Comptroller and Auditor General's Standard Report on the Accounts of the Inland Revenue 2004-05

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
7 October 2005

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 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 2004-05 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 were being carried out. That overall assurance is subject to reservations about Tax Credits and other matters recorded later. The report also describes observations about management of Corporation Tax by the Large Business Office.

3 The Inland Revenue prepared a Resource Account and a Trust Statement account of taxes and Tax Credits for 2004-05 on an accruals basis, including estimates and forecasts of taxes collectible in respect of 2004-05, as well as amounts collected.

4 I qualified my audit opinion on the Department's Trust Statement for 2002-03 and 2003-04 because of the likely level of claimant error and fraud in respect of Tax Credits. In July 2005 the Department examined a sample of 2003-04 awards and estimated that 3.4% by value of Tax Credits (some £460 million) were overpaid because of applicant error or fraud. This is lower than with previous Tax Credits schemes, in both percentage and absolute terms, but in my view remains unacceptably high. There is no evidence to suggest that the level of error would have fallen significantly from 2003-04 to 2004-05. Consequently I have qualified my audit opinion on the Trust Statement in respect of Tax Credits. I gave an unqualified audit opinion on the Resource Account.

5 I present to Parliament Value for Money reports on the economy, efficiency and effectiveness with which the Department has used its resources. During the past year I have reported on Inheritance Tax (HC 17: 2004-05) and Filing of Income Tax Self Assessment Returns (HC 74: 2005-06).

Accrual accounts and debt management

6 The accounts show income from taxes of some £260.3 billion (net of repayments and from which £13.8 billion of Child and Working Tax Credits were paid) reported on an accrual basis. The balance sheet includes some £57.0 billion of taxes due at 31 March 2005 which consists of enforceable debts of £9.6 billion and £47.4 billion of estimates and forecasts of taxes in respect of 2004-05 that will become enforceable liabilities in due course. This is explained in more detail in my certificate and report on the account at (see pages 66-67).

7 The legally enforceable tax debt of £9.6 billion included some £4.8 billion of PAYE and National Insurance contributions, £2.6 billion of self assessment income tax and £1.7 billion of Corporation Tax. In the year to end

March 2005, the Department wrote off or remitted income tax and corporation tax debts of £818 million and National Insurance contributions of £280 million, mainly resulting from business failure or insolvency.

8 The Department has made good progress on several aspects of debt management in recent years and has important work still to do, including creating a new debt management and banking organisation from the former Inland Revenue and HM Customs & Excise debt arrangements. The new Department would benefit from setting more specific and comprehensive performance indicators for debt management and debt reduction.

PAYE

9 The Department's Internal Audit Office highlighted significant and widespread errors in PAYE. They estimated for the first time that these problems had resulted in around £575 million per annum of tax due not being pursued by the Department; and that taxpayers were not being advised of around £295 million per annum potentially repayable to them. The main cause was the Department's failure to finalise and calculate correctly tax liabilities where people had more than one source of employment income. In the summer of 2005, the Department prepared an action plan to correct these weaknesses over a number of years.

Repayments

10 In 2004-05 the Department issued tax repayments amounting to £13.1 billion, of which £8.7 billion related to Income Tax and £4.0 billion to Corporation Tax. In May 2004, the Department's Repayments Risk Review Group reported serious risks of duplicate repayments, and made recommendations to address the problem. In June 2005 the Department prepared an action plan to implement all the recommendations.

11 The Department recognised that pressure to meet repayment targets might undermine the quality of work and checks undertaken to ensure accuracy and avoidance of error. Deficiencies in management information and lack of formalised, specific accountabilities have made it difficult for the Department to ensure the proper control of repayments and prevent or detect error and irregularities. In response to the NAO's recommendations, the Department made a senior officer accountable for making improvements.

Tax Credits

12 The Department paid £15.8 billion under the new Tax Credits schemes. These schemes represented a major challenge for the Department. Claimants encountered problems as the system went live in April 2003 which continued to have ramifications throughout 2004-05. Tax Credits are a substantial part of the income of the poorest families who receive them. The Department recalculates the value of awards annually, in a process called "renewal", the first of which in 2004-05 identified that one third of recipients of 2003-04 awards had been overpaid a total of some £1.9 billion in 2003-04. Subsequent backdated payments in respect of 2003-04 awards brought the total overpayments for that year to £2.2 billion. This was mainly because family income had increased by more than £2,500 compared with the income declared at the time of the original application for Tax Credits. Half of the total overpayments related to some 283,000 families who had been overpaid by £2,000 or more. Overpayments are recovered where possible from future payments of Tax Credits. The Trust Statement account has provided for £961 million of doubtful debts as at 31 March 2005 in respect of tax credit overpayments. The annual basis of the Tax Credit award means that recipients need to be able to anticipate and plan for the consequences of changes in their income. This is clearly a problem for many families until they become used to the implications of the annual calculation of their entitlement. In May 2005, the Paymaster General announced plans to improve significantly the Tax Credit system.

13 In my last report, I noted that software errors were expected to lead to further write-offs, in addition to the £37 million the Department had calculated and written-off in 2003-04. In 2004-05, the Department calculated that they should write off some £2 million of Tax Credits caused by major software errors in 2003-04 and 2004-05 that together resulted in overpayments of £174 million. The Department also wrote off £33 million in respect of some manual payments made in 2003. By 30 June 2005 the Department had calculated and written off a further £95 million when official error relief had been granted to claimants who disputed the recovery of their overpayment. The Department expect to have further write-offs during 2005-06 in respect of continuing work on 2003-04 and 2004-05 cases.

14 The Department's measures to ensure that Tax Credit applicants complied with their obligations involved routine pre-payment checks on all claims; risk based investigations; verification of childcare expenditure; and investigations of suggestions that organised crime was targeting Tax Credits. The Department will need to maintain compliance work to ensure that confidence in the fairness of the schemes is not undermined by unacceptable levels of unjustified claims.

Large Business Office management of Corporation Tax

15 The Large Business Office (LBO) handled the tax affairs of some 800 large entities and employers which generated some £18.4 billion of tax in 2004-05. The main objectives were to safeguard the flow of revenue from large businesses and employers; enable customers to meet their obligations without unnecessary cost, whilst effectively tackling and deterring non-compliance. The complexity and sophistication of tax management in the large business sectors, including EU and other international dimensions, pose some of the most difficult and potentially costly challenges for the Department, both in terms of administration cost and loss of revenue.

16 The LBO generated an additional tax yield of some £2.1 billion in respect of 2004-05 – primarily from the examination of specific tax issues. Good quality and prompt tax risk assessments are essential to achieving the best deployment of the Department's resources and the most effective compliance effort. For some years the LBO had been developing sector specialist knowledge and structures to improve tax risk identification. The Department recognised that there was significant development work to do before sector based approaches to risk assessment became fully effective. The compilation of data and calculation of financial ratios used in tax risk assessments were largely manual, time consuming and resource intensive, and not eased by the data being supplied by corporate taxpayers mainly in hard copy format rather than electronically.

17 In 2004, the Department launched a project called "Better Data for Corporation Tax". This was intended to achieve a step change in the effectiveness of compliance work through better use of management information to improve the targeting and effectiveness of enquiry work in the LBO. There were also important initiatives in internal quality assurance of Corporation Tax case work, management and structural reorganisations, employment of specialists, and new compliance processes with some customers. These initiatives are continuing within the integration plans for the new Department.

18 The LBO was integrated with the Customs and Excise equivalent in April 2005 to form the Large Business Service of HM Revenue and Customs, with a mission to "make a substantial contribution to financing the UK's future by closing the tax gap". The management by large businesses of their tax affairs will continue to pose a challenge and the Department must continue to modernise its work on Corporation Tax within the large business sectors. The Department must ensure that its various initiatives enable it to match the sophistication of large businesses with equivalent Departmental expertise and methods.

Integration to form the new Department

19 HM Revenue and Customs (HMRC) brought together most of the functions of the Inland Revenue and HM Customs and Excise from 18 April 2005. Integration offers the opportunity for the new Department to adopt a more effective approach to taxpayer compliance across all tax streams. The Department reviewed the effect of the integration on its compliance strategy and sought to develop a better understanding of the tax gap and other measures to help taxpayers comply with their obligations.

20 There are also risks involved in the integration of two large departments, including risks that existing work priorities could be disrupted. The new Department is responsible for a number of the Government's nominated "mission critical" projects and it needs to remain focused on them. These projects are:

- Tax Credits;
- Modernising Stamp Duty;
- Pensions Simplification;
- Modernising PAYE Processes for Customers;
- Mandatory Electronic Payments by certain taxpayers;
- The e-Services Programme;
- Information Centre Programme (including the mission critical project, Better Data for Corporation Tax (see paragraph 3.31 below));
- Reform of the Construction Industry Scheme.

21 The 2004 Spending Review required annual efficiency savings of £507 million by 2007-08, including staff reductions. The combined Department had 98,370 Full time Equivalent staff in post at 1 April 2004 and planned to reduce this by a net 12,500 by 1 April 2008. By July 2005, the Department had identified how the forecast savings would be achieved.

22 It is important that the staff reductions do not adversely affect service provision and the Department's capacity to deliver the new IT systems underpinning intended efficiency gains. The Department has established an Efficiency Programme Board which was tasked with managing these risks and ensuring delivery against targets.

PART ONE

Scope of the audit and significant developments

Audit scope and approach

1.1 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 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 report describes a number of significant developments on Tax Credits and the management of Corporation Tax by the Large Business Office. The results of my work not detailed in this report and suggestions of further improvements in controls have been notified to the Department in management letters.

1.3 The National Audit Office review periodically existing and new systems and significant changes to them, and undertake test examinations of individual transactions and balances as necessary. The audit approach emphasises aspects of the Department's management control over business and tax streams, including accountability; corporate governance procedures; management information; quality assurance procedures; risk analysis; and the Department's identification of obstacles to the assessment and collection of taxes. The National Audit Office also review Departmental progress in response to recommendations arising from my reports and those of the Committee of Public Accounts.

Accrual Accounts and Qualified Audit Opinion

1.4 For 2004-05, the Inland Revenue have presented a Trust Statement account on an accruals basis showing how much had been collected from or paid to individuals, corporate taxpayers and other Government Departments. This account includes estimates and forecasts of taxes collectible in respect of 2004-05, as well as amounts collected.

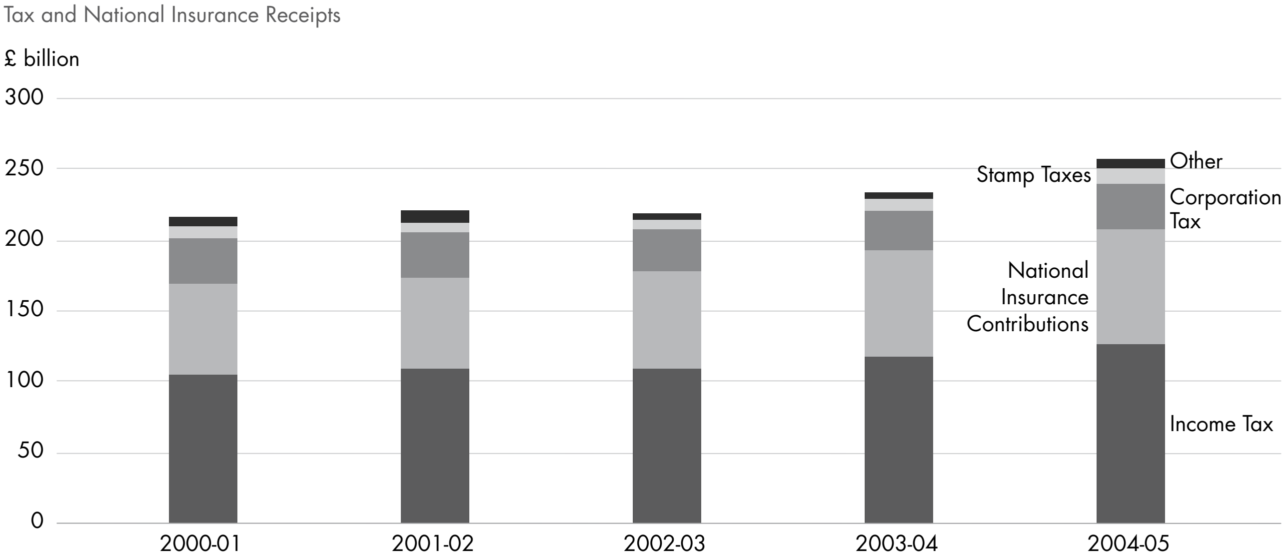
1.5 I qualified my audit opinion on the Trust Statement accounts for 2002-03 and 2003-04 in respect of non-compliance by Tax Credit claimants. I have also qualified my audit opinion in respect of Tax Credits this year, as is discussed in Part 2 of this report.

Taxes and National Insurance collectible and Tax Credits payable

1.6 In 2004-05 the Department collected some £256.9 billion, some 9.6 percent up on the previous year. The main increases were Income Tax and National Insurance (up by £14.4 billion) and Corporation Tax (up by £5.5 billion). **Figures 1 and 2 overleaf** show the trends in collections of recent years.

1.7 Receipts increased across all tax streams in 2004-05. The Department consider that the recent trend of declining corporation tax receipts was reversed largely as a result of better company profitability across most sectors of the economy. Corporation Tax is discussed in more detail in part three of this report.

1 Inland Revenue main Tax and National Insurance Receipts



Source: Inland Revenue accounts 2004-05

2 Tax and National Insurance receipts (net of repayments) and Tax Credit payments

	2001-02 £bn Cash	2002-03 £bn Cash	2003-04 £bn Cash	2004-05 £bn Cash	Net accrual adjustments[1] 2004-05 £bn	2004-05 £bn Accrual[2]
Income Tax (Gross of Tax Credits)	108.7	110.3	118.0	127.3	+3.6	130.9
National Insurance Contributions	65.3	67.4	75.2	80.3	-0.1	80.2
Corporation Tax	32.0	29.1	27.9	33.4	-0.4	33.0
Stamp Taxes	7.0	7.5	7.5	8.9	+0.1	9.0
Inheritance Tax	2.4	2.4	2.5	2.9	+0.1	3.0
Capital Gains Tax	3.0	1.6	2.2	2.3	-	2.3
Petroleum Revenue Tax	1.3	1.0	1.2	1.3	+0.1	1.4
Other	-	-	-	0.5	-	0.5
Total receipts	219.7	219.3	234.5	256.9	+3.4	260.3
Child and Working Tax Credit payments (gross)			-13.5	-15.8	+2.0	13.8

Source: Inland Revenue accounts 2004-05

NOTE

1 Net accrual adjustment is the difference between the accruals at the start and end of the year. The net accrual adjustment is added to the receipt or payment in the year to arrive at the tax or payments due on an accruals basis.

2 Figures as shown in the accruals based trust statement.

1.8 Accruals in the year-end balances mean that revenue of £260.3 billion recognised for 2004-05 is some £3.4 billion higher than would have been the case if net revenue had been recognised on the non accruals accounting basis used in previous years. Note 1 to the Trust Statement account explains the detailed accounting policies applied to the main revenue streams.

Debt and Debt Management

1.9 The amount of tax owed to the Department at the end of 2004-05 was some £9.6 billion including £4.8 billion of PAYE and National Insurance contributions, £2.6 billion self assessed income tax and £1.7 billion Corporation Tax. Around 40 per cent of the total was aged 0-3 months; 20 per cent 4 – 12 months and 40 per cent over 12 months. These figures are not directly comparable with those in the Trust Statement balance sheet as the definition of accruals for that account differs from that for debt management purposes. The Trust Statement is not intended to be used as a measure of debt management. Furthermore, both sets of figures exclude some £20 billion of "standovers". These are estimated liabilities where collection cannot be enforced as they are under appeal by the taxpayer. Much of this amount is likely to be cancelled as not due once relevant enquiries are complete. Any debts that do arise once an appeal has been settled are then enforced. The Department wrote-off tax debts of £818 million (year to March 2005) and £280 million of National Insurance contributions.

1.10 In April 2001 the Department formed the Receivables Management Service to be responsible for collecting debts, receiving and accounting for payments and following up the main areas of outstanding tax returns (PAYE and Self-Assessment). Its objective is to collect tax promptly and to keep debts to a minimum. The Department had different debt management targets to HM Customs and Excise (HMCE). For example HMCE had a target for outstanding debt, whereas the Department measured payment and filing on time and after 12 months. The Department achieved the majority of its published targets for receiving payments and for filing of returns from the different classes of taxpayer in 2004-05. The target for the percentage of self assessment taxpayers who paid by the due date was narrowly missed because the Department's Receivables Telephone Centre was unable to carry out as many telephone reminders as planned because of other business priorities. The Department expects to meet the target for 2005-06.

1.11 The Department uses an automated Integrated Debt Management System to manage the collection and enforcement of debts for Pay As You Earn and Corporation Tax. The system was introduced in November 1999 in response to the 1994 Fundamental Expenditure Review which compared the Department's debt management process with best practice in the private sector. Its objectives are to improve efficiency, reduce costs and tax arrears and to increase tax flow. The Department planned to extend the system to include Income Tax Self Assessment in 2005.

1.12 The Department had concerns about some aspects of the National Insurance contributions registered as due within the National Insurance recording system, which was historically separate from the Department. The National Insurance debt arrangements are not fully integrated into the Department's systems. The debt recorded stood at £1.24 billion at the end of 2004-05 including £616 million over 6 years old which the Department could no longer collect. However the Department had doubts about the reliability of these records. Following investigation of a sample of records, the Department concluded that it was appropriate to remove £283 million of National Insurance contributions erroneously recorded as due and wrote off the balance of £333 million as time-barred debt. The Department has set up a working group to improve the future management of National Insurance debt.

1.13 The Department has taken a number of steps to improve debt management in recent years, including developing management information about the debts. The Department monitors collectible debt balances, age profiles of debts, statistics on total debt and debt for each tax stream, performance against targets, risks and challenges for the future. Where possible debt management is automated to help ensure efficient and consistent treatment. However, the Department is aware of the need for more robust analysis of debt by customer, business area and type, and the need to improve its ability to identify high risk taxpayers and behaviours so as to target resources and attention most effectively.

1.14 In 2003, the Department started work on a Debt Analysis Matrix that it saw as a major information tool to improve business performance and help reduce debt. It is intended to enable management to address bottlenecks or delays in internal processes, to inform policy decisions about the effect of tax regimes on levels of debt and to contribute to the information needed for tax accrual and debtor accounts. The Department expect to develop the Matrix further.

HM Revenue and Customs

1.15 In July 2003, the Chancellor of the Exchequer announced a major review of the organisations dealing with tax policy and administration. The review led by Gus O'Donnell reported in March 2004 and recommended that a new Department should be created. HM Revenue and Customs (HMRC) was established in April 2005 by the Commissioners for Revenue and Customs Act which brought together most of the functions of the Inland Revenue and HM Customs and Excise.

1.16 Good governance is vital for any organisation, particularly one as complex and wide ranging as HMRC. A group of Commissioners has statutory responsibility and authority for running the new organisation. They have created a departmental Board, including several non-Executive Directors, responsible for strategic oversight and providing advice. They are also supported by a number of Committees, of which the Executive Committee, chaired by the Chairman of HMRC, is responsible for strategy and driving performance across the business. Other top-level groups include an Operating Committee and an Audit Committee comprised of and chaired by Non-Executives. Core management processes include an annual planning and performance management cycle, with an important feature being a quarterly Chairman's review of each of HMRC's 36 business units.

1.17 Efficient and effective Information Technology (IT) is essential to the administration of taxes. In October 2004, the Department made a new Board-level post of Chief Information Officer (CIO). The departmental integration offered the opportunity of improving the service IT provided. The CIO's unit has taken a more active role in identifying and pursuing business opportunities, with a more customer-focused approach. In bringing the IT together, the Department is undertaking an on-going programme of health checks of the IT systems and the NAO will monitor the resulting changes.

1.18 Integration offers the new Department the opportunity to adopt a more effective approach to taxpayer compliance across all tax streams. The Department reviewed the implications of the integration for its compliance strategy and the tax gap.

1.19 There are also risks involved in the integration of two large departments. The Department set up a Change Management Centre to oversee the changes, provide information and make recommendations on risks posed by the Department's capacity to deal with the number of planned changes. There were risks that existing priorities could be disrupted. The new Department is responsible for a number of the Government's nominated "mission critical" projects and it needs to remain focused on them. The projects are:

- Tax Credits
- Modernising Stamp Duty
- Pensions Simplification
- Modernising PAYE Processes for Customers
- Mandatory Electronic Payments by certain taxpayers
- The e-Services Programme
- Information Centre Programme (which includes the mission critical project, Better Data for Corporation Tax)
- Reform of the Construction Industry Scheme.

Corporate Social Responsibility

1.20 Corporate Social Responsibility (CSR) involves doing business in a responsible way to improve the positive impact on society and the environment. The most widely used and recognised benchmarking tool for CSR is Business in the Community's Corporate Responsibility Index (CRI). The CRI rigorously and independently assesses how effective a business has been in translating its CSR agenda into responsible business practice.
In November 2004 the Inland Revenue became the first government department to complete BitC's Corporate Responsibility Index (CRI). They also achieved the 'Big Tick' standard for each of their entries into the 2004 Awards for Excellence.

1.21 CSR will also be an important part of how HMRC does business. Building on the work of the Inland Revenue and HM Customs and Excise, HMRC will give high level leadership for CSR via a CSR Steering Group chaired at Board level, through to senior managers with key CSR responsibilities. With measurable targets and clear accountability at senior level, HMRC will ensure that CSR activities remain focused on supporting the new Department's objectives. Examples of this include:

- working with schools and homelessness agencies to help people become employable and employed, through mentoring, interview coaching and CV assistance;
- working with drug rehabilitation organisations to help educate against drug use, to protect future vulnerable members of society and contribute to the improvement of frontiers work; and
- enabling HMRC staff to undertake volunteering or personal development community activities amongst socially excluded community groups so staff better understand customers' needs, resulting in improved customer service, improved customer perception of the Department and ensuring HMRC is seen as an employer of choice amongst those groups.

Sustainable Development

1.22 As part of its response to the Government's Sustainable Development objectives, the Department developed a strategy, a policy statement and various initiatives. It published on the Department's web site *(www.hmrc.gov.uk/about/sd-report-2002-2004.pdf)* its Sustainable Development Report for 2002 to 2004 recording achievements and performance against objectives and targets. The Department emphasised the significance of its policy initiatives that affect tax payers, such as enhanced tax allowances for water-efficient technologies. The report highlighted the need to work closely with the PFI partners who operate the Department's estate, as many of the objectives such as energy efficiency and water consumption relate to the Department's use of office space. The report also highlighted that detailed data on utilities consumed needs to be improved to facilitate targeted action to improve performance. The Department is working closely on integrating arrangements across the new combined Department, and aims to publish its next report on performance in the spring of 2006.

Efficiency Savings

1.23 The 2004 Spending Review required HMRC to achieve staff reductions and annual efficiency savings of £507 million by 2007-08, out of an annual budget of about £4.6 billion. The Department had 98,370 Full time Equivalent (FTE) staff in post at 1 April 2004 and planned to reduce this by a net 12,500 FTE posts by 1 April 2008.

1.24 By July 2005, the Department had identified how the forecast savings would be achieved through:

- Investment in Information and Communication Technology;
- Reform of back office functions;
- Savings in procurement of goods and services; and
- Improvements in productive time.

1.25 A significant challenge for the Department was to establish effective governance and monitoring arrangements to ensure the savings do not adversely affect service provision or the new IT systems underpinning intended efficiency gains. The Department established an Efficiency Programme Board to manage these risks and meet targets. The Office of Government Commerce concluded that achieving the Department's efficiency savings posed a very high but achievable challenge.

Public Service Agreements

1.26 Public Service Agreements (PSAs) and associated performance targets, are at the centre of the Government's and the Department's performance management systems. PSAs include three year targets, negotiated every two years with the Treasury during the spending review process. The objectives set by the Spending Review 2004 were:

- Improve the extent to which individuals and businesses pay the amount of tax due and receive the credits and payments to which they are entitled;
- Improve customer experience, support business and reduce the compliance burden;
- Strengthen frontier protection against threats to the security, social and economic integrity and environment of the United Kingdom in a way that balances the need to maintain the UK as a competitive location in which to do business.

1.27 Good quality data are crucial for effective targets and performance measures and accountability. An NAO review in 2004-05 of the Inland Revenue's relevant data systems found that risk management tends to focus on risks to business delivery rather than risks to the quality of the underlying data. The Department acknowledged the need to improve its approach to data system risks and subsequently focused on this through the Performance and Management Information programme, which with its Customs' counterpart, is now the HMRC Information Centre programme. This introduced a clear framework for accountability and the use of data to plan, manage and improve performance through the PSA and Cost and Resource Information project.

1.28 The Department targets and reviews systematically the quality of processes within its Tax Enquiry programme. The Department failed to meet the target for the percentage of cases reaching a satisfactory standard in 2004-05. The main reason was delays in dealing timeously with correspondence from taxpayers and failure to effectively address delays by taxpayers in producing required information. Over recent years the Department has introduced a quality improvement process and assurance programme to better understand and deal with the issues. In 2004-05 it instigated a training programme to focus on quality improvement. The Department considered that the results of these initiatives should result in quality improvements over the next few years.

Reform of the Construction Industry Scheme

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

1.30 This Scheme has suffered from problems since its introduction and businesses are concerned about the costs to them of operating it. In 2000-01, the Department began preparations for introducing a new Scheme designed to:

- Reduce the regulatory burden of the Scheme on construction businesses;
- Improve the level of compliance by construction businesses with their tax obligations;
- Help construction businesses to get the employment status of their workers right.

1.31 In my report on the Inland Revenue accounts last year, I noted that the Scheme was to be introduced in April 2006, a year later than originally planned. There is a tight timetable for the introduction of the IT systems needed to support the new Scheme and the Department have tried to take on board the lessons of Tax Credits in managing this risk.

Pay As You Earn

1.32 A major programme of work by the Department's Internal Audit Office on the operation of the current PAYE businesses highlighted significant and widespread error. The Department knew of many of the underlying symptoms but for the first time the financial implications were quantified. Internal Audit estimated that around £575 million per annum of tax due had not been pursued by the Department; and that taxpayers were not being advised of around £295 million per annum potentially repayable. Internal Audit have calculated that this could mean that 3.8 million taxpayers have paid too much or too little tax. They considered it highly likely that there was additional tax at risk that had not been identified.

1.33 The main cause of the under - and over -payments was the Department's failure to finalise and calculate correctly tax liabilities where people had more than one source of employment income. There is no single PAYE account for individual taxpayers who have more than one job and inadequate end of year reconciliations. Different systems in place and a lack of communication between those systems means that the Department did not have a whole customer view. Other weaknesses identified included:

i Lack of flexibility to move work to where operational capacity is best placed to take action.

ii Inadequate Management Information Systems to help managers risk-assess operations and control PAYE business to best effect.

iii Poor quality data throughout the system, inadequate controls, and inconsistent approaches.

iv High volumes of paperwork, which have led to difficulties in managing and monitoring work volumes, backlogs of work, progress made and impacts of work done and work not completed.

v Department not pursuing some PAYE revenue due from an individual whilst pursuing Tax Credits recoveries.

vi The possibility that some Tax Credit recipients are asked to refund overpayments at the same time as the Department retained PAYE refunds due.

vii Failures to effectively address employers' non compliance with their obligations.

1.34 The Department undertook to carry out "Health Checks" across PAYE, leading to a full risk assessment and completion in the summer of 2005 of an Action Plan for recovery. The Department recognised that remedial action requiring major structural change can only be delivered over the longer term.

Modernising PAYE Processes for Customers

1.35 In April 2002, the Government announced that it would implement the recommendations of Patrick Carter's Review of Payroll Services. Regulations, laid in 2003, came into force in April 2005 to mandate online filing of large and medium employers' end of year returns and to encourage voluntary on line filing by small employers. The Department established in early 2003 a Modernising PAYE Processes for Customers (MPPC) Programme to deliver the new business processes, IT infrastructure and support for employers to give effect to those regulations.

1.36 Over the period to 2007-08, the Department also plans to modernise other elements of the PAYE processes and introduce a more flexible computer platform for PAYE. The intention is to achieve significant efficiency savings, improve customer service in PAYE for both employers and employees, simplify compliance for small business and encourage use of online services. One important element is a planned single customer view for all sources of employment income. The Department expects this to help address many of the issues identified in paragraph 1.33. The scope of the project was reduced in the summer of 2005, thus limiting one of the major benefits originally expected – a major increase in the extent of automatic reconciliation and clearance of customer records after the end of the tax year.

Spend to Save

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

1.38 In my report on the 2003 package of measures (HC 627, Session 2002-2003), I noted the importance of detailed arrangements being put in place to monitor and evaluate the measures. During 2004-05, the NAO noted that there had been earlier delays in introducing comprehensive central monitoring procedures over this package of measures. The Department made improvements towards the end of 2004, which helped to identify areas where remedial action was needed.

Tax Repayments

1.39 In 2004-05 the Department repaid £13.1 billion of tax, including £8.7 billion Income Tax and £4.0 billion Corporation Tax. Repayments are generated and authorised by seven systems that assess and record the tax affairs of individuals and companies. Claims are dealt with on a "process now, check later" basis and payment instructions sent to a centralised system that makes the payment to taxpayers. No individual in the Department had overall responsibility for repayments and no individual was specifically responsible for repayments under each tax stream. The Department has two Public Service Agreement (PSA) targets for Repayments: 97 per cent dealt with within 15 working days; and 97 per cent calculated correctly by specialist repayment offices. In 2004-05 the Department achieved 99.5 per cent on the former and 98.1 per cent on the latter.

1.40 In May 2004 the Department's Repayments Risk Review Group reported serious risks including duplicate repayments and it commented on the paucity of reliable management information about repayments. It made a number of fundamental recommendations, some of which it took forward. Following the NAO review, the Department prepared an action plan in the summer of 2005 covering all of the recommendations.

1.41 The Department's centralised repayments system is old and has certain problems which the Department planned to address by replacing the system. The planned replacement, the Payments Made Framework (PMF), was used for Tax Credits. As at 30 June 2005 the Department had no plans to move repayments to PMF and no timetable had been set for replacement of the old system.

1.42 In 2004-05, the Department undertook a review of the effectiveness of the routine anti-fraud checks on repayments and considered centralising the work to improve the quality of those checks. The Department planned to undertake in the Autumn of 2005 a feasibility study of enhanced risk profiling of repayment fraud using data from different HMRC systems.

1.43 The Department recognises the danger that pressure to meet repayment targets might undermine the quality of work and checks to ensure accuracy and avoid error. The deficiencies in management information and lack of formalised, specific accountabilities made it difficult for the Department to ensure the proper control of repayments and to prevent or detect error and irregularities. In response to the NAO's audit recommendations, the Department made a senior officer accountabable for making improvements.

Conclusion

1.44 The accounts show income from taxes of some £260.3 billion (net of repayments and from which £13.8 billion of child and working Tax Credits were paid) reported on an accrual basis. The balance sheet includes some £57 billion of taxes and National Insurance contributions due at 31 March 2005. This figure is a combination of estimates and forecasts of taxes that will become enforceable liabilities in due course in respect of 2004-05 and so it does not represent the legally enforceable debt as at 31 March 2005 . This is explained in more detail in my certificate and report on the account (see pages 66-67).

1.45 Legally enforceable tax debt at the end of 2004-05 was some £9.6 billion, including some £4.8 billion of PAYE and National Insurance contributions, £2.6 billion of self assessment income tax and £1.7 billion of Corporation Tax. The Department wrote off or remitted income tax and corporation tax debts of £818 million and £280 million of National Insurance contributions in the year to end March 2005, mainly resulting from business failure or insolvency.

1.46 The Department has made good progress on several aspects of debt management in recent years and has important work still to do, including creating a new debt management and banking organisation from the former Inland Revenue and HM Customs & Excise debt arrangements. The new Department would benefit from setting specific and comprehensive performance indicators for debt management and debt reduction.

1.47 The Department's Internal Audit Office highlighted significant and widespread errors in PAYE. They estimated for the first time that these problems had resulted in around £575 million per annum of tax due not being pursued by the Department; and that taxpayers were not being advised of around £295 million per annum potentially repayable to them. The main cause was the Department's failure to finalise and calculate tax liabilities correctly where people had more than one source of employment income. In the summer of 2005, the Department defined an action plan to correct these weaknesses over a number of years.

1.48 In 2004-05 the Department issued tax repayments amounting to £13.1 billion, of which £8.7 billion related to Income Tax and £4.0 billion to Corporation Tax. In May 2004, the Department's Repayments Risk Review Group reported serious risks of duplicate repayments, and made recommendations to address the problem. In the summer of 2005 the Department prepared an action plan to implement all the recommendations over a number of years.

1.49 The Department recognised that pressure to meet repayment targets might undermine the quality of work and checks undertaken to ensure accuracy and avoidance of error. Deficiencies in management information and lack of formalised, specific accountabilities have made it difficult for the Department to ensure the proper control of repayments and prevent or detect error and irregularities. In response to the NAO's recommendations, the Department made a senior officer accountable for making improvements.

PART TWO
Child and Working Tax Credits

Introduction

2.1 In April 2003 the Government replaced Working Families Tax Credit and Disabled Person's Tax Credit with Child Tax Credit and Working Tax Credit (Tax Credits). These changes were part of the reforms of the tax and benefit systems aimed at relieving child and in-work poverty. My Standard Reports for 2002-03 and 2003-04 recorded serious problems during the introduction of the new Tax Credits. These included delays in making awards to claimants, overpayments, software errors and the failure of essential controls. This part of my report examines the Department's progress in recovering from these problems and completion of the Department's first annual renewal of Tax Credit claims in 2004.

2.2 At the time of my reports for 2002-03 and 2003-04 it had not been possible for the Department to determine a robust estimate of the level of claimant error and fraud for the new Tax Credits. A Departmental exercise in 2000-01 indicated that they had overpaid some 10 to 14 per cent by value of the former tax credits because of claimant error or fraud. Whilst the design of the new Tax Credits and supporting systems are very different from the former Tax Credits and should have reduced the risk of error and fraud, the Department had no evidence that error rates had in fact fallen. I therefore qualified my audit opinion on the Trust Statement accounts for 2002-03 and 2003-04.

2.3 In my report for 2003-04, I noted that the Department planned to undertake work to provide more information on the level of fraud and error. This examination involves a full check of 4,700 randomly selected claimants. This exercise is not due to be completed until Spring 2006. In July 2005 the Department produced interim findings which indicated that it had overpaid £460 million (around 3.4 per cent by value) because of claimant error and fraud in 2003-04. The Department believes that these interim results are subject to a wide margin of error because they are based on work that had been completed by May 2005 and it is likely that these cases were more compliant. The final results are likely to show an increase in the proportion of cases involving claimant fraud and error. Whilst this work suggests that the level of error is lower than with the previous Tax Credits, it remained in my view unacceptably high in both the amount and percentage terms. There is no evidence to suggest that the level of error would have fallen significantly from 2003-04 to 2004-05. Consequently, I have qualified my audit opinion on the 2004-05 Trust Statement account in respect of Tax Credits.

2.4 This part of my report provides an overview of the main features of child and working tax credit and discusses the overpayments that have arisen from the nature of the schemes.

2.5 The main features of the Child and Working Tax Credit are set out in **Figures 3 and 4**.

2.6 The Department paid £15.8 billion in Tax Credits to 5 million families during 2004-05. **Figure 5** provides further details on the cost of Tax Credits and the number of families benefiting from Tax Credits.

3 Main Features of Child Tax Credit

Child Tax Credit

Available to those aged 16 or over, ordinarily resident and present in the UK whether working or not, and who are responsible for at least one child. Normally paid directly into the bank account of the main carer.

Elements	2004-2005 Annual Rates	2005-2006 Annual Rates
Family Element (one per family)	£545	£545
Higher Family Element (in first year of child's life)	£545	£545
Child Element (for each child)	£1,625	£1,690
Disability Element (for each disabled child)	£2,215	£2,285
Severe Disability Element (for each severely disabled child)	£890	£920

Source: National Audit Office

NOTE

The Family Element is reduced by 6.67p for every £1 of income over £50,000, in most cases. For families entitled to Child Tax Credit but not Working Tax Credit, the Child Element is reduced by 37p for every £1 of income over a limit of £13,480 (£13,910 for 2005-06). For families entitled to both Child Tax Credit and Working Tax Credit, the child element is reduced in the same way after Working Tax Credit, including any childcare element, has been fully withdrawn.

4 Main Features of Working Tax Credit

Working Tax Credit

Available to people aged 16 or over, working at least 16 hours per week, with dependent children or a disability or, for those without children or a disability, aged 25 years or over and working at least 30 hours per week.

Elements	2004-2005 Annual Rates	2005-2006 Annual Rates
Basic Element	£1,570	£1,620
Second adult and Lone Parent Element	£1,545	£1,595
30 Hour Element	£640	£660
Disabled Worker Element	£2,100	£2,165
Severe Disability Element	£890	£920
Element for claimants aged 50 and above, working 16-29 Hours	£1,075	£1,110
Element for claimants aged 50 and above, working 30+ Hours	£1,610	£1,660
Childcare Element - childcare costs cannot exceed £135 per week for one child and £200 per week for two or more children	70 % of costs	70 % of costs

Source: National Audit Office

NOTE

An award is reduced by 37p for every £1 of annual income over a limit of £5,060 (£5,220 2005-06).

5 Scheme Overview

Child and Working Tax Credits paid by the Inland Revenue

		2003-2004	2004-2005 (provisional)
Families benefiting[1]:		4.6 million	5.0 million
Of which	Child Tax Credit[2]	4.4 million	4.8 million
	Working Tax Credit	1.6 million	1.8 million
Amount paid by Inland Revenue		£13.5 billion	£15.8 billion
Administrative cost to Inland Revenue		£406 million	£422 million
Staff employed by Inland Revenue		7,300	8,200

Source: HMRC

NOTES

1 Figures represent the average number of families benefiting in the year. Some families benefit from both Child and Working Tax Credits

2 From April 2004, families claiming Income Support and Job Seeker's Allowance for the first time began to receive Child Tax Credit instead of receiving the child premia in their benefits.

2.7 Child Tax Credit and the childcare element of Working Tax Credit are generally paid directly into claimants' bank accounts. Where the claimant was an employee, the elements of Working Tax Credit apart from childcare were paid via the employer. Payment via employer will be phased out between November 2005 and April 2006 and replaced by direct payment by the Department.

2.8 Tax Credit awards were initially based on the claimant's income for the preceding tax year. Claimants were encouraged, but not formally required, to advise the Department of income changes during the year. The Department considered the need to revise awards during the year, if claimants reported changes in their income or circumstances. Awards were revised where claimants' incomes increased by over £2,500 and the Department sought recovery of the resulting overpayments.

Award renewal, overpayment and recovery

2.9 In the six months after the end of the tax year, in a process termed "Renewal", the Department asked claimants to confirm their circumstances, including their actual income for that year ended, and where there had been changes the Department recalculated the award. Underpayments were paid as a lump sum, and overpayments recovered, where possible, from future payments of Tax Credits over the rest of the year or longer periods, or otherwise directly from claimants.

2.10 The Department published statistics on finalised 2003-04 awards on its website on 1 June 2005 which showed that 5.67 million awards had been made in the year. The renewals process during 2004-05 resulted in no further changes to entitlement for some 3.08 million families. This was mainly where annual incomes had increased by less than £2,500 (increases below this amount are disregarded) or because claimants had reported changes in time for the Department to fully adjust payments in year. The Department estimated that the final entitlement to Tax Credits in 2003-04 would have been about £800 million lower without the £2,500 'disregard'. In 2003-04 some 1.88 million families had been overpaid a total of £1.93 billion (average just over £1,000), and 0.71 million families had been underpaid by £464 million (average £650). Half of the total amount overpaid represented cases overpaid £2,000 or more, affecting some 283,000 families. **Figure 6** shows the distribution of these underpayments and overpayments.

2.11 Tax Credit payments can be backdated and some 2003-04 awards were paid in 2004-05 creating further overpayments. The Department estimated that the total overpayment of 2003-04 awards was therefore £2.2 billion. Some £391 million was recovered in 2004-05 either directly from claimants or through adjustments to Tax Credit payments in the later part of the year. The Department also wrote off some £95 million of overpayments. It further considered that some £481 million to be irrecoverable because claimants successfully contended that they could not repay because

6 Finalised 2003-04 awards underpaid or overpaid (Excluding awards with underpayments or overpayments under £10)

Band of underpayment or overpayment	Underpaid awards (thousands)	Underpayment at 5 April 2004 (£ millions)	Overpaid awards (thousands)	Overpayment at 5 April 2004 (£ million)
Up to £50	82	2	134	4
£50 to £100	81	6	121	9
£100 to £200	111	16	193	28
£200 to £500	170	56	414	141
£500 to £1,000	124	88	388	280
£1,000 to £2,000	92	129	347	493
£2,000 to £5,000	47	136	243	725
Over £5,000	5	29	40	252
Total	**713**	**464**	**1,879**	**1,931**

Source: HMRC (Figures may not sum due to rounding.)

of hardship, or because the Department had difficulty in tracing claimants no longer entitled to receive Tax Credits. To prevent hardship to claimants, recovery of amounts overpaid can take place over several years. Full recovery of the remaining 2003-04 overpayments is expected to take at least 5 years as shown in **Figure 7**.

7 Expected year of recovery of 2003-04 award overpayments outstanding at April 2005

	£ billion
Total overpayment for recovery	**1.3**
Expected recovery:	
2005-06	0.5
2006-07	0.4
2007-08	0.1
2008-09	0.1
Later	0.2

Source: HMRC

2.12 The Department expects the amounts needing to be recovered to grow over the next few years, as a result of overpayments for further cycles. The Department does not ask claimants to pay off overpayments in a lump sum if they are continuing to receive Tax Credit payments.

2.13 The Department estimated in July 2005 that overpayments for 2004-05 awards were likely to be similar to those for 2003-04 and the Trust Statement account includes a provision of £480 million in respect of 2004-05 awards. The number of households overpaid was much higher than the government's estimates when the schemes were designed. The Department considered that this was because the original assumptions overestimated the number of claimants who would report income changes during the year and also underestimated the growth in claimant incomes.

The operation of Tax Credits

2.14 This section of my report looks at:

- Tax Credit targets;
- controls over payments;
- errors due to software problems and writes-off;
- complaints; and
- improving claimants compliance and customer service.

Tax Credit targets

2.15 The Department checks the accuracy of the processing of claims including changes in circumstances and renewals. Its Public Service Agreement includes a target accuracy of 90% for processing. **Figure 8** shows that the accuracy of processing improved in 2004-05 and the 90% target was exceeded. The significant improvement over 2003-04 reflects continuing efforts by the Department to identify reasons for inaccuracy and to introduce new procedures to prevent error.

8 Accuracy of processing and calculating awards

	2001-02 %	2002-03 %	2003-04 %	2004-05 %
Target Accuracy	92.0	93.0	90.0	90.0
Tax Credits	Scheme not in existence		78.6	96.5
Working Families Tax Credit	87.1	85.2	Scheme not in existence	
Disabled Persons Tax Credit	95.0	90.9	Scheme not in existence	

Source: HMRC

2.16 The Department's research indicated that inaccuracy was mainly due to:

- inputting of income from wrong financial year;
- inputting of incorrect income; and/or
- omission of a partner's income, when claimant notified a change in their own income.

2.17 The Department's Internal Audit Office reported in February 2005 that Tax Credit system controls were not sufficient to give assurance that data were being accurately amended and that all changes were legitimate. The Department accepted all the recommendations in the report and implemented an improvement plan in March 2005, including improved controls, additional supervisory checks and additional training.

Controls over payments

2.18 In my last report, I noted that the Department had not been able to perform the planned daily reconciliation of payments authorised with payments made. Delays in completing these reconciliations meant that some incorrect payments to claimants were not promptly detected. The delays could also have contributed to poor customer service as departmental staff may not have had a complete record of all payments made when dealing with some queries. Checking of payments authorised against payments made in respect of 2003-04 was completed in January 2005 and resulted in adjustments to some claimant records. Work on 2004-05 payments was completed in May 2005. The Department adjusts the record of payments authorised so as to match the details provided on bank statements. The Department plans to introduce a fully automated daily check of payments authorised against payments made in the second half of 2005-06. This will eliminate the need for significant work in retrospective checks.

2.19 The Department also had difficulty in reconciling its own record of payments issued with those cleared through the banks. This reconciliation is complicated by the need to take into account some 400,000 payments in respect of both 2003-04 and 2004-05 which had not been allocated to claimants' accounts at the end of 2004-05.

2.20 The amount of Tax Credit expenditure paid via employers shown in the Trust Statement Account is based on awards made by the Department. It could only know that these amounts were actually paid to claimants by checking against the instructions issued by the Department to employers. The Department sought to obtain assurance by reconciling a sample of amounts reported as paid by employers to the Departmental record of awards.

2.21 The 2003-04 reconciliation exercise was completed in February 2005 and the reconciliation rate was 78.9 per cent; the Department was unable to reconcile the remaining 21.1 per cent. The Department required employers to correct awards where errors were found. The exercise indicated that, of the total £2 billion paid out by employers, there was a likely net overpayment of £20 million (within an estimated net range of £11 million underpaid to £51 million overpaid). Given that this was the first reconciliation exercise for the new Tax Credits and that this was the first year employers had operated the new scheme, the Department believed the result of the exercise to be reasonable. The 2004-05 reconciliations were in progress at the time of this report.

Errors and writes-off

2.22 The 2004-05 Trust Statement account shows that the Department wrote off £123 million and made provision of £ 961 million for future writes-off. Further writes-off may be recorded in the accounts for 2005-06.

2.23 In my 2003-04 report I noted that certain software errors had resulted in overpayments calculated as £94 million in 2003-04 of which the Department had written-off overpayments of less than £300 totaling some £37million. I also noted that the Department expected further write-offs in respect of the balance of £57 million. In addition, the Department calculated and wrote off other overpayments of some £2 million that it considered had been caused by software errors.

2.24 The Department calculated that the software errors referred to in the previous paragraph resulted in further incorrect payments in 2004-05 of £7.9 million. Various other incorrect payments have also resulted from other system miscalculations. The Department aims to recover as many of these incorrect payments as it can in accordance with its usual policies. The Department continued in 2004-05 to investigate the reasons for these incorrect payments with a view to correcting any software errors.

2.25 Further software and other errors, mainly omitting the income of one partner from joint claims led to overpayments of around £80m during 2003-04 and 2004-05 and affected 88,000 households. The largest individual overpayment was over £20,000. The Department is attempting to recover all of these overpayments.

2.26 The unexpected problems at the time of the introduction of Tax Credits in 2003 caused the Department to issue 500,000 manual cheque payments totalling £170 million, with the supporting documentation being inadequately completed in some cases. In 2004-05, the Department wrote-off £33 million because the records were not good enough to cost-effectively match them to claimants.

2.27 There was some particular disruption due to software failings that meant the Department could not access and set up awards or make automated payments. This resulted in temporary manual payments until the claimants' records were reinstated. This time-consuming process affected approximately 35,000 records. The Department has made system changes to reduce this problem.

Complaints

2.28 The Department's Tax Credit Office received complaints in around 51,000 cases in 2004-05 and had difficulties managing this workload. This had a detrimental effect on its aim to deal with 80 per cent of correspondence within 15 working days of receipt, which it was unable to meet. The level of complaints was far higher than in any other area of the Department's work. This required increased staffing from around 200 in April 2004 to a peak of around 400 staff in April 2005.

2.29 The Department recorded conversations between claimants and Call Centre advisers. Those recordings can be used to assist in the resolution of subsequent complaints. However, in some cases, the Department could not retrieve the recording due to limits in retrieval capacity and difficulty in tracing the call on the tapes. The Department decided to purchase a new digital recording system to facilitate faster call retrieval in greater volumes and it planned to enhance storage capacity.

2.30 The Department's policy is that the claimant should not have to repay back all or part of an overpayment due to a mistake by the Department and if it was reasonable for the claimant to think the award was right. This is termed "Official Error Relief". In 2004-05 the Department received around 217,000 disputes against the recovery of overpayments. The Department faced severe difficulties in managing this level of work and introduced streamlined procedures from April 2005 for dealing with Official Error Relief. These procedures were likely to be more generous to claimants in many situations and at that time the Department estimated that the new procedures were likely to result in a net loss of £46.5 million. This was a departure from the criterion the Department previously applied that procedures resulting in a loss to the Exchequer can only be justified if there is a greater saving in administrative cost. But the Department could see no other way to manage the problem within the resources available.

2.31 **Figure 9** shows the number of cases in which complaints were received in 2004-05 and the amount of compensation paid. The Department paid compensation to complainants in accordance with its published Code of Practice 1, *Putting things right*, for the costs they incurred as a direct result of the Department's mistakes or delays and for the worry or distress caused. Payments for worry and distress are not intended to put a value on the upset caused but acknowledge that the Department was responsible.

9 Complaints and compensation

	Year to March 2005
Cases in which complaints received	51,000
Dealt with on first contact from claimant	92%
Number of compensation payments made	20,000
Compensation paid	£1.24 million
Average compensation	£62

Source: HMRC

2.32 Under the Department's Code of Practice, compensation payments for worry and distress usually range from £25 to £500, but are usually below £100. The Department trained its complaint handlers to make decisions on compensation in accordance with its policy. All compensation recommendations were reviewed by a more senior person to ensure consistency. Around 5 per cent of customers compensated have complained about the level of compensation, which the Department considered to be reasonable.

2.33 The Department's decisions on complaints and compensation decisions are final, although if claimants are unhappy with the decision they could ask the Department to review their case again. There is no right of appeal to an independent body specifically dealing with Tax Credits, but if claimants are unhappy with the way the Department handle their complaint or request for compensation, they can ask the Adjudicator to review their case or contact their MP. Claimants can also refer their case to the Parliamentary and Health Service Ombudsman (the Ombudsman).

2.34 The Adjudicator is an independent body which considers routinely whether or not HMRC has applied its discretion appropriately when investigating cases of complaints and redress. The Adjudicator has found in the claimants favour in 86 per cent of the Tax Credit investigations completed. Many of these complaints concerned the Department's handling of overpayments arising from an Inland Revenue mistake. In June 2005, the Adjudicator reported that common themes in these investigations included:

- Conflicting information on award notices, which makes it virtually impossible for claimants to understand what they are due;
- Difficulties faced in contacting the Tax Credit Helpline and instances where incorrect advice was given;
- Failure by the Department to update claimants' records;
- Delays in claimants receiving their correct entitlement;
- Payments made to the wrong bank account.

2.35 Citizens Advice Bureaux (CAB) dealt with 144,000 Tax Credit enquiries in 2003-04 and 151,000 in 2004-05, the two most frequent issues reported being poor administration by the Inland Revenue and the recovery of overpayments. In June 2005, the CAB comprehensively reported many cases where claimants had faced problems with Tax Credits. The CAB commented that the complexity of Tax Credits made it difficult for claimants to understand and that substantial levels of error have diminished confidence in Tax Credits. The Department has a dedicated helpline for intermediaries such as CAB which provides priority access to advice and case information. The introduction of a system with a provisional annual award was a culture change for many claimants who were used to budgeting and receiving benefits on a weekly basis. The system does not guarantee a weekly income and in some of the CAB cases in 2004-05 claimants saw their payments cut with no advanced warning as they were found to have been overpaid for earlier months.

2.36 Members of Parliament too received a large volume of complaints from constituents and the Department has a dedicated telephone helpline to answer their questions on behalf of constituents.

2.37 The Ombudsman received many complaints from Members of Parliament on behalf of claimants and upheld 79 per cent of these. In June 2005, the Ombudsman issued a special report on the administration of Tax Credits. This report commented that the introduction of Tax Credits had been broadly successful, but concluded that the delivery of Tax Credits does not take proper account of the needs of some of the poorest customers. It noted that Tax Credits had brought the Department a new customer group which has created fresh challenges which it has yet to meet. Disputes about the recovery of overpayments after the year end and excess payments in-year were a dominant issue in the cases referred to the Ombudsman. Several of the report's recommendations related to how the Inland Revenue sought to recover such overpayments and notified families of the process by which they could challenge recovery. The Ombudsman also highlighted several other problems with the way in which the Tax Credits system was delivered, including:

- Poor information on - and multiple versions of - award notices, which make it difficult if not impossible for claimants to work out their entitlement;
- poor communication with claimants;
- continuing problems faced by claimants in contacting the Department, including the Tax Credits Helpline; and
- delays in dealing with appeals and complaints.

2.38 On 22 June 2005 the Prime Minister told Parliament that the Government apologised for the hardship and distress that have been caused to some families and noted that action was being taken to address the criticisms of the system (see paragraph 2.46).

Improving claimant compliance and customer service

2.39 The Department's examination of a sample of awards (see paragraph 2.3) provided a new insight into claimant error and fraud and where attention on compliance could best be focussed. The Department also has carried out compliance checks throughout the claims process. These have included pre-payment verification checks, reviews on the basis of certain risk factors and, where relevant, investigation. Claims have also been subject to post payment risk assessment and investigation with recovery of amounts identified as overpaid.

2.40 In 2004-05, the Department started around 107,500 risk based investigations, of which 17,000 were pre-award and 90,500 post-award. The total was in line with the Department's internal targets and reflected the 1,225 staff years available for this work. In the 85,600 cases settled by July 2005 the payment of £130 million Tax Credits due to claimant error or fraud, relating to some 55,000 cases was prevented. Work was continuing on the remaining cases under investigation as at the end of July 2005.

2.41 Pre-award work was designed to be carried out within five days of a claim being received, with the intention of preventing incorrect awards. Information on some risks was not available at that stage and the majority of risk based investigations were therefore carried out post-award with the resulting need to recover any overpayments. In order to prevent incorrect payments the Department put greater emphasis on pre-award work in 2005-06 and has extended the time for enquiries from five days to ten days.

2.42 The Department performed a separate review of 2003-04 claims for childcare costs, by attempting to verify with childcare providers the childcare expenditure claimed in every Tax Credits award. The exercise relied on the goodwill of childcare providers who responded in 68 per cent of the claims. The Department investigated higher risk examples where, for example, childcare charges were significantly different from those claimed and found errors in 26,400 cases (21%) resulting in £18 million adjustments to reduce Tax Credit awards. As at 30 June 2005 the Department was continuing its investigations in 4,450 cases and was looking at the most effective way of following up those where childcare providers did not respond.

2.43 The 2003-04 childcare cost exercise had limited IT support due to competing IT priorities. This hindered full analysis of results, made the exercise labour intensive, and placed considerable demands on providers of information. The Department repeated the exercise in respect of 2004-05 awards but with improved IT support, which should reduce the burden on childcare providers.

2.44 The Department have evidence that Tax Credits have been targeted by organised criminals, particularly where they can make claims over the internet without proving identity. The Department's Internal Audit Office concluded that there was a lack of comprehensive information to allow a robust analysis of the problem. The Department established a group in 2004-05 to seek solutions to these issues, for example, by implementing new types of interventions to tackle organised fraud and prevent unjustified Tax Credits payments. The Department's Special Compliance Office planned to investigate all fraudulent claims over £1,500 but there were too many such cases for them to deal with. Some were therefore passed to local compliance teams to follow up. The Department intends, in 2005-06, to re-evaluate the level of activity directed at dealing with serious fraud. The Special Compliance Office works closely with banks and other financial institutions to curtail frauds involving money laundering from false Tax Credits claims.

2.45 The Department has acknowledged that more rigorous checks could have been carried out where claimants notified 'changes of circumstances' which affected their awards. The Department is considering revising procedures, including:

- Increased claimant identification requirements;
- Call centre staff to request more details about changes from claimants;
- Follow up enquiries by telephone if awards significantly increased;
- Enhanced fraud awareness programme for staff.

2.46 On 26 May 2005, the Paymaster General announced steps to improve the Tax Credits system. The Department has prepared a plan to:

- Review the effectiveness of information provided to claimants, and to reduce the number of cases where people receive unnecessary duplication of award notices;
- Test new methods of reminding claimants of the importance of providing up to date in year information on changes in income and circumstances;
- Develop options to improve the quality of the helpline service;
- Identify IT system problems and processing errors more quickly;
- Work more closely with the voluntary sector to target more active support for vulnerable families;
- Review the operation of the Code of Practice on overpayments, so that recovery can be suspended in cases of genuine hardship, while a disputed overpayment is resolved.

Compensation from EDS

2.47 During the introduction of Tax Credits, there were very serious problems which affected the stability, speed and availability of the computer system, which both delayed the processing of claims and led to incorrect payments being made. The Department and EDS (the Department's former IT supplier) have for some time been discussing these issues in an effort to agree fault, consequent loss and any compensation payable. At the time this report was finalised, those discussions continued.

Effect on the Department's other work

2.48 Problems with the introduction of Tax Credits in 2003 adversely affected tax administration. By the end of 2003-04, recovery was well underway and, in 2004-05, the Department began to absorb Tax Credits into its normal business operations with increased resources deployed to deal with the number of complaints about Tax Credits. Resources required for Tax Credits work, however, meant that some Departmental operational targets were not met in 2004-05. In particular, work on PAYE open case clearance (the Department's final check after the tax year-end that the pay and tax details for people on the PAYE system are correct) was affected as telephone calls were diverted from Contact Centres to back offices. Several hundred staff were used in this way. Although overtime was used later in the year to try to catch with up that work, it meant that the open case targets could not be achieved.

Conclusions

2.49 The Department paid £15.8 billion under the new Tax Credits schemes. These schemes represented a major challenge for the Department. Claimants encountered problems as the system went live in April 2003 which continued to have ramifications throughout 2004-05. Tax Credits are a substantial part of the income of the poorest families who receive them. The Department recalculates the value of awards annually, in a process called "renewal", the first of which in 2004-05 identified that one third of recipients of 2003-04 awards had been overpaid a total of some £1.9 billion in 2003-04. Subsequent backdated payments in respect of 2003-04 awards brought the total overpayments for that year to £2.2 billion. This was mainly because family income had increased by more than £2,500 compared with the income declared at the time of the original application for Tax Credits. Half of the total overpayments related to some 283,000 families who had been overpaid by £2,000 or more. Overpayments are recovered where possible from future payments of Tax Credits. The Trust Statement account has provided for £961 million of doubtful debts as at 31 March 2005 in respect of tax credit overpayments. The annual basis of the Tax Credit award means that recipients need to be able to anticipate and plan for the consequences of changes in their income. This is clearly a problem for many families until they become used to the implications of the annual calculation of their entitlement. In May 2005, the Paymaster General announced plans to improve significantly the Tax Credit system.

2.50 In my last report, I noted that software errors were expected to lead to further write-offs, in addition to the £37 million the Department had calculated and written-off in 2003-04. In 2004-05, the Department calculated that they should write off some £2 million of Tax Credits caused by major software errors in 2003-04 and 2004-05 that together resulted in overpayments of £174 million. The Department also wrote off £33 million in respect of some manual payments made in 2003. By 30 June 2005 the Department had calculated and written off a further £95 million when official error relief had been granted to claimants who disputed the recovery of their overpayment. The Department expect to have further write-offs during 2005-06 in respect of continuing work on 2003-04 and 2004-05 cases.

2.51 The Department's measures to ensure that Tax Credit applicants complied with their obligations involved routine pre-payment checks on all claims; risk based investigations; verification of childcare expenditure; and investigations of suggestions that organised crime was targeting Tax Credits. The Department will need to maintain compliance work to ensure that confidence in the fairness of the schemes is not undermined by unacceptable levels of unjustified claims.

PART THREE

Large Business Office management of Corporation Tax

Introduction

3.1 The aims of Corporation Tax are to ensure that business makes a fair contribution to the funding of public services whilst enabling an environment in which business can thrive. In 2004-05, the Department received net Corporation Tax of £33.4 billion. The tax was managed by two parts of the Department, the Large Business Office (LBO) and the network offices. This part of my report looks at some of the developments in the management of Corporation Tax within the LBO.

3.2 The LBO was created in 1997 to facilitate centralised leadership, ensure greater consistency of approach and increase industry awareness and specialisation. In 2004-05, the Large Business Office (the LBO) handled the tax affairs of some 800 large entities which provided about two thirds of Corporation Tax.

3.3 When the two revenue Departments merged in 2005, the LBO and HM Customs and Excise equivalent were brought together to form the Large Business Service (LBS). Its mission is to "make a substantial contribution to financing the UK's future by closing the tax gap".

3.4 Integration will be phased, with the intention that it will be substantially completed by March 2007. The Department expected to have defined the customer population of the LBS and the division of responsibilities within the LBS by the end of the Autumn 2005. A Client Relationship Manager role will be the single point of contact with each customer for all taxes and duties. The Department was looking to develop a single assessment of risk across all the taxes in order to deploy resources to best effect.

3.5 The Department has faced increasing numbers of legal challenges to the UK direct tax system including landmark cases relating to EU tax law. The Department closely monitor major litigation and the potential risks to Corporation Tax, to help identify and rectify weaknesses in the UK tax system and has introduced changes to legislation, for example the extension of the rules on transfer pricing. Corporate taxpayers' advisers and lawyers have continued to represent exceptional challenges to the Department and litigation has consumed considerable Departmental resources, notably high quality experts over extended periods.

Corporation Tax targets

3.6 The Department did not set targets for overall corporation tax to be collected in 2004-05. For 2005 to 2008 it has set a PSA target for the reduction of underpayment of direct tax and national insurance contributions due by at least £3 billion a year. Targets set for Corporation tax were achieved, with the exception of the target for the percentage of returns filed within 12 months of the due date. The Department did not achieve e-filing targets for 2004-05 and considers it highly unlikely that they will be met in 2005-06. In the summer of 2005, the Paymaster General invited Patrick Carter to provide advice on measures to increase take up of its online services. This work is due to be reported in the autumn of 2005.

3.7 The Department found unexpected difficulties in extracting from existing computer systems reliable data for 2003-04 to measure achievements against the Service Delivery Targets. These systems had been designed before the targets were set and either did not hold the information required or held it in a way that made it difficult to extract. Information to report progress on e-filing by large, medium and small companies was not available until mid-way through 2004-05 when the Department put in place arrangements for measuring e-filing.

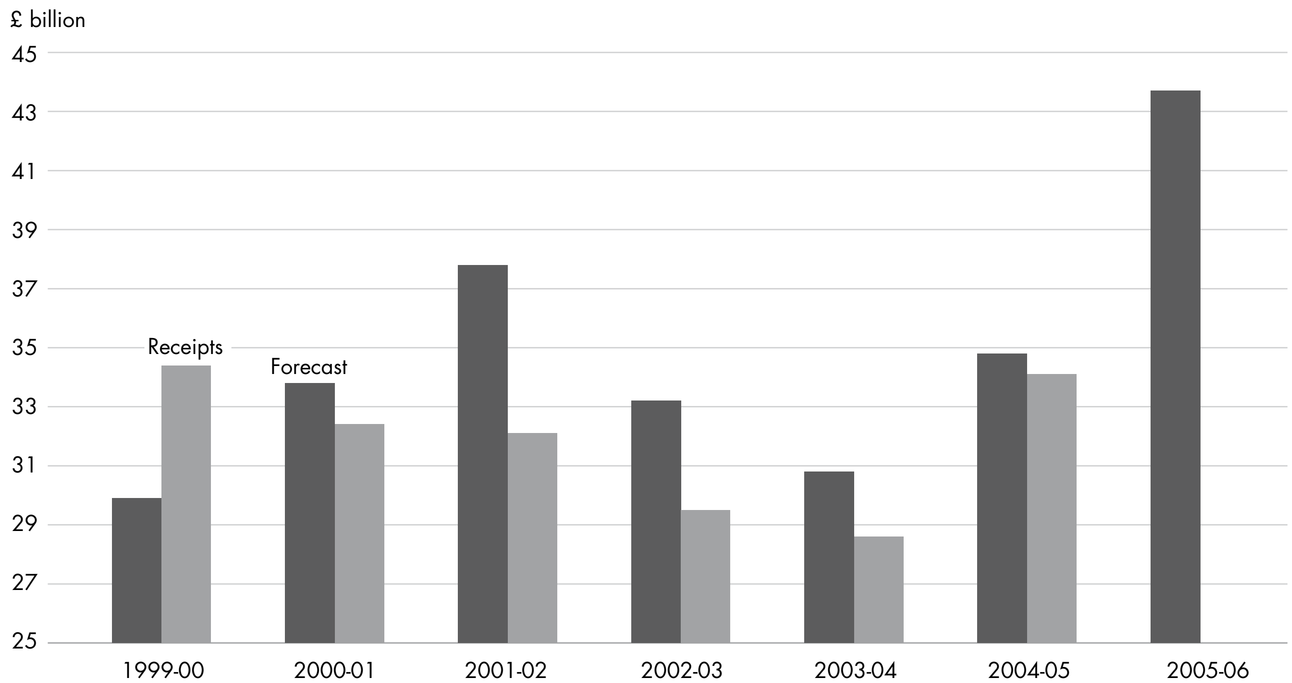
Corporation Tax Receipts

3.8 **Figure 10** shows that Corporation Tax receipts were generally below government forecasts as set out in the Budget for the five years from 2000-01 but that the shortfall was reduced in 2004-05. A significant proportion of receipts come from a small number of companies and one large adjustment can therefore have a significant impact. The Department considered that legislative changes also affect company behaviour and complicate forecasting.

3.9 In 2003 the Department commissioned an academic review which identified a number of weaknesses in the Department's forecasting model and developed a potential alternative approach. The two methods are now being used in parallel in order to test their relative accuracy and the Department will choose the most appropriate method in due course. Neither method, however, takes explicit account of the tax gap and they assume that historical trends of non-compliance will continue in the future. The Department will clearly need to review the forecasting methodology as its work on the tax gap progresses.

3.10 Receipts declined from 1999-2000 to 2003-04. The Department's research showed that a major reason for the decline was the phased introduction of Quarterly Instalment Payments (QIPs) and the abolition of Advanced Corporation Tax. These changes led to increased receipts in 1999-2000 because some companies paid more than one year's worth of tax liabilities. This was particularly pronounced in the financial sector where almost all companies pay QIPs. This effect diminished year on year until 2003-04 when payments stabilised. Departmental analysis also shows that major falls in financial company profits in 2001 and 2002 further reduced receipts and the subsequent recovery in profits has been relatively weak. The forecasts did not fully anticipate the continuing weaknesses in financial company profits.

10 Corporation Tax receipts



Source: HM Treasury Budget Reports

3.11 The Department's research suggests that the decline in receipts was not caused by significant changes in avoidance. The Department has, however, been unable to provide a robust estimate of the tax gap, in common with other fiscal authorities. But it is developing a model of the tax gap for the main customer groups. In December 1999, the Department began a programme of work for small and medium sized companies, in line with its developing Compliance Strategy, which provides data on the tax gap. The first analysis of the results started in 2005. There are difficulties in estimating the tax gap for large companies where there are unique and complex issues. This work therefore involves judgement, based on well informed risk assessments and enquiries of a small number of entities. The Department considered that new Departmental performance and management information systems should help to improve the analysis of the tax gap.

LBO targets and management information systems

3.12 The main objectives of the LBO were to safeguard the flow of revenue from large businesses and employers and enable customers to meet their obligations without unnecessary cost, whilst tackling and deterring non-compliance. The work of the LBO was planned and managed within the context of the Public Service Agreements. The LBO also measured its performance against other key targets **(shown in figure 11)**, although these did not contribute directly towards the Department's Service Delivery Agreement targets.

11 Large Business Office Targets

Large Business Office – Corporation Tax Key Targets	**2004-05 Target %**	**2004-05 Progress %**
Per cent Large Business Office correspondence replied to within 4 months	99	99.67
Per cent of issues worked to the required high standard or better	80	91.3
Per cent of entities worked to the required high standard or better	80	98.5
Process CTSA returns within 14 days	95	99.8
Process CTSA returns within 28 days	99.5	99.9
Process ITSA returns received by 30 September 2004 and processed by 31 December 2004	99	100
Process ITSA returns received by 31 January 2005 and processed by 31 March 2005	98	100
Handling of claims for tax repayments within 14 days	95	98.92
Handling of claims for tax repayments within 28 days	98	99.67
Where a group files all returns promptly, enquiries raised within 12 months of the date of filing	99.5	99.5
To work co-operatively[1]		

Source: HMRC

NOTE

1 The team's decisions, communications and actions align with the Inland Revenue Core Purpose, Core Traits and the departmental Business Direction. The team will demonstrate an acceptance of higher priorities adopting a co-operative approach by willingly sharing resources, knowledge, ideas and skills in a transparent way to achieve goals

3.13 In 2004, the LBO became concerned about the accuracy of the data used to measure the results for some of its targets. It was therefore unable to validate several important aspects of their performance for 2003-04. Senior managers also had concerns that staff did not fully understand their roles and responsibilities in relation to key targets. It set up a Performance Validation Project team in July 2004 to review processes for recording, reporting and validating performance and local LBO office governance arrangements. In August 2004, the Department's Internal Audit Office commented that that the team's proposals should provide more robust procedures. Following these developments the LBO generally outperformed its targets in 2004-05.

3.14 The LBO did not set a target for the additional Corporation Tax its work on corporation tax assessments would generate, although senior management regularly monitor the results. This was valued in the Department's annual report at £2.1 billion in 2004-05. The Department's Internal Audit Office undertake an annual review of LBO yield before it is reported and for 2003-04 identified errors in the recording of 11% of all adjustments. Some errors were relatively small, but in total the result was an adjustment of £47.7 million over-recorded in respect of 2003-04. The LBO's own annual review of specific large cases had already led to a correction of £13 million over-recorded. Errors were due to the complex relationship between the effects of different adjustments, a lack of staff understanding and human error. Internal Audit however highlighted the concerted efforts being made to address the quality and completeness of management data.

The Basic Data system

3.15 In April 2004 the LBO introduced a new system – "Basic Data" - to support and monitor casework. This was designed to address concerns with the old LBO IT system, including the need to improve reporting of tax at risk and yield information. It was also intended to improve information sharing and the monitoring of workloads.

3.16 The Department experienced problems during the changeover to the Basic Data system.

- Due to system limitations no major data cleansing exercise was possible before transferring data to the new system; this required subsequent work to remove and correct data;
- Some important data on completed enquiries were removed in error during the decommissioning of the old IT system and had to be restored;
- Tax at risk information was needed to manage ongoing work and had to be entered onto the new system. This was achieved, despite problems of access in some offices and the volume of work involved.

3.17 The National Audit Office found varying use of the Basic Data system. Some of the Department's staff lacked understanding of how to use the system, despite initial training and failed to record information appropriately, which undermined the usefulness of management information. The Department planned to improve the system later in 2005 and to issue further guidelines.

LBO working methods and quality assurance procedures

3.18 The National Audit Office reviewed procedures at three LBO offices.

Risk assessment

3.19 The LBO generates additional Corporation Tax through changes to self assessments, which arises primarily from the examination of specific issues. Effective risk assessment is important in targeting this work. Risk assessment involves the preparation of a background description of the corporates' activities, combined with an annual scrutiny of taxpayer accounts and computations to identify areas where tax law has not been applied consistently. The preparatory work is labour intensive and the department had no standardised way of undertaking it. Manual risk assessment is relatively slow and inefficient and reduces the time available for examining specific cases. There is also a time lag for initially spotting tax avoidance and other new high risk areas; annual risk assessments have to wait on receipt of the accounts and so are typically completed some 15-21 months after the tax year end.

3.20 The National Audit Office found risk assessment guidance being followed in general, but with a range of interpretations of what the process involved, and what information should be included. The LBO explained that this was to provide for some flexibility. But it does not ensure that all major risks are identified and tackled. Effective case work requires the prioritisation of identified risks, but the NAO found that evidence of this varied from very clear to ambiguous.

"Business" Sectorisation

3.21 The LBO's work in 2004-05 was influenced by the Department's 2001 "Review of Links with Business" which looked at how the Department could be more supportive to large businesses. One initiative involved creating sector groups of entities operating within a similar business, for example the pharmaceutical industry, which display common behaviours and tax risks. This could help to improve tax risk identification and achieve more consistent working of tax issues through the development of specialist knowledge. Sectors were initially seen as supporting more informed risk assessment and better understanding and working of tax issues, rather than being the main driver for managing work.

3.22 The LBO operated through 13 offices. Financial sectors casework was concentrated in 5 offices with a high degree of specialisation and non-financial work in the other 8 offices. Where work was organised by sectors the LBO had undertaken a process of consolidating work into fewer locations, typically 2 or 3. At the end of 2004-05 70% of taxpayer entities were assigned to formal sectors as shown in **Figure 12**. Some of these were more developed than others, in particular the financial sector. Each sector had a lead officer responsible for ensuring the consistency of approach and developing tax risk assessments. The Department recognised that there was significant development work to do before sectors became the primary driver for their work. It intends to change to a fully sector based management structure for the Large Business Service.

12 Sectoral analysis of LBO business

Sector	Number of taxpayer entities	Additional tax from LBO work in 2004-05 £m	Corporation Tax Receipts in 2004-05 £m
Financial	300	790	6,594
Pharmaceuticals	22	310	887
Major utilities	45	160	722
Property	13	7	167
Major retail	44	49	1,841
Air Transport/Shipping/Rail	42	28	318
Motor	20	39	136
Media	32	42	694
Telecommunications	20	22	462
Tobacco and Alcohol	13	9	253
Construction	29	24	538
General	244	623	5,831
Total	**824**	**2,103**	**18,443**

Source: HMRC

Resource allocation

3.23 The Department established a resources working group in 2001 to consider the most effective way of allocating LBO resources between offices. In 2004 the Department accepted a core recommendation of the working group and adopted a new risk based model. A new computerised caseworker diary system was introduced in 2004 to assist in allocating and recording resources, but the system failed to perform as intended. At the end of 2004-05, the Department was working with the IT provider to rectify these problems.

3.24 The Department had planned to introduce a new LBO-wide IT system to monitor the use of resources. Since the announcement to create the Large Business Service of the merged Department, however, IT plans were subsumed into developing a new process for risk management and allocating resources. This was expected to be completed in October 2005.

3.25 Resource allocation was performed on an office rather than a sector basis. Each office was required as a minimum to have an auditable system for allocating resources to taxpayer entities and risks. Entity risk scores and data on resource usage were used as a starting point in allocating resources. The mechanisms in place, and the information used to inform this process varied from office to office. Some offices were piloting the use of less senior case directors on lower risk cases, to allow more experienced staff to focus on more complex issues.

Quality assurance procedures

3.26 As part of the Continuous Improvement Programme, the LBO considered that the existing approach to quality assurance, which involved self-assessment and peer review, was not sufficiently robust and could be improved upon. In 2003 the LBO commissioned two working groups to review quality assurance and produced guidance on professional standards and quality control. These analysed the risks and the processes and standards in place to manage them within nine high level risks identified by senior management.

3.27 In March 2004 the LBO created a new Quality Standards team with the objective of evaluating the performance of the LBO as a whole. The team developed a programme of LBO reviews to tackle quality assurance, control and improvement.

3.28 The original plans for 2004-05 involved reviews of the LBO headquarters and all LBO offices, some reviewed in more depth. In June 2004, the Quality Standards team completed a pilot audit of the Peterborough Office that dealt with the retail and construction sectors, which led to refinements in the methodology used. It also highlighted the resource and time pressures, and the range of specialist knowledge which would be required in the Quality Standards team to perform in-depth reviews of all significant issues. Subsequent audits therefore involved a less comprehensive review, concentrating on pre-selected issues, ensuring risk assessment processes were in place and that minimum standards were complied with. Some planned audit work for 2005-06 was put on hold due to creation of the Large Business Service. The Quality Standards team proposed to move to a more risk-based, real-time approach, in order to achieve coverage of the largest cases over a period of years.

3.29 The Quality Standards teams work for 2004-05 found inconsistent standards of risk assessment across the offices. This was attributed to the LBO minimum standards not being sufficiently prescriptive and robust. The Department planned to review the standards as part of the creation of the Large Business Service. The team found varying approaches to resource allocation across the LBO and a lack of review of resources used and the results they achieved. They also found delays in dealing with some issues due to staffing problems, and delays in gaining input from technical specialists. The Quality Standards team itself had no powers to follow-up progress on its recommendations but reported them to the LBO senior management team who accepted them for implementation in 2005-06.

3.30 The LBO also seeks to validate its performance by commissioning customer surveys. The last survey was undertaken in August 2004 and involved over 400 telephone interviews. This reported that 85% of customers believed that the LBO was very or fairly effective at identifying tax risks, and that 78% believed that it was very or fairly effective at resolving these once identified. Only 3% thought that the LBO should concentrate on more material issues. There was, however, some criticism over the turnover in case teams, and the extent to which the LBO kept customers informed about tax issues. These findings have helped to inform the role of the Client Relationship Manager.

Major initiatives aimed at improving the LBO's effectiveness

Better Data for Corporation Tax

3.31 The effectiveness of the LBO's compliance work was hindered by limitations in its management information systems. The Department commenced work on a new direct tax compliance package in 2004, with a key element being "Better Data for Corporation Tax." This aimed to improve compliance through better use of management information to improve both the targeting and effectiveness of Corporation Tax and other enquiry work in the LBO. The Department intended this project to achieve a step change in the effectiveness of the LBO's compliance work by:

- Improved compliance and risk profiling, by introducing a more comprehensive and efficient approach to risk assessments and allowing LBO management to identify areas of increasing tax risk early;
- Better forecasting of Corporation Tax, via improved forecasting tools and business data;
- Better reporting against Public Service Agreement targets, through a suite of information for setting, reporting and evaluating targets;
- Increased tax yield, through better targeting of resources and enhanced productivity of teams from improved data and analysis tools.

3.32 Phase one of the project was completed at the end of January 2005 and offered some initial improvements to available management information. Phase one also provided limited external data on companies and limited capacity to analyse company data sources. It also provided the capability to capture electronically paper based company accounts; a number of pilot cases were captured in 2004-05 (albeit less than originally planned) and more will be added during 2005-06. Additional functions were planned in phases, with full completion scheduled for April 2006. The Department emphasised that the system's effectiveness would be considerably enhanced if company accounts and data were received electronically, which is currently not a requirement.

Specialisation

3.33 The LBO recognised the importance of building up commercial awareness. Employing tax experts specialising in particular industries and issues, for example on avoidance and transfer pricing, could yield more tax. In 2004-05 the LBO employed more specialists and tax technicians with the aim of adding value to compliance work. These were intended to improve targeting of risks, saving time on misdirected enquiries and quicker dropping of issues on which the Department was unlikely to win. The Department expected these specialists to generate additional tax of over £100 million a year by 2006-07 and considered that it would be a very cost effective initiative.

Reorganisation of the financial sector of the LBO

3.34 The financial sector was the LBO's largest and most complex sector. A high proportion (some 20% in 2004-05) of Corporation Tax came from this sector. But the Department considered that significant amounts of tax were lost through avoidance in this sector. A higher proportion of time was spent on management at the expense of specific casework than in other sectors, as the work was spread over several management units. Compliance results were also relatively poor in comparison with the non-financial sectors. The tax yield: cost ratio in the financial sector offices was 38:1 and 68:1 in the other offices, despite the financial offices dealing with businesses where tax was thought to be most at risk.

3.35 In 2005, the LBO integrated the four London financial sector offices onto one site to share a common management structure. The reorganisation offered the opportunity for significant change, improved performance and better and more flexible team working. The LBO expected the reorganisation to enable a more effective industry-wide approach and that the increased flexibility to move resources when needed was expected to produce extra yield. Further, the integration should reduce the time spent on management and release resources to improve the identification of tax risks. The Department considered that action being taken to ensure more effective resource allocation should improve the yield:cost ratios.

New compliance process

3.36 The Department piloted a new compliance process in 2002-03, involving 17 LBO customers on a voluntary basis. This aimed to improve working relationships with customers in order to identify and resolve tax issues earlier. The customers agreed to disclose significant tax risks before returns were filed and the Department agreed to focus on those risks. The Department saw the main advantages as being that the case team could focus on key risks, so that speculative enquiries should be unnecessary, and that businesses would have greater certainty of its tax charge much sooner. The customers and teams involved in the pilot judged it to be a success, and the Department was extending the process on a voluntary basis; with approximately 80 entities signed up by the end of 2004-05.

3.37 The new approach required a significant change in the approach to managing the risks of non-compliance. Rigorous analysis and evaluation is needed to ensure that the new approach effectively tackles non-compliance. In April 2005, the Large Business Service started a review of this matter.

Conclusions

3.38 The Large Business Office (LBO) handled the tax affairs of some 800 large entities and employers which generated some £18.4 billion of tax in 2004-05. The primary objective was to safeguard the flow of revenue from large businesses and employers, enabling customers to meet their obligations without unnecessary cost, whilst effectively tackling and deterring non-compliance. The complexity and sophistication of tax management in the large business sectors, including EU and other international dimensions, pose some of the most difficult and potentially costly challenges for the Department, both in terms of administration cost and loss of revenue.

3.39 The LBO generated an additional tax yield of some £2.1 billion in respect of 2004-05 – primarily from the examination of specific tax issues. Good quality and prompt tax risk assessments are essential to achieving the best deployment of the Department's resources and the most effective compliance effort. For some years the LBO had been developing sector specialist knowledge and structures to improve tax risk identification. The Department recognised that there was significant development work to do before sector based approaches to risk assessment became fully effective. The compilation of data and calculation of financial ratios used in tax risk assessments were largely manual, time consuming and resource intensive, and not eased by the data being supplied by corporate taxpayers mainly in hard copy format rather than electronically.

3.40 In 2004, the Department launched a project called "Better Data for Corporation Tax". This was intended to achieve a step change in the effectiveness of compliance work through better use of management information to improve the targeting and effectiveness of enquiry work in the LBO. There were also important initiatives in internal quality assurance of Corporation Tax case work, management and structural reorganisations, employment of specialists, and new compliance processes with some customers. These initiatives are continuing within the integration plans for the new Department.

3.41 The LBO was integrated with the Customs and Excise equivalent in April 2005 to form the Large Business Service of HM Revenue and Customs, with a mission to "make a substantial contribution to financing the UK's future by closing the tax gap". The management by large businesses of their tax affairs will continue to pose a challenge and the Department must continue to modernise its work on Corporation Tax within the large business sectors. The Department must ensure that its various initiatives enable it to match the sophistication of large businesses with equivalent Departmental expertise and methods.