refunds are due. Based on analysis from previous years, the Department estimates that around 70 per cent of open cases contain no material under or overpayments of tax. But the nature of open cases for 2007-08 may be affected by the computer changes explained in paragraph 3.7.

3.10 At 31 March 2007 there were 13 million open cases. The Department took measures designed to reduce these numbers, including redeploying staff to work on open cases, using staff in other areas to help with the easier cases and offering more overtime for its more experienced staff to deal with the more difficult cases. It expected these measures, along with the new automatic process for bringing together P14s and a greater management focus on clearance, to reduce the number of open cases to 10.5 million by March 2008. The Department subsequently increased this estimate to 12.5 million, following the redeployment of staff onto tax credits work and its efforts to reduce levels of outstanding taxpayer post.

3.11 At the end of March 2008 the actual level of open cases was 16.2 million. The Department considers that the following factors are responsible for the increase:

- as outlined in paragraph 3.7 above, automatically bringing together information on all the jobs of a taxpayer identified an additional 2.3 million cases which required manual checking;
- competing work pressures from other areas led to staff planned to be used on open case work being diverted to other work;
- economic growth and changing demographics and working patterns have led to a 30 per cent increase in the number of records held on the Department's PAYE computer systems since April 2000; and
- lower than anticipated take-up of overtime and using overtime to deal with other work pressures.

3.12 The Department now aims to have eliminated the backlog of 2006-07 and earlier open cases by 2010. It plans to achieve this through the computer changes described above which will transfer its PAYE employee records on to the National Insurance Recording System. The Department anticipates its improved ability to match information received to a taxpayer's record and the automatic reconciliation of end of year information will reduce the volume of cases generated for checking for 2008-09 and subsequent tax years. This reduction will also allow the Department to redeploy some of the staff savings to clear open cases for earlier years. The Department is also working with a specialist firm to provide advice on data matching to further reduce levels of open cases.

Improving the accuracy of processing

3.13 The Department needs to process taxpayers' information at various stages in the operation of PAYE, for example where an employee changes job or requires a new tax code. The Department's Quality Monitoring Exercise (QME), an independent monthly check on the accuracy of processing, has shown that PAYE processing accuracy is well below target. The majority of PAYE cases are processed automatically, but around 30 per cent require manual intervention which is more prone to error. The Department achieved a marginal improvement in processing accuracy in 2007-08 to 83.4 per cent (82.1 per cent in 2006-07) but still below its target of 93 per cent.

3.14 The main cause of inaccurate processing is the Department's failure to update tax codes following the processing of Self Assessment returns. This is currently a manual process and delays in taking action can mean taxpayers' codes are incorrect. Subject to the Department's PAYE records being transferred into the National Insurance Recording system in October 2008, it plans to automatically update tax codes after it processes Self Assessment returns from April 2009.

3.15 The Department's efforts to improve the quality of its coding decisions through the introduction of a spreadsheet tool, "Coding Assistant", have yet to realise the benefits in full. Although its use is mandatory, the Department has found that usage of 'Coding Assistant' is lower than expected and it has introduced new arrangements to monitor its application.

The taxation of small pensions

3.16 Our 2006-07 Report noted that some pensioners have not been paying tax on all of their taxable pension income since 1983. This shortfall is due to the provision of incorrect advice to pension providers by the Department, inappropriate local agreements and failures by local offices to implement agreed procedures. The Department estimates it has potentially not collected income tax on 420,000 pensions and that the tax loss is some £135 million a year.

3.17 The Department informed pension providers that their returns for the 2007-08 tax year must include details of every pension in payment, irrespective of the amount and of any prior local arrangement not to report certain pensions. It received these returns as part of its normal collection of PAYE end of year data which ended in May 2008.

3.18 We reported last year, the Department intended to take no action in relation to untaxed pensions for years up to and including 2006-07. It planned to collect tax for 2007-08 and subsequent years under PAYE by establishing the correct tax code to be applied for 2008-09 and collecting any underpayment of tax for 2007-08 in a later year.

3.19 The Department reviewed this timetable following its decision to defer the PAYE computer changes until October 2008 (see 3.8 above). As a consequence of this deferral the Department will not be able to collect expeditiously the tax due in respect of 2007-08 during 2008-09, as it originally planned. In the absence of the computer changes it considers significant clerical resources would be needed to establish the correct tax code for 2008-09. All of this work would need to be done manually and involve the redeployment of resources, affecting the service provided in other areas. The delay in correcting tax codes and notifying these changes to pension providers would also increase the risk of inconsistent treatment of individuals. It would also prevent the Department giving reasonable notice of the unpaid tax to the taxpayers concerned. For these reasons, following legal advice, the Department exercised its management discretion to waive the tax due for 2007-08.

3.20 The Department now intends to collect tax on these pensions for 2008-09 and future years. It will use end of year information supplied by pensions providers in April and May 2009 to issue correct tax codes for 2009-10. Any underpayments for 2008-09 and 2009-10 will be collected in 2010-11 and later years. The availability of information on pensions for 2007-08 gives the Department a better opportunity to provide the affected pensioners with an explanation before changes are made. Even after allowing for this deferral, the Department recognises that the changes could place some taxpayers in difficulty and it plans to collect underpayments over a longer period of time in cases of hardship.

Developments in the administration of Self Assessment

Introduction

3.21 Self Assessment was introduced in 1996 for taxpayers with a number of sources of income and with less straightforward financial affairs. In 2007-08 the Department collected £30.2 billion tax through the system, after repayments. Our 2006-07 Report commented on a number of issues in the Department's administration of Self Assessment, including the progress made in delivering online services, taxpayers' compliance with their obligations, repayments and self assessment debt. In 2008 we have examined the Department's progress in dealing with these issues.

The self assessment process

3.22 Under Self Assessment, the primary responsibility for calculating the tax liability rests with the taxpayer rather than the Department. Taxpayers are required to complete returns to establish how much income tax they should pay and to provide the Department with the information it needs to validate this calculation. Taxpayers have a statutory obligation to submit their returns for the preceding tax year by 31 January. The Department operates a statutory penalty regime for taxpayers who fail to meet this deadline.

3.23 Over the years the Department has made changes to the self assessment process to ease the compliance burden on taxpayers. In April 2008, the Department issued a re-designed main return for the 2007-08 tax year, which is simpler and reduces the number of pages that some taxpayers are required to complete.

3.24 In 2008 the Department is introducing measures, recommended in Lord Carter's 2006 review of its Online Services, to increase the number of taxpayers who file electronically and to help manage the peak pressures. These involve:

- bringing forward the deadline for filing paper returns to 31 October (without changing the 31 January deadline for filing electronic returns) to provide an incentive for online filing;
- withdrawing approval for computer generated paper 'substitute' returns; and
- reducing the period for the Department to enquire into returns from 12 months from the 31 January filing deadline to 12 months from the date the return is filed to remove a perceived disincentive for early filing.

Filing of self assessment returns

3.25 The Department had two Public Service Agreement (PSA) targets relating to the timely receipt of self assessment returns and online filing. In 2007-08, the Department did not meet its challenging target for improving the percentage of self assessment returns filed on time, but significantly exceeded its target for the percentage of returns filed online as shown in **Figure 2 overleaf**. This is in part as a result of changes since 2004-05 which removed 1.6 million taxpayers with relatively simple tax affairs and a better record for filing self assessment returns.

2 Self Assessment Returns Issued and Performance against Filing Targets

	2005-06		2006-07		2007-08	
Returns issued (million)	9.08m		9.28m		9.32m	
Filing Targets	**Target %**	**Result %**	**Target %**	**Result %**	**Target %**	**Result %**
By 2007-08 increase percentage of Self Assessment returns filed on time to at least 93 per cent	90.6	90.3	91.5	89.2	93.0	88.6
By 2007-08 increase the percentage of Self Assessment returns filed on time and online to 35 per cent	25.0	24.3	29.0	35.1	35.0	46.0

Source: HM Revenue & Customs

3.26 The Department's system for the online filing of Self Assessment returns was introduced in 2000 and has been at the forefront of its drive to engage with the taxpayer through the internet. There has been a continuing increase in levels of online filing since the system was introduced. In 2007-08, 46 per cent of returns (3.8 million) were filed online, which was significantly in excess of the Department's target of 35 per cent.

3.27 The Department experienced difficulties with the Self Assessment online system on the 31 January 2008 filing deadline. This disruption arose because of a capacity problem in one of the computer systems supporting the online service which meant the system was not available to some taxpayers on 31 January 2008. Whilst a record number of 204,000 taxpayers were able to file online on 31 January, the Department estimates between 10,000–15,000 taxpayers who attempted to file their returns online were unable to do so.

3.28 The Department planned for a significant increase in filing of returns around the 31 January deadline. The Department secured assurances from its supplier that the online service could be supported at the expected volumes at the peak period. However, on the day the hardware problem meant that the level of customer attempts to use the online service could not be supported. The Department and the supplier have reviewed how online services are tested to ensure peak demands are met in the future. In April 2008, the Department delivered a planned update to its Self Assessment online system, as part of its programme to place it on a new computer platform. The Department confirms that this change has addressed the hardware problem it had at the end of January. It is also undertaking a wider review of lessons learned to enhance the speed with which it responds to such events.

3.29 Of the 9.3 million returns issued for the 2006-07 tax year, around 11.4 per cent were outstanding after the 31 January filing deadline. The results for 2007-08 of 88.6 per cent of returns filed on time were slightly lower than those in the previous three years and significantly below the Department's target of 93 per cent. The Department attributes this fall in performance to the removal from Self Assessment of taxpayers with relatively simple tax affairs, who had a better record of filing and paying on time and its decision to limit media advertising in 2007-08 because of limited resources.

Improving the accuracy of self assessment processing

3.30 The Department processes all self assessment returns to establish if taxpayers have paid the right amount of tax and to recover additional amounts due or to repay any overpayment. It also updates taxpayers' records and, in PAYE cases, individuals' tax codes to ensure that the right tax is deducted from employees' future earnings. The Department has improved its rate of accuracy in processing Self Assessment returns. In 2007-08 the Department accurately processed 97.6 per cent of Self Assessment returns (96.5 per cent in 2006-07), exceeding its target of 97.5 per cent.

Taxpayers compliance with their obligations

3.31 The Department undertakes an annual random enquiry programme to assess the accuracy of filed returns. Based on the latest results available for 2002-03, 34 per cent of filed returns were inaccurate. The Department estimates that between £2.9 billion and £3.7 billion tax was therefore at risk because of inaccurate returns. The random enquiry programme covers only registered Self Assessment taxpayers and is not intended to provide an estimate of under-declared income from people working in the informal economy or taxpayers who are engaged in other employment for which they are not declaring their income. In addition, enquiries will not always identify the full extent of non-compliance, especially where Third Party Information is not available to verify the data supplied by taxpayers. The Department is investigating whether the estimates of tax at risk from the random enquiry programme could be reliably adjusted to take account of the incomplete detection of underreported tax liabilities. The Department is also taking action to improve the timeliness of its estimates of tax at risk to better assess the effectiveness of its compliance activities.

Making repayments

3.32 Repayments arise when the tax paid, on account or by deduction at source (for example through the Pay As You Earn system), exceeds the individual's tax liability. In 2007-08 £4.0 billion Self Assessment repayments were made. The value of repayments has remained relatively constant since 2002-03, but they have fallen as a percentage of receipts from 17 per cent to 12 per cent. Our previous Reports have noted weaknesses in the Department's controls over repayments, including a historic lack of formalised accountabilities, deficiencies in management information and a failure to follow standard procedures.

3.33 The Department has established a Direct Tax Repayment Fraud Delivery Group which covers all income tax repayments. The Group meets monthly to progress an Action Plan to make improvements to the repayments process and so reduce risks. The Department has also taken steps to address continuing failures to follow existing procedures and processes. It has set up assurance arrangements to check that instructions are being followed. As part of its Pacesetter Programme, it is implementing standard processes across its main activities with regular "workplace assessment checks".

3.34 In our 2006-07 Report we noted that the Department had evidence of organised criminal activity to obtain fraudulent repayments, sometimes submitting self assessment returns even though none have been requested (unsolicited returns). It introduced improved controls in April 2007 to monitor these returns and introduced a new risk assessment process for all repayments and those at greatest risk are checked before the payment is made.

Debt management

3.35 Self Assessment taxpayers are required to pay any outstanding tax by the 31 January after the end of the previous tax year. In 2007-08, 88.3 per cent of Self Assessment taxpayers paid amounts owed on time, against the Department's target of 89.8 per cent. The Department attributes this shortfall in performance to the removal from Self Assessment of taxpayers who had a better record of paying on time, as noted in paragraph 3.29. **Figure 3** provides an analysis of self assessment receipts and the average monthly debt since 2004-05.

3.36 Self Assessment taxpayers can appeal against assessments, penalties, surcharges or amendments. These items are "stood over" as not collectible and not forwarded for collection until the appeal is cleared. The Department records details on work lists, which should be monitored so that liabilities can be adjusted and charges released for collection promptly. The Department's latest available estimate of the value of Self Assessment disputed charges stood over was £1.1 billion.

3.37 In 2007, Internal Audit raised concerns about the management of Self Assessment charges 'stood over'. It found that these were given little attention and substantial backlogs of uncleared items had built up. While these items may not necessarily give rise to a debt, delays in forwarding these amounts for collection can make it harder for the Department to subsequently collect debt and potentially lead to a loss of revenue. In response, the Department has undertaken a review of the end to end process for handling standovers in order to introduce improvements and is now starting to address these issues. The Department is also considering how it can increase levels of automation in the process to speed up how it handles certain items.

3 Self Assessment Debts

Year	Self Assessment Receipts £bn	Average Monthly Debt[1] £bn
2004-05	21.84	2.68
2005-06	23.43	2.89
2006-07	26.59	3.13
2007-08	30.23	3.21

Source: HM Revenue & Customs

NOTE

1 The cyclical nature of Self Assessment means that a monthly average figure debt over the year provides a more representative measure of overall level of debt to be collected than a snapshot at a point in time.

Conclusions

The collection of income tax through PAYE

3.38 Following the introduction of online filing in 2005, the Department continues to improve its processing of employer end of year returns. By 31 October 2007 it had processed 92.5 per cent of 2006-07 returns received, and 98.6 per cent of returns received from employers met the Department's quality standards. It still needs to develop better management information to support its governance of the end of year filing process. Following the automation in May 2007 of changes to tax codes for benefits in kind it has updated 72 per cent without manual intervention. The Department needs to ensure it can promptly process those cases which cannot be cleared automatically.

3.39 In 2008 the Department is planning to transfer its processing of PAYE for individuals on to the National Insurance Recording System and so allow it to bring all information on individuals' employment and pensions income together. The Department originally planned this change for April 2008, but deferred it until October 2008 to allow more time to assure supporting systems. The Department's implementation of computer system changes to modernise PAYE processing, including the introduction of online filing in 2005 and the bringing together of taxpayer P14 records in 2007, has in the past met with initial difficulties leading to increased workloads. It needs to ensure that it has tested fully its arrangements for the transfer of processing to the National Insurance Recording system.

3.40 At the end of the tax year, the Department's computer system may identify discrepancies in taxpayer records or be unable to match a return to a record and so it will establish an 'open case' for manual checking. Delays in clearing 'open cases' can mean that taxpayers are not notified on a timely basis of additional tax payable or refunds due. At the end of March 2008 the Department had 16.2 million open cases, which exceeded its revised target of 12.5 million. Computer system developments did not deliver the reduction expected, staff were released to other work and there was lower than anticipated overtime. The Department plans to reach a steady state position by 2010 where there are no backlogs for 2006-07 and earlier years and the open cases for each tax year will normally be cleared within a year. The number of cases that will require manual intervention following the implementation of the computer changes cannot be predicted with absolute certainty, so the Department needs to consider the processing resources necessary to clear the backlog of 'open cases', should this exceed its current estimate.

3.41 Since 1983 the Department has not collected all the tax due from some pensioners because of a failure to apply the PAYE regulations properly. It estimates that this error could affect some 420,000 pensions with a tax loss of some £135 million per annum. It has taken steps to correct the tax treatment, but because of the deferral of the transfer of processing to the National Insurance Recording System, the Department will not now be in a position to correct tax codes until 2009-10. The Department has exercised its management discretion to waive the tax due for 2007-08 because it could not now give the taxpayers concerned reasonable notice of the tax payable. It will therefore not collect the estimated £135 million of tax due for 2007-08 as it originally planned. It will start to tax these pensions from 2008-09.

The collection of income tax through Self Assessment

3.42 The Department is introducing a number of important changes to the Self Assessment process in 2008. It has introduced a shorter, simplified return for the 2007-08 tax year and will bring forward the deadline for those who file paper returns from 31 January to 31 October. The Department did not achieve its previous target for the submission of returns by the 31 January deadline, although this target was always a challenge following the removal from Self Assessment of certain taxpayers with a better compliance record. The Department has planned publicity campaigns to remind taxpayers of the new deadline.

3.43 The Department has made good progress in the number of returns filed online. In 2007-08, 46 per cent of returns (3.8 million) were filed online and on time significantly exceeding its target of 35 per cent. A record number of 204,000 taxpayers submitted online returns on 31 January, but between 10,000 and 15,000 taxpayers could not because of a capacity problem in the computer systems supporting the service. The Department and its supplier have updated the Self Assessment online system and reviewed the testing of online services to ensure peak demands are met in the future. It is also reviewing the wider lessons learned to enhance the speed with which it responds to such events.

3.44 The Department's latest estimates based on the 2002-03 tax year indicate that 34 per cent of filed returns were inaccurate putting between £2.9 billion to £3.7 billion tax at risk. This estimate is based on registered Self Assessment taxpayers and does not cover under-declared income from people working in the informal economy. The Department needs to produce its estimates of tax at risk more quickly so that it can better assess the effectiveness of its compliance activities. The Department should develop a strategy for increasing the levels of accuracy in filed returns.

3.45 Self Assessment taxpayers can appeal against assessments, penalties, surcharges or amendments. These items are "stood over" as not collectible and not forwarded for collection until the appeal is cleared. The Department's latest estimate of the value of these amounts is £1.1 billion. The Department's Internal Audit found that "stoodover" items were given little attention and substantial backlogs of uncleared items had built up. The Department reviewed the process for handling standovers to identify areas for improvement and is now starting to address these issues.

PART FOUR

Value Added Tax

Introduction

4.1 Value Added Tax (VAT) is levied on the supply of goods and services within the United Kingdom and Isle of Man. Registered businesses pay VAT on the goods and services they purchase (input VAT) and may, subject to VAT regulations, offset it against the VAT charged on the sale of their own goods and services (output VAT). If output VAT exceeds input VAT, businesses pay the balance to the Department. If there is an excess of input VAT, businesses claim a repayment from the Department. In 2007-08 the Department collected net VAT receipts of £81.2 billion, and processed around eight million VAT returns, as shown in **Figure 1**.

4.2 Our 2005-06 Report focused on the Department's efforts to combat missing trader fraud, including action taken to prevent fraudsters from entering the VAT system. The 2006-07 Report provided an update on the Department's progress in tackling missing trader fraud and also outlined the actions taken to improve and strengthen the VAT registration process.[1] During 2007 the Department took much longer to process VAT registrations which led to an increase in complaints from legitimate traders and professional advisors. As part of our work in 2007-08 we have examined the Department's progress in addressing these delays. This report covers:

- the statutory framework for VAT;
- the VAT registration process;
- VAT registration performance;
- the main causes of the processing delays; and
- the Department's action plan.

1 Net VAT receipts/Budget forecast

Year	Budget Forecast (£billion)	Net VAT Receipts (£billion)
2004-05	73.1	73.0
2005-06	76.3	72.9
2006-07	76.5	77.4
2007-08	80.0	81.2

Source: HM Revenue & Customs and HM Treasury Financial Statement and Budget Reports

NOTE

Net VAT receipts reflect cash received and therefore do not match the Trust Statement income figure which is prepared on an accruals basis.

The Statutory Framework for VAT

4.3 The EU Principal VAT Directive provides the general legislative framework for EU Member States to administer VAT. Under the VAT Act 1994, traders are required to register for VAT if their taxable business turnover has exceeded a defined threshold in the previous twelve months, or is expected to exceed the threshold in the next 30 days. From 1 April 2008 the Government increased this threshold from £64,000 to £67,000.[2] If traders fail to notify the Department of their liability to be registered in time, they may incur a late registration penalty. Traders operating below the threshold or intending to trade may also opt for voluntary VAT registration, provided their goods or services are 'taxable supplies' for VAT purposes. In 2007-08 around 30 per cent of registration applications were voluntary.

1 Comptroller and Auditor General's Reports: 2005-06: *VAT missing trader fraud* (HC 1159); 2006-07: *Value Added Tax* (HC 626).
2 HM Treasury, Budget 2008, Chapter A Budget Policy decisions, March 2008 (HC 388).

4.4 Traders cannot charge or reclaim VAT before the Department has processed their applications. Nor can they show VAT as a separate item on any invoice they issue. They can include an amount equal to the VAT which they will be able to charge after registration. This can be done from the date they are liable to be registered, before the certificate of registration containing their VAT number is received. Once registered, traders are required to send the outstanding VAT invoices to their customers within 30 days. These arrangements allow businesses to function while waiting for a VAT registration number. The inability to charge VAT before registration is a fundamental of the structure of the tax. VAT can only be charged by a registered business. However, the Department recognises that where there are extensive delays, these arrangements are cumbersome and costly for businesses to operate and can delay the recovery of VAT incurred by the trader.

The VAT Registration Process

4.5 Traders who apply to register for VAT can do so on paper VAT 1 forms, or electronically through the Department's website. The Department's National Registration Service (NRS) is responsible for ensuring that registration applications, deregistrations and registration amendments (variations), are processed promptly and accurately. The Department now processes VAT registration applications at two regional Registration Units.[3] The Wolverhampton Unit deals with routine applications, and the Grimsby Unit processes the more complex applications, such as group registrations. Two other Registration Units, at Newry and Carmarthen were originally scheduled to stop processing registrations work from April 2007, as part of the Department's reorganisation plan, but remain in operation to assist with the workload.

4.6 The Department aims to support the needs of customers, provide advice and guidance and to ensure that processes are effective to meet demand. But it must balance this customer-focused approach against the requirement to reduce losses owing to VAT fraud and other non-compliance. The Department has a Public Service Agreement (PSA) Target to reduce, by 2007-08, VAT losses to no more than 11 per cent of the theoretical VAT liability. An important part of the Department's strategy to prevent missing trader fraud, labour provider fraud, and other types of evasion, is to stop criminals from entering the VAT system in the first place. It subjects all applications to an initial, semi-automated risk assessment process to identify potentially fraudulent applications, the first of up to three levels of checking, determined by the risk they represent, as shown in **Figure 2 overleaf**.

4.7 These checks led to the refusal of 6,577 registration applications in 2007-08 (6,073 in 2006-07), as shown in **Figure 3 overleaf**. These figures include applications rejected because the trader did not respond to the Department's request for additional information. This total probably included suspect applications from fraudsters. The Department's implementation of tighter registration controls, together with other measures, has helped to reduce significantly the cash losses arising from missing trader fraud. The Department estimated these losses at between £1 billion and £2 billion in 2006-07, compared to between £2 billion and £3 billion in 2005-06.[4]

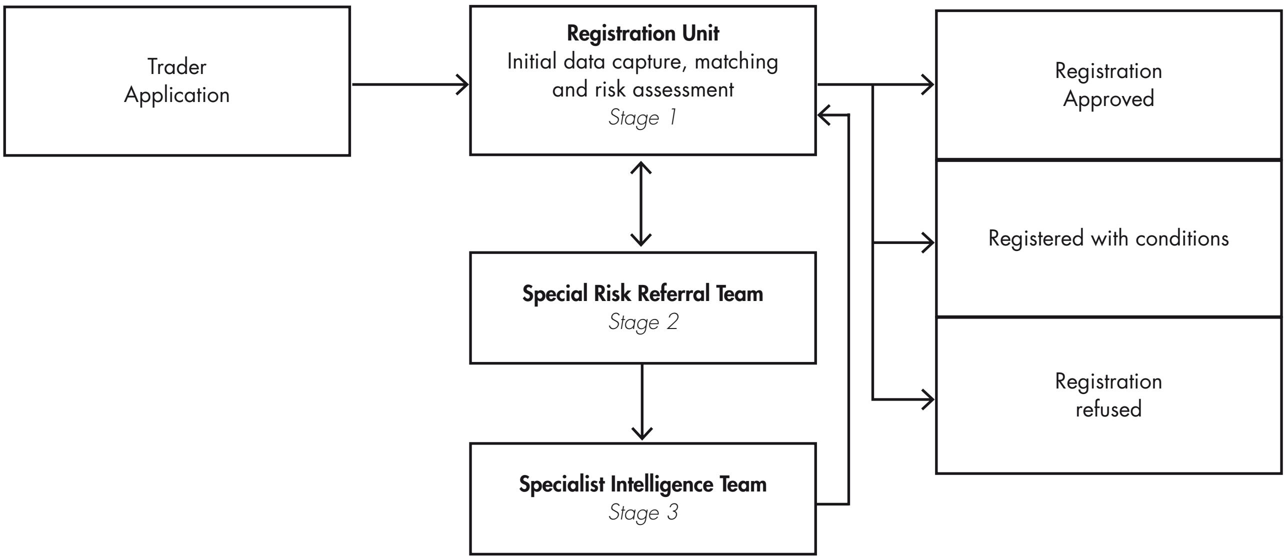
VAT Registration Performance

Completeness and accuracy target

4.8 Under the Public Service Agreement the Department had a target to increase the proportion of applications for VAT registration that were complete and accurate to 50 per cent by March 2008.[5] In 2007-08 it exceeded this target with around 70 per cent of applications deemed accurate and complete, compared with 27 per cent in 2005-06, as shown in **Figure 4 on page R33**. The redesign of the main registration application form (VAT 1) and clearer guidance has made it easier for applicants to understand and complete the forms. The Department also changed the way it gathers the underlying data to measure its performance, which has helped improve the completeness and accuracy of its performance reporting.[6] In September 2006, the Department set up a Registration Working Group comprising all internal stakeholders, to coordinate efforts to improve customer service to legitimate traders applying for registration.

3 There is a separate team – the Non-Established Taxable Persons Unit (in Aberdeen) – which deals with applications from businesses that are located outside the UK but which make taxable supplies within the UK and are, therefore, required to account for UK VAT.
4 HM Revenue & Customs Paper – *Measuring Indirect Tax Losses* 2007.
5 HMRC PSA 2005-08, Objective II, Target 6b.
6 Comptroller and Auditor General: *Fourth Validation Compendium Report Volume 2* (HC 22-II) p40.

2 The VAT registration process



Source: HM Revenue & Customs

NOTES

During the initial Stage 1 checking, the Registration Units may contact traders to ask for further information before continuing to process the application. This occurs, for example, where the application is incomplete, unclear, or evidence of intent to trade or of economic activity is needed to make the risk assessment decision. Some 95 per cent of applications require no further risk assessment and the processing is completed. The rest are referred for Stage 2 checking. Only around 1 per cent of all applications are referred to the Specialist Intelligence Team.

If the Registration Unit does not have sufficient evidence to refuse an application but still has concerns about a trader, it can impose conditions on the registration, such as requiring a financial guarantee or shortening the first VAT period to enable the Department to make an early assessment of compliance.

3 VAT registration checks and outcomes

	2005-06	2006-07	2007-08
New registration applications received	284,804	285,176	274,607
Missing Trader Risk Applications			
New applications subject to detailed checking by specialist risk and intelligence teams	8,672	10,635	10,986
New applications refused on suspect grounds[1]	2,271	4,382	5,083
Businesses registered with specific conditions	1,230	2,320	1,973
Labour Provider Risk Applications			
New applications subject to detailed checking by specialist risk and intelligence teams	1,189	809	1,208
New applications refused on suspect grounds[1]	1,242	1,691	1,494
Businesses registered with specific conditions	446	246	270

Source: HM Revenue & Customs

NOTE

1 Includes suspect fraudulent applications refused by Registration Units without referral to Risk and Intelligence Teams, and those refused following further checks.

Processing targets

4.9 The Department has revised its methodologies and targets to measure the timeliness in processing VAT registration applications. In 2005-06, against a target of 95 per cent, the Department processed 97 per cent of applications from traders within 15 working days. However, this target did not accurately reflect processing times as the calculation only started from the date the Department considered the application to be complete and accurate. It recognised that processing times were much longer for applications not complete and accurate on receipt and, in December 2006, set a new and challenging target of processing 95 per cent of all applications within 14 calendar days by March 2008, as shown in **Figure 5**. This was subsequently revised to 70 per cent in August 2007. In making this change, the Department recognised that some applications would take longer to process, either because they were not complete or accurate or because they would need additional checking for risk reasons. The Department has reported its performance against these targets both to the Joint VAT Consultative Committee (JVCC)[7], and to Parliament in answers to questions from individual Members. The Department had good reasons for changing its internal targets and measures but the changes made it difficult for stakeholders to monitor like for like performance over time.

4 VAT registration performance

	2005-06	2006-07	2007-08
Number of new registration applications received	284,804	285,176	274,607
Percentage of applications received electronically	13%	20%	30%
Percentage of applications that were deemed complete and accurate for the PSA target	27%	49%	70%
Percentage of applications processed within target 14 days [Not measured in 2005-06]	N/A	27%	40%

Source: HM Revenue & Customs

NOTE
The increase in online applications has contributed towards the increase in complete and accurate applications.

5 VAT registration processing: measures and targets

Period	Details of measure	Target
Up to April 2006	Customs and Excise Charter Standard: Process complete and accurate applications within 15 working days of receipt	95%
April 2006 to November 2006	HMRC Standard: Process complete and accurate applications, or contact for further information, within 21 calendar days of receipt	95%
December 2006 to July 2007	Process or identify as high risk, within 14 calendar days of receipt	30% by March 2007 95% by March 2008
August 2007 to date	Process all applications within 14 calendar days of receipt	70% by March 2008

Source: National Audit Office

7 The JVCC was established in 1990 with the aim of bringing together HMRC and representative trade and professional organisations. Designed to be a platform for all parties to exchange views and discuss the operation of VAT policy and law, it also presents an opportunity for feedback on proposed changes in the Department.

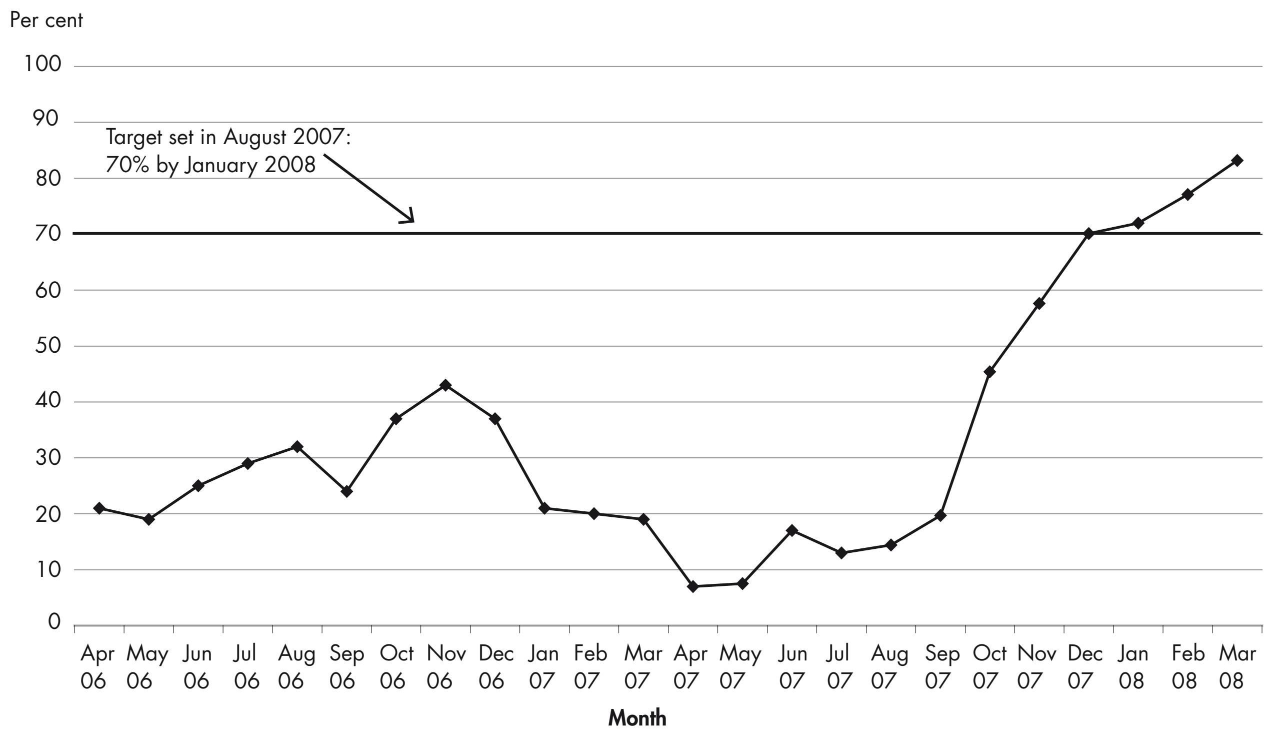
Improvements to processing VAT registrations

4.10 In early 2006 the Department recognised that it needed to improve its performance in processing applications for VAT registration. Between April and August 2006, it processed fewer than 30 per cent within 14 calendar days, as shown in **Figure 6**. The Department took the following measures to improve its performance.

- In March 2006, it introduced the 'Lean' efficiency project at Wolverhampton Registration Unit to identify and remove inefficiencies in working practices and provide a more flexible and effective service. It also aimed to create further capacity at Wolverhampton to cater for the additional work expected from the closure of the Newry and Carmarthen VAT Registration Units. The Department expected the new processes to be operational for all core registration work by March 2007 and it achieved this goal.
- It restructured the way it carried out the risk advisory function on registration applications. Before September 2006, registration staff based at each of the Units initially assessed all applications supported by experienced risk advisors. The Department created a new centralised registration risk referral team, under the control of the Risk and Intelligence Service, which took over responsibility for the Stage 2 risk assessment process (Figure 2). The new team released registration resources to deal with straightforward applications and allowed the risk advisors to be redeployed.

4.11 When the Department implemented these initiatives, it also strengthened its range of anti-fraud measures, to reduce the growing threat of missing trader fraud. These measures included introducing revised risk assessment criteria, to help the Registration Units identify better those registration applications that were potentially suspect.

6 Applications processed within 14 calendar days



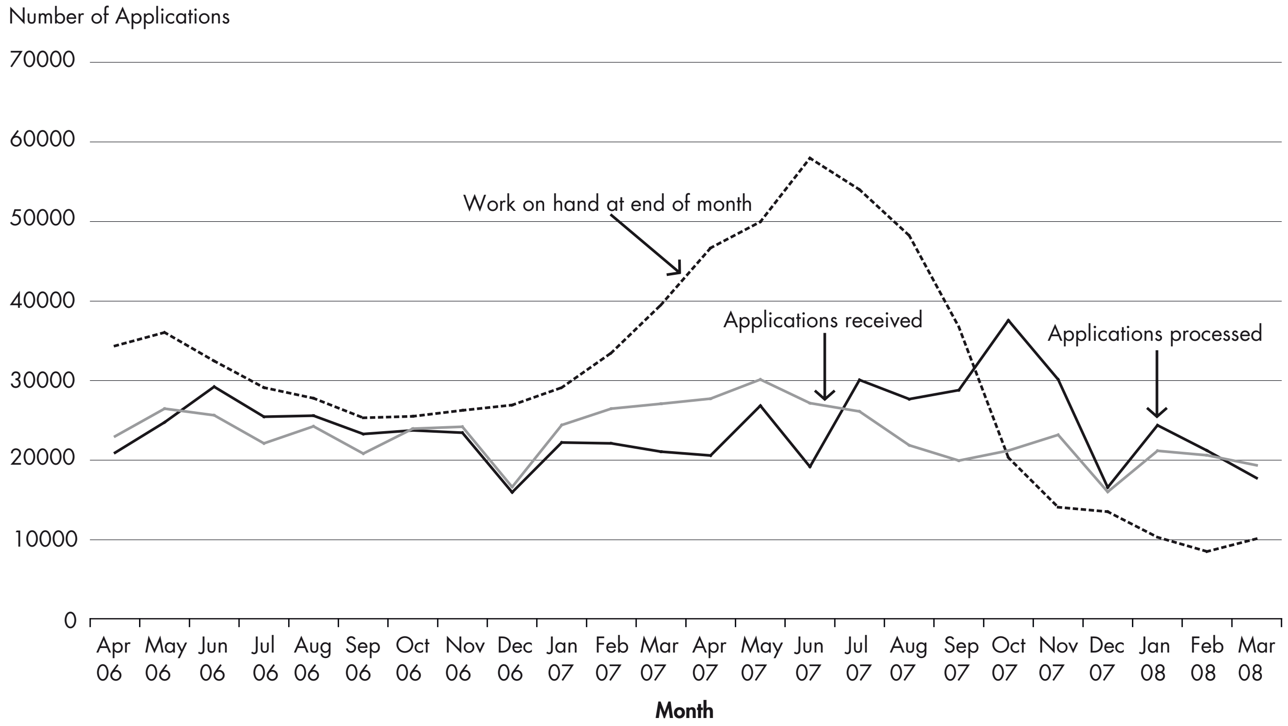
Source: National Audit Office analysis of HM Revenue & Customs data

4.12 The Department recognised that it would take time to embed the improvements in processing and aimed to deliver improvements in performance by March 2007. It also considered more immediate solutions to help improve processing times, including the redeployment of experienced staff or increasing the use of overtime. But it decided not to pursue these and instead focused on the underlying problems described in paragraph 4.10 to increase performance in the long term. These measures brought initial improvements in autumn 2006, but the Department's performance then declined significantly in the first half of 2007.

- The number of applications processed within 14 calendar days decreased from 42 per cent in November 2006, to its lowest point of around 7 per cent in April 2007.
- The average number of days taken to process an application rose from 29 days in March 2007 to around 42 days in August 2007.
- The level of work on hand increased from around 29,000 applications in January 2007 to a peak of about 58,000 in June 2007, as shown in **Figure 7**.

4.13 As performance declined during early 2007, the Department recognised that it would need to take further action to ensure that straightforward applications from legitimate traders could be processed within 14 days. In July 2007, it introduced a detailed plan that has led to a significant improvement in dealing with these cases. The following paragraphs outline the principal factors that contributed to the build up in processing delays and the measures the Department took to improve performance.

7 VAT registration: work on hand



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

NOTE

Work on hand is defined as the number of registration applications received but not yet completely processed. This definition includes applications received but on which work had not yet commenced.

The Main Causes of the Processing Delays

4.14 A combination of factors came together at around the same time to contribute to the delays in processing VAT registration applications.

Risk assessment procedures

4.15 The Department's tighter registration procedures, introduced in 2006, helped to significantly reduce VAT losses arising from missing trader fraud. But these tighter criteria and some poorly targeted risk parameters resulted in more applications, including from legitimate traders, requiring additional information or being referred to Risk and Intelligence for further checks. The newly formed Stage 2 Team had to cope with a significant increase in applications referred by the Registration Units when staff were being trained and, initially, had limited access to some of the necessary IT systems. All these factors added to the time taken to process applications.

Staffing

4.16 Reorganisation of the Registration Units from four to two sites caused short term staffing problems. From January 2007, the Department steadily transferred registration processing services from Newry and Carmarthen to Wolverhampton and Grimsby. But staff numbers in Wolverhampton and Grimsby fell, through general staff turnover and the workforce-change efficiency programme. One of the efficiency initiatives was to reduce contract staff across the Department and to redeploy permanent staff to fill the vacancies. Registration was adversely affected, since a large number of contract staff, some of whom were experienced, had been doing the work for around three years. The contract staff left in March 2007 but the Department found it difficult to redeploy permanent staff. For instance, at Wolverhampton only two members of staff volunteered for redeployment and a shortfall of 30 full time staff equivalents resulted. Furthermore, there was a lead time of several weeks before non-VAT staff, who were redeployed, were fully operational. There was no overtime budget to cover this contingency.

Increase in applications

4.17 In the 2006 Pre-Budget Report the Government announced action to tackle the growth in Managed Service Company (MSC) Schemes.[8] The Government considered that these Schemes were being used to avoid paying the correct amount of income tax and national insurance contributions. To circumvent the new measures some practitioners switched their operations from Managed Service Companies to those which they believed the Department would class as Personal Service Companies (PSCs). PSCs were not covered by these new measures but were still subject to the pre-existing legislation. Many of these newly converted PSCs applied for VAT registration. The Department countered this switch in the 2007 Finance Bill, but it had to process around 20,000 applications from companies purporting to be PSCs.

Computer problems

4.18 Early in 2007 the Department experienced problems with the registration workflow systems. These are relatively old and there were periods when the systems were not operational or not operating at full speed, which contributed to the registration delays. Temporary manual solutions were introduced to address some of these problems, but this inevitably increased processing times.

Management information

4.19 Before August 2007 the Department was unable to monitor accurately the number of registration applications on hand, for the following reasons:

- Staff shortages meant that some applications were not entered promptly on to the registration computer system.
- The computer data was not robust. It incorrectly included old cases that had been recorded twice and refused registrations that had not been properly closed on the system.
- Unfinished applications were not captured within the Department's processing targets. The Department therefore only identified significant delays that had occurred after processing, in some cases long after the Registration Units had received the application.

8 An MSC is a type of intermediary company through which the services of workers are provided to an end client. The definition of an MSC was clarified as a result of the consultation. It is now statutorily defined in Chapter 9, Income Tax (Earnings and Pensions) Act 2003, as inserted by the Finance Act 2007.

4.20 In August 2007, the Department carried out a manual count of unprocessed applications, which identified 48,224 applications on hand, much higher than the normal expected workload, as shown in Figure 7. This result showed that the Department needed robust management information to assess the extent of the processing problems. The Registrations Units have since performed more frequent manual counts to monitor the position. As at March 2008 there was still a discrepancy of some 9,000 between the manual count and the data recorded on the VAT registration computer system. In the longer term the Department aims to use the computer systems to monitor work on hand and is currently performing data cleansing exercises to ensure that they record reliable information.

The Department's Action Plan

4.21 In July 2007, the Department agreed an action plan to address the problems in processing VAT registration applications, as shown in **Figure 8**. It set the following targets to be achieved by January 2008:

- process 70 per cent of all applications within 14 calendar days; and
- reduce the number of applications not started from around 32,000 to nil.

8 Department's Action Plan

Key Action Points	Implementation
Reassigning all new registration work to a single site Registration Unit. Backlogs transferred to other Registration Units for processing.	All new low risk paper applications processed at Wolverhampton. Other Registration Units, Grimsby, Newry and Carmarthen focussed on processing the backlogs. In December 2007 all new online applications were processed at Wolverhampton. Prior to this date they were directed to the old 'postcode ordained' Registration Units.
Increasing staffing levels on pre-registration work in Wolverhampton, by filling 72 full time posts by 10 August 2007.	Redeployment of trained staff from other registration areas, such as deregistration and variations. New staff recruited and overtime budget also made available.
Productivity improvements in the processing centres.	Registration process streamlining was already underway, via the 'Lean' process. Additional staff at Wolverhampton increased its processing capacity. External consultants were appointed to review current registration processes and to identify areas for further improvement.
Risk parameters to be reviewed and updated to ensure they reflect current intelligence on fraud risks, which, among other things, should lead to a reduction in the number of unnecessary referrals back to applicants – and the delays these cause.	Risk parameters were reviewed and amended in July 2007. The key criterion was to amend the risk parameters without jeopardising the risk controls. Certain types of registrations applications were also deemed to be low risk, which meant that around 30 per cent of the 55,000 backlog of registrations could then be cleared without further checks. Risk teams assigned responsibility for deciding additional information requirements needed to assess risk.
Completing some stabilisation of the current VAT IT systems in August, with other improvements due in November.	Measures implemented to stabilise the current IT systems as planned. In addition the Department is costing options to replace and upgrade parts of the system, which will provide improvements in the medium term.
Identifying and setting internal processing targets for the Stage 2 and 3 checks.	New targets for the length of time taken to process high risk applications, Figure 9.

Source: HM Revenue & Customs

4.22 The Department acknowledged that it would take until October 2007 before its customers would see marked improvements. It had to tackle its existing backlogs before it could improve the service for new applications, and the Registration Units also had to train new and redeployed staff before they could start to work on registrations. To provide traders with up to date information on performance the Department reported on its website, usually on a monthly basis, the average processing times for applications. The Department also used its regular consultative forum, the Joint VAT Consultative Committee, to outline the action plan and to report progress. By January 2008 it had made significant improvements in processing registration applications, around 72 per cent were processed within 14 days. By March this figure had risen to 83 per cent, as shown in **Figure 9**.

4.23 The Department's implementation of its action plan reduced the delays in processing of VAT registration applications. But it has also adversely affected other parts of the VAT registration operations. For example, moving staff around within the Registration Units has slowed the processing of VAT de-registrations. By December 2007 work on hand had risen to around 100,000 of these cases, against a normal monthly intake of some 7,000 cases. The Department deployed some new staff to work on the de-registrations but as they did not have previous VAT experience, they could not deal with cases as quickly as the fully trained staff. The Department has acknowledged that any backlog in deregistering traders could in turn delay the issue of final tax assessments to those customers who were leaving the VAT system. However, it has sought to mitigate the effect of any such delays by focussing on cases with large outstanding debts. The Department recommenced de-registration work at Wolverhampton in November 2007, following the recruitment of further staff, and in January 2008 transferred deregistration work to Newry and Carmarthen. It is aiming to clear the backlog by October 2008.

Conclusion

4.24 The Department faces two key challenges on VAT registrations. Firstly, to facilitate trade by ensuring that registration applications are processed as quickly as possible. Secondly, to ensure that potential fraudsters are prevented from entering the system. Since 2004-05, the Department has faced a sustained attack from fraudsters and has strengthened, among other things, its registration controls to prevent fraudsters from obtaining a VAT registration number.

4.25 In 2006 the Department introduced long term measures to increase registration performance which was initially successful but deteriorated significantly in the early part of 2007:

- The level of work on hand increased from around 29,000 in January 2007 to a peak of 58,000 in June 2007;
- The number of applications processed within 14 calendar days fell to its lowest point of 7 per cent in April 2007; and
- The average number of days taken to process an application rose from 29 days in March 2007 to around 42 days in August 2007.

9 Action plan: performance targets and progress to date

Measure	Target	Position as at July 2007	Position as at January 2008	Position as at March 2008
Applications processed within 14 calendar days	70%	13%	72%	83%
Average number of days to process an application	14 days	39 days	16 days	11 days
Number of not started applications	0	c32,000	1,181	2,977
Proportion of applications requiring further risk checks	<10%	11.94%	2.52%	2.34%
Average number of days to process applications undergoing Stage 2 and Stage 3 checks	January: 60 March: 50	189	61	42

Source: HM Revenue & Customs

NOTE

The Department does not have an agreed target for work on hand, but it is closely monitored. The figures as at January and March were 10,316 and 10,131 respectively. The average number of applications received per month in 2007-08 was around 23,000.

4.26 A combination of factors contributed to this deterioration in registration performance.

- Increased checks to counter the threat from fraudulent traders, together with other measures helped the Department to tackle missing trader fraud, reducing the estimated VAT losses by £1 billion. But some risk parameters were poorly targeted, resulting in more legitimate applications being subjected to delays whilst being checked than might otherwise have been necessary.
- These additional checks coincided with the reorganisation of the Registration Units which did not happen as planned and resulted in significant staff shortages. The Department released experienced casual staff before it had redeployed permanent staff from other parts of the Department. This situation was exacerbated by an increase in general staff turnover. Staff also took longer to process applications against a background of increased computer problems, and a significant increase in applications from traders seeking to circumvent legislative changes.
- The restructured risk team initially took longer to process the registration applications owing to the inexperience of the new team and the lack of access to the appropriate computer systems.
- The VAT registration computer systems could not provide reliable information on the level of work on hand as the data was not robust. Also, staff shortages meant that some applications were not entered promptly on to the registration computer system. The Department was not fully aware of the increase in work on hand until it undertook a manual exercise in August 2007, which assessed the level at 48,000 applications.

4.27 In July 2007, the Department prepared an action plan to improve the registration performance by January 2008. The long lead time reflected the need to tackle the existing backlogs and to allow time for new staff to be fully trained. As at January 2008 the Department had made significant improvements in processing registration applications, achieving its target of processing 70 per cent of applications within 14 days. By March this figure had risen to 83 per cent. But the focus of resources on improving this part of the registration service has not been without detriment to the timeliness of the de-registration process, where performance has dropped.

4.28 The Department has now prepared an action plan to address the de-registration backlog and is continuing to monitor the registration staffing position. It has also prepared a contingency plan which will be implemented should the registration problems re-emerge. In the longer term the Department aims to use the computer systems to monitor work on hand and is currently performing data cleansing exercises to ensure that they record reliable information.

PART FIVE

Excise Duties – The Alcohol Strategy

Introduction

5.1 Excise duties are levied on beer, wine, spirits and other alcohol products, cigarettes and other tobacco products and mineral oils. Duty is payable on UK transactions and imports, and in most cases, on the quantity rather than the actual value. The detailed rules are set out in various EU Directives but, subject to agreed minimum rates, each EU Member State may determine its own rates of excise duties.

5.2 UK alcohol duties on beer and spirits are based on alcoholic content. Rates for cider and wine are structured in bands according to the alcoholic content of the product and whether it is sparkling. The Government announced, in Budget 2008, that alcohol duty rates will rise by 2 per cent above the rate of inflation in each of the next four years.

5.3 In 2007-08, the Department collected total alcohol revenue of £8.3 billion comprising: spirits £2.4 billion, wine £2.6 billion and beer and cider £3.3 billion. Since 2005-06, the Department's yield from alcohol duties has increased by £0.5 billion (6 per cent), broadly in line with the forecasts contained in the Annual Budget Report, as shown in **Figure 1**.

5.4 In 2004, the Committee of Public Accounts recommended[9] that the Department should:

- disclose estimates of the alcohol fraud as a range to reflect the inherent uncertainties;
- develop alternative methodologies and identify new data sources to prepare estimates of beer and wine fraud;
- work more closely with alcohol producers to allow resources to be targeted more effectively at the point where alcohol is diverted in the supply chain;

1 Alcohol Net Receipts/Budget Forecast

	2005-06		2006-07		2007-08	
	Net Receipts (£ billion)	**Forecast (£ billion)**	**Net Receipts (£ billion)**	**Forecast (£ billion)**	**Net Receipts (£ billion)**	**Forecast (£ billion)**
Spirits	2.3	2.5	2.2	2.3	2.4	2.3
Wine	2.3	2.3	2.4	2.4	2.6	2.5
Beer and Cider	3.2	3.4	3.2	3.4	3.3	3.4
Total Alcohol	**7.8**	**8.2**	**7.8**	**8.1**	**8.3**	**8.2**

Source: National Audit Office analysis of HM Revenue & Customs and HM Treasury Budget Reports

NOTE

Net receipts reflect cash received and therefore does not match the Trust Statement income figure which is prepared on an accruals basis.

9 Thirty-Second Report of Session 2003-04 (HC 284).

- discuss with the trade the effectiveness of its current anti-fraud measures and the opportunity for further regulatory or operational improvements;
- improve communication between anti-fraud teams throughout the Department; and
- identify likely additional costs arising from the introduction tax stamps and take appropriate steps to mitigate these costs.

5.5 We have examined the Department's management of alcohol duties and the steps that the Department has taken to implement the Committee's recommendations. This report covers:

- administration of the alcohol duty suspended system;
- alcohol diversion fraud;
- measuring the illicit alcohol market;
- the alcohol strategy;
- operational measures;
- regulatory measures: duty stamps;
- recent developments; and
- future developments: excise movement and control system.

Administration of the Alcohol Duty Suspended System

5.6 Commercial brewers, distillers and other producers based in the United Kingdom are legally required to register their production premises with the Department. Businesses may also import alcohol from other EU and non EU Countries. Excise duty is liable at the time the alcohol is either produced or imported. Under EU Single Market legislation (Council Directive 92/12), businesses can hold alcohol or move it between registered premises or excise warehouses (including those in other EU Member States) without payment of duty. This is known as duty suspension and enables authorised traders to defer payment nearer to the time when they release their goods for consumption. Other businesses may acquire duty suspended alcohol from other EU Member States, under the Registered Excise Dealers and Shippers Scheme and the Occasional Importers Scheme. However, they must pay excise duty either on receipt of the goods or prior to the goods being received, as shown in **Figure 2 overleaf**.

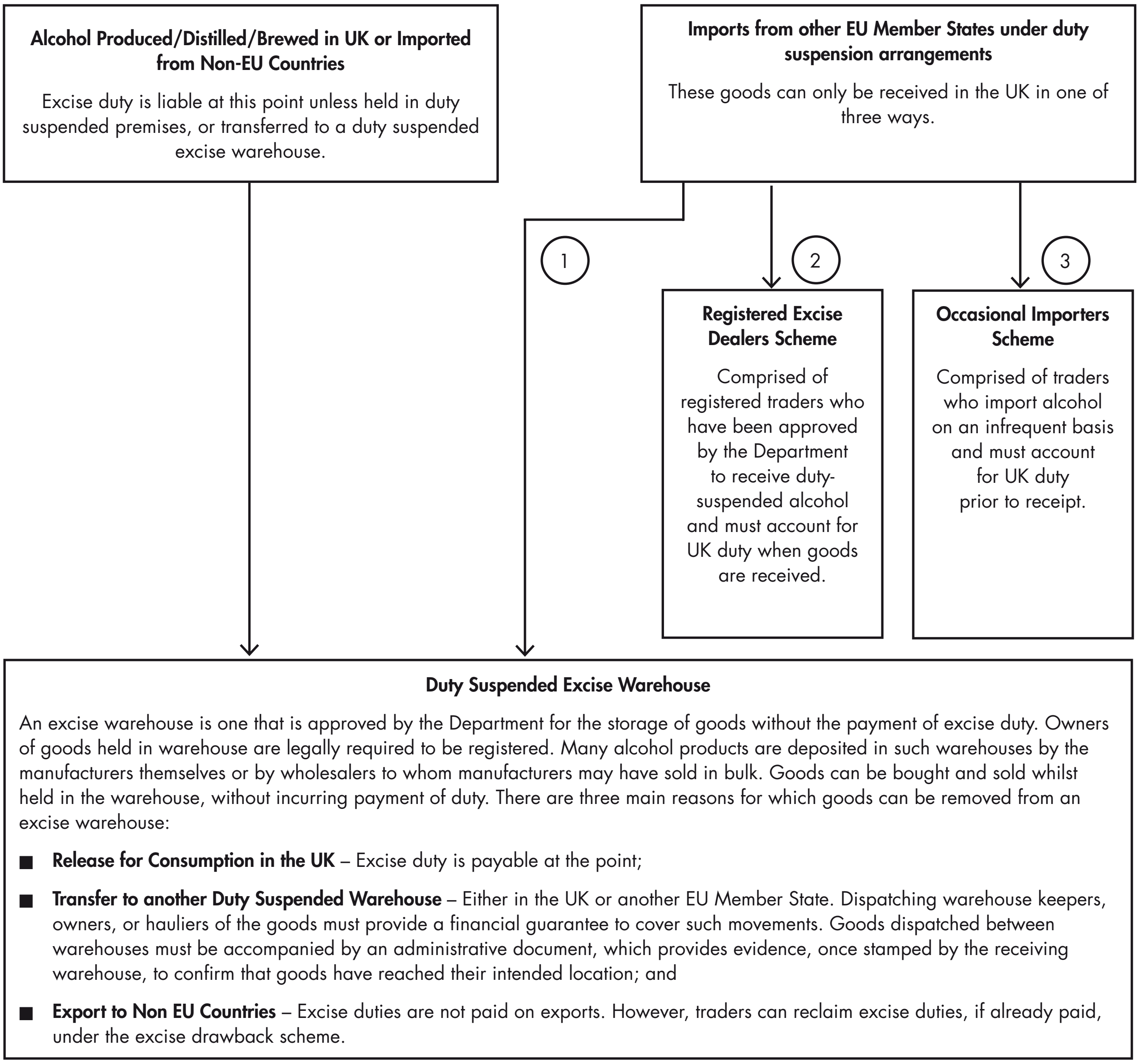
Alcohol Diversion Fraud

5.7 The duty suspension arrangements facilitate legitimate trade by allowing the 'free' movement of alcohol and avoid the need for routine fiscal controls at frontiers, including frontiers between EU Member States. Since the mid 1990's, fraudsters have exploited these arrangements. Excise diversion fraud occurs where goods intended for export or delivery to another excise warehouse under duty suspension are diverted for consumption in the UK without the UK duty being paid. Because of their relatively high duty rates, the highest risk products tend to be white spirits (notably vodka and gin) and Scotch whisky. Fraudsters tend to sell their Illicit alcohol through licensed premises, usually at, or close to, normal duty paid prices. The Department has found that large organised crime syndicates and small scale operators alike are committing alcohol duty frauds. The Department has identified three main types of excise diversion fraud: inward, outward and inland, as shown in **Figure 3 overleaf**.

5.8 In any fraud, the Department's challenge is to establish the point at which the alcohol is illegally diverted. One or more of the owners of the goods, warehouses or operators, employees and transporters may be complicit in the fraud. The loss of duty may not be evident for several weeks, as the Department is required, under EU law, to allow traders a set period, about a month, to declare alcohol movements. One or more of the warehouses involved could be in a different EU Member State.

5.9 Tax revenue is also at risk from other types of fraud and smuggling. Fraudsters may seek to mask their activities under the pretext that they are making legitimate acquisitions or imports under the Registered Excise Dealers and Shippers (REDS) or Occasional Importers Schemes. Fraudsters can abuse both of these schemes by running duplicate loads under the same paperwork. Smuggling is another means by which fraudsters illegally bring excise goods into the UK, though this is relatively rare. Fraudsters can smuggle alcohol by simply mis-describing the goods, or by concealing the alcohol goods among other products.

2 Outline of the Alcohol Duty Suspended System



Source: HM Revenue & Customs

3 Types of Alcohol Diversion Fraud

Inward diversion: fraud involving duty suspended goods from the EU diverted onto the UK home market without payment of UK duty.

Outward diversion: fraud involving duty suspended goods ostensibly for export which are diverted onto the UK home market without the payment of UK duty.

Inland diversion: fraud involving duty suspended goods moving within the UK which are diverted directly onto the UK market without the payment of UK duty.

Source: HM Revenue & Customs

Measuring the Illicit Alcohol Market

5.10 To measure the effectiveness of its Alcohol Strategy, the Department requires a means of estimating losses arising from fraud. Spirits fraud is estimated as the difference between the volume of spirits consumed in the UK, using data from the Office for National Statistics household surveys, and the volume of spirits on which duty has been paid. The calculation is complex, incorporating adjustments for underreporting on household surveys. This is a relatively untested area for Governments both across the EU and around the world. The United Kingdom is one of the few to try to make such estimates.

5.11 In the past, the alcohol industry has contested the accuracy of the Department's estimate of the total spirit market represented by illicit alcohol goods. The Department has since worked with the Office for National Statistics and the spirits industry to consider ways of improving the quality of its estimates. In 2006, the Office for National Statistics examined the feasibility of developing a specific survey designed to capture alcohol consumption, which is generally under-reported in the household surveys. It concluded that such a specific survey would not significantly address the problem of underreporting and the associated uncertainties. The Department has subsequently decided against taking forward a bespoke survey. It concluded that the costs of carrying out such research is likely to exceed the benefits and that a separate survey would not provide better information than the current surveys prepared by the Office for National Statistics.

5.12 The Department now publishes its estimate of the illicit spirit market as a range, consisting of an upper and lower bound within which the true level of fraud lies. Using operational intelligence, the Department has estimated the lower limit at a negligible level, and the upper limit using the Office for National Statistics data at £400 million. Because the year-to-year changes in the illicit market share are subject to uncertainty, the Department uses the mid-point to assess the long term illicit market trend, which fell from 8 per cent in 2001-02 to 5 per cent in 2005-06, as shown in **Figure 4**.

5.13 Owing to the delay in collecting and analysing survey data, the Department does not publish estimates of the illicit market performance until 18 months after the end of the relevant financial year. The Department therefore uses other techniques and information to monitor performance on a real time basis, such as comparing actual receipts to forecasts and analysing operational intelligence data. The Department is currently developing indicators that will provide additional information on the level of suspected fraudulent activity.

5.14 Beer and wine duties account for around 60 per cent of the alcohol duty collected. The Department does not yet have reliable estimates for beer and wine fraud. The methodology that the Department uses for estimating spirits fraud cannot be used for beer and wine, since experience shows that it produces unrealistic estimates. The Department has recognised that it can do more to provide a robust estimate of the scale of beer and wine fraud. It has met with associations representing the industry to discuss how it can improve and develop such estimates.

4 Spirits: Illicit Market and Associated Revenue Losses

	2001-02	2002-03	2003-04	2004-05	2005-06
Illicit Market Share:					
Upper Estimate	17%	14%	15%	7%	10%
Lower Estimate	–	–	–	–	–
Associated Revenue Losses[1]					
Upper Estimate	£600m	£500m	£600m	£250m	£400m
Lower Estimate	–	–	–	–	–
Mid-Point Share	8%	7%	8%[2]	4%	5%

Source: HM Revenue & Customs

NOTES

– Indicates estimates of negligible levels of fraud.

Figures are rounded to the nearest £50m or 1 per cent.

1 Includes both alcohol duty and VAT. This will overstate losses to the extent that VAT is collected on sales of illicit alcohol through normal retail outlets.

2 At the time the PSA Target was set in 2003-04, the estimated illicit market share was calculated at 7 per cent using a methodology which has since been revised.

The Alcohol Strategy

5.15 The Department launched its Alcohol Strategy in 2005 in response to increases in estimates of spirits fraud, then estimated at £250 million in lost excise duty. The Government provided additional resources to enable the Department to meet a challenging Public Service Agreement Target to reduce the market share represented by illicit spirits from 7 per cent in 2003-04 to 3 per cent by March 2008. The aim of the Strategy was to provide a coordinated national response to reduce alcohol (specifically spirits) fraud through operational and regulatory measures, as well as through improved cooperation with the legitimate trade. It also aimed to develop further best practice for intelligence and risk assessment. The majority of the measures introduced under the Strategy are focussed on improving controls across all alcohol products.

5.16 The Department has made progress in embedding the key elements of the Strategy and has developed new governance arrangements to ensure delivery of the Alcohol Strategy. A Directors' Working Group has overall responsibility for monitoring performance against the PSA target. Below this Group, the Department established an Alcohol Strategy Delivery Group (ASDG) responsible for the commissioning of projects (i.e. national and collaborative projects) to address high risk traders and activities, and to coordinate interventions across the Department as a whole. All the operational teams involved in delivering the strategy are represented on the ASDG, which minimises the possibility of overlap and allows the efforts of all teams to be concentrated on identified risks, as shown in **Figure 5**.

Operational Measures

Risk and Intelligence

5.17 The Alcohol Central Coordination Team (ACCT) has played an important role in the successes of the alcohol strategy. The Department established the ACCT to enable all alcohol risk information and intelligence to be coordinated, collated and used to inform the targeting of assurance and detection activity. The ACCT uses all available intelligence and tax information to profile the highest risk businesses for intervention. The Department's Local Compliance, Detection and other appropriate stakeholders, covering Direct Taxes, Excise and VAT, pool their ideas and resources to tackle the suspect businesses. This collaborative approach has allowed the Department to investigate irregularities using a combination of skills, knowledge and intelligence; enabling the Department to achieve results which may not have been realised if approached by one business stream of the department alone, as shown in **Figure 6 on page R46**.

Registrations

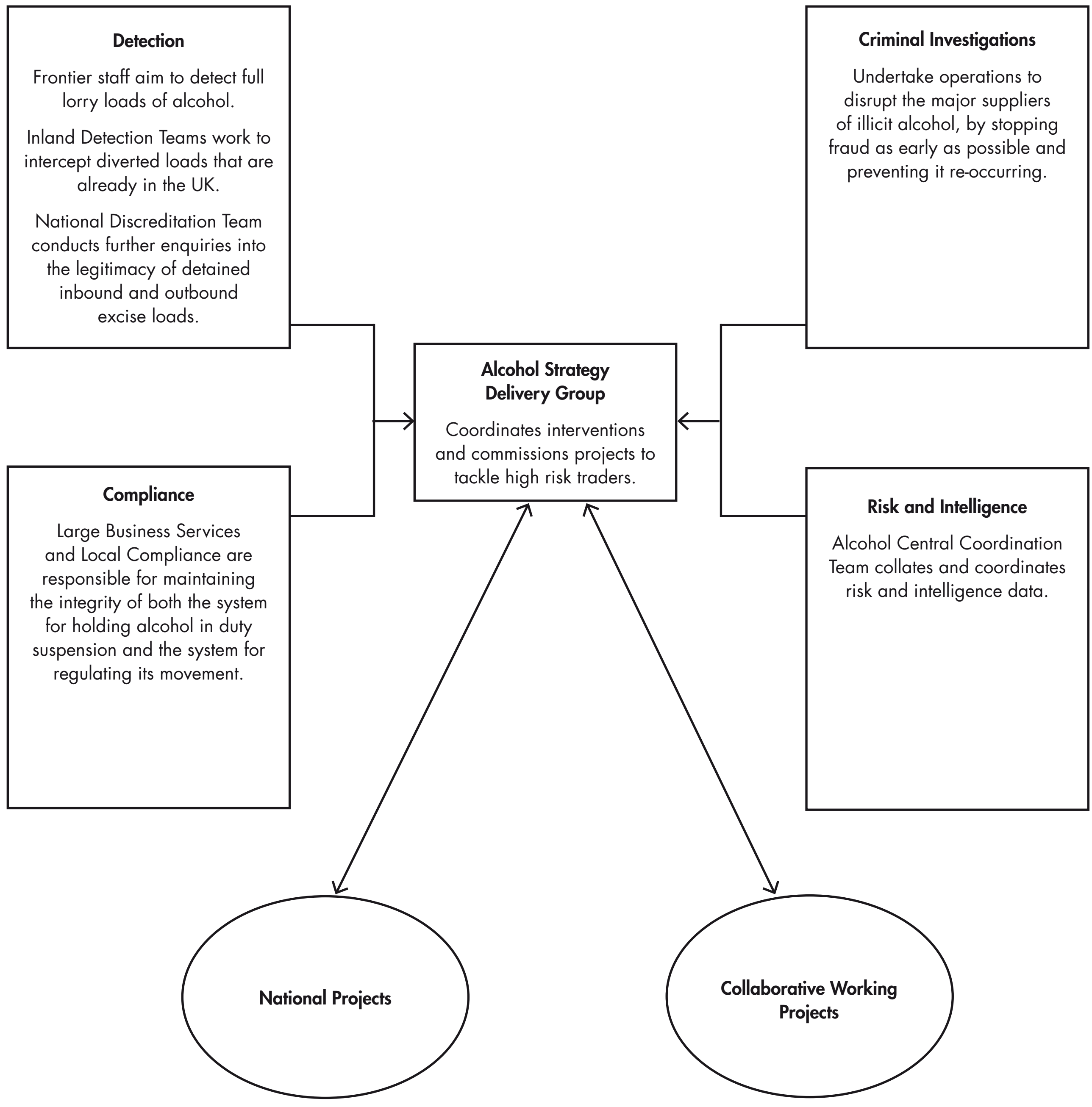
5.18 All traders involved in the duty suspended alcohol supply chain are legally required to be registered with the Department who, before approving the registration, will undertake checks to identify high risk traders and potential fraudsters. Specialist teams scrutinise registration applications, assesses them for risk and, where necessary, refer applications to compliance teams for additional enquiries. These compliance teams then recommend, based on their enquiries, whether the Department should accept the referred applications. To improve the quality and consistency of recommendations, the Department has established a small team of experienced compliance officers to review such recommendations. The team ensures that the Department has given proper consideration to all relevant aspects and, if not, refers the application back to the operational teams for further enquires. The specialist team also provides advice and support to operational staff. In 2007-08, the Department refused 165 applications out of a total 501 received.

Detection

5.19 The Detection team has a key role in tackling all types of excise fraud. This team, of around 4,000 staff, operates within the newly created UK Border Agency which the Government set up in April 2008, and which from April 2009, will be an executive agency of the Home Office.[10] The Department has agreed a delivery plan with the UK Border Agency for 2008-09, which sets out the contribution that the UKBA is expected to make towards achieving the objectives of the excise anti-fraud strategies, including the Alcohol Strategy. It plans to extend these arrangements to future years.

10 UK Border Agency (UKBA), brought together the border control capability of the Department; the Border and Immigration Agency; and UK Visas, to improve overall security at the border.

5 Key operational teams involved in tackling alcohol fraud



Source: HM Revenue & Customs

6 Illustration of a complex alcohol fraud case

This example relates to a trader moving duty suspended alcohol in and out of the UK.

The Department's review of the trader's business records established that the trader had complex associations with other companies, through shared directors and company secretaries. Working together, the Department's Local Compliance and Detection Teams identified the trader's involvement in inbound and outbound alcohol diversion fraud. The Teams established that eight consignments of duty suspended spirits had not reached their intended destination warehouse in Spain and had been diverted to the UK domestic market. An excise assessment of around £700,000 was raised on the trader to recoup the duty not paid.

The Department raised a further excise assessment, some £100,000, for a consignment of spirits destined for the Cape Verde Islands via Portugal which did not arrive. This also resulted in the Department applying sanctions to the movement guarantee of the haulier who it adjudged was also complicit in the attempted fraud. This action restricted the haulier's ability to move duty suspended alcohol.

Detection activity resulted in the seizure of two consignments of spirits, where the UK excise duty evaded would have been £220k. The Department noted that the alcohol did not bear duty stamps and that the trader had removed commercial lot codes to prevent tracing the product and goods.

The Department's Local Compliance case team also worked closely with Direct Tax colleagues who have subsequently carried out extensive research into the director and family members employed by the trader. The lifestyle of the director did not appear consistent with earnings. The Department found that family members could not have funded their homes and vehicles on the salaries they had disclosed to the Department. Its examination of the records at the premises initially resulted in the trader making a voluntary disclosure of an undeclared bank account, cash hoard, and the disposal of a previously unknown warehouse with an associated capital gain of £250,000.

The trader made a further voluntary disclosure which allowed the Department to identify a small business freight venture, an offshore account and four further bank accounts with balances between £15,000 and £250,000 in each account. Subsequently, the trader's accountant disclosed links to capital offshore accounts, with defalcations stretching back over a decade or more. The Department expects to recover duties in excess of £1 million.

Source: HM Revenue & Customs

Criminal Investigations

5.20 There has been a significant decrease in the number of people prosecuted for alcohol fraud, from eighty six in 2003-04 to one in 2007-08, as shown in **Figure 7**. Although considerable investigation resources have been deployed to other areas of greater revenue losses, such as VAT and Tobacco, alcohol fraud has featured in many operations. Information developed during these investigations has been used extensively to identify high risk traders and guide compliance and detection activity. Notwithstanding the decrease in the numbers of prosecutions the Department has continued to use other sanctions to tackle fraudsters, such as seizures, penalties, additional assessments, deregistration and confiscation orders. In 2007-08, the Department seized 5.2m litres of illicit alcohol, an increase of around 20 per cent compared with 2003-04, as shown in **Figure 8**.

5.21 In 2007-08, Local Compliance examined 160 high risk cases which the ACCT had identified. Of these, the Department only applied sanctions in 56 cases (i.e. 35 per cent). These cases were tackled by officers using civil procedures. But given the complexity of the cases and, in particular, the criminal nature of the activities, this proved challenging and resulted in a low hit rate. The Department has recently set up a Special Civil Investigations Team to tackle the main alcohol fraudsters identified by the ACCT, using the most appropriate sanctions available across all taxes. This new team works closely with other operational areas within the Department including Criminal Investigation.

Regulatory Measures: Duty Stamps

5.22 The Government's introduction of duty stamps for spirits facilitates the identification by consumers, traders and the Department of non-UK duty paid spirits.[11] Since October 2006, bottles that qualify for the scheme (35cl or larger, 30 per cent alcohol content or above) must display a stamp unless they passed the UK excise duty point before this date. The duty stamp is available in two formats:

- **A free standing stamp** – which is product specific, e.g. gin, vodka, rum with a unique serial number printed on its face; and
- **A label stamp** – which is incorporated into the bottle labels with a unique reference number for each stamp design.

11 Recommended in a report by John Roques, *The collection of excise duties in HM Customs and Excise*, July 2001.

7 Analysis of gangs disrupted, prosecutions and convictions

	2003-04	2004-05	2005-06	2006-07	2007-08
Gangs disrupted	24	4	2	0	0
Spirits – number of people prosecuted	24	7	9	5	1
Spirits – number of people convicted	21	0	9	5	1
Mixed cases – number of people prosecuted	62	1	0	0	n/a
Mixed cases – number of people convicted	34	0	0	0	n/a

Source: HM Revenue & Customs

NOTE

Mixed case is where more than one excise fraud is committed, e.g. both alcohol and tobacco goods were involved. From 2007-8 this is now reported by which ever contraband has the greatest duty liability.

8 Other sanctions used by the Department to tackle alcohol fraud

	2003-04	2004-05	2005-06	2006-07	2007-08
Assessments raised	£63m	£30m	£44m	£46m	£62m
Civil penalties issued	N/A	N/A	N/A	£23,000	£77,000
Confiscation orders	N/A	£13,000	Nil	Nil	£260,000
Number of vehicles seized	317	325	215	135	167
Number of approvals revoked or amended	N/A	N/A	N/A	67	54
Number of Commissioners' Directions imposed	N/A	N/A	N/A	21	31
Quantity of alcohol seized:					
Spirits (Litres)	407,858	303,252	237,904	384,078	548,291
Beer (Litres)	2,773,385	2,170,932	2,522,253	1,915,173	3,815,549
Wine (Litres)	1,134,567	629,034	292,945	303,048	854,508

Source: HM Revenue & Customs

NOTE

The table includes the outcome of all alcohol compliance assurance activities undertaken by Detection, Larger Business Services and Local Compliance.

N/A = Data not available.

5.23 Spirits for export from the UK must not be stamped or must have any duty stamp removed or voided, making outward diversion of stamped product much more difficult and high-risk for fraudulent traders. The Department is therefore able to focus on inward diversion through either the duty suspension system, Registered Excise Dealers and Shippers scheme or the Occasional Importer scheme) or smuggling, via targeted frontier and assurance activity.

5.24 The Department has made several interventions where it has intercepted and seized duty stamp spirits purported to be for export. Officers checking the security features embedded in the duty stamps have also identified and seized poor quality counterfeits. In early 2007, an individual was sentenced to eight months in jail for smuggling spirit bottle labels bearing counterfeit label stamps.

5.25 The Department has delayed the full enforcement of the regulations at the retail sector level because some of the 'fast moving' alcohol products released into the retail market before October 2006, and therefore unstamped, remained on the retail shelves for a considerable period of time. Once these have been sold the Department's task in identifying illicit spirit bottles will be easier.

5.26 The compliance costs set out in Regulatory Impact Assessment[12] were calculated on the basis of the industry paying for the duty stamp and were gross of any offsetting measures. However, the Government has sought to mitigate these costs by:

- incurring production and distribution costs of the duty stamps;
- withdrawing the requirement for duty stamps to be paid up front;
- freezing spirits duty rates;
- allowing spirit duty stamps to be incorporated in the label on a bottle rather than a strip over the bottle opening; and
- providing a £3 million capital investment fund to assist the industry. As at March 2008 only around £270,000 of this had been claimed. Some claims have been rejected as the criteria were not met.

5.27 In December 2007, the Department began a consultation process, to gather the views of the industry on the effect of duty stamps on the spirits market, the compliance costs associated with duty stamps and the manner in which the scheme was implemented. The outcome of the review is expected in the second half of 2008.

Cooperation with the Trade and EU Member States

Legitimate trader population

5.28 The Department and the legitimate trade work closely to reduce the opportunities for fraudsters to secure supplies of duty suspended alcohol. The main contributors have been the Joint Alcohol and Tobacco Consultation Group, the Joint Warehousing Fraud Task Force and the Joint Spirits Fraud Task Force, which provide an effective forum for feeding the trade's concerns back to the Department. Several Memoranda of Understanding (MoUs) have also been agreed with associations representing alcohol traders, which provide a framework for cooperation on a range of issues relating to alcohol fraud.

5.29 The Department recently revised the existing memoranda, following discussions with the associations representing the spirits industry, to set out more clearly its responsibility in providing feedback to traders. It provides feedback in the form of quarterly newsletters on the progress of the MoUs, significant successes achieved by the Department's anti-fraud enforcement activities, and progress of new anti-fraud policy measures or regulations. The Department also clarified its information requirements to reduce the administration burden on traders and to enhance the quality of the information they supply.

5.30 Members of the Scotch Whisky and the Gin and Vodka Associations (which represent around 95 per cent of the spirits industry) were first to sign a memorandum in 2005. Other associations representing Bonded Warehousekeepers, United Kingdom Warehousekeepers and the Wine and Spirit Trade have also signed MoUs. The Department is looking to agree memoranda with the British Beer and Pub Association and Transporters, which would extend the MoUs to other sectors involved with the acquisition, distribution and sales of alcohol.

EU Member States

5.31 Cooperation with other EU Member States is essential in tackling both inward and outward alcohol diversion, and is governed by EU regulations. Tax/Customs Authorities may seek further assistance from their counterparts in other EU Member States, in establishing whether alcohol products have been delivered fully intact to the correct intended location. All EU Member States are legally required to respond to requests for information/cooperation within three months of receipt.

5.32 The Department's past performance in responding within this time frame has not been good. In 2007, the Department introduced new procedures for dealing with requests from, and sending requests to, other EU Member States. The National Verification Centre (NVC) coordinates all incoming requests. In addition, outgoing requests are now risk assessed and approved by the ACCT with the help of the NVC, to ensure that only high priority cases are referred, therefore reducing the administration burden on receiving Member States. The Department's performance in processing incoming requests has improved. In 2007-08, 74 per cent were replied to within the three month statutory deadline. There has also been a significant fall in requests sent to other EU Member States, from 2,859 in 2006-07 to 712 in 2007 08. This fall contributed to an increase in the proportion of the Department's requests responded to within three months, from 22 per cent in 2006-07 to 53 per cent in 2007-08, as shown in **Figure 9**.

12 £6 million in the first year and £4 million per year ongoing costs.

This improvement has also been facilitated via enhanced cooperation between the Department and other EU Member States.

5.33 The Department is currently examining further ways it can work with other Member States, for example, in joint operations. The problems facing the Department and why cooperation with other EU Member States is important are illustrated in **Figure 10**.

Recent Developments

Counterfeit activity

5.34 The Department's operational intelligence has identified an increase in counterfeit spirits. Counterfeit alcohol can be either brought into the country in commercial quantities or produced in the UK from duty-free denatured alcohol.[13] Counterfeits not only result in a loss of duty receipts to the Exchequer, but also present an increased health risk to the public. The Department has concluded that part of the increase in this activity could reflect signs that the current strategy is succeeding to prevent fraudsters from diverting genuine products. The Department has also noticed an increase in counterfeit alcohol being smuggled from Eastern European Countries.

5.35 To counter the threat arising from the misuse of UK produced denatured alcohol the Department has introduced a package of measures including tightening up the system for approving users of denatured alcohol. The Department has also increased the level of assurance work at existing approved distributors and users of denatured alcohol to ensure only bona fide businesses have access to alcohol.

9 Cooperation with other EU Member States

	2006-07	2007-08
Requests sent by the Department to other EU Member States	2859	712
Percentage of requests sent to other EU Member States which were replied to within 3 months	22%	53%
Requests received by the Department from other EU Member States	1608	1933
Percentage of requests received from other EU Member States which were replied to within 3 months	73%	74%

Source: HM Revenue & Customs

5.36 The Department is working with other EU Member States to raise awareness of the increasing threat of counterfeits and organised a conference in February 2008 to discuss the exchange of information on industrial and denatured alcohol suppliers. It has chaired a subsequent meeting with other Member States. One of the outputs from this collaboration is the exchange of information about transactions involving the movement of denatured alcohol between Member States. The information received will enable the Department to ensure that denatured alcohol entering the UK from another Member State has not been used for the illicit production of counterfeit spirits. The Department is also working with Local Authorities Coordinators of Regulatory Services and Trading Standards, and has developed protocol arrangements aimed at exchanging information to combat the threat to public health and UK revenues from counterfeit alcohol. **Figure 11 overleaf** provides an example of collaborative working.

Drawback claims

5.37 The Department identified that the duty drawback system was coming under threat with instances of beer duty refunds being claimed on goods that were ineligible as there was a lack of evidence to show that duty had been paid on the beer. The claims rose from around £3m in the first quarter of 2005-06 to around £10m in the corresponding quarter in 2006-07. Although the Department was aware of this increase in the level of claims, it did not take action immediately until it was raised by the National Audit Office during its routine audit work. It subsequently responded by strengthening its scrutiny procedures and by clarifying the evidential requirements needed to support a claim which allowed legitimate businesses to continue to submit claims whilst thwarting fraudulent claimants. This led to a reduction in the value of claims received to around £4m per quarter.

10 Example of an excise diversion fraud

The Department identified a case where a UK tax warehouse despatched a goods vehicle with an administrative accompanying document to France carrying a full load of alcohol products. The fraudster, however, swapped the full trailer for an empty one and diverted the goods illegally to the UK retail market. The empty trailer was taken to France where the administrative accompanying document was fraudulently stamped. The empty trailer was then loaded with cheap alcohol and returned to the UK, where the consignment was sold illegally in the retail market.

Source: HM Revenue & Customs

13 Alcohol used for industrial, medical and scientific uses are legally required to be made unsuitable for drinking by the addition of denaturants prior to dispatch to the end user. Once denatured to UK standards, all classes of denatured alcohol are relieved of duty.

11 An illustration of joint working between HMRC and Trading Standards

In 2007, the Department, working with local Trading Standard Officers, succeeded in shutting down an illegal distillery in the West Midlands, which was capable of producing thousands of litres of counterfeit whisky. Working together, the Department and Trading Standards raided a property in Holloway Bank, Wednesbury, seizing 200 litre-bottles and several large vats. The fraudsters had used potentially poisonous animal feed as a cheap alternative to grain during the distilling process.

Source: HM Revenue & Customs

Future Developments: Excise Movement and Control System

5.38 In 1998, EU Member States set up a Working Group to analyse the area of excise fraud, identify the weaknesses in current excise procedures and recommend areas for improvement. The Group's report noted weaknesses in the paper-based Administrative Accompanying Document (AAD) system for excise goods moving under duty suspension. In particular, the Group noted that the existing System for the Exchange of Excise Data (SEED), sponsored by the Commission, was updated and exchanged with other EU Member States only once a month and in some instances the data was not complete. Its usefulness in helping Tax Authorities tackle alcohol fraud was therefore limited, as fraudsters could disappear before Tax Authorities were aware that fraud had been undertaken. The Working Group concluded that an EU wide integrated computer system should be developed to monitor and control the movement of goods under excise duty suspension regulations. The Excise Movement and Control System (EMCS) will allow Tax Authorities access to real time information about consignments in transit, therefore enabling them to plan inspection visits in advance to check that goods have arrived at their correct destinations.

5.39 Following a joint Council of the EU and European Parliament decision to proceed with the project, all Member States agreed to phase in EMCS from April 2009 with the intention of the system being fully operational by January 2010. The Department believes that it is unlikely that the EU legislative timetable will meet this timescale and so the project may be delayed. It will not be possible for a Member State to operate a paper-based system when other EU Member States are operating an electronic system, as the movement of the excised goods from a Member State using the electronic system will require an electronic sign-off from the warehouse in the receiving Member State. Every Member State will, therefore, need to be equipped to provide this sign–off before the scheme can be introduced. The Department's development of its computer system is currently on schedule, and the first element is due for delivery in April 2009, with a second element due for delivery in October 2009. Notwithstanding the possible legislative delays, the Department will need to ensure that its computer system is fully operational by January 2010 if it is not to delay the introduction of the EMCS across the EU.

Conclusion

5.40 The Department launched its Alcohol Strategy in 2005 in response to increases in estimates of spirits fraud, estimated at £250 million in lost excise duty. It has made good progress in embedding the measures underlying the Strategy, which is underpinned by a robust governance system. The Department has a Public Service Agreement Target to reduce the illicit spirits market to three per cent by March 2008. The latest data available shows the illicit market share mid-point at five per cent in 2005-06, a decrease of three per cent since 2003-04.

5.41 The Department has addressed the recommendations made by the Committee of Public Accounts in 2004. In particular, the Department has:

- Revised its methodology for estimating the illicit spirits market. The United Kingdom is one of the few countries to try to make such estimates, which are inherently difficult. The Department has not yet found an acceptable method for measuring potential tax gaps for other alcohol products, such as beer and wine, which in total comprise around 60 per cent of the duties collected. The Department recognises that it needs to do more and is working with the industry to establish a robust methodology to estimate the extent of the illicit market for all alcohol products.
- Established Memoranda of Understanding (MoUs) with the alcohol industry to provide a framework for cooperation in tackling alcohol fraud. The Department intends to agree memoranda with the British Beer and Pub Association and Transporters, which would extend the MoUs to other sectors involved with the acquisition, distribution and sales of alcohol.

- Developed an internal coordinated response to tackle suspected high risk traders. The Alcohol Strategy Delivery Group (ASDG), comprising representatives of all the internal operational groups involved in tackling alcohol fraud, coordinates the Strategy and ensures that all teams work together either through national or collaborative projects. The Department has developed a delivery agreement with the newly established UK Border Agency for 2008-09, which sets performance targets and ensures that this new body will continue to play a full role in the development and implementation of the Alcohol Strategy.
- Introduced tax stamps in October 2006 to make it easier to identify illicit bottles of spirits. Measures have been introduced to mitigate the associated compliance costs. The Department has delayed the full enforcement of the legislation in the retail sector to allow legitimate unstamped spirits to be sold making it easier to identify illicit bottles, but it plans shortly to implement an assurance programme to detect and deter fraudsters.

5.42 The Department is also working with the European Union to tackle alcohol fraud. The Department's response to requests from other EU Member States has been reasonable, but there is still room for improvement. In 2007-08, the Department responded to 74 per cent of requests within the statutory deadline but recognises that it should aim to provide replies to 95 per cent of requests within the deadline. The Department is working with the European Union to improve the performance of other Member States in responding to requests from the United Kingdom, with on average, only 53 per cent of outgoing requests receiving replies within the statutory 3 month period.