Comptroller and Auditor General's Standard Report on the Accounts of the Inland Revenue 2002-03

Issued under Section 2 of the Exchequer and Audit Departments Act 1921 as amended by the Government Resources and Accounts Act 2000

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Comptroller and Auditor General
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Executive Summary

1. Section 2 of the Exchequer and Audit Departments Act 1921 requires me to examine the accounts of the Inland Revenue on behalf of the House of Commons to ascertain that adequate regulations and procedure have been framed to secure an effective check on the assessment, collection and proper allocation of revenue, and that they are being duly carried out. I am also required by that Act to examine the correctness of sums brought to account and to report the results to the House of Commons.

2. This report fulfils my responsibility under Section 2(2) of the 1921 Act. No tax collection system can ensure that all taxpayers and potential taxpayers comply with their obligations. As part of the Department's Public Service Agreement targets they aim to reduce the number of individuals and businesses who do not comply. Subject to:

   - the major reservations I have recorded about tax credit error;
   - recognising that it is not possible to secure full compliance;
   - other specific matters raised in this report, and matters outstanding from earlier years' reports,

     the National Audit Office's work in 2002-03 provided overall assurance that the Inland Revenue's regulations and procedure continued to provide an effective check on the assessment, collection and proper allocation of revenue, and that they are being duly carried out.

3. The Inland Revenue prepared Resource Accounts and a Trust Statement account of taxes and tax credits. I qualified my audit opinion on the latter in respect solely of error rates on tax credits (see paragraphs 2.5 - 2.7). I gave an unqualified opinion on the Resource Accounts.

4. I also present to Parliament Value for Money reports on the economy, efficiency and effectiveness with which the Department have used their resources. Since my last report on the Department's accounts in December 2002, I have reported on External Fraud against the Inland Revenue (HC 429) along with a similar report on the Department for Work and Pensions. I shall report later in 2003-04 on the Strategic Transfer of the Estate to the Private Sector - STEPS - project.

5. This report records audit observations on certain developments in corporate governance, Tax Credits, Employer Compliance with tax requirements and Capital Gains Tax. The main points arising from these examinations were as follows.

Working Families' and Disabled Person's Tax Credits

6. The Working Families' and Disabled Person's Tax Credit schemes began in 1999, ended on 6 April 2003 and spent some £17.8 billion. The Department were able only in August 2003 to provide me with the results of their examination of samples of tax credit applications made during part of 2000-01. Error rates were 10-14 per cent by value and the estimated level of overpayment for a full year was between £510 and £710 million.

7. The Department have not undertaken similar exercises for 2001-02 or 2002-03. The Department emphasise that they had incorporated the lessons learned into their design of the new tax credits. For these tax credits the Department must consider undertaking an exercise each year to determine the effectiveness of their controls in detecting error and ensuring that payments are properly calculated to reflect claimants' circumstances.

8. The level of overpayment identified by the Department is cause for serious concern and as a result I have qualified my opinion on the Trust Statement for 2002-03. The improved controls in the new tax credit system should help to reduce overpayments. But the Department are not yet able to assess the likely extent of that reduction.

New Tax Credits

9. New tax credits represented for the Department a major challenge in an area of work which was relatively new to them. The level of the problems caused to tax credit claimants and employers as the systems went live demonstrated that there were undetected gaps in the design of the testing regime for the systems.

10. In July 2003 the Department received from EDS an explanation of the technical problems that had delayed payment to claimants. The results of the audit by independent consultants should enable the Department to check whether there are any other technical issues outstanding so that they can be sure that they have learnt the lessons sufficiently to give assurance that similar problems will not occur as the tax credit systems are expanded.

11. The Department's consideration with EDS of the underlying technical problems had to have regard to the discussions between them about compensation for the unsatisfactory performance of the system, and the possibility of legal action. In November these discussions were continuing and the Department hoped to resolve them shortly. Once they are resolved I shall return to these aspects.

12. The Department must pay particular attention to ensuring that recovery from the problems with the introduction of new tax credits does not undermine their reputation for integrity of processing of taxpayers affairs, which is essential to the effective assessment and collection of tax.

13. In addition to the significant challenges of maintaining day to day running of the system and catching up on backlogs, there are many major issues for the Department in controlling tax credits for 2003-04. These include ensuring that:

- they have a rigorous approach to deciding how many, and which applications are "higher risk" as they require only those applications to be checked against prior-year income records before payment;
- they can manage the risk if claimants delay reporting changes in their circumstances;
- the problems with the start of the new tax credit systems and recovery from that position, have not led to errors in detailed information about claims or payments.

Employer Compliance

14. The Department's employer compliance activities provide assurance that employers are collecting PAYE Income Tax and National Insurance Contributions correctly. These activities are important to the collection of some £155 billion, or 68 per cent of total revenue. The Department have introduced many new initiatives to target more effectively their compliance resources and to help employers. The Department should develop further their methods to measure the impact of their compliance activities, including enabling activities designed to improve employer compliance.

15. Departmental statistics suggest significant geographical variations in employer compliance performance, such as in the percentage of cases where penalties are levied. The rate of penalties levied for large employers have been applied consistently. The Department need to consider ways in which they can monitor and report more effectively on the equity of treatment of smaller employers and consistency of performance. The Department should also continue to consider the overall effectiveness of the penalty regime.

16. Employer Compliance checks on aspects of payroll administration such as tax credits may not be sufficient to provide adequate assurance to the Board and to Parliament on the proper treatment of those items by employers overall. Employer Compliance and tax credit claimant compliance teams, worked separately in 2002-03. Following a National Audit Office suggestion, the Department are to undertake a joint review to consider the opportunities of a more co-ordinated approach to tax credit compliance. They should consider the sufficiency and validity of the current checks and the need for quantifiable assurance on tax credits.

Capital Gains Tax

17. Capital Gains Tax contributed £ 1.6 billion – around one per cent of the total taxes collected by the Inland Revenue in 2002-03. Some 32 per cent of Capital Gains Tax payers provided just one per cent of that collected, whilst one per cent of taxpayers contributed some 34 per cent. Recent initiatives to enhance the effectiveness of the Capital Gains Tax systems include the creation of teams specialising in Complex Personal Returns and, in some geographical areas, small specialist teams. The Department are undertaking internal reviews to improve the information available to management to help them target resources to best effect.

18. The Department are developing their research into areas of non-compliance but do not consider it practicable to measure the tax gap specifically attributable to Capital Gains Tax. Most Capital Gains Tax arises from taxpayers with high net income or high worth and so it is likely that non-compliance on the part of those taxpayers covered by Complex Personal Returns teams would have the biggest impact on the Capital Gains Tax yield. The Department should ensure that their research explores as fully as possible the scope for detecting, estimating and minimising non-compliance with Capital Gains Tax obligations in this particular customer group.