National Audit Office

HM Revenue & Customs 2012-13 Accounts

Report by the Comptroller and Auditor General

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Summary

About this report

1 This report provides the findings and overall conclusion of work conducted under section 2 of the Exchequer and Audit Departments Act 1921, by which the Comptroller and Auditor General (C&AG) must assess the adequacy of the systems to assess and collect taxes.

2 This report forms part of our programme of audit work on HM Revenue & Customs (HMRC). The programme includes our examinations under section 2, our annual financial audit of HMRC's accounts, and value-for-money studies assessing how HMRC spends its money. Our work is designed to support effective parliamentary scrutiny of HMRC's activities, to provide insight and make recommendations to help HMRC meet its objectives.

3 The report is arranged in five parts:

- **The Summary** describes the scope of the audit and provides our overall conclusion and main findings and recommendations in each area.
- **Part One** sets out key facts and figures about revenue collected by HMRC in 2012-13 and highlights relevant findings from reports published in the last year.
- **Part Two** covers progress in stabilising and operating the PAYE service and delivery of Real Time Information.
- **Part Three** covers HMRC's performance in tackling value added tax (VAT) fraud.
- **Part Four** examines HMRC's progress in tackling fraud and error in respect of tax credits and the effectiveness of its approach to managing debt arising from the tax credits system.

Scope of the audit

4 Section 2 of the Exchequer and Audit Departments Act 1921 requires the C&AG to examine the accounts of HMRC "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". The C&AG is 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. Taken alongside the C&AG's audit opinion on HMRC's Trust Statement, which records the tax revenues HMRC has collected, this report meets this requirement.

5 In forming his conclusion, the C&AG considers a range of work that complements his section 2 examination. This includes the results of our financial audit of HMRC's accounts and findings from value-for-money reports and reports published under the C&AG's section 2 powers. We have published four value-for-money reports on HMRC in the last year: *Tax avoidance: tackling marketed avoidance schemes;*[1] *Customer service performance*;[2] *Progress on reducing costs*;[3] and *Tackling tax credits error and fraud*.[4] We also published a section 2 report on HMRC's *Progress in tackling tobacco smuggling*.[5]

6 The C&AG provides a separate audit opinion on HMRC's Resource Accounts, which record HMRC's running costs and other spending, most significantly its spending on tax credits. Before 2011-12, tax credit expenditure and related balances were reported in HMRC's Trust Statement. From 1 April 2011, these are reported in the Resource Accounts to reflect changes in accounting policy resulting from the Government's 'clear line of sight' project to align departmental budgets and accounts. For ease of reporting, we have included our examination of tax credits in this report.

Conclusion

7 HMRC aims to deliver three strategic priorities: to improve customer service; to reduce operating costs; and to reinvest money from its efficiency savings to generate increased tax revenue. There are inherent tensions in reconciling these priorities. Our 2012-13 work programme helped us to form a view on HMRC's progress against each priority. We found that HMRC had made good progress in reducing costs and had met its revenue targets, but has much further to travel to raise customer service standards to an acceptable level. Improving its service to customers is an important element of HMRC's strategy to collect a higher proportion of the tax due by helping people and businesses to comply voluntarily with their tax obligations.

8 Critical to HMRC's ability to increase its efficiency and reduce the tax gap further will be its success in delivering on two key commitments: to increase automation and digitalisation of its tax collection systems; and to reduce avoidance and evasion by investing further in its enforcement and compliance activities. HMRC is committed to being at the forefront of the Government's Digital Strategy with the objective of modernising its business to deliver a better service with fewer and better targeted resources. It has made progress in 2012-13 by, for example, introducing online registration for VAT and successfully piloting Real Time Information, a system which is central to modernising the PAYE system and implementing Universal Credit. But when we looked at HMRC's response to marketed tax avoidance schemes, we found it had 41,000 open avoidance cases at 31 August 2012, and had yet to demonstrate whether it could successfully manage this number down. HMRC therefore faces a considerable management challenge if it is to continue to meet its commitments to increase revenue by stepping up its anti-avoidance and anti-fraud activities.

1 Comptroller and Auditor General, *Tax avoidance: tackling marketed avoidance schemes*, Session 2012-13, National Audit Office, HC 730, November 2012.
2 Comptroller and Auditor General, *Customer service performance*, Session 2012-13, HC 795, National Audit Office, December 2012.
3 Comptroller and Auditor General, *Progress on reducing costs*, Session 2012-13, HC 889, National Audit Office, February 2013.
4 Comptroller and Auditor General, *Tackling tax credits error and fraud*, Session 2012-13, HC 891, National Audit Office, February 2013.
5 Comptroller and Auditor General, *Progress in tackling tobacco smuggling*, Session 2013-14, HC 226, National Audit Office, June 2013.

9 In fulfilling our statutory duties, while recognising that no tax collection system can ensure that all those who have a tax liability comply with their obligations, we conclude that in 2012-13 HMRC has framed adequate regulations and procedures to secure an effective check on the assessment, collection and proper allocation of revenue, and that they are being duly carried out. This assurance is subject to the observations on specific aspects of the administration of taxes in this report and our other reports to Parliament.

Specific findings and recommendations

PAYE and Real Time Information (Part Two)

Findings

10 We have previously reported on the difficulties HMRC has faced in operating PAYE after introducing its National Insurance and PAYE Service (NPS) system.

11 HMRC has met its target to operate a normal PAYE service by March 2013. In line with its commitment to the Committee of Public Accounts, HMRC has:

- cleared the 6.7 million outstanding end-of-year reconciliations for 2008-09 and 2009-10 by 31 March 2012 – HMRC carries out end-of-year reconciliations on each taxpayer's record to determine whether the correct amount of tax has been paid;
- cleared the outstanding PAYE cases predating the introduction of NPS relating to the 2003-04 to 2007-08 tax years by December 2012; and
- reconciled the 2010-11 and 2011-12 tax years by March 2013 (paragraphs 2.5 to 2.7).

12 It has cost less to stabilise the PAYE service than HMRC had expected. Up to 31 March 2013, stabilisation had cost £78.9 million against an estimated £80.9 million although an estimated £953 million of tax relating to tax years 2003-04 to 2009-10 has been foregone (paragraph 2.8).

13 The NPS system gives HMRC the opportunity to do more to keep taxpayer records up to date in-year than its previous computer systems. Day-to-day workload management involves manually dealing with in-year changes to taxpayer records triggered by taxpayers and work automatically generated by the NPS system (work items). HMRC prioritises its workload to ensure that taxpayers pay the right amount of tax. While HMRC responds to taxpayers' requests to make in-year changes, it does not currently plan to process all those work items which would keep tax codes correct in-year. During 2011-12, there were more work items generated than HMRC had the capacity to handle. Therefore HMRC prioritises their clearance, including these in-year items, based on the impact on the accuracy of a taxpayer's final liability to tax. HMRC is developing proposals to eliminate more work items through its business process re-engineering programme and will re-prioritise its available resource to ensure that the highest priority work is done (paragraph 2.12).

14 During 2012-13, HMRC successfully piloted its new PAYE data capture system, Real Time Information (RTI). RTI is a major change to the PAYE system. It enables PAYE information to be captured when payments are made rather than annually. RTI is a critical part of the Department for Work & Pensions' roll-out of Universal Credit which we will report on in due course (paragraph 2.19).

15 There were some limitations to the scope of the RTI pilot, which means that certain functions of the system have not yet been fully tested. Lower than expected employer numbers participating in the pilot, resulted in HMRC having to revise its plans and focus on bringing in larger schemes, to ensure the required number of individual employment records were tested during the pilot. Only 66,240 employer schemes participated in the pilot against HMRC's original assumption of 250,000, however more than six and a half million employee records were tested which exceeded the planned volume. The pilot covered the initial validation of employer records and submission of data files to HMRC. From April 2012, starter and leaver data has been transferred into the NPS system but testing of all data transfers from RTI to the NPS system and end-of-year year reconciliation processes only started in April 2013 after RTI's live roll-out. New issues may arise as more employers start to use RTI for the first time or as further IT system changes are made (paragraphs 2.20 and 2.22).

16 The RTI programme budget does not include contingency for any significant extra development costs. The current expected cost of £356.6 million is £115.5 million more than outlined in the original business case because of new development costs needed to increase the system's functionality as a result of consultation with stakeholders and better cost estimations. Within the expected cost, HMRC has not budgeted for any significant extra development costs arising from new issues (paragraphs 2.28 and 2.29).

17 The financial and accounting systems supporting RTI are not yet fully accredited. Financial accreditation is a formal requirement of HMRC's Change Programme and provides assurance that any new systems are acceptable for accounting and financial control purposes. The RTI systems went live on the basis that action would be taken to resolve identified financial design issues by 31 October 2013. These issues do not affect an employer's ability to submit data to HMRC but do weaken HMRC's ability to produce and report financial information on PAYE. HMRC is currently undertaking work to understand the impact of these issues and how best to address them (paragraphs 2.24 to 2.25).

18 The resilience needed to maintain the RTI service if there is a major technical failure is not in place. Online and time-sensitive system implementations are usually developed with formal technical resilience and disaster recovery capability. HMRC chose not to pay for full resilience because of the cost implications and because PAYE could be operated in an emergency without RTI. However, although RTI has the potential to be used by other government departments, the lack of full resilience may inhibit its use in areas of activity where a temporary disruption to service cannot be tolerated. Data submissions can be held temporarily in a queue but this would not provide continuity of service in the event of a catastrophic failure. The RTI service failing at a critical processing time could increase the volume of customer communications and lead to more effort for employers (paragraphs 2.26 to 2.27).

19 While the delivery of individual projects has been well managed, HMRC is still developing its long-term strategy for improving the PAYE process and defining its future operating model. As a result, HMRC has to manage the risk of projects operating in isolation and that, in the face of operational pressures, short-term decisions may not support its longer-term objectives. It has invested in new systems, such as RTI, and is currently scoping how it might exploit the data it provides as part of developing its long-term strategy for improving the PAYE process and defining its future operating model (paragraphs 2.32 to 2.33).

Recommendations

20 HMRC should complete its planned programme of process and system improvements to reduce the volumes of work items generated by the NPS system and should further improve its in-year maintenance of taxpayers' records. More up-to-date and accurate tax codes being maintained during the year should lead to fewer over and underpayments of tax, reduced customer contact and a positive impact on HMRC's performance targets.

21 HMRC must urgently address the financial system design issues for accounting under RTI. Failure to address these accounting issues could result in HMRC being unable to correctly allocate and account for some PAYE payments received from employers or to identify and collect amounts outstanding.

22 HMRC should adopt measures to address the lack of technical resilience and disaster recovery for RTI. In the short term, HMRC should document and test contingency measures for the main technology-enabled processes to ensure they could continue to run if there is a technical failure.

23 HMRC should decide on its future operating model for PAYE and determine how it will exploit the opportunities and benefits provided by RTI. Without clarity on the operating model or how the use of RTI can be exploited, it is difficult for HMRC to forecast its overall workload and operational resources required. HMRC needs to consider which changes notified under RTI should update taxpayer records in real time, and to what extent work performed at the end of the tax year can be undertaken earlier.

Tackling VAT fraud (Part Three)

Findings

24 HMRC estimated the tax gap for VAT in 2010-11 as £9.6 billion (30 per cent of the total estimated tax gap of £32 billion). This equates to 10.1 per cent of the VAT that could theoretically be collected. HMRC estimated that missing trader intra-community (MTIC) fraud constituted between £0.5 billion and £1 billion of the VAT tax gap, but it does not publish a full breakdown of the tax gap by behaviour (paragraph 3.7).

25 HMRC has made good use of intelligence to respond to the risks of VAT fraud. In the recent past, intelligence from industry has allowed HMRC to tackle the risk of repayment fraud in the renewable energy market. Competitors have also provided useful intelligence to let HMRC know about suppliers who are operating in the hidden economy. HMRC has liaised effectively with other European tax administrations and reacted quickly to new threats to the VAT system (paragraphs 3.10 to 3.12).

26 HMRC's online VAT registration system has proven popular with taxpayers but it is too early to determine whether it has delivered the projected reduction in revenue losses. Since implementation began in October 2012, between 81 and 84 per cent of all monthly registrations have been online, exceeding HMRC's target of 80 per cent. The online registration project aims to reduce revenue losses (by between £30 million and £35 million a year) by improving and automating HMRC's risk checking and decision-making. The new system is generating twice as many cases for investigation as its predecessor, but HMRC has yet to show whether this is delivering the expected enhancement in the security of the VAT system. HMRC plans a post-implementation review after January 2014, but this has yet to be scheduled (paragraphs 3.13 to 3.19).

27 In 2012-13, HMRC checks prevented £579 million of erroneous repayment requests, but its checking of payment returns is more limited. HMRC uses an automated system to profile VAT repayment returns and identify those where there is an increased risk of error or fraud for additional checks. It undertakes fewer real-time risk profiling checks on payment returns (paragraphs 3.23 and 3.29).

28 HMRC's current risk profiling of VAT returns identifies cases where compliance yield can be maximised, rather than where the risk of VAT evasion may be greatest. HMRC uses predictive analytics, based on customer histories, to identify those customers posing the greatest risk to revenue. This drives its approach to customer interventions. HMRC plans to examine the feasibility of extending this model to more explicitly target evasion risks (paragraphs 3.21 and 3.28 to 3.29).

29 HMRC's interventions and wider cooperation have helped reduce significantly the VAT losses from MTIC fraud. Since it peaked at between £2 billion and £3 billion in 2005-06, HMRC has worked with others to reduce losses caused by MTIC fraud to an estimated £0.5 billion to £1 billion in 2010-11 (paragraph 3.34).

30 HMRC has yet to produce a comprehensive plan to react to the emerging threat to the VAT system posed by online trading. HMRC has helped secure legislative change to the place of supply for VAT purposes for certain products. While it has developed tools to identify internet-based traders and launched campaigns to encourage compliance, overall HMRC has shown less urgency in developing its operational response. In March 2013, HMRC began scoping work to review its current activities and internet-based traders with greatest potential to commit VAT fraud. Its more detailed compliance work is unlikely to start until later in 2013 (paragraphs 3.39 to 3.45).

Recommendations

31 HMRC should establish whether its online VAT registration system is delivering the expected reduction in revenue losses. The new VAT registration system is generating increased volumes of cases to investigate, but it is not yet clear that this is leading to expected improvements in the security of the VAT system.

32 HMRC should consider the costs and benefits of enhanced real-time risk profiling of VAT payment returns. Understandably, HMRC focuses its current scrutiny of VAT returns where taxpayers are requesting repayments, but this creates a risk that significant levels of fraud in other returns may not be detected.

33 HMRC needs to increase the urgency with which it is responding to the fraud risks posed by internet-based traders. HMRC has assessed the risks presented by online traders. It has introduced initiatives to address specific risks but, to date, these have had limited financial impact. The timing of HMRC's future plans does not reflect the scale of public and parliamentary concerns about the way these businesses operate.

Personal tax credits (Part Four)

Findings

34 The C&AG has qualified his regularity audit opinion on HMRC's 2012-13 Resource Accounts because of material levels of error and fraud in the payments of personal tax credits. The overall level of error and fraud in 2011-12 (the latest year available) indicates that payments of between £1.9 billion and £2.3 billion were made to claimants incorrectly because of error and fraud. Further amounts of between £170 million and £360 million are not being paid to claimants because of error (paragraph 4.9).

35 HMRC's central estimate of error and fraud of 7.3 per cent is the lowest since the current personal tax credit scheme was introduced. HMRC estimated the level of error and fraud in 2011-12 payments to be between 6.6 and 7.9 per cent (compared with between 7.5 and 8.8 per cent in 2010-11). The 2011-12 central estimate of error and fraud is 7.3 per cent (8.1 per cent midpoint in 2010-11), which is the lowest figure since the personal tax credit scheme was introduced in 2003-04 (paragraph 4.10).

36 HMRC and HM Treasury have not yet published a new target for savings from reducing error and fraud in tax credits awards. HMRC failed to meet its target of reducing error and fraud to 5 per cent of finalised tax credits awards by March 2011. In evidence to the Committee of Public Accounts on 6 March 2013, HMRC estimated that it is likely to deliver losses identified and prevented of between £2.5 billion and £3 billion in the four years to 2015. The Committee of Public Accounts has recommended HM Treasury and HMRC should introduce a new target for savings from reducing tax credits error and fraud by 2017 to which HMRC should be held to account (paragraphs 4.12 and 4.19).

37 **HMRC has adopted a more prudent methodology for measuring the losses prevented by its interventions.** Following publication of the 2010-11 error and fraud results, HMRC reassessed the relationship between error and fraud and how losses prevented through interventions were estimated, and adopted a more prudent methodology in 2012-13 (paragraphs 4.14 to 4.16).

38 **HMRC faces a significant challenge to meet its target of reducing the gross personal tax credits debt balance to £3.7 billion by March 2015.** In 2011-12, HMRC set itself a target to reduce the gross personal tax credits debt balance from £4.7 billion to £3.7 billion by 31 March 2015. As disclosed in the 2012-13 Resource Accounts, HMRC's gross personal tax credits debt balance increased from £4.0 billion at 31 March 2012 to £4.8 billion at 31 March 2013 (paragraphs 4.24 and 4.25).

39 **HMRC has undertaken a detailed analysis of its success in recovering historic debt, which has led to a significant increase in the provision for uncollectable amounts.** HMRC has tracked the history of recovery of debt raised in 2009-10 and this has led it to revise its estimation of the recovery rate for debts from 43 to 31 per cent. As a result, HMRC has increased its provision for irrecoverable debt by £1.0 billion (paragraph 4.26).

40 **HMRC has launched a series of initiatives with the aim of improving its debt recovery performance, but it is too early to determine whether these will achieve the expected outcomes.** Alongside a debt collection campaign, HMRC has extended schemes to recover debts through PAYE and debt collection agencies and has developed plans to extend recovery of overpayments from ongoing awards. The most significant initiatives will not have an impact before 2014-15. HMRC also faces challenges in improving collection rates, given its need to strike the right balance between pursuing collection and a claimant's ability to pay (paragraphs 4.28 to 4.31).

Recommendations

41 **HMRC should look to build on its successful approach to tackling error and fraud within each of its six identified areas of risk.** HMRC have estimated reduced losses due to error and fraud in 2011-12 in three of the six identified risk areas. HMRC should establish what factors contributed to its success in these areas of risk and seek to apply any lessons learned across other risk areas.

42 **HMRC should analyse its remaining balance of tax credits debt to see whether it can recover individual debts.** The tax credits debt balance increased to £4.8 billion as at 31 March 2013 and HMRC recognises that much of this is unlikely to be collectable. HMRC needs to prepare a robust analysis of the age and collectability of debt and collect what is value for money to do so before it considers writing these off.

System-wide findings and recommendations

Findings

43 HMRC has made progress in applying lessons learned identified in our 2011-12 report on Accounts (Annex One). Our work in 2012-13 has identified priority areas of activity that HMRC should seek to strengthen:

- **While improving customer service is one of HMRC's three core strategic objectives, its main focus and energy in this spending review period has been to meet its commitments to reduce costs while increasing revenue from its compliance and enforcement work.** Our report on *Customer service performance* recognised the resources HMRC has committed and the progress it has made to recover customer service standards from a very low base. It continues to lag behind other service delivery organisations in the extent to which it places the needs of customers at the heart of decision-making. Achieving compliance with their tax obligations thus remains more difficult and costly than it should for many citizens and smaller businesses.
- **HMRC faces complex challenges such as combating the mass-marketing of tax avoidance schemes and changes to the way taxes are administered. In some cases, it has not always responded by establishing the critical information systems required to help it assess risks and target resources and is hampered by old and inflexible information systems.** HMRC's culture places a high value on data and it uses performance information widely across its business. It has invested in new systems, such as RTI, and is currently scoping how it might exploit the data it provides as part of developing its long-term strategy for improving the PAYE process and defining its future operating model. Furthermore, HMRC has focused efforts on tackling VAT fraud caused by erroneous repayment requests. HMRC uses a variety of tools to determine its risk based interventions but it recognises that it needs to make its risk profiling more comprehensive and more fully understand the behavioural impact of its activities on compliance.

Recommendations

44 HMRC should recognise the extent of cultural change required to put customers at the heart of its decision-making and should identify and seek to apply best practice in customer service from elsewhere in government and the private sector. It needs to build awareness and commitment throughout its business that its customers matter and to place equal focus and attention on meeting their needs so it becomes easier for all taxpayers to pay the right tax at the right time, and to get help when needed.

45 HMRC should prioritise initiatives to improve the quality of its data and to improve management information to aid decision-making. It should build the case for investment in its information systems in the medium to long term. HMRC's culture places a high value on data and it uses performance information widely across its business. However, it is hampered by old and inflexible information systems. The outcome of discussions with HM Treasury about where HMRC deploys resources over the 2010 Spending Review period has been to prioritise spending that will provide a quick return in terms of cash revenue. More sustainable and potentially larger gains could be achieved in the longer term by strategic investment in HMRC's critical information systems, helping it to assess tax risks and target its resources more accurately.

Annex One: HMRC's progress against recommendations in HMRC's 2011-12 accounts

46 In our report on HMRC's 2011-12 accounts,[6] we identified three broad themes that linked our findings and recommendations to our wider value-for-money work on HMRC's activities. We recommended that HMRC should seek to apply these lessons across the full range of its activities. Our analysis of HMRC's progress in each of these areas is outlined in **Figure 1**.

Figure 1
HMRC progress against lessons learned identified in our 2011-12 report on accounts

HMRC has made progress in applying lessons learned

NAO recommendation	Progress	Commentary
To improve the analysis of the costs and benefits of interventions, such as debt campaigns and initiatives to reduce tax credits error and fraud	Limited	HMRC has work in progress to improve its understanding of cost. It has developed a costing model as part of its business improvement programme to identify the end-to-end costs of common processes across all its tax streams. However, we found in our study, *Progress on reducing costs*, that its use of costing techniques is still immature, and on *Tax avoidance: tackling marketed avoidance schemes*, that HMRC could not identify the full cost of its avoidance activities. We also found in *Tackling tax credits error and fraud* that HMRC was unable to reliably measure the impact of its interventions to reduce error and fraud, and it had significantly overestimated their benefits.
To use better understanding of risks, such as risk profiling of taxpayers, to prioritise and target its activities	Good	HMRC has strengthened its understanding of its customer base and its risk profiling as a means to prioritise activities and allocate resources, which is an essential element of its business transformation programme. Through reports such as *Tackling tax credits error and fraud* we identified how HMRC could improve its risk assessment and targeting of interventions to address the points at which error and fraud is most likely to enter the system.
To be clearer about what its future operating model will be before implementing structural change	Good	In 2012-13, HMRC has continued work to underpin its future vision with a clearer statement of its future operating model, which has informed the choices and decisions made in implementing its change and cost reduction programme. In *Progress on reducing costs* we found that HMRC was moving from making tactical efficiency savings and quick wins towards a more strategic approach to managing and using its resources, and that its cost reduction plans were consistent with its longer-term vision for transforming its business.

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

6 Comptroller and Auditor General, *HM Revenue & Customs annual report and accounts 2011-12*, HC 38, June 2012.

Part One

Departmental performance in 2012-13 and the Comptroller and Auditor General's work on HM Revenue & Customs

1.1 This part of the report discusses:

- tax revenues in 2012-13;
- tax debt management;
- changes to child benefit;
- the UK–Switzerland tax agreement; and
- work we have published on HMRC's activities.

Tax revenues in 2012-13

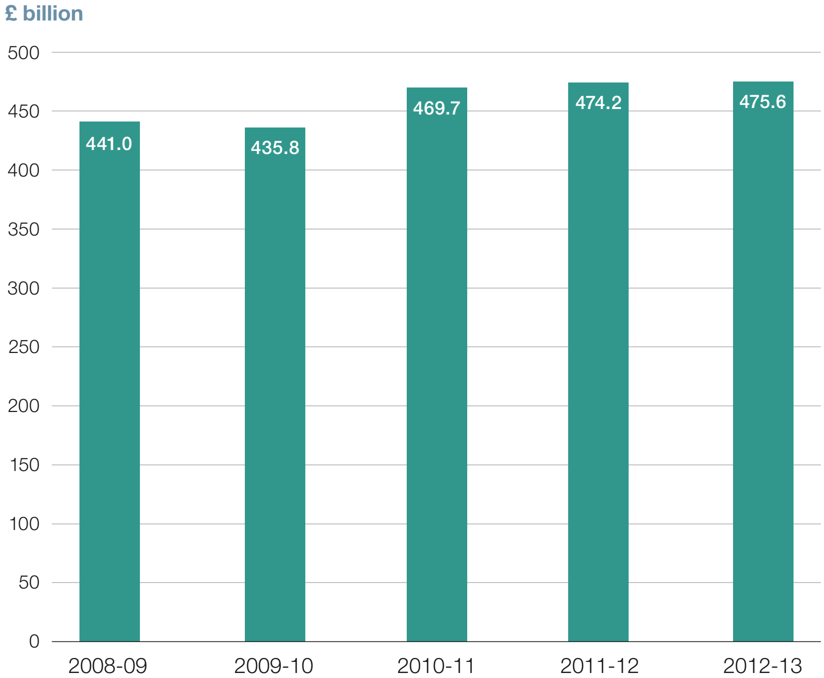
1.2 In 2012-13, total revenues accruing to HMRC were £475.6 billion – £1.4 billion (0.3 per cent) more than in 2011-12. **Figure 2** overleaf shows the tax revenues reported in HMRC's Trust Statement[7] in the last five years. The Trust Statement reports the revenues and expenditure, and assets and liabilities, related to taxes and duties.

1.3 **Figure 3** on page R17 shows the changes in tax revenues between 2011-12 and 2012-13. Corporation tax revenue decreased by £0.9 billion – a reduction in the main rate of corporation tax from 26 per cent in 2011-12, to 24 per cent in 2012-13, may have impacted total receipts. In addition, HMRC stated that revenues from offshore oil and gas production fell by £0.4 billion following lower production levels and higher expenditure, partly offset by increased revenue from financial and life assurance sectors. VAT revenue increased by £1.4 billion, which HMRC has explained by increased revenue from the business services and automotive sectors. Income tax and National Insurance revenues decreased by £0.8 billion, which HMRC states follow a reduced estimate for revenue receivable through self-assessment.

7 *HM Revenue & Customs annual report and accounts 2012-13*, HC 28, June 2013; *HM Revenue & Customs annual report and accounts 2011-12*, HC 38, July 2012; *HM Revenue & Customs annual report and accounts 2010-11*, HC 981, July 2011; *HM Revenue & Customs 2009-10 accounts*, HC 299, July 2010; *HM Revenue & Customs 2008-09 accounts*, HC 464, July 2009.

Figure 2
Total revenue from 2008-09 to 2012-13

In 2012-13, total revenue was £475.6 billion, £1.4 billion more than 2011-12



NOTES

1 Total revenue figures represent accruals based values taken from published accounts.

2 The total revenue figure for 2010-11 varies from the published accounts because of changes in accounting policy as a result of the government's 'clear line of sight' project to align departmental budgets and accounts.

3 Total revenue figures for the years 2008-09 varies from those published in the respective Trust Statement, which include tax credits as negative taxation within revenue for those years.

4 Total revenue in 2008-09 excludes revenue from fines and penalties.

Source: HM Revenue & Customs

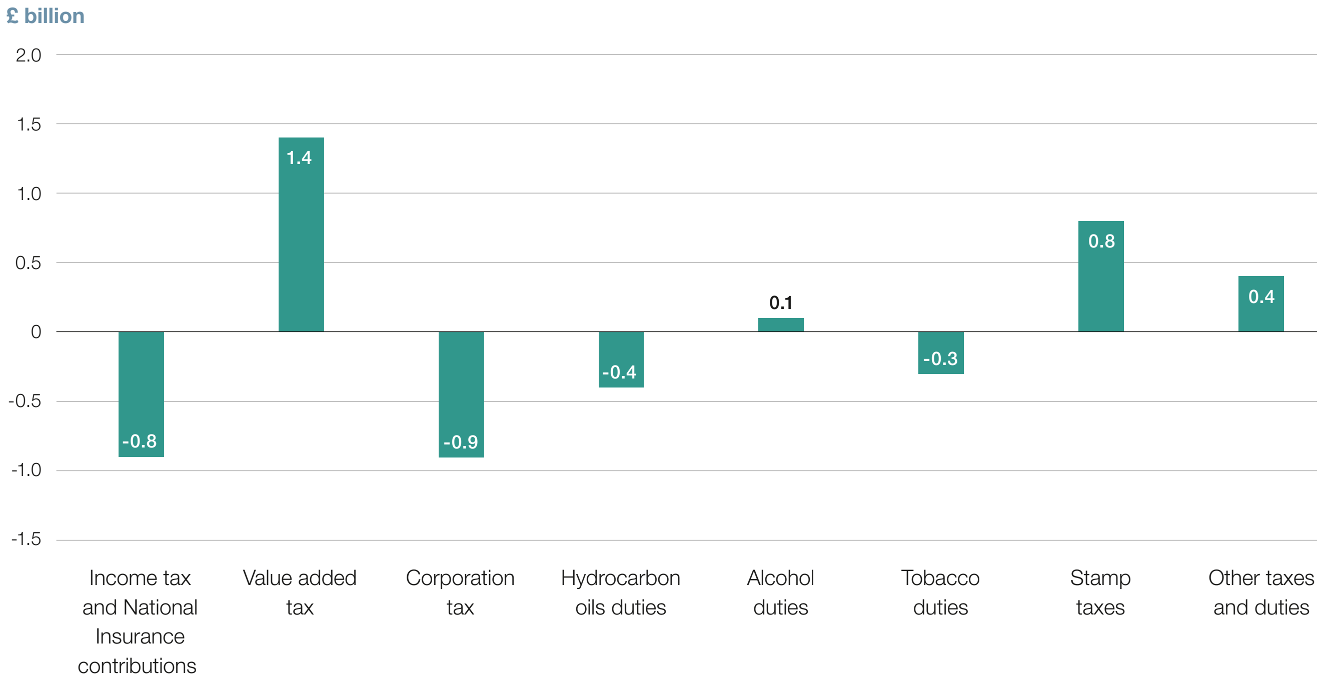
Update on tax debt management

1.4 We reported on tax debt management in our report on HMRC's 2011-12 accounts.[8] Tax debt occurs when a tax liability remains outstanding after the due payment date. It is defined by HMRC as amounts which are overdue for payment and are legally enforceable. Tax debt is not shown separately in HMRC's Trust Statement but is included within a larger figure described as 'receivables'.

8 Comptroller and Auditor General, *HM Revenue & Customs annual report and accounts 2011-12*, HC 38, June 2012.

Figure 3
Change in tax revenues, by tax stream, from 2011-12 to 2012-13

VAT revenue increased by £1.4 billion between 2011-12 and 2012-13



Source: HM Revenue & Customs

1.5 The value of tax debt under active management by HMRC at 31 March 2013 stood at £12.2 billion, compared with £13.3 billion at 31 March 2012. This sum excludes tax credit debt, arising when HMRC identifies that customers have been overpaid tax credit, which we examine in Part Four. HMRC continued to collect significant amounts of overdue tax: £34.5 billion, compared with £37.9 billion in 2011-12. There has been a greater emphasis by HMRC on clearing older debt during the period. The value of debt written off during the year or which HMRC has decided not to pursue for reasons such as hardship or value for money ('remitted') has increased from £5.17 billion last year to £5.31 billion this year. The majority of debt written off is due to insolvency.

1.6 HMRC has made progress in implementing the debt management strategy introduced in 2009-10. It is using its new debt analytics system to allocate risk scores to its debt and design debt collection campaigns based upon customer segmentation, starting with corporation tax and VAT debt. This new approach will be applied to other debt types in 2013-14. In line with recommendations made in our report on HMRC's 2011-12 accounts, it has started to collect cost data for debt collection activities, but these data are not yet reliable or robust enough to identify the costs of all its collection activities and interventions to support the efficient allocation of resources. However, the analytics system is being used increasingly to test and compare the relative effectiveness of different collection strategies and techniques.

Child benefit

1.7 On 7 January 2013, HMRC introduced a new tax charge for those with income over £50,000 and who receive, or whose partner receives, child benefit. The charge increases in proportion to income until it fully offsets the child benefit received at incomes above £60,000. This change has a number of implications:

- **Individuals** must either opt out of receiving child benefit payments or the partner with the higher income needs to declare the child benefit income received by them, or their partner, through the income tax self-assessment process. They may need to register or rejoin the self-assessment income tax regime.

- **HMRC** is responsible for raising awareness of these changes. By March 2013, it had directly communicated this change by letter to 0.8 million (75 per cent) of those thought likely to be affected and also by other media, including advertising and information on its website. HMRC will continue to raise awareness during the 2012-13 self-assessment programmes. The volume of those filing self-assessment income tax returns is expected to increase by 350,000. Additional administration costs are estimated at £13 million per annum.

- The 2012-13 Resource Accounts record child benefit as expenditure. Where individuals have stopped receiving their payments, this will reduce overall child benefit expenditure. Where individuals have chosen to pay the tax charge, the Trust Statement accounts for them as additional revenue. Note 9 to the Resource Accounts explains the accounting treatment.

1.8 Overall, the change is expected to produce net annual savings of £1.5 billion by 2015-16.

UK–Switzerland tax agreement

1.9 On 6 October 2011, the UK and Swiss governments signed an agreement to tackle offshore tax evasion. The agreement aims to settle the past tax liabilities of UK individuals who hold assets in Swiss bank accounts through a one-off payment covering liabilities. It will also establish a new withholding tax to collect future amounts due. Any person under investigation at 31 May 2013 who had not authorised the one-off payment to be made before the investigation commenced, or those subject to a previous relevant investigation and who did not disclose relevant assets in Switzerland, cannot benefit from the clearance of past tax liabilities. Also, there will be no clearance of past liabilities for those involved in criminal attacks on the tax system or for anyone whose relevant Swiss assets are the proceeds of non-tax crime.

1.10 During 2012-13, the Swiss authorities made an upfront payment of 500 million Swiss francs – equivalent to £342 million – in anticipation of future payments expected under the agreement. Under the agreement, individuals choosing not to share their details with HMRC will suffer a one-off levy as well as a new withholding tax for future amounts due. Alternatively, individuals can make voluntary disclosures to settle tax liabilities. HMRC forecasts that a total of £4.4 billion will be received over the next three years in respect of past tax liabilities, either directly from individuals or through the levy by Swiss banks. Note 2.8.2 in the Trust Statement explains the accounting treatment of this revenue.

Summary of National Audit Office work in the last year

1.11 Against the background above, in 2012-13 we published the following reports.

Reports published under the Comptroller and Auditor General's section 2 powers

1.12 In June 2013, we published a report reviewing HMRC's renewed strategy for tackling tobacco smuggling,[9] which followed a similar evaluation of HMRC's renewed alcohol strategy published in January 2012.[10] We found the strategy to be logical, incorporating a wide range of complementary measures to tackle tobacco smuggling, but HMRC's approach to deterring and disrupting the distribution of illicit tobacco within the UK is not yet effectively integrated. HMRC's focus on building overseas intelligence is yielding success. HMRC exceeded internal operational targets in 2011-12 but fell short of more stretching targets in 2012-13 and has failed to capitalise on additional reinvestment funding made available under the 2010 spending review settlement. Two years on, HMRC lacks a timely and comprehensive assessment of the impact of its strategy on the scale and nature of tobacco smuggling.

9 See footnote 5.
10 Comptroller and Auditor General, *Renewed alcohol strategy: a progress report*, Session 2010–2012, National Audit Office, HC 1702, January 2012.

Value-for-money reports

1.13 We published four value-for-money reports in 2012-13:

- *Tax avoidance: tackling marketed avoidance schemes*.[11] In 2010-11, HMRC estimated the difference between the tax that is collected and the tax that should be collected to be £32 billion, of which £5 billion was due to those "using the tax law to get a tax advantage that Parliament never intended". We found that HMRC had made some important headway in reducing the opportunities for avoidance by closing legal loopholes, but that the large number of users of avoidance schemes posed a significant challenge with little evidence of HMRC making progress in preventing some promoters from selling highly contrived schemes. We recommended that it increase its efforts to understand and influence the market of promoters and users of avoidance schemes and improve its management information to better direct its anti-avoidance effort.

- *Tackling tax credits error and fraud*.[12] In June 2012, HMRC estimated tax credit error and fraud in 2010-11 to be around 8.1 per cent, which meant it had missed its target to reduce error and fraud to 5 per cent of finalised entitlements by March 2011. We found HMRC had not yet developed an effective response to stopping error and fraud occurring on claims in the system because of changes in claimants' circumstances, although it was moving in the right direction by introducing innovative approaches that could make a difference in the future. We recommended that it should establish error and fraud plans for high risk areas and make better use of data analysis.

1.14 The two further reports focused on how HMRC is run:

- *Progress on reducing costs*.[13] In our second report on HMRC's cost reduction programme we found that in 2011-12, the first year of the programme, it had saved one third of the total it needed to save by 2014-15 and had maintained performance in key strategic areas, improving its value for money. It had reduced its costs by £296 million – 19 per cent more than target – but we noted that further reductions would be challenging. HMRC is moving from making tactical efficiency savings and quick wins towards a more strategic approach to managing its resources. We recommended that HMRC continue to strengthen its management and governance of savings that do not come from defined and funded cost reduction projects. In 2012-13, it identified new savings of £249 million: 4 per cent more than its target.

11 See footnote 1.
12 See footnote 4.
13 See footnote 3.

- *Customer service performance*.[14] Our report concluded that while HMRC has improved its customer service, overall performance represented poor value for money for customers. We recognised that HMRC had restored customer service levels from a low point in 2010 and had committed to making further improvements. Its future plans were ambitious given past performance and the difficult decisions it has to make in order to meet its spending review commitments to reduce costs and increase tax revenues. We recommended it develop a longer-term customer service strategy. Since our report and the Committee of Public Accounts hearing, HMRC has committed to making improvements to customer service such as migrating its 0845 helplines to 03 numbers, offering a call-back service, increasing online self-service and revising performance targets. It has now migrated two of its 0845 numbers; set itself new targets and begun a call-back service trial. HMRC's customer service performance has improved in 2012-13 with HMRC achieving performance targets and answering on average 78 per cent of calls and 85 per cent of post within 15 days.

14 See footnote 2.

Part Two

The PAYE service

Introduction

2.1 Pay As You Earn (PAYE) is HMRC's largest single tax collection process. In 2012-13, HMRC collected £150.9 billion in income tax and £101.7 billion in National Insurance contributions, of which approximately 85 per cent was collected through PAYE. There are approximately 41 million individuals with an active PAYE record. Each year HMRC processes around 60 million[15] returns for separate employments and pensions.

2.2 In June 2009, HMRC implemented the National Insurance and PAYE Service (NPS) system to bring together individuals' tax records into a single taxpayer account. It encountered significant difficulties in administering PAYE after implementing NPS, which we have reported on in our reports on HMRC's 2010-11 and 2011-12 accounts. HMRC committed to stabilising the PAYE service by the end of March 2013.

2.3 HMRC is changing the way it administers PAYE. In April 2012, HMRC piloted its online Real Time Information (RTI) system which will require employers to report PAYE information more frequently. HMRC plans to have fully rolled out RTI by October 2013, largely to support Universal Credit. From October 2013, the Department for Work & Pensions plans to expand Universal Credit pathfinders, which started in April 2013, and progressively roll-out Universal Credit to all claimants by 2017.

2.4 This part of the report covers HMRC's:

- progress in stabilising the PAYE service; and
- readiness for the roll-out of RTI.

15 Of these about 6.5 million were reported through Real Time Information in 2012-13 for separate employments and pensions.

Progress in stabilising the PAYE service

2.5 Up to and including 2012-13, the majority of employers paid PAYE deductions for their employees to HMRC monthly based on tax codes from HMRC, and only provided detailed information on the deductions made for each employee after the end of the tax year. HMRC would then reconcile the tax due with the payments received throughout the year to ensure that employees had paid the correct amount of tax. These end-of-year reconciliations can sometimes result in under and overpayments of tax, for example where an employee's circumstances changed.

2.6 When NPS was introduced in 2009, HMRC encountered significant difficulties in administering PAYE, which caused a backlog in end-of-year reconciliations. HMRC committed to undertaking a programme of work to stabilise the PAYE service and to clear this backlog.

2.7 **Figure 4** shows how HMRC cleared the backlog of reconciliations and completed the final 12 months of the stabilisation programme by the end of March 2013, in line with its commitment to the Committee of Public Accounts. By bringing PAYE up to date, HMRC has reconciled all outstanding PAYE cases, up to and including the tax year 2011-12, that the NPS system identified for review. HMRC has either cleared the cases or, for a small minority, are following up for further information or investigation.

Figure 4
HMRC performance against its commitments to stabilise NPS

HMRC successfully delivered the final 12 months of the stabilisation programme

HMRC aimed to stabilise NPS by completing	Target date	Task completed?
Outstanding end-of-year reconciliations from 2008-09 and 2009-10 (6.7 million)	31 March 2012	✔
Outstanding reconciliations from 2003-04 to 2007-08	31 December 2012	✔[1]
End-of-year reconciliations for 2010-11 and 2011-12 within accelerated processing timetable	31 March 2013	✔[2]

NOTES
1 Actual completion date 31 October 2012.
2 There are 17,500 cases which HMRC have reviewed where further information is being requested or further investigations are taking place (paragraph 2.7).

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

2.8 The stabilisation and clearance of outstanding cases has come at a cost, both in processing costs and uncollected taxes. Up to March 2013, HMRC had spent £78.9 million in stabilising PAYE, against an estimated £80.9 million, and had foregone an estimated £953 million of tax to keep workloads manageable (**Figure 5** overleaf).

Figure 5

Stabilisation of PAYE: estimated tax foregone

HMRC's best estimate of total tax forgone during the stabilisation programme is £953 million

Estimated tax foregone (£m)	Explanation
266	Consequence of temporary increase in threshold for debt collection (applies to tax years 2008-09 and 2009-10)
630	Estimated notional tax foregone in respect of open cases (applies to tax years 2003-04 to 2007-08)
57	Successful claims under Extra-Statutory Concession A19[1]
953	**Total**

NOTE

1 An Extra-Statutory Concession is a relaxation which gives taxpayers a reduction in tax liability to which they would not be entitled under the strict letter of the law. Concession A19 is a concession relating to arrears of tax arising through official error, specifically where the Department has not used the information in a timely manner.

Source: HM Revenue & Customs

Managing the PAYE service in-year

2.9 For the PAYE service to work effectively, HMRC should only be dealing with three open tax years at any one point in time for the majority of taxpayers. This means that over 12 months, HMRC should:

- reconcile taxpayer accounts for the previous tax year;
- make some in-year adjustments to reflect changes in circumstances, thereby keeping some taxpayer accounts up to date; and
- calculate and send tax codes for the following tax year.

2.10 HMRC must therefore efficiently administer in-year changes to taxpayer records and actions generated by the NPS system in-year (known as work items) alongside maintaining customer service standards. The majority of changes are processed automatically and the remainder require manual review.

2.11 In 2011-12, we reported that the NPS system generated more work items than HMRC had the capacity to handle. **Figure 6** shows actual work items generated in 2012-13 against forecast and the projections for the following two years. HMRC is forecasting a reduction in work items generated year on year. Those work items which impact on the accuracy of a taxpayer's ultimate liability are planned to be worked. Although this means that some tax codes will not be reviewed in-year, all taxpayer accounts will be automatically reviewed at year end, with the majority showing that no further action is required. Any items identified for manual intervention will be worked in the following year.

Figure 6
How HMRC will deal with work items generated by NPS

HMRC plans to reduce the volume of work items generated to around 10 million in 2014-15

	2012-13 plan (million)	2012-13 actual (million)	2013-14 forecast (million)	2014-15 forecast (million)
Total generated	25.8	24.1	17.4	13.3
Tapped[1]	(5.1)	(2.8)	(2.8)	(2.8)
Planned to automate/eliminate	(1.1)	(0.8)	(2.5)	(3.2)
Total requiring manual work	**19.6**	**20.5**	**12.1**	**7.3**
HMRC's capacity to work	14.4	16.0	10.7	5.3
Excess over capacity	**5.2**	**4.5**	**1.4**	**2.0**

NOTE
1 Tapped: Work items which HMRC does not intend to action in the normal course of business.

Source: HM Revenue & Customs

2.12 HMRC currently prioritises work items to ensure that the excess produced above its capacity to work them does not impact on the taxpayer's final liability to tax. It does this by prioritising those work items affecting what the taxpayer has to pay after annual reconciliation. Not all work items affect customers' tax records and therefore HMRC prioritises or seeks to 'tap' (switch off) those items so they are not generated for action. HMRC has no plans to work all in-year work items which would adjust the taxpayer's code to ensure that in-year tax deductions are correct, although RTI is expected to update taxpayers' records based on data about starting and leaving employment. HMRC has also started a project to deliver further automated solutions.

2.13 HMRC is relying on business process re-engineering and opportunities presented by RTI to reduce the number of under and overpayments required at each year end. If HMRC is able to reduce its work items as it hopes, it is likely that this would improve the accuracy of customers' records held during the year. More up-to-date and accurate tax codes being maintained during the year should lead to fewer over and underpayments of tax at the end of the tax year, reduced customer contact and a positive impact on HMRC's performance targets.

2.14 The full impact of RTI on the volume of work items is yet to be determined, although HMRC expects the volume of work items to reduce with more taxpayer records automatically reconciled at the end of the tax year.

Implementing Real Time Information

2.15 Implementing RTI is the next stage in HMRC's modernisation of PAYE. With RTI, employers must report employees' income tax and National Insurance deductions on or before payment, rather than after the end of the tax year, as described in paragraph 2.5.

2.16 Under RTI, some elements of the PAYE process will no longer be required, such as employer end-of-year returns and in-year forms for starters and leavers. It should also reduce the time it takes to complete end-of-year reconciliations and increase the number of automated reconciliations. However, end-of-year reconciliations will still be needed as, for example, HMRC would only be notified of benefit in kind information, such as company cars, at the end of the tax year.

2.17 RTI offers HMRC the prospect of tracking changes in income and employment in-year, ensuring that individuals remain on the correct tax code when employments change and thereby reducing the level of under and overpayments of tax.

2.18 Receiving data more regularly brings many potential benefits for HMRC including:

- greater efficiency through automation of tasks and workflow management;
- more timely information on employees' actual earnings leading to more accurate tax credit renewals; and
- improvements in cash flow and debt management from the closer monitoring of in-year tax receipts.

2.19 The timetable for implementing and rolling out RTI nationally – by April and October 2013 respectively – is challenging. It was originally driven by the Department for Work & Pensions' plans to progressively extend Universal Credit from October 2013 for which PAYE information on employment and pension income is required.

Real Time Information pilot

2.20 Learning from the implementation of NPS, HMRC ran a pilot of RTI during 2012-13 with employers invited to test the new technology and processes. The pilot started on time (April 2012), but the number of employer and pension schemes using RTI by 31 March 2013 was significantly lower than the original assumption of 250,000 schemes. Due to lower than expected employer volumes, HMRC revised its plans and focused on bringing in larger schemes to ensure the required number of individual employment records were tested during the pilot. Only 66,240 employers and pension schemes participated in the pilot, although these included over 6.5 million individual employment records, in line with planned volumes. The lower number of employer schemes participating meant that live employer volume testing in advance of the full roll-out in April 2013 was lower than originally anticipated.

2.21 Various bodies have expressed concern over the requirements placed on smaller employers by the more frequent payroll reporting requirements of RTI and whether such employers were sufficiently represented in the pilot exercise. Seventy-three per cent of employer schemes participating in the pilot had nine or fewer employees. **Figure 7** outlines the mix of schemes involved in the pilot. As participation in the pilot was voluntary, the pilot results may not necessarily reflect the issues experienced by all employers or in all industry sectors.

2.22 The pilot covered the initial matching of employer records with those held by HMRC and the electronic submissions of payroll information. During the pilot year to April 2013, only starter and leaver data has been transferred into the NPS system and testing of the internal data interfaces between RTI and the NPS system, enabling the performance of end-of-year reconciliations, only started from April 2013 after the live roll-out of RTI. Further IT releases are scheduled for October 2013 and April 2014. Consequently, new issues may arise as more employers start to use RTI for the first time or with further IT system changes.

2.23 The pilot has been successful in testing functionality and system performance, while identifying issues for HMRC to address before the live roll-out to all employers. One of the most significant issues is the creation of duplicate employment records when employer payroll references differ from HMRC records, as a result of the employers changing references without informing HMRC. This could lead to incorrect tax codes being issued to employees. In response, HMRC have developed methods to identify and correct such cases, and are working to address all cases from the pilot period. By the middle of May, HMRC had identified approximately 10,000 duplicates from 21 million employments validated within RTI. This issue will continue as employers migrate on to RTI and HMRC is monitoring daily. It also demonstrates the value in undertaking such a pilot.

Figure 7
Size and volume of employers involved in RTI pilot

The RTI pilot covered 65,850 employer schemes and 6,573,011 employments

Size of employer scheme	Number of schemes	Number of employments
5,000 employees and greater	283 (0%)	4,441,093 (66%)
250 to 4,999 employees	1,306 (2%)	1,490,200 (22%)
50 to 249 employees	3,656 (6%)	376,327 (6%)
10 to 49 employees	12,672 (19%)	275,365 (4%)
0 to 9 employees	48,323 (73%)	128,276 (2%)
Total	**66,240**	**6,711,261**

Source: HM Revenue & Customs

Financial systems accreditation

2.24 Financial accreditation is a requirement of HMRC's Change Programme and provides HMRC with assurance that any systems introduced are acceptable for accounting and financial control purposes. As RTI reflects a major change to how financial information is gathered, the RTI project board had to obtain internal financial accreditation over the financial systems supporting RTI. Full accreditation will not be granted until implementation of the appropriate principles and controls.

2.25 RTI went live without full accreditation on the basis that the financial system design issues identified would be resolved by October 2013. A number of these system requirements were identified towards the end of the pilot and were not included in the original business case. These issues do not impact an employer's ability to submit data to HMRC using RTI but do result in weaknesses in HMRC's ability to produce and report financial information about PAYE. HMRC is currently undertaking work to understand the extent to which failure to address these accounting issues could result in HMRC being unable to correctly allocate and account for some PAYE payments received from employers or to identify and collect amounts outstanding.

Contingency arrangements

2.26 Online and time-sensitive system implementations are usually developed with formal technical resilience and disaster recovery capability to help maintain the service being offered if there is a technical failure. HMRC chose not to develop full resilience because of the cost implications and because the PAYE service could be operated in an emergency without RTI.

2.27 HMRC management is confident that the RTI service could be recovered if there is a significant processing disruption. However, RTI has the potential to be exploited by other government departments and the absence of resilience may inhibit its use in areas of activity where a temporary disruption to services cannot be tolerated. Data submissions can be held temporarily in a queue but this would not be sufficient to provide continuity of service in the event of a catastrophic failure. A failure in the RTI service at a critical processing time could also increase the amount of customer communication with HMRC and lead to more effort on behalf of employers.

2.28 We reported in 2011-12 that the delivery of the RTI programme lacked any contingency arrangements. In response, HMRC has developed various short-term scenario-based contingencies to achieve the October 2013 delivery date. However, there is no significant contingency spend within the project for any major delays or problems with the implementation.

2.29 The current expected cost of implementing RTI at £356.6 million is £115.5 million more than originally estimated because of new development costs required to increase the system's functionality as a result of consultation with stakeholders and better cost estimations. Within the expected cost, HMRC has not budgeted for any extra costs stemming from significant new issues arising.

2.30 A phased approach is now being adopted to get the remaining 1.9 million employer schemes into RTI by the October 2013 deadline. As part of this phased approach, in March 2013, HMRC announced a temporary relaxation to 5 October 2013 of RTI reporting arrangements for small businesses (fewer than 50 employees) to allow extra time for these employers to adapt their processes and change arrangements with payroll providers. On 12 June 2013, HMRC announced that it will be seeking to extend this temporary relaxation until April 2014.

2.31 HMRC reports that take-up of RTI has to date exceeded its expectations since the live roll-out, with approximately 1.4 million employer schemes filing RTI returns with 23.9 million employments by the end of May 2013. However, there are a number of risks to HMRC meeting its timetable, including the operational capacity of its systems and resources to manage take-on volumes over the April to October period, which HMRC is monitoring on a daily basis.

Future operating model

2.32 HMRC sees digitalisation as key to its ability to modernise its business and deliver a better service with fewer and better targeted resources. HMRC has an overall objective to reduce costs and believes staff should be engaged in value-added activities such as tax collection and customer service, rather than in back-office processing work. A number of individual projects, including those on NPS work items and RTI implementation described above, have been designed to support that objective.

2.33 Efforts to reduce workload have been targeted at tasks that save the most manual effort and those with a direct tax impact have been prioritised. While this has led to some successes, HMRC is still developing its long-term strategy for improving the PAYE process and defining its future operating model. Detailed scoping work is currently under way to determine how to exploit the opportunities and benefits provided by RTI and support a business process re-engineering and digitalisation programme. This is, and must continue to be, a priority for HMRC.

Part Three

Tackling VAT fraud

Introduction

3.1 Value added tax (VAT) is a tax levied on the supply of goods and services within the United Kingdom and Isle of Man. In 2012-13, net VAT revenue totalled £101 billion (gross revenues of £176 billion less repayments of £75 billion).

3.2 VAT registration is compulsory for businesses with an annual turnover above the registration threshold (from 1 April 2013 this increased from £77,000 to £79,000). Businesses with turnover below this level can choose to register for VAT voluntarily. There are currently 1.9 million businesses registered for VAT.

3.3 Registered businesses incur VAT on the goods and services they buy (input tax) and, subject to partial exemption restrictions, can recover the cost against the VAT charged on the sale of their own goods and services (output VAT) or by reclaiming a repayment from HMRC, if there is an excess. VAT is, therefore, ultimately paid by the consumer and collected by businesses on behalf of HMRC.

3.4 VAT is susceptible to fraud to a greater extent than most other taxes collected by HMRC. This is partly because repayments are an integral part of the system, as some traders claim back more input tax on their purchases than they pay output tax on their sales. This creates both the opportunity and incentive for criminal attack, by claiming repayments that are not based on legitimate business activity.

3.5 This part of the report covers:

- the current assessment of the extent of revenue lost from the VAT system because of fraud;
- HMRC's approach to identifying and tackling the risk of fraud;
- progress in combating missing trader intra-community (MTIC) fraud; and
- HMRC's plans to improve its response to tackling fraud.

Assessment of the current level of VAT fraud

3.6 HMRC estimated the tax gap for VAT in 2010-11 as £9.6 billion (30 per cent of the total estimated tax gap of £32 billion). This equates to around 10.1 per cent of the amount of VAT that could theoretically be collected. HMRC estimated that MTIC fraud constituted between £0.5 and £1 billion of the VAT tax gap.

3.7 A range of customer behaviours contribute to the VAT gap, including errors, failure to take reasonable care and conflicting legal interpretations. Our review focused on behaviours leading to deliberate evasion and criminal attacks. Aside from the estimate of MTIC fraud losses, and VAT debt (£0.9 million in 2011-12), HMRC does not publish a breakdown of the VAT tax gap by behaviour. Fraudulent behaviour contributes to the VAT tax gap in a number of areas:

- **Hidden or shadow economy fraud:** genuine businesses with a turnover above the VAT registration threshold who do not register for VAT.
- **Suppression of revenues:** genuine businesses with legitimate trading activity perpetrate a fraud by understating a portion of their sales or by falsely inflating their claims for the VAT on purchases to reduce their tax liability.
- **MTIC fraud:** fraudsters register for VAT in the United Kingdom to buy goods from other European Union member states VAT-free. They subsequently sell goods in the United Kingdom inclusive of VAT without paying over VAT due to HMRC.
- **Repayment fraud:** fraudsters registered for VAT make false claims for repayments.

HMRC's approach to identifying and tackling the risk of fraud

3.8 HMRC seeks to identify and tackle the risk of VAT fraud through a series of measures including:

- using intelligence provided by customers, European Union members and others;
- automated risk profiling of VAT registration applications;
- risk assessment of VAT returns; and
- risk profiling of VAT repayment claims.

3.9 HMRC does not deploy enforcement and compliance staff to individual tax regimes, so does not routinely measure the total staff time and cost devoted to tackling VAT fraud each year. However, during 2012-13, HMRC estimates that 4,120 front-line caseworkers were allocated to managing the risk of VAT non-compliance, of which an estimated 2,335 worked primarily on tackling VAT fraud.

Using and sharing intelligence

3.10 Intelligence from taxpayers and other European tax administrations plays an important role in alerting HMRC to emerging threats against the VAT systems. In the recent past, for example, intelligence from industry has allowed HMRC to tackle the risk of repayment fraud in the renewable energy market. Competitors have also provided HMRC useful intelligence on suppliers who are operating in the hidden economy. This intelligence enables HMRC to focus its compliance activity on specific business sectors and regions.

3.11 HMRC also works increasingly closely with other European tax administrations, which is important given the pan-European nature of VAT fraud. This has alerted HMRC to new threats, such as trading in carbon credits.

3.12 In 2007, the Committee of Public Accounts[16] criticised HMRC's track record in responding positively to requests for cooperation from other European tax jurisdictions to tackle missing trader fraud. HMRC set a target to respond to 80 per cent of all requests within 90 days. In 2011, the latest year for which data is available, HMRC met this target by responding to 86 per cent of requests. This is a significant improvement from the 55 per cent achieved in 2005-06, with HMRC the best performing administration among the larger member states. However, the response rate is still below the 100 per cent rate the Committee encouraged HMRC to move closer towards.

Automated risk profiling of registration applications

3.13 A crucial first stage in preserving the integrity of the VAT systems is ensuring that only bona fide businesses are able to register. HMRC implemented the first phase of its VAT registration transformation (VRT) project in October 2012. It will enable traders to apply for their VAT registration, amend their details and deregister online for the first time.[17] The project cost HMRC £22.3 million (to the end of March 2013), and the planned VRT costs are not separately identified within the wider One Click programme.[18]

3.14 In addition to improving customer service and reducing HMRC's operational costs, the project intended to reduce revenue losses, including those caused by fraud, by between £30 and £35 million in each subsequent year. HMRC expects to reduce the number of processing staff by 109 between 2012-13 and 2015-16, with savings of £180,000 per annum in 2013-14 and £360,000 per annum in 2014-15 and 2015-16. Benefits will arise through automated risk checking and decision-making (for example to establish duplicate applications from businesses already registered for VAT) and allowing more sophisticated risk assessment, using the IT platform Connect.

16 HC Committee of Public Accounts, *Standard report on the accounts of HM Revenue & Customs: VAT missing trader fraud*, Forty-fifth Report of Session 2006-07, HC 250, July 2007.

17 Customers were required to file VAT returns online prior to the introduction of VRT, but were unable to get an online decision and issue of their VAT certificate, which they can now do as a result of the VRT project.

18 VRT is part of the One Click programme (bringing tax services online), with a total programme budget of £113 million. In 2012-13, there was a £16 million overspend against a £10 million One Click budget.

3.15 All registrations are assessed using identity checks alongside Connect, which HMRC uses across many of its taxes. Connect identifies links between individuals and companies using a range of data sources. The Connect tool is used as part of an automated replacement for the manual risk assessment checks previously carried out. A range of rules have been defined within Connect to identify potentially risky or fraudulent traders.

3.16 The first phase of VRT delivered the online registration facility with phase 2, which went live in December 2012, introducing automated variation and deregistration processing. Between April and June 2013, the final phase of the project, which includes the production of better management information, will be rolled out.

3.17 Since the system went live, the data transfer process between VRT and Connect has failed numerous times. None of these delays have been significant and HMRC processed 98 per cent of non-risky returns within its three-day target. HMRC is investigating this issue as ongoing failures in the links between Connect and VAT systems could become more serious when the processing of repayment returns using Connect goes live later in 2013.

3.18 Since implementation of the first phase of the VRT project, between 81 and 84 per cent of all monthly registrations have been made online, exceeding HMRC's 80 per cent target. In excess of 2,000 registration requests have been identified as potentially risky and requiring further investigation each month, compared to an average of less than 1,000 cases before implementation of VRT. HMRC has not yet assessed whether the increased caseload for investigation generated by the VRT system risk rules is delivering the expected outcome in terms of preventing risky traders entering the VAT system.

3.19 HMRC plans a formal post-implementation review of the launch of the VRT system. This is expected to be after January 2014 but has not yet been scheduled. Until such a review has been completed it is not possible to conclude whether the VRT project has delivered the expected benefits in terms of reduced revenue losses, including those caused by fraud.

Monitoring and profiling of VAT returns

3.20 VAT-registered businesses submit regular online VAT returns to HMRC, along with an assessment of their tax liability. Most businesses file returns quarterly in arrears, but can request to submit monthly or annual returns to HMRC. Where HMRC identifies businesses that are in a payment position at a high risk of non-compliance, they demand more regular, monthly VAT returns.

3.21 Each month HMRC undertakes a central risk analysis for VAT traders. This uses a predictive analytical model which is run against the returns made by the 1.9 million businesses registered for VAT. HMRC's objective is to prioritise investigations which will maximise financial returns, rather than to target businesses where the risk of VAT evasion and fraud may be greatest.

3.22 HMRC regularly monitors VAT returns and applies different approaches depending on the nature of the return:

- **Repayment returns:** Where VAT returns lead to a repayment to the taxpayer, there is a more immediate fraud risk. HMRC uses an automated risk profiling tool to identify high risk returns, which are investigated.
- **Payment returns:** Fraud can still arise from returns where payments are made to the Exchequer if revenue has not been fully declared or expenses overstated. Returns are assessed using limited real-time data validation checks.

Repayment returns

3.23 HMRC conducts prepayment checks to prevent fraudulent repayments being made, but must meet customer service standards to process 90 per cent of VAT repayment requests within ten working days of receipt of the return. **Figure 8** shows that in 2012-13, HMRC processed 2.12 million repayment returns, of which 191,000 (9 per cent) were subject to further checks, with £579 million repayments prevented.

3.24 HMRC uses an automated system ('the credibility suite') to profile VAT repayment returns and identify those where there is an increased risk of error or fraud. Where high or medium risk returns are identified, HMRC conducts an assessment of the return, which may involve visiting the trader before the repayments are authorised and, in some instances, will reject them. The system considers factors such as:

- the company's trading history and performance;
- trends from previous VAT returns; and
- information provided on the current return.

Figure 8
VAT repayments made, stopped and failing initial checks in 2012-13

Of the 2.1 million repayment returns processed in 2012-13, 0.8 per cent were stopped or amended owing to fraud or error

Status of repayments	Volume (percentage of 2.1 million returns)	Value (£m)
Subject to further checks	190,996 (9%)	26,320
Repayments stopped/reduced	16,861 (0.8%)	579

Source: HM Revenue & Customs

3.25 In recent years there has been little change to the automated system and the criteria used to risk profile repayment requests. Although HMRC has identified potential amendments, these have rarely been implemented because of the constraints of the legacy system and the consequential impact on HMRC's ability to predict the effect on the volume of cases assessed as high risk.

3.26 In March 2013, HMRC identified a number of traders who had been submitting repayment requests for sums just below the threshold it had set to trigger an investigation. HMRC's analysis suggests that this may have caused a loss of some £500,000. This emphasises that organised fraudsters are adaptable and will attempt to submit multiple registrations and returns until they are successful in discovering the parameters at which HMRC operates its fraud controls. HMRC is aware that it needs to monitor and respond quickly to emerging threats to the VAT system.

3.27 HMRC recognises the need to modernise its system for risk profiling VAT repayment requests. It is currently developing a replacement system that will offer a more comprehensive and flexible set of risk factors. The new system will incorporate the existing rules and parameters, but will exploit the functionality of Connect by enhancing risk profiling at the pre-repayment stage. The new system is intended to be introduced in autumn 2013 and will eventually replace the credibility suite, subject to resolving existing problems with the interface between VAT systems and Connect (noted in paragraph 3.17). Sensibly, HMRC plans to carry out 500 visits to traders to compare the level of stopped payments under the new system with those generated by the credibility suite. It intends to keep the credibility suite in the short term to mitigate the risk of failure of the replacement system.

Payment returns

3.28 HMRC undertakes separate checks on all returns that are submitted, using its central risk analysis model (noted in paragraph 3.21) to identify those businesses where HMRC interventions have potential to generate the greatest compliance yield. The current focus of this model is on tackling non-compliance, informed by past customer behaviour and the level of risk associated with the trade sector. The analysis does not specifically target VAT evasion and fraud.

3.29 HMRC recognises that it could build on the strengths of this analysis and its taskforces programme to more explicitly focus on tackling the risk of evasion. It is planning to review the feasibility of this development during 2013-14. For example, HMRC's analysis currently excludes sector benchmarks and cross-tax data which, if included, would allow a comparison of tax declared against expectations. In addition, Connect is not currently used in the initial risk assessment of payment returns in the way that it is used to risk assess registrations and is planned to be used for repayment returns.

3.30 HMRC's other main activities include an analysis of trade sectors and geographical regions to identify emerging risks, followed by a focused review as part of individual campaigns and taskforces. It also monitors traders who are making payments but not submitting returns. In these cases it may send a 'prime assessment'[19] of VAT payable by the company. HMRC has not established the potential benefits of sophisticated risk profiling of payment returns as routine, to show whether this could yield a high rate of return on investment in terms of revenue loss prevented.

3.31 Since May 2011, HMRC has created 43 taskforces with the aim of securing around £173 million in additional tax revenue; to date it has recorded additional revenues from these initiatives of £72 million. Taskforces often work across taxes and involve other government departments and have recorded some notable successes to date. For example, HMRC's analysis identified a higher proportion of zero-rated to standard-rated sales in fast-food restaurants in certain cities than elsewhere in the country. This analysis led to individual establishments being assessed and HMRC estimates that this resulted in additional VAT revenue of £40 million.

3.32 HMRC uses campaigns to target particular trades or professions and encourage behavioural change and increased compliance with tax requirements. It estimates that previous campaigns have raised more than £600 million across all tax streams with more than 22,000 investigations covering trades such as medical professionals, plumbers and electricians.

3.33 HMRC business areas agree an annual level of cases to be investigated, driven by resource availability, and selected after payment profiling and work by campaigns and taskforces. During 2012-13, HMRC agreed a 49,000 caseload of which 17,000 had not yet been started as at 31 March 2013. HMRC informed us that cases with high fraud risk would have been resolved earlier and that its optimum level for the stock of cases was 15,000. However, there is a shortage of management information on the age profile and nature of this workload. This increases the risk that cases will not be prioritised and investigated sufficiently quickly to protect against revenue losses.

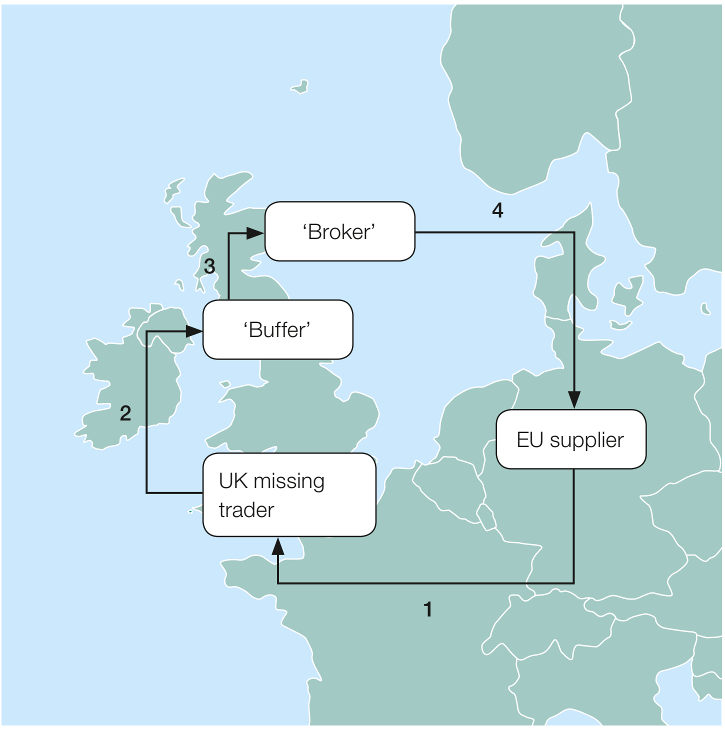
Progress in tackling missing trader intra-community fraud

3.34 HMRC has been tackling missing trader intra-community (MTIC) fraud since it emerged as a particular risk area in 2000. **Figure 9** illustrates that MTIC fraud, in its simplest form, involves a business obtaining a VAT registration number in the UK for the purpose of purchasing goods, VAT free, from other European Union member states. The business then sells the goods at a VAT inclusive rate in the UK and disappears without paying the VAT to HMRC. In its most abusive form, commonly referred to as carousel fraud, traders sell the same goods repeatedly through contrived supply chains involving other traders in both the UK and other member states of the European Union.

19 If taxpayers fail to submit VAT returns by the required date, HMRC will make an assessment for the amount of VAT that it believes is owed, based on its best judgement, to protect the Exchequer's interest.

Figure 9
The missing trader intra-community fraud process

The MTIC process is complex, even in its simplest form, and involves a number of players



1 A European Union supplier from another member state sells goods for £1,000,000 to a trader based in the UK free of VAT.

2 The trader sells the goods to another trader ('the buffer') at a reduced price of £900,000 plus £180,000 VAT. To avoid the price of goods spiralling up each time the carousel turns, one business in the chain must sell at a loss. The initial UK trader subsequently goes missing without paying the VAT due.

3 The buffer accounts for VAT correctly and sells the goods to a trader at the end of the UK chain ('the broker') for £950,000 plus £190,000 VAT.

4 The broker makes a zero-rated VAT sale back to the original European Union supplier for £970,000 and is entitled to reclaim the input VAT of £190,000 on the goods purchased from the buffer. HMRC pays the claim and incurs a cash loss because the missing trader did not pay the VAT due.

Source: National Audit Office

3.35 The level of attempted fraud increased from 1999-2000 to a peak in 2005-06 when HMRC estimated it at between £3 billion and £4 billion. However, as a significant proportion of attempted frauds were stopped, the estimated actual cash loss was between £2 billion and £3 billion. Since then, HMRC's interventions and cooperation with others has helped reduce losses to an estimate of between £0.5 billion to £1 billion in 2010-11. This reduction has coincided with a change in the nature of the threat; the more significant losses were incurred when the threat and the response were less sophisticated and fraudsters were able to submit repayment returns. The risk now is that large businesses can be included as buffers in the MTIC transaction chain, making the losses more difficult to detect. The MTIC trader is paid by the large business and the related input tax is not repaid but offset against the tax liability of the large business.

3.36 As part of the 2010 Spending Review, HMRC secured agreement to reinvest £917 million of efficiency savings across its business between 2010-11 and 2014-15, on the basis that this would return £7 billion of additional revenue a year by March 2015. It allocated £25 million of this funding to projects directly related to tackling MTIC fraud, with the objective of generating benefits of £1.6 billion over the spending review period. During 2013-14, we will be examining HMRC's progress in meeting its additional revenue targets from its reinvestment programme.

3.37 Reinvestment contributed to funding key initiatives such as the VAT MTIC Fraud Trader Monitoring project where HMRC enhanced its monitoring of business sectors. HMRC is responding swiftly to intelligence that MTIC traders could launch criminal attacks against the VAT system in particular industries, for example parts of the energy sector. HMRC informs large legitimate companies in these sectors of the potential threat and the need for due diligence in the business they undertake. This may include a requirement to tell HMRC of any new traders in the sector, enabling HMRC to check the VAT registration status and other intelligence about the third party.

3.38 The UK is one of few nations to publish its estimate of the tax gap each year and, alongside this, an estimate of losses due to missing trader fraud. There has been no published estimate of the VAT gap across the European Union for any period since 2009.[20] There is no consistent methodology used across member states to derive this estimate, so the estimate and any comparatives are not yet meaningful.

Plans to tackle VAT fraud

Internet-based trading

3.39 We assessed the risks to the VAT system posed by e-commerce in our 2006 report.[21] We concluded that HMRC's judgement that the overall risk to VAT revenue from e-commerce was at that point low appeared reasonable. Since then, the substantial increase in e-commerce sales has presented increased challenges.

20 Reckon LLP, 'Study to quantify and analyse the VAT gap in the EU-25 member states', 21 September 2009.
21 Comptroller and Auditor General, *HM Revenue & Customs: VAT on e-commerce*, Session 2005-06, HC 1051, National Audit Office, May 2006.

3.40 Increases to the breadth and volume of online trading affects the number of traders providing goods and services whose cumulative value may exceed the VAT threshold. During 2012-13, the Committee of Public Accounts has raised concerns that some internet traders may either not be declaring all of their taxable income or failing to pay over VAT charged to UK customers.

3.41 For many products marketed over the internet, current European Union rules mean that the place of supply for VAT purposes is based on where the business is established, rather than where the customer is based. From 2015, subject to approval of the Finance Bill 2014, these rules will change for supplies of telecommunications, broadcasting and e-services. Thereafter they will be taxed in the member state where consumption takes place.

3.42 As well as pursuing a policy response, as in the above example, HMRC recognises that it needs an adequate compliance response to ensure that internet-based traders are paying their fair share of VAT and not enjoying a competitive advantage over UK-based traders.

3.43 As noted in our earlier report, HMRC's assurance arrangements for ensuring that UK businesses register and pay the VAT due in part address the risk that VAT payable on e-commerce is not declared. Anti-evasion and avoidance activities now include tools that can interrogate websites to identify turnover arising from internet sales and identify businesses trading in certain goods or services and not paying the full amount of tax owed. This information feeds into HMRC's campaigns and taskforces.

3.44 HMRC has supplemented its approach with initiatives focused on the significant areas of risk. Since our last report, this includes:

- undertaking an e-commerce pilot in 2007 to analyse users of major marketplace and auction websites; and
- launching in 2012 an e-marketplace campaign, aimed at giving people who use online marketplaces to buy and sell goods as a trade the option to disclose voluntarily the tax they owe. This initiative has had a limited financial impact to date – HMRC has reported that the e-Markets Disclosure Facility resulted in 702 notifications and raised around £650,000. As at 30 November 2012, investigations using data gathered as part of the campaign have recovered a further £670,000.

3.45 HMRC recognises the need to secure public confidence in its ability to tackle the risks of revenue loss associated with e-commerce. In March 2013, it began scoping work to review internet-based traders and identify those with greatest potential to commit VAT fraud. More detailed compliance work is unlikely to start until later in 2013.

Sector-specific initiatives

3.46 In addition to the general initiatives and controls already noted, HMRC has undertaken a number of specific initiatives and monitored the activity of those traders considered to present the greatest risk of committing MTIC fraud. These include:

- **Educating the wholesale gas and power markets** on how MTIC fraudsters work and what action they can take to protect themselves. HMRC sees this sector as particularly vulnerable to MTIC fraudsters and issues specific alerts to registered traders to inform them of matters of heightened threat.
- **Introducing new vehicle import processes.** In conjunction with the Driver and Vehicle Licensing Agency, in April 2013, HMRC introduced a new Notification of Vehicle Arrivals procedure. Private individuals must pay VAT on an imported vehicle in advance of receiving car registration documents and businesses must declare the output tax on their next VAT return. HMRC believes that this initiative will help tackle the VAT gap estimated to cost £110 million per annum.
- **Analysing credit/debit card spends** to identify those business sectors where turnover declared on VAT returns may be less than actual turnover. Dependent on legislative changes, HMRC expects to start receiving data from merchant services providers from autumn 2013, which it is planning to use from spring 2014 onwards to target enforcement and compliance activity.

Part Four

Personal tax credits

Introduction

4.1 In 2012-13, HMRC spent £30 billion on child and working tax credits (personal tax credits), which offer financial support to around 4.8 million families, supporting around 7.9 million children.

4.2 The personal tax credits scheme is designed to be flexible enough to react to changes in claimants' circumstances. However, claimants do not always understand their obligations to tell HMRC when their circumstances change and to report their actual income and circumstances at the end of the tax year. Claimants may make errors in their applications, which result in incorrect payment awards. For example, claimants may misunderstand what they should report as income, or miscalculate their childcare costs. Claimants' final entitlement, based on their actual income and circumstances in the year, can only be calculated after the end of each year. If claimants have been paid more than they were entitled to, overpayments and debts arise, which HMRC seeks to recover.

4.3 In February 2011, the government announced its intention to introduce a new 'Universal Credit' to replace many of the current working-age benefits, including working and child tax credits, with a single means-tested payment. The Department for Work & Pensions plans to progressively roll-out Universal Credit nationally from October 2013, with all remaining tax credits payments ceasing, and claimants being required to apply for Universal Credit by 2017.

4.4 This part of the report describes:

- how HMRC's accounts report personal tax credits;
- why the Comptroller and Auditor General (C&AG) qualified his audit opinion in 2012-13; and
- the actions HMRC is taking to reduce personal tax credits error and fraud; manage personal tax credits debt; and prepare for the implementation of Universal Credit.

4.5 The report structure is in line with HMRC's priorities for the coming year, confirmed by the Chancellor of the Exchequer in February 2013 when he wrote to HMRC's Accounting Officer.

Accounting for personal tax credits

4.6 2012-13 is the second year that HMRC has reported personal tax credits in its Resource Accounts.[22] The Resource Accounts record all HMRC's running costs and wider expenditure. Until 2010-11, HMRC's Trust Statement, which records the tax revenue it has collected, reported personal tax credits. The change came from the Treasury's 'clear line of sight' initiative designed to align budgets, estimates and accounts to improve parliamentary oversight and control. Total expenditure recorded in HMRC's 2012-13 Resource Accounts is £47 billion, of which £30 billion was on personal tax credits.

The C&AG's audit opinion

4.7 In forming his audit opinion on HMRC's Resource Accounts, under the Government Resources and Accounts Act 2000, the C&AG is required to obtain evidence sufficient to give reasonable assurance that the expenditure and income reported have been applied to the purposes intended by Parliament and the financial transactions conform to the authorities that govern them (his regularity opinion).

4.8 The C&AG has qualified his regularity opinion on HMRC's 2012-13 Resource Accounts owing to the material level of error and fraud in personal tax credits expenditure. This expenditure has not been applied to the purposes intended by Parliament and does not conform to the requirements of the Tax Credits Act 2002. The Act specifies the criteria that govern entitlement to personal tax credits and the method to be used to calculate the amounts to be paid. Transactions do not conform to the governing legislation and are therefore irregular for one of two reasons:

- error or fraud results in payments of personal tax credits to households that are not entitled to those credits; or
- error or fraud results in under or overpayments which differ from the entitlement specified in the legislation.

4.9 This is the second year in which HMRC's Resource Accounts have been qualified in respect of the regularity of personal tax credits expenditure, however HMRC's Trust Statement, in which personal tax credits were reported in previous years, received similar qualified audit opinions since the scheme commenced in 2003-04. The C&AG has consequently reported on personal tax credits every year since they were introduced.

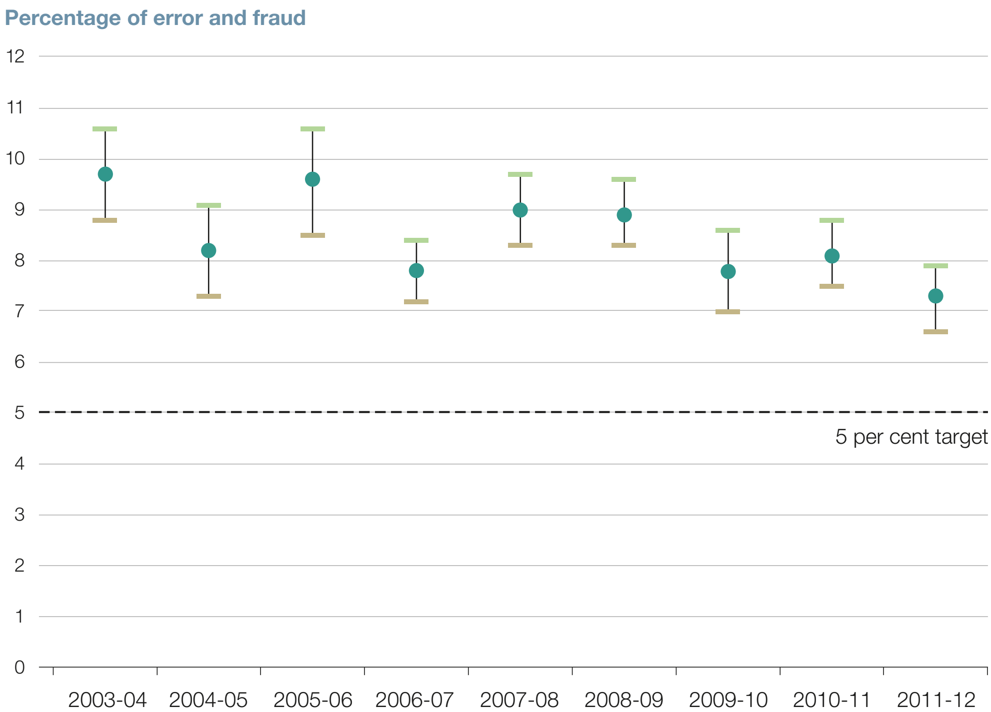
22 Comptroller and Auditor General, *HM Revenue & Customs annual report and accounts 2011-12*, HC 38, June 2012.

Reducing personal tax credits error and fraud

4.10 HMRC's estimate of error and fraud within the personal tax credits system decreased from between 7.5 and 8.8 per cent in 2010-11 to between 6.6 per cent and 7.9 per cent in 2011-12, as shown in **Figure 10**. The 2011-12 central estimate of error and fraud is 7.3 per cent (8.1 per cent midpoint 2010-11) and is the lowest since the current personal tax credit scheme was introduced in 2003-04. The 2011-12 error and fraud percentages equate to payments of between £1.9 billion and £2.3 billion being made to claimants incorrectly because of error or fraud and a further £170 million to £360 million not being paid to claimants because of error. The overall levels of error and fraud in finalised awards are significant within the context of the £30 billion spent on personal tax credits in 2012-13. Note 10.3 to HMRC's Resource Accounts discloses its best estimate of all error and fraud within the personal tax credits system.

Figure 10
HMRC error and fraud estimates from 2003-04 to 2011-12

HMRC missed its target to reduce tax credits error and fraud to 5 per cent by March 2011



	2003-04	2004-05	2005-06	2006-07	2007-08	2008-09	2009-10	2010-11	2011-12
Lower bound	8.8	7.3	8.5	7.2	8.3	8.3	7.0	7.5	6.6
Central estimate	9.7	8.2	9.6	7.8	9.0	8.9	7.8	8.1	7.3
High bound	10.6	9.1	10.6	8.4	9.7	9.6	8.6	8.8	7.9

NOTE

1 HMRC reports error and fraud within a range around a central estimate. The figures referred to within this report are the central estimates. The National Audit Office reviews the methodology for producing this estimate, which meets the national standard for official statistics. It is the best estimate of error and fraud available.

Source: HM Revenue & Customs, Child and Working Tax Credits Error and Fraud Statistics, 2003-04 to 2011-12

4.11 In June 2012, HMRC announced that, based on the midpoint of 8.1 per cent in its estimate of the overall level of error and fraud in finalised awards, it did not achieve its target to reduce personal tax credits losses caused by error and fraud to no more than 5 per cent of the value of finalised entitlement by March 2011. In addition, as part of the 2010 Spending Review and within the context of the error and fraud strategy, HMRC has a commitment to deliver £8 billion of personal tax credits error and fraud losses prevented by 31 March 2015.

4.12 HMRC agreed the £8 billion target based on its original understanding of the impact of its interventions and its calculation of the losses prevented measurement. Under its new understanding of the impact of its interventions and its current approach, HMRC will be unable to achieve this target. It currently expects to deliver £2.5 billion to £3 billion of losses prevented using its revised measurement methodology.

Measuring in-year error and fraud performance

4.13 HMRC can only measure the personal tax credits error and fraud in any year once the awards for that year are finalised. It has, therefore, developed proxy indicators to allow it to track ongoing progress in reducing error and fraud in-year in the form of a calculation of losses prevented through intervention.

4.14 Our report *Tackling tax credits error and fraud*[23] noted that following publication in June 2012 of the 2010-11 results, HMRC's analysts reassessed the relationship between the overall level of error and fraud in the tax credits system and the losses prevented by its 2010-11 interventions. HMRC concluded that the interventions had a lower than expected impact on the level of error and fraud. In July 2012, HMRC assessed the actual level of error and fraud prevented in 2010-11 as £480 million – one-third of the £1.4 billion originally claimed. In the most part, the difference related to the assumptions underpinning the calculation around the preventative effect and the 'carry over' effects – the extent to which claims would have continued to be correct after its interventions.

4.15 HMRC has continued to calculate the proxy measure in the same way for comparability internally, but for the purposes of management monitoring levels of error and fraud, they have reassessed their assumptions and the original proxy measure is amended to include only what it has direct evidence to support. Using the new basis, HMRC estimates that its actions will have prevented losses of £694 million in 2012-13.

4.16 Our 2011-12 review noted inconsistencies and errors in the way that HMRC staff had recorded the impact of interventions in terms of estimated losses prevented. In our 2012-13 review, we found evidence of some inconsistencies and errors, although at a lower level than in 2011-12. We have also seen evidence of enhanced quality checks by HMRC, which should help to ensure the accuracy of reported performance in future.

23 See footnote 4.

Error and fraud strategy and targets

4.17 HMRC's approach, launched in April 2009, seeks to: provide better support to claimants by helping them through the claim and renewals process, confirming that information held is accurate; prevent error and fraud from entering the system at important stages in the process; and tackle non-compliance by targeting high risk claims for compliance and other enquiries. The strategy launched in April 2009 now needs to be refined based on the latest available analysis to truly tackle error and fraud.

4.18 Our report *Tackling tax credits error and fraud* analysed the reasons why HMRC did not meet its March 2011 target for reducing error and fraud in finalised tax credits awards. This also highlighted (based on 2010-11 results) the limited progress HMRC had made in addressing three of the six risk areas it had identified: undeclared partner; work and hours; and children. HMRC's analysis of error and fraud in finalised 2011-12 awards, as shown in **Figure 11** overleaf, indicates that it has made progress in two of the six risk areas: children and childcare; while income and undeclared partner have worsened.

4.19 The Committee of Public Accounts considered our report at its hearing in March 2013. In its subsequent report,[24] the Committee concluded that HMRC has made little progress in reducing losses from error and fraud in tax credits. It recommended that HMRC should:

- agree with HM Treasury a new target for savings from reducing tax credits error and fraud up to 2017, to which HMRC should be held to account;
- work with the Department for Work & Pensions to ensure a consistent approach to measuring error and fraud throughout the welfare system;
- produce a plan setting out how it will tackle losses occurring because of individuals' changes of circumstances; and
- systematically review what internal and external data sources are available for each of its six risk categories and develop a credible plan for reducing error and fraud losses in each category before Parliament's summer recess 2013.

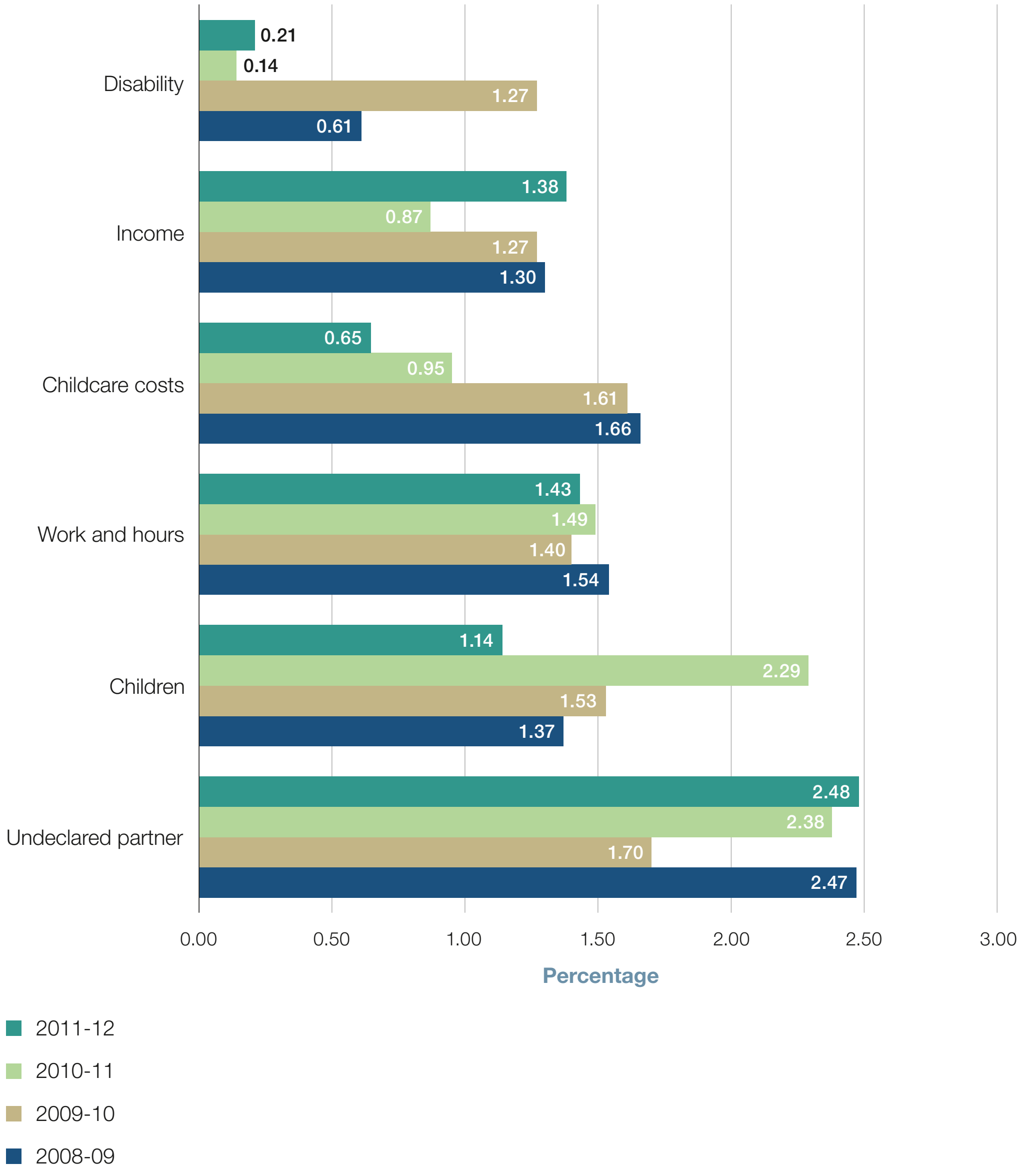
4.20 The government is yet to formally respond to the Committee of Public Accounts recommendations, but HMRC have started to analyse how data can be used in a smarter and more effective ways and is refining its understanding of what factors combine to make a claim more risky.

4.21 Also, in autumn 2013, HMRC plans to select 1,000 cases from its completed high risk renewals interventions from April to July. Once the interventions are complete, it will track these for three months to collect data on how the cases change. This should allow HMRC to improve its methodology for tracking better the impact of its interventions to tackle error and fraud and therefore provide further information to direct its strategy.

24 HC Committee of Public Accounts, *HM Revenue & Customs: tax credits error and fraud*, Fourth Report of Session 2012-13, HC 135, May 2013.

Figure 11
HMRC error and fraud estimates by risk area for 2008-09 to 2011-12

Error and fraud losses have reduced in 2011-12 in three of the six identified risk areas



NOTE

1 The values are HMRC's best estimate of the primary reason for an adjustment to awards. HMRC does not publish confidence intervals for these estimates. The figure does not sum to total error and fraud due to rounding.

Source: National Audit Office analysis of HM Revenue & Customs' Child and Working Tax Credits Error and Fraud Statistics

Current initiatives to reduce error and fraud

4.22 As noted in Part Two, HMRC's Real Time Information (RTI) project should enable it to have an up-to-date position on the salaries of employees paid through the PAYE system. This could reduce the level of error and fraud due to overpayments of tax credits, where recipients have not reported changes to their circumstances. This has the potential to reduce the levels of error and fraud in the income risk area identified in Figure 11.

4.23 In March 2013, HMRC signed a contract with Transactis for a three-month trial of the provision of extra capacity from the private sector to tackle tax credits error and fraud. This is in line with our recommendation that HMRC should improve the quality and volume of interventions by using third parties.

Managing personal tax credits debt

4.24 HMRC has a target to reduce the gross personal tax credits debt balance to £3.7 billion by March 2015. There are no interim targets for the debt balance.

4.25 At 31 March 2013 the total value of tax credits debt was £4.8 billion (£4 billion at 31 March 2012). The £0.8 billion increase in total debt between 31 March 2012 and 2013 is the net effect of £1.8 billion of new debts identified in-year offset by £0.7 billion of recoveries and £0.3 billion of debt remissions.

4.26 In 2012-13, HMRC began tracking historic debt to calculate new recovery rates, using data on debt raised in 2009-10. This led it to reduce estimated recovery rates by 12 per cent (from 43.3 per cent to 31.4 per cent) and increase the provision for irrecoverable debts by £985 million (from £2.3 billion to £3.3 billion). This followed our finding last year that HMRC had inadequate management information on the age profile and recoverability of tax credits debt and that the level of irrecoverable debt could be substantially higher than it had initially estimated, resulting in a change to the accounts.

4.27 Personal tax credits debt will continue to increase if HMRC does not take steps to better recover and clear debt. In 2012-13, HMRC generated £1.8 billion of new personal tax credits debt by identifying overpayments from the award finalisation process and from changes reported by claimants or identified in-year through error and fraud interventions. HMRC estimates that it is likely to produce £1.9 billion of new personal tax credits debt in 2013-14 and, based on current business processes, total debt could increase to £5.5 billion by 2014-15.

4.28 HMRC is developing a number of strategies and initiatives to address existing and new tax credits debt. These include:

- allocating more resources to target the collection of tax credits debt including the use of enhanced segmentation data to improve the design and effectiveness of debt campaigns; and
- exploring the feasibility of using private sector support through innovative payment models.

4.29 HMRC's latest tax credits debt campaign has moved its focus away from only looking at new debt. For this campaign, which commenced in autumn 2012 for 14 months until March 2014, HMRC has categorised the debt into segments. This enables HMRC to tailor how it pursues debt, depending upon the claimant's circumstances and ability to pay.

4.30 At the end of March 2013, of the 495,000 cases (value £562 million) in the debt campaign, HMRC has tackled 213,000 (value £272 million). This included cases where HMRC had agreed repayments under time to pay arrangements, as well as debts recovered in full and cancelled debts. Full repayment of debts had been made in some 19,500 cases (£12.6 million) with 'time to pay' arrangements set up for a further 121,000 items with a value of £152 million. Converting tax credits debt into cash remains challenging and needs to be set in the context of HMRC's need to strike the right balance between pursuing collection and a claimant's ability to pay, so as not to cause hardship through its approach to debt recovery.

4.31 In addition to its debt campaign, HMRC has launched a series of initiatives aimed at improving its record in debt recovery, as outlined in **Figure 12**. These have the potential to achieve significant reductions in the outstanding debt balance (£648.9 million over the coming years) but it is too early to predict their probability of success.

Figure 12
HMRC initiatives to improve debt recovery and estimated recovery

HMRC estimates that it will recover £648.9 million of tax credits debt through specific initiatives over the coming years

Initiative	Estimated recovery	Time frame
Recovery of debts through PAYE coding	£38.9 million[1]	12 months – 2013-14
Debt collection agencies	£90 million	26 months – January 2013 to end of 2014-15
Updating IT to collect historic debt by deducting proportions of payment from new claimant awards	£520 million	From April 2014
Total	**£648.9 million**	

NOTE

1 Represents the maximum possible recovery in 2013-14. The full value will not be recoverable through PAYE. Due to changes in customer circumstance a proportion will need to be collected through other means.

Source: HM Revenue & Customs

Preparing to implement Universal Credit

4.32 In February 2011, the government announced its intention to introduce a new Universal Credit to replace many of the current working-age benefits, including working and child tax credits, with a single means-tested payment. Universal Credit is designed to improve work incentives and simplify the benefits system, by creating a single streamlined working-age benefit. This should be easier for people to understand, and easier and cheaper for staff to administer and reduce the opportunities for error and fraud.

4.33 From October 2013, the Department for Work & Pensions plans to expand Universal Credit pathfinders which started in April 2013, and progressively roll-out Universal Credit to all claimants by 2017.

4.34 HMRC is working with the Department for Work & Pensions to share lessons learned from tax credits to enable the Department for Work & Pensions to build error and fraud prevention into the design of the new Universal Credit system. HMRC is responsible for stopping existing tax credits claims when a claimant becomes eligible for Universal Credit.

4.35 HMRC will still be accountable for historic tax credit debt. HMRC and the Department for Work & Pensions are working closely to develop mechanisms for recovering tax credits debt directly from Universal Credit. HMRC will be required to inform the Department for Work & Pensions of the debt it has outstanding for a household so that debt can be collected on HMRC's behalf. Any debt that cannot be recovered in this way will be recovered using HMRC's own direct methods of recovery.